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COMBINED HEARINGS HELD BY THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

HEARINGS

BEFORE THE

JOINT SELECT COMMITTEE ON DEFICIT REDUCTION CONGRESS OF THE UNITED STATES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

SEPTEMBER 13, SEPTEMBER 22,
OCTOBER 26, AND NOVEMBER 1, 2011

Printed for the use of the Joint Select Committee on Deficit Reduction

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THE HISTORY AND DRIVERS OF OUR NATION'S DEBT AND ITS THREATS

TUESDAY, SEPTEMBER 13, 2011

UNITED STATES CONGRESS,
JOINT SELECT COMMITTEE
ON DEFICIT REDUCTION,
Washington, DC.

The committee met, pursuant to call, at 10:33 a.m., in Room SH–216, Hart Senate Office Building, Hon. Patty Murray [co-chairman of the committee] presiding.

Present: Senator Murray, Representative Hensarling, Senator Baucus, Representative Becerra, Representative Camp, Representative Clyburn, Senator Kerry, Senator Kyl, Senator Portman, Senator Toomey, Representative Upton, and Representative Van Hollen.

OPENING STATEMENT OF HON. PATTY MURRAY, A U.S. SENATOR FROM WASHINGTON, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Chairman MURRAY. Good morning. This hearing of the Joint Select Committee on Deficit Reduction will come to order.

As my co-chair, Representative Hensarling, mentioned at our meeting on Thursday, we have agreed to alternate chairing these hearings, with him chairing the hearings that are held on the House side, and I will be doing the ones here in the Senate.

I want to recognize and thank all of our fellow committee members for being here today, as well as our witness, Dr. Elmendorf, for joining us today.

And I want to thank all the members of the public who are here today as well. We appreciate your presence and ask that you help us maintain decorum by refraining from any displays of approval or disapproval during this hearing.

Before I start, I do want to announce that the joint select committee's Web site is now up and running. Members of the public can go to *http://www.deficitreduction.gov/*, where they can provide us input and ideas to this committee and where all public hearings will be streamed live, starting today.

Today, we are going to start off with brief opening statements from committee members—15 minutes for Democrats and 15 minutes from the Republican side. We will then hear from Dr. Elmendorf. And following his testimony, we will have some time for questions and answers.

The topic of today's hearing is "The History and Drivers of Our Nation's Debt and Its Threats." I think this is a fitting opening for

us for the difficult work this committee has ahead of us. We are tasked with tackling a problem that wasn't created overnight and that didn't come about just in the last few years.

Our debt and deficit problems have a lengthy and complex history, and we will not be able to truly address them without a deep and honest understanding of the policies and circumstances that have led us to where we are today.

The challenges that we face are real, and our task will not be easy. But I am confident we can get it done because we have done it before.

Like a number of my fellow committee members, I was here back in the '90s, when we were facing serious deficits and a mounting public debt. I was proud to work with President Clinton and Republicans in Congress to balance the budget in a way that truly worked for the American people, a way that made smart cuts to Government spending that were desperately needed, included revenues, and continued to make the strong investments in healthcare, education, and infrastructure that helped lay down a strong foundation for economic growth.

The balanced and bipartisan work we did not only balanced the budget and it not only helped set our country up to create millions of new jobs, but it also put us on track to completely pay down our debt by 2012, which was a great accomplishment.

But as we all know, a lot has changed since then. For many reasons, our deficit and debt have exploded in the years since. Some of these reasons have to do with Government policies here at home, some with decisions made regarding our policies overseas, and others due to the financial and economic crisis that has devastated families and businesses here over the last few years.

I am looking forward to hearing more about the scope and drivers of our deficit and debt from Dr. Elmendorf today. And I am confident the members of this committee can help bring our Nation together once again around a balanced and bipartisan path to fiscal health and economic growth.

[The prepared statement of Chairman Murray appears in the appendix.]

Chairman MURRAY. With that, I will call on my co-chair, Mr. Hensarling, for his opening statement.

OPENING STATEMENT OF HON. JEB HENSARLING, A U.S. REPRESENTATIVE FROM TEXAS, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Co-Chair HENSARLING. Thank you, Madam Co-Chair.

The purpose of today's hearing is to really highlight the unsustainable nature of our Nation's debt. And I believe the term "unsustainable," frankly, is understated.

I certainly want to welcome Dr. Doug Elmendorf, head of the CBO, who, when I was a member of the Budget Committee, I have had an opportunity to work with, truly a professional in this town. Sir, I look forward to your testimony.

In the last organizational meeting we had, I mentioned the work by Professors Carmen Reinhart and Kenneth Rogoff, "This Time Is Different." Through their historical study of financial crisis, they

indicated that letting debt rise above 90 percent of GDP was, frankly, a recipe for bad things to happen to a nation.

Well, this year, our Nation has raced past that tipping point. Our gross debt has now surpassed 100 percent of GDP. And I believe there are two crises in our Nation—not just the debt crisis, but the jobs crisis—and they are clearly connected. The explosive growth in our Nation's debt hampers our job creation today.

Last week, I quoted a small business person from the 5th District of Texas on the subject. Today, I want to quote from a few more, names you may be more familiar with.

Bernie Marcus, former chairman and CEO of Home Depot, which employs 255,000. "If we continue this kind of policy, we are dead in the water. If we don't lower spending and if we don't deal with paying down the debt, we are going to have to raise taxes. Even brain dead economists understand that when you raise taxes, you cost jobs."

Mike Jackson, CEO, AutoNation, 19,000 employees. "The best thing that this town could do to help this economic recovery become sustainable is to deal with the deficit and to see tax reform."

Jay Fishman, chairman and CEO of Travelers Insurance Company. "What is really weighing on their minds is not knowing how the coming explosion in Federal debt is going to affect their borrowing costs, liquidity, cost of doing business, and prices."

Finally, 2 or 3 months ago, the U.S. Chamber came out with a survey, their small business survey, 83 percent of respondents said that America's debt and deficit have a negative impact on their business.

So I would make the point, Madam Co-Chair, that a path to credible deficit reduction is a jobs program, and we should not be deterred in that mission. We have a spending-driven debt crisis. The deficit reduction will be a jobs plan.

And I look forward again to hearing the comments of our colleagues as we go about this important work and of the testimony of Dr. Elmendorf. And I yield back.

Thank you.

[The prepared statement of Co-Chair Hensarling appears in the appendix.]

Chairman MURRAY. We will now turn to our members, beginning with Representative Becerra.

OPENING STATEMENT OF HON. XAVIER BECERRA, A U.S. REPRESENTATIVE FROM CALIFORNIA

Representative BECERRA. I thank the two co-chairs and thank Dr. Elmendorf for being with us.

The creation of this Joint Select Committee on Deficit Reduction is the direct result of legislative policies and economic recessions that have hit us over the last 10 years and that have caused the Congressional Budget Office's 10-year estimated $5.6 trillion surplus in 2001 to turn into a more than $6 trillion deficit that we see today. So to know where to go with the work that we have to do, you have to know from where we came.

Today, we will hear about how we lost our way. What we will hear is that a select few in this country enjoyed the additional Gov-

ernment spending that occurred in those 10 years while the rest of Americans are being confronted with paying the tab.

In January 2001, CBO's assessment in its yearly Budget and Economic Outlook report was this, "The outlook for the Federal budget over the next decade continues to be bright. Assuming that current tax and spending policies are maintained, CBO projects that the mounting Federal revenues will continue to produce growing budget surpluses for the next 10 years."

But as we all know, current tax and spending policies were not maintained. Dr. Elmendorf, it is exactly these policies that induced the Federal deficit, which I want to explore in my questioning with you today.

Decisions were made to extinguish a $5.6 trillion surplus. The individual and groups who received the most benefits should be willing and ready to ante up, to meet their patriotic duty to contribute revenues and necessary spending decisions to heal this country's long-term fiscal situation.

We need to ask ourselves was it the senior citizen, the student, or the Wall Street banker who received the benefit of this spending binge? When we have our answer, we should ask the appropriate person or group to pay their fair share to right the wrong of running up the Government's debt.

I look forward to working with my colleagues to take the responsibility of improving job creation in this country and fixing the long-term deficits that we face by ensuring that those responsible for our deficits pay their fair share.

And with that, I yield back the balance of my time.

[The prepared statement of Representative Becerra appears in the appendix.]

Chairman MURRAY. Thank you very much.

Senator Kyl?

OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM ARIZONA

Senator KYL. Thank you, Madam Chairman.

And welcome, Mr. Elmendorf.

The subject of the hearing today is "The History and Drivers of the Nation's Debt and Its Threats." Obviously, you need to know what the problem is before you can develop solutions.

One of the things we will hear is that entitlement spending is a key driver of our debt. And I think there is a consensus about that on both sides of the aisle. The concern I have is that some people fear that that means that the solution has to be a cut in benefits or a cut in payments to providers for programs like Medicare and Medicaid, for example, and I would like to focus very specifically on a potential alternative to that.

There may be very substantial savings that can be obtained from administrative efficiencies that would not involve cuts in these programs. That is one of the things that I will be talking to Dr. Elmendorf about today.

We hear a lot of talk about waste, fraud, and abuse. It is a trite phrase, but the reality is there is a significant amount of truth to it. And I think, especially with regard to Medicare and Medicaid, we have to find ways to achieve these administrative savings.

Let me just quote from one of the experts from Cato Institute, Mike Cannon. In a Forbes blog less than 2 months ago, he says, "Judging by official estimates, Medicare and Medicaid lose at least $87 billion per year to fraudulent and otherwise improper payments, and about 10.5 percent of Medicare spending and 8.4 percent of Medicaid spending was improper in 2009."

Others, like Harvard fraud expert Malcolm Sparrow, say actually that is low. He said loss rates due to fraud and abuse could be 10, 20, maybe even 30 percent in some segments.

Obviously, this is an important subject to address. And in order to do that, we may have to spend a little bit more money on the front end for people who can review the claims that are filed and so on, in order to make sure that they don't pay improper claims.

But at the end of the day, one of the reasons we haven't attacked this problem is that the CBO has had a very difficult time in scoring potential savings based upon potential approaches to the problem. And what I want to explore with Dr. Elmendorf today is how CBO can help our committee find ways to achieve administrative efficiencies, saving a lot of the money that we should not be spending, so that we do have the money to spend on the beneficiaries and the providers of important programs like Medicare and Medicaid.

Madam Chairman, Mr. Chairman, thank you.

Chairman MURRAY. Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Senator Murray.

I want to begin just by echoing what Senator Kyl said. I think there is a lot of fraud and waste in the Medicare and Medicaid, which we don't properly attack, and much of that is due to scoring requirements that we have to adhere to. And I would hope that we could somehow create a way to get beyond that. It is an excellent point, and I am glad that he made it.

One of our Founding Fathers, Patrick Henry, once said, "I know of no way of judging the future, but by the past." And today, we examine the past for lessons to improve our economic future—to reduce the deficit, create jobs, and create the certainty our country needs to thrive in the global economy.

The world is watching us. They are watching us closely. They are watching what we do and the next steps that we take as a country to confront our deficits. We can do this. We have already begun the process by cutting $900 billion. We have already done it. We have taken a first step.

And while the road ahead will not be easy, we have a duty, I think, to think even bigger, aim higher, ensure our country is on sound fiscal footing for the long term. We have a duty, I think, to ensure that we approach these cuts in a balanced way that creates jobs.

When I was home in Montana again last weekend, I heard over and over again, people said, "Max, let's get it done. Appreciate you being on that committee. Get it done. We need our country to get it done."

I know every member of this panel hears the same comments from their constituents when they are home, just as every Member of Congress does. And I urge us to listen to the wishes of our employers.

We are just the hired hands. We are just the employees. The people that we work for, the people that elect us or unelect us want us to get this done in a balanced, fair way.

Today, we review the sources of our problem. It is obvious that the factors that created our current deficit are the cost of two wars; long-term healthcare costs, which we began to tackle in health reform; a stagnant economy, which increased spending; and reduced Federal revenues, which are at historic lows.

Today, Federal revenues make up about 15 percent of GDP, compared to, for example, about 17 to 19 percent during the Reagan administration. A combination of factors created the deficit. It will take a combination of factors to resolve it. There is no silver bullet. So let's get together and get our work done.

[The prepared statement of Senator Baucus appears in the appendix.]

Chairman MURRAY. Thank you very much.

Representative Upton?

OPENING STATEMENT OF HON. FRED UPTON, A U.S. REPRESENTATIVE FROM MICHIGAN

Representative UPTON. Well, thank you, Madam Chair.

And I intend to be brief. Chris Van Hollen reminded us last week that we had 77 days to get this thing done. That means we have about 72 days now, and we are going to leave some extra days, hopefully, for you, Dr. Elmendorf, to have your green eyeshade guys and women be able to put this package together for us to reach the goal.

Last week, I sat with Chairman Camp and Chairman Baucus—and Chairman Baucus, again, my folks in Michigan this last weekend assured me that they are rooting for us as well to get a solution to the problem that they all really do understand. And I know the three of us were on our feet when the President talked about entitlement reform, specifically Medicare and Medicaid. And I must say that I was disappointed that I did not see the President's written proposal come up like he did some others yesterday.

So I just want to say I am looking forward to working with all my colleagues here. I am going to submit my full statement for the record so that we can go back, so that we, in fact, all can go to work to get this thing done.

I yield back.

[The prepared statement of Representative Upton appears in the appendix.]

Chairman MURRAY. Thank you very much.

Representative Clyburn?

OPENING STATEMENT OF HON. JIM CLYBURN, A U.S. REPRESENTATIVE FROM SOUTH CAROLINA

Representative CLYBURN. Thank you very much, Madam Chair, Mr. Chairman.

Dr. Elmendorf, thank you for taking the time to talk with us today.

I think it is appropriate that today's hearing is entitled, "The History and Drivers of Our Nation's Debt and Its Threats." If we want to solve the related problems of debt and joblessness, we need to know how these problems arose. In 2000, we had a $236 billion surplus and had begun paying down our National debt. The economy was booming for all Americans, unemployment was at 4 percent, and the poverty rate dipped to its lowest level since 1979.

Instead of building on the policies that have served us so well, we embarked upon two wars, one of which was dubious at best. Using credit cards, we instituted two tax cuts, totaling $544 billion, which were tilted in favor of millionaires and billionaires. We created a new prescription drug benefit program, which CBO estimates will cost $967 billion over the next 10 years, and allowed mortgage lenders to gamble away the economic prosperity of millions of American families.

And then it was declared that deficits don't matter. This special committee was created because deficits and debt do matter. Now we find ourselves with painfully slow growth, unacceptably high unemployment, deficits as far as our eye can see, and a mounting long-term debt burden.

As we work together to achieve significant deficit reduction, it is important for us to remember how we got here. Many factors got us into this situation, and many factors are needed to get us out.

We must balance the budget with a balanced approach that includes job creation, revenue increases, and smart spending cuts. Shared sacrifice will be required. We cannot solve the problem on the backs of the most vulnerable in our society who did nothing to cause the problem.

I am willing to make tough compromises. I have said that if the distance between an opponent and me is five steps, I am willing to take three, as long as the opponent takes the other two.

Dr. Elmendorf, thank you again for being here, and I look forward to discussing these issues with you in the Q&A period.

Thank you, and I yield back.

[The prepared statement of Representative Clyburn appears in the appendix.]

Chairman MURRAY. Senator Portman?

OPENING STATEMENT OF HON. ROB PORTMAN, A U.S. SENATOR FROM OHIO

Senator PORTMAN. Thank you, Madam Chair.

And welcome to Director Elmendorf. As you all know, this committee is going to be relying heavily on you for your analysis and for your scoring. And to you and your colleagues behind you, I thank you in advance for the many hours that you will put in. Our success or failure will depend in large measure on your good work. So we need you and look forward to your responses to our many requests.

I listen to my colleagues' comments this morning, and I must say I am delighted that you are here today because we need to have a little objective analysis of how we got to where we are, and I

know you will provide that. I hope you will also talk about the appropriate baseline for us to use to examine our proposals.

When measuring new proposals, the baseline questions help us determine "compared to what,"—whether it is a spending issue or revenue issue. And as you know, I have some concerns about the current law baseline because I don't think it is realistic. And I want you to address that today, if you could. Is the current-law or current-policy baseline more realistic? Or is there another one like the long-term extended baseline, alternative fiscal scenario? All these questions matter greatly in our work.

We have a $1.5 trillion task over the next 10 years. This, of course, is a huge challenge. But I would also like your analysis of how that compares to what you see as the real fiscal challenge over the next 10 years and the real economic challenge we face.

As many of the colleagues on the committee have mentioned this morning, obviously our economy is directly linked to what we do. And we will hear about this today from you. We will see how we got in this situation we are in, largely because of economic conditions. Just as in the late '90s because of the growing economy we were able to come to a unified balanced budget faster than anybody expected.

Using your data and the current policy baseline, as I look at $1.5 trillion, I think it is about 4 percent of projected spending over the next 10 years. So, in that sense, $1.5 trillion seems realistic. It is also, as I look at it, based on, again, your data and the current policies, less than 20 percent of the projected increase in the deficit over the next 10 years.

So $1.5 trillion seems to me to be something we should be doing at the very least. Again, I look forward to your insights on that and what is the most realistic baseline.

I hope you and your colleagues will also help us better understand the impacts of policy choices over the coming decades. As I look at your projections, it seems to me that deficit and debt levels would be devastating to our economy over the second, third, and fourth 10 years if we don't do something about the longer-term impact.

So while we could within this budget window find ways to get to $1.5 trillion, it will not be something that markets will react to well, in my view, unless we also are looking at long-term impacts. I would love to have your view there.

The long-term budget estimates are so unsustainable that your alternative budget scenario simply stops calculating the national debt after 2036 because it is so unsustainable. We will have crossed into totally unchartered territory.

Clearly, entitlement spending is driving those long-term deficits to impossible levels. I am interested in hearing what reforms you think can protect those in need, which we must do, while at the same time modernizing these programs and placing them on a sustainable path for future generations.

Again, thank you for being before us. And more importantly, thank you for all the hard work you will be doing with us over the next several weeks.

[The prepared statement of Senator Portman appears in the appendix.]

Chairman MURRAY. Thank you.
Senator Kerry?

OPENING STATEMENT OF HON. JOHN KERRY, A U.S. SENATOR FROM MASSACHUSETTS

Senator KERRY. Madam Chairwoman, thank you.

We all agree that we are facing an unsustainable financial future, and under the CBO's alternative fiscal scenario, the debt is going to reach 82 percent of GDP by 2021. That is higher than any year since 1948, and we all agree we can't let that happen.

But to avoid that dismal scenario, we are going to have to be pretty clear-eyed about the way that we got here and the forces that keep us on this dangerous trajectory. I think it is factual to say that this road began now more than a decade ago. Some would argue even longer.

But you have economic meltdown, two wars, rounds of the largest tax cuts in history that did not produce the jobs that were predicted, and then efforts to forestall larger economic collapse more recently. All of these contributed.

Demographic challenges loom large in the outyears, and it is more than just a spending problem, narrowly defined. And I think we do the dialogue a disservice by oversimplifying it because if it was a mere spending issue, it would be a lot easier to solve. But also because many tax expenditures are a form of spending in disguise.

Now while there may be partisan interpretations of how we got here, there is a bipartisan consensus not just about the urgency of action to dig us out of this mess, but about the approach that it requires. When I say bipartisan, three bipartisan groups that looked at the problem in recent months—Rivlin-Domenici, Simpson-Bowles, and the so-called Gang of Six—have all said—all, unanimously—that any real solution needs to be balanced with a mix of revenues and spending cuts and long-term reforms.

Now we benefit from their guideposts, and we also benefit from the cautionary lessons, important cautionary lessons of other countries. That means not fixating on austerity measures alone, particularly in the short term.

We have seen the damage that they have caused across Europe, and we can't put our own fragile economy in jeopardy by taking actions that will slow economic growth and decrease job creation. We need growth, not just revenue and not just cuts. And any economist worth their salt, any business person in America today will tell us creating jobs today helps reduce the deficit tomorrow.

Last week, the Committee for a Responsible Budget, a bipartisan organization including some of our country's leading experts on budget issues, including the co-chairs of the fiscal commission, recommended that this committee go big, go long, and go smart. I think Director Elmendorf's testimony today helps solidify the reality that we need to go big and reap savings of more than $1.5 trillion to address long-term deficits. We need to go long and address our long-term budget issues. And most importantly, we need to go smart and address the budget without preconceived dogmas or political agendas.

So I look forward to delving into these issues today with you, Dr. Elmendorf, and thank you for coming here to help us shape fair, balanced, thoughtful recommendations for this committee.

[The prepared statement of Senator Kerry appears in the appendix.]

Chairman MURRAY. Representative Camp?

OPENING STATEMENT OF HON. DAVE CAMP, A U.S. REPRESENTATIVE FROM MICHIGAN

Representative CAMP. Thank you, Madam Chair.

There has been a lot of important things already said this morning. Our time is short today. Both in the committee and as Mr. Upton pointed out, our time is short in terms of trying to meet the responsibilities we have been given under the Budget Control Act.

So I look forward to hearing from Mr. Elmendorf. I think it is important that we just get down to business. So I will yield back the balance of my time.

Chairman MURRAY. Thank you.

Representative Van Hollen?

OPENING STATEMENT OF HON. CHRIS VAN HOLLEN, A U.S. REPRESENTATIVE FROM MARYLAND

Representative VAN HOLLEN. Thank you, Madam Chairman.

Yesterday, there were two important developments that relate to our work. First, the President submitted to the Congress a jobs plan that is fully paid for over 10 years. Every day that Americans are out of work is another day that the country is hurting and the deficit is growing.

The fastest and most effective way to reduce the deficit in the short term is to put Americans back to work. I hope this committee will address that reality in our work as we move forward.

Second, yesterday, as Senator Kerry mentioned, the co-chairs of the Bipartisan National Commission on Fiscal Responsibility, Alan Simpson and Erskine Bowles, called upon this committee to "go big," urging us to use this unique opportunity to develop a plan to reduce the deficit by about $4 trillion over 10 years, including the almost $1 trillion in savings from the Budget Control Act. They are right. I believe we should proposal a plan of that size.

The bipartisan Simpson-Bowles commission, the bipartisan Rivlin-Domenici commission, as well as the Gang of Six, have provided us with a framework of how to achieve that goal. What is clear in all of them is that we need a balanced approach to reduce the deficit, one that contains savings achieved from modernizing certain programs, as well as savings gained by simplifying and reforming the tax code in a way that generates revenue.

Addressing a problem of this magnitude requires shared responsibility in order to grow our economy and reduce the deficit. The testimony we will hear today from Mr. Elmendorf demonstrates why such a balanced approach is necessary. It vividly illustrates the policy choices driving our deficit are the significant cuts made to revenue, combined with increasing retirement and healthcare costs due to the retirement of the baby boomers.

Let's not duck those realities. Let's follow the advice of the three other bipartisan commissions and go big. I don't agree with every

one of their proposals, but those three groups have provided this bipartisan group with a framework from which to start.

Time is short. The clock is ticking. I hope we will get to work and follow that balanced framework approach that has been set by, again, three other bipartisan groups that look to tackle the issues that this committee is asked to address.

Thank you, Madam Chairman.

[The prepared statement of Representative Van Hollen appears in the appendix.]

Chairman MURRAY. Thank you.

Senator Toomey?

OPENING STATEMENT OF HON. PAT TOOMEY, A U.S. SENATOR FROM PENNSYLVANIA

Senator TOOMEY. Thanks, Madam Chair.

And Dr. Elmendorf, thank you. I look forward to working with you as well.

Just a couple of points I wanted to stress. I think the point has been made, but I want to underscore that the problem that we face is, of course, much worse than what the current law baseline would seem to suggest. That is not a criticism. It is simply an observation.

The current law baseline is not meant to be a predictor of the future. If it were, it would be a really bad one, as we know.

In addition, some things have changed since you did that. The economy has gotten weaker. I would argue the sovereign debt crisis in Europe has gotten worse. So these things have aggravated the situation.

And then there is the fact that I think the risks are greater for downside surprises than upside surprises, if you will—things like the contingent liabilities that are lurking out there, which could come home to roost at any point in time.

The assumptions that you make about interest rates are not necessarily unreasonable. But if they are wrong, it is most likely that rates will be much higher rather than lower, significantly aggravating our problem. So I want to underscore that I think we should be striving to do every bit as much as we possibly can.

I hope that we will be able to dwell somewhat today on just how significant the big entitlement programs are the long-term drivers of this problem. And I hope we will be able to discuss what I see as a real danger in taking the approach that I think you might be advocating, although I am not entirely clear—the danger of delaying the spending cuts for fear that we will weaken a fragile economy.

On page 29 of your testimony, you do go through a list of the risks associated with delaying spending cuts now. I would argue that if we tolerate or aggravate the current deficit problem with the promise that we will work it all out in the future, that is a very, very dangerous direction to head in. And at the end of the day, there is no free lunch, and a Government spending expansion here is actually going to do more harm than good.

So, finally, the one point that I really want to underscore is just the importance of growth. If we can have policies that will encourage maximizing economic growth, all problems are easier to solve

with a strong, growing economy. And I think that should guide our decisions.

With that, Madam Chair, I yield the balance of my time.

Chairman MURRAY. Thank you very much.

With that, we will turn to our witness for today. Dr. Douglas Elmendorf is the eighth Director of the Congressional Budget Office. His term began on January 22, 2009.

Before he came to CBO, Dr. Elmendorf was a senior fellow in the Economic Studies Program at Brookings Institution. As the Edward M. Bernstein Scholar, he served as co-editor of the Brookings Papers on Economic Activity and the Director of the Hamilton Project, an initiative to promote broadly shared economic growth.

He has served as an assistant professor at Harvard University, a principal analyst at the Congressional Budget Office, a senior economist at the White House Council of Economic Advisers, a Deputy Assistant Secretary for Economic Policy at the Treasury Department, and an Assistant Director of the Division of Research and Statistics at the Federal Reserve Board. In those positions, Dr. Elmendorf has gained a wide range of expertise on budget policy, Social Security, Medicare, national healthcare reform, financial markets, macroeconomic analysis and forecasting, and many other topics.

So I am very glad that he has agreed to join our committee here today. Dr. Elmendorf, thank you so much for taking the time and for helping us get through this. And we would look forward to your testimony.

STATEMENT OF DOUGLAS ELMENDORF, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. ELMENDORF. Thank you, Senator Murray, Congressman Hensarling, and all the members of the committee.

I appreciate the invitation to talk with you today about the economic and budget outlook and about CBO's analysis of the fiscal policy choices facing this committee and the Congress.

The Federal Government is confronting significant and fundamental budgetary challenges. If current policies are continued in coming years, the aging of the population and rising costs for healthcare will push up Federal spending measured as a share of GDP well above the amount of revenue that the Federal Government has collected in the past. As a result, putting the Federal budget on a sustainable path will require significant changes in spending policies, significant changes in tax policies, or both.

Addressing that formidable challenge is complicated by the current weakness of the economy and the large numbers of unemployed workers, empty houses, and underused factories and offices. Changes that might be made to Federal spending and taxes could have a substantial impact on the pace of economic recovery during the next few years, as well as on the Nation's output and people's income over the longer term.

I will talk briefly about the outlook for the economy and the budget and then turn to some key considerations in making fiscal policy. The financial crisis and recession have cast a long shadow on the U.S. economy. Although output began to expand 2 years ago,

the pace of recovery has been slow, and the economy remains in a severe slump.

CBO published its most recent economic forecast in August. That forecast was initially completed in early July and updated only to incorporate the effects of the Budget Control Act. In our view, incoming data and other developments since early July suggest that the economic recovery will continue, but at a weaker pace than we had anticipated.

With output growing at only a modest rate, CBO expects employment to expand very slowly, leaving the unemployment rate, as depicted by the dots in the figure, close to 9 percent through the end of next year. I should say all these figures are taken from the written testimony and nearly in the order in which they appear in the testimony.

As a result, we think that a large portion of the economic and human costs of this downturn remain ahead of us. The difference between output and our estimate of the potential level of output, shown by the gap between the lines in the figure, has cumulated so far to about $2.5 trillion. By the time output rises back to its potential, which will probably be several years from now, we expect that cumulative shortfall to be about twice as large as it is today, or $5 trillion.

Not only are the costs associated with this shortfall and output immense, they are also borne unevenly, falling disproportionately on people who lose their jobs, are displaced from their homes, or own businesses that fail.

I want to emphasize that the economic outlook is highly uncertain. Many developments could cause economic outcomes to differ substantially in one direction or the other from those we currently anticipate. If the recovery continues as expected and if tax and spending policies unfold as specified in current law, deficits will drop markedly as a share of GDP over the next few years.

Under CBO's baseline projections, shown by the dark blue portion of the bars in the figure, deficits fall to about 6 percent of GDP in 2012, about 3 percent in 2013, and smaller amounts for the rest of the decade. In that scenario, deficits over the decade total about $3.5 trillion.

But as a number of you have said, those baseline projections understate the budgetary challenges because changes in policy that will take effect under current law will produce a Federal tax system and spending for some Federal programs that differ sharply from the policies that many people have become accustomed to.

Specifically, CBO's baseline projections include the following policies specified in current law. First, certain provisions of the 2010 Tax Act, including extensions of lower rates and expanded credits and deductions enacted in 2001, 2003, and 2009, all expire at the end of next year.

Second, the 2-year extension of provisions designed to limit the reach of the alternative minimum tax, the extensions of emergency unemployment compensation, and the 1-year reduction in the payroll tax all expire at the end of this year.

Third, sharp reductions in Medicare's payment rates for physician services take effect at the end of this year.

Fourth, funding for discretionary spending declines over time in real terms in accordance with the caps established under the Budget Control Act.

And fifth, additional deficit reduction of more than $1 trillion will be implemented as required under the act.

Changing provisions of current law so as to maintain major policies that are in effect now would produce markedly different budget outcomes.

For example, and shown by the full bars in the figure, if most of the provisions of the 2010 Tax Act were extended, if AMT was indexed for inflation, and if Medicare's payment rates for physician services were held constant, then deficits over the coming decade would total $8.5 trillion, rather than the $3.5 trillion in the current law baseline. By 2021, debt held by the public would reach 82 percent of GDP, higher than in any year since 1948.

Yesterday, CBO released an analysis of the enforcement procedures of the Budget Control Act. As shown in the slide, we estimate that if no legislation originating from this committee is enacted, the following would occur over the next decade.

Reductions in the caps on discretionary appropriations for defense would cut outlays by about $450 billion. Reductions in the caps on discretionary appropriations for nondefense purposes would cut outlays by about $300 billion. And reductions in mandatory spending would yield net savings of about $140 billion. The total reduction deficits would be about $1.1 trillion.

The estimated reductions in mandatory spending are comparatively small because the law exempts a significant portion of such spending from the enforcement procedures. As a result, about 70 percent of the total savings would come from lower discretionary spending. Cuts in defense and nondefense spending of that magnitude would probably lead to reductions in the number of military and civilian employees and in the scale and scope of Federal programs.

Beyond the coming decade, as you know, the fiscal outlook worsens, as the aging of the population and rising costs for healthcare put significant and increasing pressure on the budget under current law. When CBO issued its most recent long-term outlook in June, debt held by the public was projected to reach 84 percent of GDP in 2035 under current law and about 190 percent of GDP under policies that more closely resemble the current policies.

Although new long-term projections would differ because we would incorporate the latest 10-year projections, the amount of Federal borrowing that would be necessary under current policies would be clearly unsustainable. In sum, the Federal budget is quickly heading into territory that is unfamiliar to the United States and to most other developed countries as well.

As this committee considers its charge to recommend policies that would reduce future budget deficits, its key choices fall into three broad categories listed in the slide. How much deficit reduction should be accomplished? How quickly should deficit reduction be implemented? What form should deficit reduction take? Let me take up these questions briefly in turn.

First, regarding the amount of deficit reduction, there is no commonly agreed upon level of Federal debt that is sustainable or opti-

mal. Under CBO's current law baseline, debt held by the public is projected to fall from 67 percent of GDP this year to 61 percent in 2021. However, stabilizing the debt at that level would still leave it larger than in any year between 1953 and 2009.

Lawmakers might determine that debt should be reduced to amounts lower than those shown in CBO's baseline and closer to those we have experienced in the past. That would reduce the burden of debt on the economy, relieve some of the long-term pressures on the budget, diminish the risk of a fiscal crisis, and enhance the Government's flexibility to respond to unanticipated developments. Of course, it would also require larger amounts of deficit reduction.

Furthermore, lawmakers might decide that some of the current policies scheduled to expire under current law should be continued. In that case, achieving a particular level of debt could require much larger amounts of deficit reduction from other policies.

For example, if most of the provisions in the 2010 Tax Act were extended, the AMT was indexed for inflation, and Medicare's payment rates for physicians were held constant, then reducing debt in 2021 to the 61 percent of GDP projected under current law would require other changes in policies to reduce deficits over the next 10 years by a total of $6.2 trillion, rather than the $1.2 trillion needed from this committee to avoid automatic budget cuts.

In 2021 alone, the gap between Federal revenues and spending if those policies were continued and no other budgetary changes were made, as shown by the right pair of bars in the figure, is projected to be 4.7 percent of GDP. Putting debt on a downward trajectory relative to GDP in that year would require a much smaller deficit. Reaching that objective, declining debt relative to the GDP from that starting point would require a reduction in the deficit of about 2.5 percent of GDP, or $600 billion in that year alone.

Your second set of choices involves the timing of deficit reduction, which involves difficult tradeoffs summarized in the slide. On one hand, cutting spending or increasing taxes slowly would lead to a greater accumulation of Government debt and might raise doubts about whether the longer-term deficit reductions would ultimately take effect.

On the other hand, implementing spending cuts or tax increases abruptly would give families, businesses, and State and local governments little time to plan and adjust. In addition, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion.

However, credible steps to narrow budget deficits over the longer term would support output and employment in the next few years by holding down interest rates and reducing uncertainty, thereby by enhancing confidence by businesses and consumers. Therefore, the near-term economic effects of deficit reduction would depend on the balance between changes in spending and taxes that take effect quickly and those that take effect slowly.

As shown in this next slide, credible policy changes that would substantially reduce deficits later in the coming decade and beyond without immediate spending cuts or tax increases would both sup-

port the economic expansion in the next few years and strengthen the economy over the longer term.

Moreover, there is no inherent contradiction between using fiscal policy to support the economy today while the unemployment rate is high and many factories and offices are underused and imposing fiscal restraint several years from now when output and employment will probably be close to their potential. If policymakers wanted to achieve both a short-term economic boost and longer-term fiscal sustainability, the combination of policies that would be most effective, according to our analysis, would be changes in taxes and spending that would widen the deficit today, but narrow it later in the decade.

Such an approach would work best if the future policy changes were sufficiently specific, enacted into law, and widely supported so that observers believe that the future restraint would truly take effect.

Your third set of choices involves the composition of deficit reduction. Federal spending and revenues affect the total amount and types of output that are produced, the distribution of that output among various segments of society, and people's well-being in a variety of ways.

In considering the challenge of putting fiscal policy on a sustainable path, many observers have wondered whether it is possible to return to previous policies regarding Federal spending and revenues. Unfortunately, the past combination of policies cannot be repeated when it comes to the Federal budget. The aging of the population and rising costs for healthcare have changed the backdrop for budget decisions in a fundamental way.

Under current law, spending on Social Security, Medicare, and other major healthcare programs, the darkest line in the figure, is projected to reach about 12 percent of GDP in 2021, compared with an average of about 7 percent during the past 40 years. That is an increase worth 5 percent of GDP. Most of that spending goes to benefits for people over age 65, with smaller shares for blind and disabled people and for nonelderly, able-bodied people.

In stark contrast, under current law, all spending apart from Social Security and the major healthcare programs and interest payments on the debt is projected to decline noticeably as a share of the economy. That broad collection of programs includes defense, the largest single piece; the Supplemental Nutrition Assistance Program, formerly known as food stamps; unemployment compensation; veterans benefits; Federal civilian and military retirement benefits; transportation; health research; education and training; and other programs.

That whole collection of programs has incurred spending averaging 11.5 percent of GDP during the past 40 years. With expected improvement in the economy and the new caps on discretionary spending, it falls in our projection by 2021 to less than 8 percent of GDP, the lowest share in more than 40 years, under current law and in our baseline projections.

Putting those pieces together and including interest payments, between 1971 and 2010, as shown by the left pair of bars in the figure, Federal spending averaged about 21 percent of GDP. But

under current law for 2021, as shown by the right pair of bars, CBO projects it to grow to about 23 percent of GDP.

Alternatively, if the laws governing Social Security and the major healthcare programs were unchanged and all other programs were operated in line with their average relationship to the size of the economy during the past 40 years, Federal spending would be much higher in 2021, around 28 percent of GDP. That amount exceeds the 40-year average for revenues as a share of GDP by about 10 percentage points.

In conclusion, given the aging of the population and rising costs for healthcare, attaining a sustainable Federal budget will require the United States to deviate from the policies of the past 40 years in at least one of the following ways. Raise Federal revenues significantly above their average share of GDP, make major changes in the sorts of benefits provided for Americans when they become older, or substantially reduce the role of the rest of the Federal Government relative to the size of the economy.

My colleagues and I at CBO stand ready to provide the analysis and information that can help you in making these important choices.

Thank you. I am happy to take your questions.

[The prepared statement of Dr. Elmendorf appears in the appendix.]

Chairman MURRAY. Thank you very much, Dr. Elmendorf.

As we begin the work that has been outlined for us as a committee under the Budget Control Act, I think it is helpful for us to have a clear understanding of the scope of the problem, and you laid that out very clearly for us. I think we all agree this task is pretty enormous, and we have to come together around a balanced approach that addresses our fiscal situation, but also focuses on making sure that we remain competitive and looks at our long-term growth.

So I wanted to start by just asking you to expand a little bit on what you were just talking about and talk to us about what we should consider in weighing the tradeoffs between helping our economy in the short term to help create growth and not causing significant harm in the long term.

Dr. ELMENDORF. In our judgment, and this is consistent with a consensus of professional opinion, cuts in spending or increases in taxes at a moment when there are a lot of unused resources in the economy—unemployed workers, empty homes, unused factories and offices—and when monetary policy is finding it difficult to provide further support for economic activity because the Federal funds rate is already very close to zero, then under those conditions cuts in spending and increases in taxes will tend to slow the economic recovery. They will tend to reduce the levels of output and employment relative to what would otherwise be.

At the same time, and this is also quite consistent with a consensus professional opinion, over time, as our economy moves back toward potential output and those unused resources become used again, under those sorts of economic conditions, cuts in spending or increases in taxes that reduce outsize budget deficits are good for the economy, bolster output and incomes.

That may seem like a paradox, but it isn't really. It is just reflecting the view that the effect of Federal fiscal policy on the economy depends on economic conditions and on the stance and abilities of monetary policy.

And that is why, in our judgment, the analysis that we have done and presented to the Congress on a number of occasions over the past few years, to provide the greatest boost to economic activity now and over the medium run and long run, the combination of fiscal policies likely to be most effective would be policies that cut taxes or increase spending in the near term, but over the medium and longer term move in the opposite direction and cut spending or raise taxes.

Chairman MURRAY. Okay. Thank you.

Dr. Elmendorf, as you know, several bipartisan groups have released reports in the last 9 months with recommendations for reining in our deficit and spending and stemming the rise of Federal debt. All of them came with a balanced approach, and I am concerned that Congress has not yet included revenues or entitlements, as we have focused only so far on discretionary spending cuts and caps, when I think we need to be looking at balanced approaches.

Now some have made it clear that they want entitlements off the table. Others have made it clear they want revenues off the table. Unfortunately, that leaves only a relatively very small amount of discretionary and mandatory spending that Members so far have been willing to focus on.

Would you agree that while cuts and caps we instituted within the Budget Control Act can help somewhat with the long term, what we really need is a comprehensive approach that does address both revenue and mandatory programs?

Dr. ELMENDORF. So, Senator, as a matter of arithmetic, there are a lot of different paths to reducing budget deficits, and it is not CBO's role to make recommendations among those alternative paths. I think the crucial point, though, is that the more large pieces of the puzzle one takes off the table, then the greater the changes will need to be in the remaining pieces.

You can see this very clearly in this picture. In 2021, this pictures shows, under current law, revenues being about 21 percent of GDP. If one instead wants to——

Senator BAUCUS. Can you explain that? We can't see it.

Chairman MURRAY. It is hard to see.

Dr. ELMENDORF. I am sorry. So this is Figure 14 in the written testimony, if you have that in front of you? What the left-hand—I will explain it.

Senator BAUCUS. Exhibit 14?

Dr. ELMENDORF. Yes. Exhibit 14.

Senator BAUCUS. Thank you.

Dr. ELMENDORF. Figure 14 in the written testimony. The left-hand set of bars shows the averages over the last 40 years. The far left bar is revenues. Revenues have averaged about 18 percent of GDP. Then the right-hand bar shows the major pieces of spending. The bottom chunk is Social Security and major healthcare programs. This is——

Senator BAUCUS. Could you try a page?

Chairman MURRAY. Page 42.

Senator BAUCUS. Forty-two. Thank you.

Dr. ELMENDORF. The left-hand piece, as I said, is revenues. They have averaged 18 percent of GDP. The right-hand bar shows spending, Social Security, and the major healthcare programs—that is Medicare, Medicaid, now CHIP—in the future, including subsidies to be provided through insurance exchanges. In the past, that has averaged about 7 percent of GDP.

All other non-interest spending—that is other mandatory spending, it is defense spending, it is nondefense discretionary spending—has averaged 11.5 percent of GDP. And interest payments have averaged about 2.25 percent of GDP. With the deficit, that has been a little under 3 percent.

For 2021, under current law, revenues would rise to be about 21 percent of GDP. Social Security and the major healthcare programs would be 12, a little over 12 percent of GDP. That is 5 percent of GDP more than the average for the past 40 years, and that is the essence of the point that the aging of the population and rising costs for healthcare have changed the backdrop for the decisions that you and your colleagues make.

If those policies continue to operate—those programs continue to operate in the way they have operated in the past, they will be much more expensive than they have been in the past because there will be more people collecting benefits, and each person will be collecting more in benefits. And that is the crucial driver of the future budget trajectory relative to what we have seen in the past.

The other category, other non-interest spending, as you can see, is already much smaller in 2021 under current law and our projections than it has been historically. And that is a combination of improvement in the economy, which we think will reduce the number of people on food stamps, collecting unemployment insurance, and so on, but also discretionary spending caps that reduce both defense spending and nondefense discretionary spending in real terms and thus reduce them fairly sharply as shares of GDP.

Chairman MURRAY. Dr. Elmendorf, I am out of time.

Dr. ELMENDORF. Sorry.

Chairman MURRAY. And as chair, I am trying to keep everybody to that. But I appreciate that response and want to turn it over to my co-chair, Congressman Hensarling.

Co-Chair HENSARLING. Thank you, Madam Co-Chair.

And Dr. Elmendorf, maybe we will continue on this line of questioning. Is it possible to pull up your Figure 12 from your testimony, if somebody could help me with that?

Dr. ELMENDORF. Figure 12?

Co-Chair HENSARLING. Page 39 of your testimony. I believe it is entitled Figure 12.

Now as I understand it, this chart is a chart of historic and projected growth on Social Security, Medicare, other major healthcare programs. You wouldn't happen to have this chart plotted against growth in GDP, would you?

Dr. ELMENDORF. So these are shares of GDP. This is spending on these programs expressed as a percentage of GDP.

Co-Chair HENSARLING. Okay. But historic average, post World War II GDP has averaged what, roughly 3 percent annual economic growth?

Dr. ELMENDORF. I think that is about right, Congressman. I don't know for sure.

Co-Chair HENSARLING. Okay. On your Figure 14, again, Social Security and major healthcare programs have averaged 7.2 percent of GDP. Current law, going to 12.2 percent of GDP in just 10 years. So from 7.2 to 12.2, not quite double, but certainly that could be described as explosive growth, could it not?

Dr. ELMENDORF. Very rapid, Congressman. Yes.

Co-Chair HENSARLING. We won't parse terms. As I am looking at some of your CBO data just for the last 10 years, apparently Social Security has grown at an average of 5.8 percent, Medicare 9.1 percent, Medicaid 8.8 percent in the last decade. And again, we now have a revised GDP growth outlook coming out of your August revision of your baseline.

So, is it a fair assessment that we have Social Security, Medicare, other healthcare programs that are potentially growing two and three times the rate of growth in our economy?

Dr. ELMENDORF. They have grown much faster in the past, and our projections are for them to continue to outpace economic growth. Of course, the exact amount is uncertain, but the gap in the growth rates that we have seen historically has been very large, as you said.

Co-Chair HENSARLING. Now, Senator Toomey certainly in his comments talked about the current law baseline, and although an important exercise, it is certainly not dispositive to the task in front of us. But under a current law baseline, Medicare physicians are due to take essentially a 30 percent pay cut next year. Correct?

Dr. ELMENDORF. Yes. That is right.

Co-Chair HENSARLING. Does CBO—I believe recently you testified that CBO did not have a model to really impact—to show the impact of such a cut on healthcare delivery. Is that correct? Is CBO developing a model, or is that beyond the scope of what you do?

Dr. ELMENDORF. It is in the long-term plan, Congressman. We and others have raised concerns that the much slower growth projected for payments to physicians through Medicare relative to the private sector could affect the access to care or quality of care received by beneficiaries. But we do not have a model and are not about in the near term to have a model that would enable us to make any more specific predictions along those lines, I am afraid.

Co-Chair HENSARLING. Well, what I am trying to get at is clearly—and again, I quoted the President, who I don't often agree with, in our last organizational meeting, where he said, "The major driver of our long-term liabilities, everybody here knows, is Medicare and Medicaid and our healthcare spending. Nothing comes close." And I take it you would probably agree with that assessment as well, Dr. Elmendorf?

Dr. ELMENDORF. Yes. That is right.

Co-Chair HENSARLING. But I am also trying to get to the qualitative aspect of this, too, in our current systems, and you say CBO is developing a model. I know that CMS actuaries have said as essentially if that under the current baseline that, "Medicare bene-

ficiaries would almost certainly face increasingly severe problems with access to care." That is the Medicare actuaries, August of 2010.

The Medicare trustees 2011 report, talking about the growing insolvency, "Beneficiary access to healthcare services would be rapidly curtailed."

The President's Administrator for Centers for Medicare and Medicaid Services has said, "The decision is not whether or not we will ration care. The decision is whether we will ration with our eyes open."

So, to some extent, Dr. Elmendorf, even though CBO doesn't have a model, we are looking at not just programs that are driving the insolvency of our country, but in many respects, left unreformed, is also shortchanging the beneficiaries as well. Would you agree with that assessment, or again, until you have your model, that is——

Dr. ELMENDORF. I think all I can say, Congressman, is that the extent of the pressure on providers of care to Medicare beneficiaries may depend a lot on the time horizon over which one looks. When the actuaries make projections for 75 years into the future, they have shown a picture that I have seen in testimonies about the relative payment rates to providers many, many decades into the future.

The sorts of changes that are in train for the coming decade might affect access to care or quality of the care, as I have said, but would be much less severe in those effects than if those same policies were left in place for the remainder of the 75-year period that the actuaries make projections for. So, but beyond that, we just don't have a way of trying to quantify for you the extent of the impact on beneficiaries.

Co-Chair HENSARLING. Apparently, the trustees in CMS do so far. In an attempt to lead by example and follow the lead of my co-chair, I see my time is now ended.

Thank you, Dr. Elmendorf.

Dr. ELMENDORF. Thank you.

Chairman MURRAY. Representative Becerra?

Representative BECERRA. Dr. Elmendorf, thank you very much for your testimony, and you focused quite a bit of your time on what is coming up, which, if we are not careful, could be pretty bad.

But we are dealing right now with a $14 trillion national debt plus—$14 trillion-plus national debt and fairly massive deficits today, and we have been charged to come up with savings from these current and past deficits of at least $1.5 trillion.

And so, let me ask that a few charts that I have, the first chart actually is a chart CBO's work done in 2001 that I would like to have raised. It is called "Changes in CBO's Baseline Projections of the Surplus Since January 2001," and what I would like to do on that chart, if we can get that up, is just point out what was being projected by your office back in 2001 and then analyze—and I think all my colleagues have copies of those charts with them—and analyze that.

Now it is very difficult to make out these tables and make much sense of them. But for those who can make out the lines, the num-

bers on those charts, the very top line, the total surplus as projected in January——

Senator BAUCUS. Xavier, could you tell us what page that is on?

Representative BECERRA. It should be a separate package that you got——

Senator BAUCUS. Oh, it is a handout.

Representative BECERRA. It is a separate handout. That is correct. It should be——

Dr. ELMENDORF. I think this is a table that CBO has published and posted on its Web site, but it is not included in the testimony that I brought today.

Representative BECERRA. That is correct. And I only will make a couple of points here since it is difficult to read all the numbers on the table. But the first one is that the top line there, total surpluses as projected in January 2001, projected that after—from 2001 to 2011, if you totaled it up, we have surpluses of $5.610 trillion.

And if you go down to the very bottom of the chart, towards the very bottom, to the line that says "Actual Surplus or Deficit," under the year 2002 column, by the year 2002, there was a negative 158, which means a deficit of $158 billion.

So that while the projections in 2001 were for record surpluses totaling over 10 or so years, $5.6 trillion, by the second year, by 2002, we were already beginning to run deficits, not surpluses. So we knew well in advance of the year 2011 that the Federal Government was beginning to run deficits—in fact, record deficits—that could ultimately harm our economy.

I have another chart that uses the data from the CBO that we just discussed and tries to put it in a little easier form to analyze. And the Pew Center did this chart, taking the data from the Congressional Budget Office to try to segment out where that change from surplus to deficit went. All those dollars that were spent, all the revenue through the tax code that was lost, where did it go?

And obviously, the biggest piece of the pie on the right, technical and economic, that is what I think you described earlier as shortfall in Nation's output. In other words, all the things that have caused us to have less output than we had expected, projected. The recession and so forth probably constitutes the biggest portion of that.

After that, the second biggest slice of the pie that drove our deficits, you can see, are the tax cuts in 2001 and 2002, the Bush tax cuts. Actually, you could put together our defense costs, which are here in the very bottom, "Operations in Iraq and Afghanistan" at 10 percent, and "Other Defense Spending," a little bit further up to the left, at 5 percent, and you have 15 percent of the pie due to defense spending, and so on.

And interestingly enough, increase in net interest, money we pay just on the interest we owe on that national debt, is one of the largest items as well. So nothing productive comes of making those payments.

I raise all that because as we talk about where we should target our solutions, we should know what has driven us most towards these large annual deficits that now give us this over $14 trillion national debt.

And the final chart that I wanted to raise because it also points out the actual discretionary spending part of the pie, which you spent some time on—not the tax expenditures, not the spending we do through the tax code, which is the largest portion, but through the allocations we make every year through the budgeting process, the appropriation process. Hard to tell again, unless you have a chart in your hand, but the largest item shows the change in spending from 2001 to 2010, the greatest percentage of that added spending in those 10 years was in the Department of Defense, much of it because of the war in Iraq and the war in Afghanistan. But fully two-thirds of the costs or the extra spending that was done from 2001 to now 2010 has come in spending done in the Department of Defense.

You could compare that to, say, the Veterans Department, Veterans Affairs Department. The share of the new spending over that 10-year period that went to veterans was about 5 percent. Education, you can see further down the list. The new spending beyond what was expected in 2001, it is about 1 percent.

And I think that is important to sort of gauge that. And as much as I hope we have a chance to get into some of this and talk about where we have to go, I think it is important to know where we are coming from. And so, I thank you for being here to help us gauge those responses into the future.

I yield back.

Chairman MURRAY. Senator Kyl?

Senator KYL. Thank you, Madam Chairman.

Rather than make a speech, which would probably have the effect of dividing us if I responded to my colleague, I would like to focus on areas where we might find agreement, going back to my opening statement, and to begin with a quotation from the President.

In March of last year, he said, and I quote, "It is estimated that improper payments cost taxpayers almost $100 billion last year alone. If we created a Department of Improper Payments, it would actually be one of the biggest departments in our Government."

Well, this committee can address the question of improper payments, but I think we are going to need CBO's help in order to do that. For 2010, GAO estimated total improper payments at over $125 billion. And according to its report, Medicare, Medicaid, and unemployment insurance ranked 1, 2, and 3 in total improper payments. Their figures were slightly below those I quoted earlier.

But the bottom line is that if you had $100 billion, as the President says, in overpayments each year, over a decade, that is $1 trillion. More than $1 trillion when you compound it. It is an area we need to address.

And since it doesn't involve cuts in benefits or fundamental reform of programs—which I happen to think we should do, but I am trying to stay on areas where we can reach bipartisan consensus here—we are going to need help in scoring how to approach this.

My first question I guess I should ask is do you agree, whether it is with these specific numbers or not, with the President's contention, let's just say, that at least there is a significant amount of inappropriate payment for some of the programs that I have mentioned?

Dr. ELMENDORF. So I agree with that. I have two quick comments. One is that there is a difference, of course, between improper payments and fraud. Fraud is a much narrower category involving certain legal issues.

Some improper payments are simply that people didn't put Social Security numbers into forms where they should have or so on. And if the forms were filled out properly, the payments might be still made.

So just people should understand that when they see some of these largest numbers for improper payments, that is a much broader set of situations than the sort of thing that we read of prosecutions regarding in the newspaper.

Second point to make, of course, is not just whether the improperness or the fraud is out there, but what policy levers the Government has to go after that. Of course, those programs are not trying to encourage improper payments or fraud. There is an active effort on the part of the Justice Department, as well as the part of the departments running these programs, to crack down on fraud. And you do see stories in the newspaper about prosecutions.

So the question that we can help the committee work on is what policy levers are available that can try to wring some of that money out of the system?

Senator KYL. Exactly so. And that is where we need your advice. And the comment about fraud is obviously correct. I think fraud is not the most significant part of these overpayments, but it is important.

One question is would we benefit in a cost-benefit analysis by devoting more resources to trying to root that out? We should deal with that. Another would deal with whether or not hiring additional people to check before the check goes out rather than audit after we find the problem would be beneficial.

The prompt payment requirements represent part of the challenge that we have here, as I understand it. So, now, is it true that CBO has—well, let me just ask, has CBO itself done an analysis of these numbers?

Dr. ELMENDORF. I don't have numbers comparable to the ones you quoted to use. But we do spend a fair amount of time working with Members of Congress, working with the people at CMS, and so on to think about ways that policies could be changed that would try to reduce the level of those payments.

And as you know, the Budget Control Act, in fact, included provisions for raising the caps in discretionary spending to cover some of those increased efforts that you described.

Senator KYL. Right.

Dr. ELMENDORF. And we included in our estimate of the effects of that act the savings that we thought would accrue in terms of reduced payments.

Senator KYL. Well, just to summarize, will you work with us to try to help us identify the potential policy that could result in, on a cost-benefit analysis, significant savings if we were to implement it?

Dr. ELMENDORF. Yes. We certainly will. But can I just also caution, I am not against our working with you on any issue that you want us to work with you on, but there is no evidence that sug-

gests that this sort of effort can represent a large share of the $1.2 trillion or $1.5 trillion or the larger numbers that some of you have discussed as being the objective in savings for this committee.

Senator KYL. Well, the GAO, if the GAO report is right, if what the President said is right, if there is over $100 billion in just 1 year alone, then even if we get 25 percent of that, it is a significant amount of money. It is at least something that I think on a bipartisan basis we can agree on because it doesn't involve fundamental reform of the program, it seems to me.

Now there is a second area that I wanted raise here, too, and that is asset sales. There are a lot of different reports. CRS, for example, in 2009 said the Government held well over 10,000 unneeded buildings, spending $134 million just to maintain them. The President's budget assumed savings by selling property and so on.

One of the things we would also like to ask you to do, and I know you have scored the President's proposal, but that was a proposal that relied on incentives to sell property. If we simply mandated the sale of property, I think we would need your advice about how to structure that so that we would get the best return for the sales that we would want to accomplish.

Will you work with us on that potential area of—that is revenue rather than savings, but it all amounts to the same thing in terms of helping us with our problem.

Dr. ELMENDORF. Yes, Senator. Of course, we will work with you. I would caution again. We have done a fair amount of work. We have given testimony on this topic, and there is no evidence that the amount of savings that could be—or extra revenue that could be reaped by the Government through efforts in this direction could represent any substantial share of numbers that begin with "t" for trillion.

The Base Closure and Realignment effort has not yielded significant amounts of money for the Government in terms of selling the property. It saved money in terms of operating some of these facilities, but not much has been sold.

When one sees these numbers of thousands of Government properties not being used, many of them by number are shacks in the middle of nowhere that don't have market value. And the properties that have the most value—there has been some back and forth I have seen in the newspapers about property in Los Angeles—then the people who live around it are fighting very hard to prevent the Federal Government from selling it.

Not to discourage you from passing laws to the contrary. But what happens are the things that are most valuable is that the people who are there are using it or potentially using it or want the area to stay that way tend to push back very hard, and history suggests that very little money is actually reaped.

But we are certainly ready to work with you on policies in that direction.

Chairman MURRAY. Senator Baucus?

Senator BAUCUS. Thank you, Senator Murray.

Again, I want to follow up with Senator Kyl's questions. I think we should explore this much more vigorously than we have in the

past, and I think you and I and others will try to work with you to try to find some solutions here.

On the version I have of your statement, it is page 5. You are talking about the timing of deficit reduction, and you state that according to analysis, essentially, credible policy changes that would substantially reduce deficits later in the coming decade for the longer term, the thought being spending, cuts in spending are efficient, would both support economic expansion in the next few years and the strength of the economy longer term.

My basic question is, could you give us some examples about how we could achieve both goals, namely jobs and deficit reduction? That is really one of the key questions here is how do we do this?

There are probably several ways. You mentioned that deficit reduction has to be, in the longer term, credible because we can't do something that is not credible. It has to work, but we have to find the balance. And I wondered if you could give us a couple examples in how we accomplish that?

Dr. ELMENDORF. Well, there are a number of possibilities, Senator. We released a report in January of 2010 that analyzed a set of alternative proposals for spurring job growth. We looked at increased transfer payments. We looked at cuts in all sorts of different types of taxes. We looked at other types of Government spending increases.

And I don't want to be appearing to steer the committee in any particular direction among those choices because the choices involve not just the effects on the economy—and we did estimate quantitatively the impact on output and employment. They also involve choices about what you want the Government to do, what sorts of activities it should be engaged in, what the role of the Government should be relative to the private sector.

So the set of choices in making stimulative policy, in addition to doing deficit reduction policy, are far beyond our technical role. I think the crucial points, though, are that cuts in taxes or increases in spending in the near term will spur output and employment in the near term. But just by themselves, they will reduce output and incomes later on because of the extra debt that is accumulated.

Senator BAUCUS. Right. I——

Dr. ELMENDORF. If one wants to also improve the medium and longer-term outlook for the economy, then one needs to have deficit reduction that offsets the extra costs in the near term and reduce the deficit further relative to the unsustainable path of current policies.

Senator BAUCUS. I appreciate that. In fact, I think I have your chart, your table, that is entitled "Estimated Effects of Policy Options on Output and Employment." And I applaud you for it because, according to that chart, you, for example, with respect to jobs as to cumulative effects on employment, in 2010, '11, '10 to '15, you have highs and lows that you rate. You know, this creates more jobs than that.

So you give us a sense of what—for example, increasing the aid to the unemployed is very high in terms of its economic effect and helping people without jobs, but also with respect to the economy and GDP. So I appreciate that, and I will work with you to try to find ways to address that.

I would like to turn to another question, and that is I don't want to steal from my good friend Rob Portman. He can follow up a lot more. But it is sort of the baseline question. And you say that we can get to 61 percent of GDP in 2021 under current law. But I think most of us here in this room don't think that current law is very realistic. There are going to be changes, and you list some of the changes in your statement, namely, the tax cuts—2010 tax cuts, AMT indexed for inflation, Medicare payment rates, and so forth.

And if we were to assume that those provisions are going to be extended as something called the current policy, that instead of trying to get—instead of $1.2 trillion as to 61 percent of GDP in 2021, the figure I have is about $6.2 trillion.

Dr. ELMENDORF. Yes. That is right. The cost of extending those expiring provisions amounts to about—including the interest cost that would result, amounts to about $5 trillion over the coming decade. So the choice of the Congress about those policies is much larger an impact potentially than the stated target deficit reduction of this committee.

Senator BAUCUS. All right. So let's say we want to reduce the deficit by, what, 6.2—5 plus 1.2 is 6.2, let's say, for example.

Dr. ELMENDORF. Okay.

Senator BAUCUS. What would the composition of that reduction be if we reduce the deficit somewhat in parallel, in tandem with proportion to the causes of the additional $5 trillion? I guess it would just be——

Dr. ELMENDORF. Well, most of the extra $5 trillion under your scenario comes from a reduction in taxes. So if one wanted to offset that, that is what you are suggesting, then one would need to raise significant tax revenue through some other channel.

I mean, I think I understand the purpose for this hearing of talking about the history of debt and how we got here. And I think you are extending that a bit into the future, looking at what policy changes would get us to a certain place. But I think really the fundamental question for you is not how we got here, but where you want the country to go. What role do you and your colleagues want the Government to play in the economy and the society?

Senator BAUCUS. That is right.

Dr. ELMENDORF. And if you want a role that has benefit programs for older Americans like the ones we have had in the past and that operates the rest of the Government like the ones we have had in the past, then more tax revenue is needed than under current tax rates.

On the other hand, if one wants those tax rates, then one has to make very significant changes in spending programs for older Americans or other aspects of how the Federal Government does its business.

Senator BAUCUS. That is exactly right, and I don't want to take time here. But it is just really the question. Where do we want to go? And do we want to have AMT indexed, for example? Do we want to have SGR, the physicians payment rate? Do we want to increase taxes for middle-income Americans beginning 2013, or upper income, or not?

I mean, these are basic questions we are going to have to ask ourselves, and they all have consequences, really. And the consequences if we want to do all that is what we just agreed on. Namely, it is a $5 trillion addition to our job here. But in addition, we have what the President is going to have us do with his jobs plan.

Thank you.

Dr. ELMENDORF. Yes, Senator.

Chairman MURRAY. Representative Upton?

Representative UPTON. Well, thank you again, Dr. Elmendorf.

I want to underscore what our friend Mr. Kyl said about fraud and abuse. I mean, there is nothing more irritating to any of us here or certainly to our constituents, and any assistance that you could help us on that I know would be low-hanging fruit in a major way for us to include as part of the package.

Let me ask just an early question as to timing of this whole event. We are tasked to have a vote prior to November 23rd. What is the timing—I mean, other than as soon as possible. What is the realistic date that truly we have to have our documentation submitted to you?

I know sometimes a lot of our Members are frustrated trying to get a CBO score. I know that there is not a higher priority for you all to do this. But what is really the date that you are going to want the material so that we can complete the work by the statute?

Dr. ELMENDORF. As you know, Congressman, from your work on the Energy and Commerce Committee, in order to process——

Representative UPTON. Which would feed into the queue ahead of Ways and Means in terms of the committee——[Laughter.]

Dr. ELMENDORF. It is an iterative process in which we often see preliminary versions of ideas and offer some preliminary feedback. But if this committee intends to write legislation that would change entitlement programs in specific ways, that process usually takes weeks of drafting to make sure that the letters of the law that you are writing accomplish the policy objectives that you are setting out to accomplish.

And as part of that drafting process is our estimating ultimately the effects of the letter of the law as it is being written. So it will take us at least a few weeks.

I have a terrific set of colleagues who are incredibly talented and work unbelievably hard. But we need to do our jobs right, and that means not just pulling numbers out of the air. So we have said in discussions with some of the staff of the committee that, with all respect, your decisions really need to be mostly made by the beginning of November if you want to have real legislation and a cost estimate from CBO to go with that before you get to Thanksgiving.

Representative UPTON. Now I want to get a better understanding of some of the estimates of the cost impact to the Affordable Care Act. As we know, the bill increased taxes on some of our Nation's most innovative job creators, reduced Medicare spending significantly. The tax increases and Medicare cuts were traded to create three new entitlement programs, which have yet to take effect, and according to our staff's projections, which are based on your most

recent baseline, those new entitlement programs will cost the Nation nearly $2 trillion over the first 10 years from '14 to 2023.

So, question one, have you all estimated the full 10-year costs for each of these entitlement programs, Medicaid, health coverage subsidies and the creation of the CLASS Act, for the '14 to '23 period when they are fully implemented?

Dr. ELMENDORF. No, Congressman. We have not.

Representative UPTON. Do you anticipate doing that at all?

Dr. ELMENDORF. No. As you know, we produced estimates for the 10-year period that was under consideration when the law was being considered, and then we provided a rougher sense of what we thought would happen in the second decade from that point in time.

As the time moves forward and the budget window moves out, we will ultimately end up with a 10-year budget window that will be from 2014 to 2023. But even then, it is not obvious that we will have an estimate of the effects of that legislation by itself.

Some pieces of that legislation create new institutions, new flows of money that didn't exist before, insurance exchanges and subsidies. And those lines of our cost estimate will, in some sense, become real flows of money at that point in time.

But much else of that legislation made changes in existing programs, in payments through Medicare and so on. And we will never know for sure what money actually is flowing differently because of that piece of legislation . We will see flow for certain purposes through certain accounts, but isolating the effects of that legislation won't really be possible.

The prescription drug benefit is one of the few pieces of legislation where we can look back at how we did. In a sense, that is because much of that legislation—not all, but much of it, the big part—created a whole new stream of money that would have been zero otherwise. So we can see the difference.

But for most legislation that the Congress passes, one can never really go back and tell. That is the risk of our table that we gave to Congressman Becerra and others. One can never really go back and tell what happened. And so, the healthcare legislation will be like that at some point.

Representative UPTON. Well, if there is a way that you would take the percentage of GDP and try to match that up with the out-years and look at 9, 10, 11, 12 years out? Is that a thought that you might take up?

Dr. ELMENDORF. Well, so we did. So we can talk with you further, Congressman. We did do an estimate as the net effect of the law, the share of GDP over the second 10 years. And we talked in our estimates at the time about some of the bigger pieces of the legislation, things that were growing rapidly or growing more slowly or so on.

That sort of calculation is not really possible to do on the level of little specific provisions. It is just too broad a brush we need to paint with at that horizon, given the uncertainty involved. But if there are other ways of looking at those pieces that would be helpful to you, we are happy to try to do that.

I think we made very clear—I hope nobody is confused about this—that legislation created significant new entitlements that

raise Federal outlays. It also made other reductions in outlays and raised revenues in ways that on balance we think and still think reduce budget deficits. But that was a net effect of very large changes with different signs, and that increases the uncertainty surrounding those estimates of the net effects.

Representative UPTON. Thank you.

Chairman MURRAY. Thank you.

Representative Clyburn?

Representative CLYBURN. Thank you very much, Madam Chair.

Dr. Elmendorf, since we have been sitting here, we received notice that the Nation's poverty rate has increased to 15.1 percent, up almost a full percentage point. Now back in, I think it was September 2010, in testimony before the Senate Budget Committee, you said this.

"Regarding structural changes, the end of the housing boom, and the recession have all induced a reshuffling of jobs among businesses, occupations, industries, and geographical areas. Those developments suggest that gains in employment in the next several years will rely more than usual on the creation of new jobs with different businesses in different industries and locations and requiring workers with different skills."

Do you still feel that to be true?

Dr. ELMENDORF. Yes, we do, Congressman. We think that much of the extra unemployment we are seeing now is what economists would call a cyclical response to a weakness in the demand for goods and services. But that some of the extra unemployment we see now is more what economists call a structural problem, which involves, importantly, the mismatches that we discussed in the passage you read, also relates to unemployment insurance benefits and other factors in the economy.

We made a rough attempt to quantify those pieces in our August update. But the upshot of that is to say that we think there is an important piece of current unemployment that relates to this kind of structural mismatch that would—makes it harder for those people to go back to work, because it is not so much going back as it is going on to something else.

Representative CLYBURN. Then that means then your view is there is not much that can be done in the short term to attack this?

Dr. ELMENDORF. I wouldn't quite say that. It is challenging. I mean, I think what I would say is that the cyclical part of the unemployment, that part that is responsive to the weakness in demand for goods and services, can be addressed through aggregate economic policies.

The people who are unemployed for structural reasons, in a sense, because of the sort of the thing that they knew how to do in the place that they live isn't being done there or anywhere anymore, that isn't amenable to broad macroeconomic policy. It might be responsive to certain types of more focused policies—training programs, for example.

I think the broad brush summary of training programs is that it is hard to make them work, but not impossible. I don't want to suggest that. But I think it is just a different sort of policy that would need to be considered in order to help some of those people

find new jobs, to help other people create the jobs that those people would be able to do.

Representative CLYBURN. Well, just let me say, to be certain, I am just as concerned as my good friend Senator Kyl is about fraud and abuse. I want to cull that out of the system as well as we possibly can.

The problem I have, though, is that with these kinds of numbers and with what you have just laid out, it means that those in need are increasing rapidly. And the question then becomes if you look at the median family, household income declining 2.3 percent, that means that irrespective of what may be happening to people who may not be deserving of the assistance, there are increases occurring among the needy very rapidly, and we have not done anything to absorb that challenge.

Dr. ELMENDORF. Certainly right, Congressman, about the number of people who are hurting. One thing I would say is that the Federal budget automatically does some things for those people. Food stamp participation is up. A lot more money is flowing out that way. Unemployment insurance, even apart from extensions, will pay benefits to more people if more people are unemployed.

So some of the automatic features of entitlement programs end up helping those people, but I don't want to suggest that that has inoculated them against the overall problems that they face.

Representative CLYBURN. That means our burden of doing smart cuts is greater than what it may appear just looking at the numbers. It means we really need to look into all of these programs and see exactly where cuts ought to be made rather than just dealing with a number.

Thank you very much. I yield back.

Dr. ELMENDORF. Yes, Congressman.

Chairman MURRAY. Senator Portman?

Senator PORTMAN. Thanks, Madam Chair.

Building on what my colleague, Congressman Clyburn, just said and what Co-Chair Hensarling talked about earlier in terms of the impact of the deficit and debt on the economy, Dr. Elmendorf, have you got a reaction to the Rogoff and Reinhart study, which shows that once you are at 90 percent of gross debt, which we are already, that you have an impact on GDP, therefore on jobs, therefore on the kind of issues that Congressman Clyburn talked about?

Dr. ELMENDORF. So we are certainly familiar with that work, Senator. Carmen Reinhart is a member of our panel of economic advisers. We benefit from her expertise.

I think the thing to note about the study, first of all, as it was said, is that they are looking at gross debt. So those are larger numbers than the numbers that you will see from me. We focus on debt held by the public.

Senator PORTMAN. Right.

Dr. ELMENDORF. The other thing to say is that they divided the world into buckets in a sense, different levels of debt. That doesn't prove that there is some particular tipping point at 90 percent. It says that above—but their evidence shows that above that level, economies tend not to do well.

We just had an issue brief last year about the risk of a fiscal crisis, and in other things that we have written, that we don't think

it is possible to identify a particular tipping point. But there is no doubt that as debt rises, risks of fiscal crises rise. The Federal Government loses the flexibility to respond to unexpected international developments or problems at home because of this looming debt.

And we are, as I said, moving into territory that is unfamiliar to most developed countries for most of the last half century.

Senator PORTMAN. In fact, in looking around the world, and there is a recent report by Alberto Alesina of Harvard University showing that the most successful and pro-growth test of reduction took place in countries that relied chiefly on austerity programs, spending cuts. And nations that relied more on tax increases were less successful in reducing the deficits and had slower economic growth.

Have you looked at some of these countries that have gone through the same process we are going through now, and what comment can you give us today on what we can learn from the experience of those countries? And maybe if you know about Professor Alesina's study?

Dr. ELMENDORF. So I do know Alberto's work. There have been a number of studies, as you know, looking at the international experience of countries that have faced fiscal crises and have undertaken austerity programs. The IMF looked at a very similar set of data to the work of Alberto and Silvia and came to a different conclusion, in fact. Their conclusion was that in countries that really set out to do fiscal austerity, the results tended to not be good in the short term.

I think the principal lesson of looking at countries like Greece and others is that it is a terrible situation to end up in, where one has to make drastic, abrupt changes in policy. But if you look at Greece or Ireland or the experience in the UK, which did not face such a crisis but has made a very determined pivot in its policy, those economies are not doing very well right now.

And I think leaders in those countries felt they had no alternative, given where they had gotten to, that they were at a point where people were not lending the governments money anymore or were about to stop lending them money, in the view of the governments. So they had to make drastic changes. But that is not a situation that we would like to find ourselves in as a country.

Senator PORTMAN. It appears as though we are heading there if you look at the current policy baseline and some of the more realistic assumptions that my colleague, Senator Baucus, talked about. If you look at your chart with regard to baselines, you say that we have about a $3.5 trillion deficit increase over the decade under the current law baseline, but under current policy that you have, you say it is about $8.5 trillion.

I would add tax extenders in there like the R&D tax credit and others, and possibly, you are up to about $9.3 trillion.

Dr. ELMENDORF. Yes.

Senator PORTMAN. So, again, the $1.5 trillion is a relatively small part of the problem. It is about 17.5 percent, by the way, of your $8.5 trillion number. So I do think that as we look at our work, we are going to need your help on looking at more realistic baselines. We are making very difficult choices on things like alternative minimum tax, SGR, and ending the UI extension and payroll tax and so on.

In terms of what drives that, your Figure 14, I think, is very instructive, which talks about the major healthcare programs. Earlier, there was discussion about President Obama's comments. "The major driver of our long-term liabilities," he said, "everybody here knows is Medicare and Medicaid and our healthcare spending. Nothing comes close."

Assuming you agree with that, which I assume you do?

Dr. ELMENDORF. Yes.

Senator PORTMAN. What do you think ought to be the primary focus of this committee?

Dr. ELMENDORF. Again, Senator, it is really not the place of me or CBO to offer recommendations about how to proceed. But there is no doubt that the aspect of the budget that is starkly different in the future relative to what we have experienced in the past 40 years is spending on programs for older Americans and spending on healthcare.

And the reasons those programs are so much more expensive in the future is partly due to changes in policy over time, but most importantly due to a greatly increased number of older Americans and higher cost for healthcare. As a matter of arithmetic, it is possible to raise taxes or carve away at the rest of the Government in a way that can support those programs in this form for some time, but there should be no illusion about the magnitude of the changes required in other policies to accommodate that.

If one really leaves those programs in place, then, in fact, under current law already the rest of the Government would be much smaller relative to the size of the economy in 2021 than it has been historically. And one would need to raise revenues substantially.

I mean, this is a 5 percent of GDP increase in the cost of Social Security and major healthcare programs in 2021, relative to the 40-year average. Five percent of GDP is a very big number, and that is why I think many people believe that there should be changes in that part of the budget.

Senator PORTMAN. So if the 22.7 percent of GDP is spending in that 2021 estimate under, again, current law and not even current policy, the major driver is Social Security and major healthcare programs. That is as compared to the historic average the last 50 years of about 20.8 percent.

Revenues there go from 18 percent historic average up to 20.9 percent. My understanding is even under current policy, revenues go up above the 18 percent level. So your $8.2 trillion——

Dr. ELMENDORF. A little bit.

Senator PORTMAN [continuing]. Or the $9.3 trillion, which is I think a more realistic estimate, also includes a slight increase in revenues, is that correct, as a percent of GDP?

Dr. ELMENDORF. I think a slight increase. Yes. That is right, Senator.

Senator PORTMAN. Twenty-two percent, I think, is the number.

Dr. ELMENDORF. I am not sure exactly. But, yes, a slight increase.

I would just add one fact here. The number of Americans over the age of 65 is going to rise by about one third in the coming decade. One third more beneficiaries of Social Security and Medicare a decade from now, roughly, than there are today. And on top of

that, with higher healthcare costs per person, one can see why these programs in their current form are becoming much more expensive over time.

Senator PORTMAN. Thank you.

Chairman MURRAY. Senator Kerry?

Senator KERRY. Thank you, Madam Chairman.

Dr. Elmendorf, I want to try to move through a couple of things fairly quickly, if we can. You said a moment ago that the aspect of the budget that is starkly different is, I think you said, the number of older Americans and the cost of healthcare. Is that correct?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. And those are the two things that you said are starkly different about the aspect of the budget today?

Dr. ELMENDORF. Today, and in the future. Yes, even more so in the future.

Senator KERRY. But isn't it accurate that we have balanced the budget I think since World War II five times, and that each time we have balanced the budget, revenues have been somewhere between 19 and 21 plus percent of GDP? Is that accurate?

Dr. ELMENDORF. That sounds right, Senator. I have not checked exactly.

Senator KERRY. And assuming that is accurate, we are currently at 15 percent, 15.3 I think is your prediction for this year, of revenues to GDP. Correct?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. So isn't it fair to say that, in fact, there is an aspect about our budget today that is starkly different, which is the level of revenues relative to GDP. It is starkly different, isn't it?

Dr. ELMENDORF. Yes. That is right, Senator.

Senator KERRY. And it is starkly different in that it is well lower than the historical average of when we balanced the budget or not balanced the budget?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. So let me ask you, given that reality and given the reality that you and others—I think last year, the Committee on Fiscal Future of the United States, which was a joint effort of the National Academy of Sciences and the National Academy of Public Administration—developed four budget scenarios.

They had one budget scenario where you had nothing but cuts, another budget scenario where you had nothing but tax increase, and then two in between. The only way they could keep the revenues at the historical average and keep the spending at a decent level was basically with cuts. But that doesn't get you where you need to go in terms of some of this historical average and not winding up with major, major cuts in terms of the benefits of Medicare or Medicaid.

So if you want to avoid—you made the statement to us a moment ago that we have to make a decision about what we want to do. Most people have accepted that we don't want to have major reductions to—we have reforms, yes. We need to do a better job of making them fiscally sound. But I haven't heard anybody stand up on either side of the aisle and say there ought to be huge cuts in benefits.

If that is true, then aren't we forced into a situation where we look somewhere near the historical norm with respect to the revenue to GDP percentage?

Dr. ELMENDORF. So if one wants to leave spending on Social Security and the major healthcare programs roughly in line with what would happen under current law, then one needs to either further carve away at all the other functions of the Government, or one needs to raise revenues above their historical average share of GDP by a significant amount, or one could do combinations of those.

But there is no way to simultaneously let Social Security and the major healthcare programs grow the way they would under current policies or anything close to that and operate the rest of the Federal Government in line with its role in the economy over the past 40 years and keep revenues the same share of GDP they have been on average in the past 40 years. And the reason those things are inconsistent, even though they worked in the past 40 years, is because the number of people who will be older and the number who will be—and the amount they will be collecting in health benefits will be so much larger in the future than in the past.

Senator KERRY. Well, I happen to agree with that judgment that you have made, and I think it is a very important one with respect to how we approach this.

I also want to—we are going to obviously have some time here to discuss the healthcare piece, but isn't it true that, well, the Medicare excess cost growth, how does that compare to the excess cost growth in overall healthcare spending over the next decade?

I think in recent estimates that you found that Medicare in the excess cost growth was actually lower than the historical average now. Isn't that true?

Dr. ELMENDORF. Yes. So excess cost growth, meaning not necessarily excessive in the judgmental sense, but just faster growth in benefits per person than in the growth of GDP per person, that sort of excess cost growth in Medicare under current law is pretty close to zero for the coming decade. That would be a very sharp change from the experience of the past 40 years.

Senator KERRY. And what do——

Dr. ELMENDORF. In relation to the discussion we had earlier about payment rates to providers.

Senator KERRY. So what do we attribute that significant reduction in the Medicare cost growth rate?

Dr. ELMENDORF. So importantly, to features of the law, like the cuts in payment rates to physicians due to take effect the end of this year and like a number of the other cuts to provider payments enacted in last year's major health legislation.

Senator KERRY. So that has had a beneficial effect in terms of restraining growth in Medicare—in Medicare cost?

Dr. ELMENDORF. Yes. That is right.

Senator KERRY. Thank you. I will reserve my time at this point.

Chairman MURRAY. Representative Camp?

Representative CAMP. Well, thank you.

Director Elmendorf, I am sure you remember, as last year you testified before the President's National Commission on Fiscal Responsibility and Reform on a topic very similar to what you are

covering today. It seems as if your presentation then said, then and now, that we need to get control of the automatic spending increases that have been built into the Government's budget. Is that a fair statement of your testimony then and now?

Dr. ELMENDORF. Well, again, I think we said that those pieces are growing very rapidly and that to accommodate that, as it stands, would require very large changes in other aspects of the money the Government spends or collects.

Representative CAMP. Those are the significant drivers of our current situation.

Dr. ELMENDORF. Yes.

Representative CAMP. So what programs in particular are at the core of CBO's projections for the long-term Government spending? And which programs are responsible for the largest increases in Government spending?

Dr. ELMENDORF. So if one looks at Figure 12 from the written testimony on page 39, and coming up on the screen for those with very good eyesight, one can see that this picture shows growth over the next decade in Social Security and in Medicare and in other major healthcare programs.

Representative CAMP. Do the other major healthcare programs include all of the Healthcare Act, long-term care and other Medicaid increases?

Dr. ELMENDORF. So the other major healthcare programs are Medicaid, the Children's Health Insurance Program, and subsidies through insurance exchanges, and some related smaller spending.

Representative CAMP. And the long-term care entitlement?

Dr. ELMENDORF. The long-term care entitlement, as you recall, actually raises money for the Government in the first decade of its life. And I don't know if that has been netted out here or not. I don't think so, actually, Congressman.

But one can see from this picture that the largest increase as a share of GDP over the coming decade among these three categories is the other major healthcare programs, followed by Social Security and Medicare.

Representative CAMP. All right.

Dr. ELMENDORF. And that is principally, I think, because of a great increase in the number of beneficiaries from the expansions enacted last year and continued sharp increases in costs for beneficiaries in those programs.

Representative CAMP. In your prepared testimony before the President's commission, you also included a chart, which—if we could pull that up now, and everyone has a copy of this chart at their desk in their packet—which showed real GDP per capita under different economic conditions. You will notice under the alternative fiscal scenario, the line stops between 2025 and 2030.

And you explained then that that line stops because economic growth collapses and that it simply can't handle debt loads that high. Is that an accurate statement of what you testified before the President's commission?

Dr. ELMENDORF. Yes. That is right. We have updated this picture in our long-term projections from this year. But similarly, Congressman, not at quite the same point, the amount of debt under

this alternative scenario becomes so large that our models don't know what to do with it.

I don't think the economy would actually get that far at all because the people in the economy will be looking ahead and foreseeing what is happening. I think, in fact, much more serious problems will come sooner than we show in these pictures.

Representative CAMP. And I think you said that the Government debt has become so high that you don't know what to do with it because private investment ceases to function and the economy ceases to function under that scenario. Is that correct?

Dr. ELMENDORF. Ceases to function at some point. Again, I think that the freezing up would probably come sooner than we show in those pictures because of an anticipation of that problem.

Representative CAMP. And I think that analysis really does go along with what other analysts have said of the country's debt-to-GDP ratio when it exceeds 90 percent, and I am talking total debt to GDP ratio, that it reduces economic growth, as others have said in their time, by about 1 percent at that level.

Dr. ELMENDORF. Yes. I think the models that we are using here are consistent with a consensus approach to estimating this sort of issue.

Representative CAMP. And am I correct to say that our total debt-to-GDP ratio is over 90 percent at this time?

Dr. ELMENDORF. Yes. I think that is right, Congressman.

Representative CAMP. And what impact do you think these massive levels of debt relative to GDP have on the economy in general and specifically on the prospects for job creation?

Dr. ELMENDORF. Those levels of debt are a burden on the economy. They reduce our output and our incomes relative to what we would enjoy if we had done less borrowing and had done more saving.

Representative CAMP. This committee has been tasked under the Budget Control Act with finding $1.5 trillion in deficit reduction over a 10-year period. What is the size of the economy over the next 10 years?

Dr. ELMENDORF. So GDP today is about $15 trillion. We think it grows over the course of the coming 10 years. If you have done that calculation, Congressman, I would be happy to hear the number from you.

Representative CAMP. Well, just assuming over 10 years, $150 trillion, we are talking about 1 percent of our economy, are we not, in terms of rough numbers?

And the reason I want to point out this number is you mentioned the impact of us making decisions about spending that might have impacts on the economy, and I just want to put in perspective, over the next 10 years, these reductions in debt that we are asked to find over the next 10 years roughly represent about 1 percent of the economy. And I am talking very rough numbers.

Dr. ELMENDORF. So I think that sounds about right to me, Congressman. And I agree that the problem is very large by the standards of the incremental fiscal policy decisions that the Congress normally makes. But it should not be viewed as unsolvable. Changes in policy can put us on a different path.

Representative CAMP. And in terms of outlays, I think this amount over the next 10 years represents about 3 percent of our outlays, and as I think Senator Portman mentioned as well. And so, I think we need to put it in perspective that while I am not underplaying how difficult this might be, but in terms of impacting the economic trajectory of the United States economy, we are not over the next 10-year period in significant percentages of either economy or outlays. Most families and businesses have had to do with less than 3 percent, and I think it is something over a 10-year period, they have obviously had to do with less than that.

Dr. ELMENDORF. Yes.

Representative CAMP. And just lastly, I realize my time has expired. I do want to just ask you one quick thing.

We may come to agreement on impacts within the 10-year budget window, but we may have decisions that are outside of the 10-year budget window. And I just wanted to ask if you would be willing to work with us to find ways to measure the impact of policies outside the traditional budget window and if you would commit to helping us do that?

Dr. ELMENDORF. Yes. Absolutely, Congressman.

Representative CAMP. Thank you very much, and I yield back.

Chairman MURRAY. Representative Van Hollen?

Representative VAN HOLLEN. Thank you, Madam Chairman.

Let me just start, Dr. Elmendorf, by thanking you for your testimony and just say that—and this goes for Republicans and Democrats alike—we are all entitled to our own opinions, but not to our own facts. And the last time that our budget was balanced was back in the 2001, 2000 time period. And in fact, during that time, revenues as a percent of GDP was 20.6 percent in the year 2000 and 19.5 percent in the year 2001.

And the last time spending was 18 percent of GDP was about 1967, and it has risen since then largely because we, as a nation, decided to make sure that older Americans in their retirement had the health security they needed. So it is important to keep those facts in mind as we go forward.

Now you posed a very fundamental question to this committee, and let me ask you this. If we were to try and continue with current retirement and healthcare, security programs in the future, we would need significant changes to revenue beyond current law, would we not, in order to fund them and balance our budget, assuming we kept the rest of Government constant?

Dr. ELMENDORF. Yes. That is right, Congressman.

Representative VAN HOLLEN. And if we were to try to preserve those—let me ask you this. If we were to continue current revenue policy without any changes, it would require very deep cuts to those retirement and security programs, would it not, if we were to try and bring down the deficit?

Dr. ELMENDORF. If you also maintain the rest of the Government in accordance with its historical pattern, yes, Congressman.

Representative VAN HOLLEN. That is right. And as you pointed out in your testimony, in fact, over the next 10 years as a percent of GDP, that is going down, is it not?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. Okay. So that is the fundamental question, and I think we recognize that we have to deal with the outyear issues. We have a demographic challenge. We have more and more people retiring. But as you just pointed out, if we want to avoid huge cuts to Medicare and to Social Security, we also have to deal with the revenue piece. In other words, we have to increase revenues beyond current policy if we want to avoid very deep cuts.

So I think it is important that we look at the revenue side of the equation right now, and you have presented that to us in your testimony. And I think it is time for this committee to get real and recognize that, yes, there are spending issues, especially in the outyears, but there is also a revenue issue.

Now, as you point out, under current law, the 10-year cumulative deficit is $3.4 trillion. Correct? Under current law.

Dr. ELMENDORF. I think it is a $3.5 trillion.

Representative VAN HOLLEN. Three and a half trillion dollars?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. And as you point out on page 19 of your testimony, if we continue current tax policy and the current physician payments under Medicare, that will rise from $3.4 trillion to over $8.5 trillion. That is there in your testimony.

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. Now you mentioned those two factors together, but I think it is important to point out that of that over $5 trillion, that the huge bulk of it has to do with continuing current tax policy, does it not?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. And in fact, by my calculation, you get just under $4 trillion on revenue. And if you add the debt service associated with that, you are talking about $4.5 trillion of your $5 trillion dealing with current revenue policy. Is that right?

Dr. ELMENDORF. Yes. That is right.

Representative VAN HOLLEN. So, just to be clear, if this committee were to adjourn today and the Congress were to adjourn for the next 10 years and go away, we would actually achieve greater deficit reduction than if we went, took the Simpson-Bowles advice and went big. Is that not right?

In other words, we would get over $4 trillion over that 10-year period, even if we fixed the doctor, physician reimbursement piece, right?

Dr. ELMENDORF. So if—let me make sure I have this right. If you extended those expiring tax provisions——

Representative VAN HOLLEN. That is right.

Dr. ELMENDORF [continuing]. And indexed the AMT for inflation——

Representative VAN HOLLEN. Yes.

Dr. ELMENDORF [continuing]. Then that would add to deficits by $4.5 trillion or so. That would be larger than the amount of savings if this committee stayed——

Representative VAN HOLLEN. It is simple math, right? It would be more than the $4 trillion that a lot of people talked about, right?

Dr. ELMENDORF. Yes. That is right.

Representative VAN HOLLEN. Okay. So I think it is important, as we look at this challenge, to look at both sides of the equation

there. And what we are talking about, just so we can translate this into what the American people have experienced, what we would be talking about is essentially going back to the same tax rates and tax policy that was in effect during the Clinton administration, a period of time when 20 million jobs were created and the economy booming.

Now I am not suggesting we go back to that particular tax policy, but if you look at Simpson-Bowles compared to current law, they provide about a $2 trillion tax cut compared to current law, as opposed to $4 trillion. If you look at Rivlin-Domenici, they propose about a $1 trillion tax cut compared to current law, approximation.

So if we are really going to address this challenge, let's recognize that if we don't deal with the revenue piece, as Dr. Elmendorf said, you are talking about dramatic cuts to health and retirement security for America's seniors. We have to take a balanced approach. That is why the other bipartisan groups took that kind of approach.

Thank you, Madam Chairman.

Chairman MURRAY. Senator Toomey?

Senator TOOMEY. Thank you, Madam Chairman.

Since my colleagues have raised this issue, I just want to touch on a couple of things that didn't quite make it into the conversation so far. Isn't it true that as recently as 2007 the current tax rate structure yielded revenue that was about 18.5 percent of GDP?

Dr. ELMENDORF. I think that is right, Senator. Yes. The current level, of course, is very low because the economy is very weak.

Senator TOOMEY. Exactly. And the main reason that total revenue as a percentage of GDP is so much lower than the historical levels is because we have an economy that is still effectively in a recession, very high unemployment, very weak, lack of growth. Isn't that right?

Dr. ELMENDORF. Yes. That is right.

Senator TOOMEY. And as recently as 2007, the deficit that we had that year was about, if I remember correctly, less than 1.5 percent of GDP, I believe. And if we could get to the point where we consistently had deficits of 1.5 percent of GDP, then our debt as a percentage of our economy would clearly be declining, and we would have, to a very large extent, solved this problem, if not completely.

Dr. ELMENDORF. Yes. That is right. If you could—yes. That is right.

Senator TOOMEY. To the level of the deficit that we had in 2007, with the current tax rates. Let me ask a couple of other questions, if I could?

You went through, and I don't think there is any dispute that excessive debt has all kinds of negative implications—we all acknowledge that—including the possibility that we get to the point where you have a financial crisis, an economic freezing up.

Isn't it true that it is essentially impossible to know precisely when you get to that point?

Dr. ELMENDORF. Absolutely.

Senator TOOMEY. So it is just not knowable?

Dr. ELMENDORF. I think it is just not knowable.

Senator TOOMEY. Right. Isn't there a danger that the magnitude of the debt is already impeding economic growth, having a chilling effect on investment and risk taking? Isn't that possible?

Dr. ELMENDORF. I think the level of debt is probably weighing on economic activity. All things equal, of course, we wish we had less.

Senator TOOMEY. Right.

Dr. ELMENDORF. I think the question is how to proceed from here.

Senator TOOMEY. I guess the point I want to make is given that it is probably already weighing on economic growth and given that we acknowledge that continuing down this path eventually leads to a full-blown crisis and we can't know when, that suggests to me that it is very dangerous to delay making meaningful reform. And while there is some concern that curbing the size of the deficit in the short run impedes economic growth, I would argue that it is already happening.

And if we—if the future promised reductions in the deficit either weren't credible or at some point became less credible, then we could discover we are already in that territory where the financial crisis could emerge. Isn't that a danger that we would run in delaying this?

Dr. ELMENDORF. I think there are disadvantages to delay, Senator, as we said in the written testimony and as I repeated here. Again, based on our analysis, which I think is consistent with a consensus of professional opinion, immediate increases in taxes or cuts in spending would slow the economic recovery. But that is not meant to imply that there aren't a variety of factors that can matter in different ways, not meant to imply that we are sure we have that right.

But that is, I think, the consensus of professional opinion.

Senator TOOMEY. It might be, but there certainly is an alternative point of view about that, especially with regard to the spending side.

Dr. ELMENDORF. Yes, Senator. That is right.

Senator TOOMEY. And even though you and I might disagree on this debate somewhat, I am sure you would agree that when it comes to its impact on economic growth, not all Government spending is equal.

Dr. ELMENDORF. That is absolutely right.

Senator TOOMEY. Spending in your models would generate more rather than less. Similarly, not all tax cuts are comparable, right?

Dr. ELMENDORF. Exactly.

Senator TOOMEY. Some encourage economic growth more than others?

Dr. ELMENDORF. Exactly.

Senator TOOMEY. And in fact, crudely speaking and broadly speaking, that spending and tax cuts, while they may arithmetically have the same impact on the deficit if you assume they have no other implications, in fact, they do have other implications?

Dr. ELMENDORF. That is right. And when we do economic modeling of the consequences of alternative fiscal policies, we try to capture that. We incorporate the level of marginal tax rates on labor and capital and those effects on work and on saving.

Senator TOOMEY. Right. And on page 33 of your testimony, you observe that lower marginal rates enhance the incentive to work and save and invest, and that has a pro-growth feedback on the economy.

One of the things we haven't discussed, but I would like your reflection on, is the possibility of a revenue-neutral tax reform that simplifies the code, broadens the base, and lowers marginal rates. Wouldn't that tend to enhance growth and, therefore, enhance revenue to the Government?

Dr. ELMENDORF. Yes. That is right, Senator. The magnitude of that effect, of course, depends on the specifics of the policies that would be enacted.

Senator TOOMEY. Right. And so, I wonder if you have a rule of thumb that you could share with us. For instance, for a given incremental increase in the rate of growth on average, what kind of impact does that have on the deficit over an extended period of time?

Dr. ELMENDORF. Well, so we offer our rules of thumb for that in the back of our annual Budget and Economic Outlooks. And the magnitude of that effect I will offer to you in one moment.

Senator TOOMEY. A figure that comes to mind, and maybe you could confirm or refute, is that a 0.1 percent of additional growth on average sustained over 10 years is roughly $300 billion in additional revenue? Is that about——

Dr. ELMENDORF. Yes. That is just right.

Senator TOOMEY. So a full percent, I mean, this may not be perfectly linear, but it certainly goes in the same direction?

Dr. ELMENDORF. Yes. It almost certainly isn't perfectly linear, and we offer these rules of thumb for small changes because we are just not sure what else might happen with very large——

Senator TOOMEY. The point is a small, sustained change in growth has a huge impact on the deficit or reducing the deficit. Would you agree with that?

Dr. ELMENDORF. Yes. That is right.

Senator TOOMEY. Thank you.

Thank you, Madam Chairman.

Chairman MURRAY. I thank you very much. And we have gotten through our first round here, and I appreciate everybody keeping it concise.

I am going to have to use the prerogative of my chair to make a small change at this time. The House is going to be having votes at approximately 1 p.m. There are 12 of us, and the time is very short. So unless somebody throws something at me, I am going to limit each of us to 2 minutes in the final round and would ask everybody to please keep it to that timeframe.

Dr. Elmendorf, let me just ask, as you have been talking about, in the long-term budget report from January, CBO included an analysis on the impact of lower than expected economic growth on the Federal budget. I wanted to ask you, what does CBO estimate is the impact on the deficit projections in the near term and over the next 10 years if GDP growth continues to weaken beyond what is reflected in the current estimates?

Dr. ELMENDORF. So, certainly, a weaker economy implies worse budget outcomes, primarily because tax revenues fall. Also because

there is some extra spending in some of the entitlement programs that we talked about a moment ago.

We have not done quantitative estimates of budget outcomes for other particular scenarios beyond what is in these rules of thumb that we have offered in our volume in January. And the rules of thumb are rough because a lot of things can or may not rise and fall with the rest of the economy.

We have been surprised in the past few years at some of the outcomes of tax revenue even given the state of the economy. But there is no doubt that a weaker economy is worse for the budget and a stronger economy is a lot better for the budget. The challenge is how to move the economy, and it is not easy to move a $15 trillion economy.

Chairman MURRAY. Thank you.

I do have a question about sequestration. I am going to submit it for the record because I do think it is important. As hard as the choices we are looking at here, we need to understand the impact of that, and I appreciate the information you have put out on that.

But the significant impacts to sequestration I think need to be understood by our committee as well. So I will submit that for the record.

Dr. ELMENDORF. I will be happy to answer it, Senator.

Chairman MURRAY. And reserve my time and turn it over to Mr. Hensarling.

Co-Chair HENSARLING. Dr. Elmendorf, I think it was Senator Kerry who brought up that revenues today are roughly at 14 percent of GDP. Doesn't your latest budget estimate under a current policy baseline show that revenues go back to their historic norm of 18 percent of GDP in 2014?

Dr. ELMENDORF. Yes. That is right, Congressman. They are a little over 15 percent today, and the improvement in the economy and other underlying factors in the tax code we think will push that up to a little over 18 percent under current policy.

Co-Chair HENSARLING. Your alternative fiscal scenario, which is a current policy baseline, also shows spending going from a historic average of roughly 20.5 percent up to 34 percent of GDP. Is that correct?

Dr. ELMENDORF. That sounds about right, Congressman.

Co-Chair HENSARLING. So is it fair to say that with respect to revenues, one is episodic related to the lack of economic recovery, the other is structural. Is that a fair assessment?

Dr. ELMENDORF. Yes. Both factors are at work right now, Congressman, and——

Co-Chair HENSARLING. Let me continue on there. Those who have advocated or have brought up that historically when the budget has been balanced, taxes have gone beyond their historic norm of roughly 18 percent of GDP to closer to 20 percent of GDP. And again, this is your alternative fiscal scenario shows that spending by 2035 goes up to 33.9 percent, and the same alternative fiscal scenario shows that taxes already on a path to increase from 18 percent of GDP to 18.4.

So following the analysis of those who advocate that in order to achieve a balanced budget that revenues have to come up from what you say they are already rising, from 18.4 to, say, 20 percent

of GDP, wouldn't the analysis also suggest under a balanced approach that spending has to decrease essentially 14 percentage points under your alternative fiscal scenario to reach its historic norm?

Dr. ELMENDORF. So, Congressman, I would rather not parse the meaning of the word "balance," given its role, apparent role in your discussions. But you are right that if revenues were at 20 percent of GDP, then balancing the budget, given the assumptions, it would require a reduction in spending.

Co-Chair HENSARLING. Thank you.

Chairman MURRAY. Representative Becerra?

Representative BECERRA. Dr. Elmendorf, I think I am going to start calling you "Sergeant Friday." You are here essentially giving us at least your best interpretation of the facts, and we appreciate that because you are not trying to give us opinion. You are not telling us whether in 5 years or 10 years we should reduce the benefits we give to seniors under Medicare or make a change to our defense and security needs.

You are simply telling us what the numbers show and leaving it to us as policymakers to come up with a good mix. And I appreciate that. I suspect your mother or father or your grandmother or grandfather are probably also pleased that you are just talking numbers and not saying what should be done to them with regard to Medicare or Social Security or anything else.

One quick point, with regard to the discussion of our long-term costs, you mentioned Medicare and Social Security and Medicaid. Medicare and Medicaid, because they deal with healthcare and healthcare costs, are in a different boat than Social Security, are they not, in terms of their long-term costs?

Dr. ELMENDORF. Yes. That is right. The increases in spending for those programs that we project under current law are a lot greater over time than for Social Security.

Representative BECERRA. And indeed, Social Security, by about 2028, 2030, starts to stabilize and stays pretty constant in terms of its cost to the Federal Government into the outyears, right?

Dr. ELMENDORF. Yes. Roughly so. After the baby boom generation has primarily retired, that line roughly levels out.

Representative BECERRA. And because you are dealing with facts, you are not here to tell us about how to make that fix to healthcare because the reality is that Medicare and Medicaid are simply reimbursement or financing systems. If we were to just cut benefits for a senior, that doesn't necessarily mean that their healthcare cost will drop. That shifts the cost more into the pocket of the senior to pay for that care if Medicare just reduces what it reimburses?

Dr. ELMENDORF. I think it depends on the policy, of course. But there are some policies that shift cost, and there may be some policies that reduce overall costs.

Representative BECERRA. Thanks, Sergeant Friday. Appreciate it.

Dr. ELMENDORF. Thank you, Congressman.

Chairman MURRAY. Senator Kyl?

Senator KYL. Thank you, Dr. Elmendorf.

Just one question in the interest of time here. While I know you agreed with Senator Toomey's observation that there is another point of view or other points of view, regarding your argument that

cuts in spending now can harm economic growth or delay economic recovery, that is true of defense spending as much as other spending. Is that not correct?

Dr. ELMENDORF. It is true of potentially all types of spending. There may be differences across types, but I think that is a more subtle distinction.

Senator KYL. Yes. And here, with defense, for example, you have high unemployment of returning veterans to begin with. You have the reduction in end strength. You have more people potentially unemployed. You have people making radios and building ships and so on. And if those cuts, therefore, end up reducing the employment in those industries and the amount of money spent in those areas, obviously, it could delay economic recovery.

Dr. ELMENDORF. Yes. That is right, Senator.

Senator KYL. Thank you.

Chairman MURRAY. Senator Baucus?

Senator BAUCUS. Thank you, Madam Chairman.

I wondered, Dr. Elmendorf, if you could just again, we discussed a little bit of it already, what changes either let's say in tax policy will stimulate the economy most, if you could rank them somehow?

Dr. ELMENDORF. Well, as it turns out, in the table which you are looking, Senator, from our January 2010 report, we did consider the effects of a set of alternative tax cuts. We have not updated this table since that point. If we did, I think the numbers would be slightly different, but probably not fundamentally different.

Reductions in payroll taxes that we studied here were among the more powerful levers, followed by expensing of investment costs, and then followed below that by a little bit by broader reductions in income taxes. And the reason for that difference is principally that the money that is saved by employers or employees in payroll taxes we think translates into a fairly comparatively large amount of incremental spending. And also in the case of a cut to what employers pay amounts to at least a temporary discount on the cost of hiring workers.

Senator BAUCUS. Let me change subjects. If we have a revenue-neutral tax reform, corporate or individual, and the tax reform, let's say, on the individual side is dramatic, broaden the base, lowering the rate, et cetera, how much growth would result from a very simplified tax code along those lines?

Dr. ELMENDORF. A tax code with a broader base and lower rates would spur economic growth, but the magnitude is something we would have to take specific proposals from you back to our models and work hard on them for a while before we could hazard any sort of quantitative estimate.

Senator BAUCUS. Okay. Thank you.

Dr. ELMENDORF. Thank you, Senator.

Chairman MURRAY. Representative Upton?

Representative UPTON. Thank you.

I am concerned about the impact of the Affordable Care Act on job creation. Can you provide us a detailed explanation of the methodology used to calculate how many employers will actually drop their healthcare coverage for their employees?

Dr. ELMENDORF. I can provide a brief summary in the next minute and three-quarters, Congressman. We have a model of

health insurance coverage in which employees and employers are trying to obtain coverage at low cost, but also giving weight to the quality of the coverage they receive.

In our analysis, the Affordable Care Act encourages some employers to provide insurance coverage who would not have otherwise because of the mandate for insurance coverage and some of the subsidies. On the other hand, it encourages other employers who would have offered coverage not to offer any more. And we think that latter effect outweighs the former, and we have a small reduction in employer-sponsored insurance coverage.

Our estimates are very consistent with the estimates of other people, with large-scale models like those at the Urban Institute. Obviously, there is a tremendous amount of uncertainty around those estimates, and there have been some surveys that have suggested there would be more employer dropping.

At this point, based on the things that we have seen since we did those estimates, we are comfortable those estimates make sense. But it is an issue where we have been asked to explore the sensitivity of the budgetary effects to alternative outcomes in terms of employer-sponsored insurance coverage, and we are working on those estimates now.

Representative UPTON. Could you actually provide us maybe a dial-up? I don't know what your percentage is. I thought it was like as low as 5 percent or less?

Dr. ELMENDORF. It is a small percentage. I am not exactly sure.

Representative UPTON. Yes. And I wonder if you could provide us an estimate, if it was maybe 10 or 20 percent?

Dr. ELMENDORF. So the challenge we have is that it matters a lot for budgetary cost who ends up with and without employer-sponsored health insurance coverage. So we can't really do just a scaling up in that sense. We have to understand in the model, and there are ways to change the assumptions in the model to give different answers. But we need to do that because that will affect the budgetary cost.

It is also not obvious that the budgetary cost is as large as it may seem at first. If people are not getting employer-sponsored coverage and move to the exchanges, they will pay—the Government will pay more for their coverage. On the other hand, the employers will have extra money that they were previously using to buy health insurance with. Most economists think that money will turn up as wages for workers. They will pay taxes on that.

If it doesn't, it will turn up as additional corporate profits, and they will pay tax on that. So the overall budgetary effects will depend on the combination of changes in exchange subsidies, in Medicaid costs, and in tax receipts. But we are working on that, Congressman.

Representative UPTON. Thank you.

Chairman MURRAY. Thank you.

Representative Clyburn?

Representative CLYBURN. Thank you, Madam Chair.

Dr. Elmendorf, let me look at revenue from a different perspective here. Is it fair to say that the decrease—or the increase in unemployment has decreased revenue going into the Federal coffers?

Dr. ELMENDORF. Yes. That is right, Congressman.

Representative CLYBURN. If we had a decrease in unemployment of just, say, 0.5 percent—from 9.1 to 8.6—what would be the level of revenue increase?

Dr. ELMENDORF. I can't do that in my head, Congressman. It would help, but I don't know. And it would help partly because we would pay less unemployment insurance benefits and partly because of people who are earning money would pay taxes on those earnings.

Representative CLYBURN. So it is a double whammy.

Dr. ELMENDORF. Both sides of the budget would be affected.

Representative CLYBURN. I would like to see some computer printout.

Dr. ELMENDORF. I will task my computer with that assignment, Congressman.

Representative CLYBURN. I appreciate it. Thank you.

Chairman MURRAY. Senator Portman?

Senator PORTMAN. I think Congressman Clyburn has just made a great point, which is the economy plays such a huge role here. And since this is a hearing about the history of how we got here, I have gone back and looked at your May 12, 2011, report, which talked about earlier 32 percent of the difference between a $5.6 trillion surplus projected and the $6.2 trillion deficit, which is an $11.8 trillion swing, 32 percent of that is because of the economy.

And about 33 percent of it is new spending. About a third of that spending is for global war on terror—Iraq, Afghanistan, and other spending on the war on terror. It is about 39 percent is due to new spending when you add the 6 percent that is the stimulus.

Fifteen percent is the Bush tax cut. By the way, over 70 percent of that went to those making less than $250,000 a year. And then the rest is interest and the AMT and the rebates in 2008.

So I think it is a great point that the economy is going to drive so much of this. And we talked about this earlier, but you said that you thought that increasing taxes at this point would have a negative impact, just as you thought that certain spending cuts would have a negative impact on economic growth and jobs.

But then, in response to Senator Baucus, you said that some tax reform, particularly lowering the rates, broadening the base, would have a positive economic impact. Can you briefly speak to that as it relates to the corporate tax code and the possibility also of lowering the rate to make the U.S. more competitive?

Dr. ELMENDORF. So I think that in terms of both the individual income tax and the corporate income tax, economists widely agree that lower tax rates and broader base would be good for the economy both because the lower rates would reduce the disincentive to worker to save and also because broadening the base itself can, if done in certain ways, reduce the incentives for misallocating capital resources.

Again, to actually estimate the effects on the economy, we or our colleagues at the staff of the Joint Committee on Taxation would need to have specific proposals and would need to spend some time trying to model those. It is a very complicated business, as you know, Senator.

Senator PORTMAN. How long would it take you?

Dr. ELMENDORF. I will not commit to that. Offhand, if we have proposals from you, we will work on them as fast as we possibly can. I will certainly promise you that.

Senator PORTMAN. And prioritize them, right?

Dr. ELMENDORF. We are giving very high priority to the work of this committee, Senator.

Senator PORTMAN. Thank you, Madam Chair.

Chairman MURRAY. Senator Kerry?

Senator KERRY. There is a big distinction, is there not, almost obvious, Dr. Elmendorf, if 98 percent of America was getting a tax cut and 2 percent, who happen to be the wealthiest people whose decisions are very different and whose impact on the economy is very different, there is a big difference in that versus sort of a blanket discussion of all of the tax cut versus none. Correct?

Dr. ELMENDORF. In terms of the economic effects, yes, Senator.

Senator KERRY. Yes.

Dr. ELMENDORF. We think that is right.

Senator KERRY. And I think that is part of the modeling that needs to be done here because I think that distinction will be very telling in a lot of ways.

What I want to ask is I think it would be helpful to all of us on the committee, I have great respect for the Rogoff-Reinhart analysis. In fact, I suggested we might get them in here, and I think it is an important one. But, and here is the "but," and I would like you to draw the distinction for us.

Your analyses and much of our discussion centers around the public debt. The public debt is 62 percent, I believe, of GDP. But we have had a number of references here to the gross debt, which obviously includes all of the trust funds and so forth, where there is a very different impact because of the full faith and credit of the United States and printing and so forth.

Help us understand how that distinction might play out in our deliberations, particularly with respect to the impact on interest rates. I think the public debt has far more impact on interest rates than on the economic judgments, does it not? So maybe you can just educate us a little bit on that distinction between them.

Dr. ELMENDORF. Yes, Senator. So CBO focuses on debt held by the public because we think that is a better measure of the impact of Federal borrowing on financial markets today than gross debt. Of course, any snapshot of what the Government owes at a point in time will be very incomplete without looking at where the fiscal trajectory is going, and that is why we always combine our reporting on current levels of debt held by the public with projections of revenues and spending. And certainly, financial markets are very attentive not just to the current amount of debt, but also to the amount of debt they would expect the Government to be trying to get them to buy in years ahead.

But our view is that debt held by the public, together with these projections for the future, offers you and your colleagues a fairly complete, by no means perfect, but a fairly complete picture of the Federal budget situation.

Gross debt, which, as you said, includes money, includes bonds held by various Government trust funds, we think does not really measure the amount of—does not measure the amount of debt that

the private financial system has been asked to absorb today, nor is it a very good measure of what will happen in the future because for some programs, the amount of debt held in those trust funds is a lot less than the amount that they will need to pay benefits under current law. In other cases, the amount of debt held in the trust funds doesn't actually correspond to future spending. So we just don't think that is the most useful measure.

Now in the work that Carmen Reinhart and Ken Rogoff did, they viewed that as the best available measure for the set of countries over the period of time that they have done this analysis for. And I don't want to put words in their mouth, but we have discussed this issue with Carmen.

And, but I think in our case, because we do these very elaborate projections on a very detailed level of the budget, that combining those projections with debt held by the public gives you and your colleagues the best sense of where this country stands today.

Senator KERRY. Thank you.

Chairman MURRAY. And Representative Camp?

Representative CAMP. Thank you very much.

I just wanted to point out that as part of the fiscal commission, I researched how often Federal revenues exceeded 20 percent of GDP in the history of our country, and we found they have only done it three times since—in the history of our country—in 1944, in 1945, and 2000.

And in 2000, they were 20.6 percent of GDP revenues, and that was really largely due to the threefold increase in capital gains from $40 billion in 1999 to $12 billion—or $121 billion in 2000. So that was what drove that.

Is that and——

Dr. ELMENDORF. I think that is right, Congressman.

Representative CAMP. Thank you.

And in the 11 fiscal years since 1940, we have had surplus revenues for 4 of those years between 19 and 20 percent, and for 7 of those years, they were less than 19 percent of GDP.

So I have a letter that outlines all of this that I would like to submit for the record. And I just think it is important to point out that, again, during the 12 years in which the budget was in surplus, outlays never exceeded 19.4 percent of GDP, and I think it is important to keep those revenue levels in historical perspective.

Chairman MURRAY. Representative Van Hollen?

Representative VAN HOLLEN. Thank you, Madam Chairman.

I would again point out that the last time Federal spending was around 18 percent of GDP or lower was about 1967. We made a decision in this country to provide for health security for seniors. So we have really got to look at that period of time since then if we want to continue that commitment, including what years the budget was in balance, which was in 2000–2001 period.

Look, Dr. Elmendorf, I think you have made a very good point in your testimony. I know you are not making recommendations, but I think your testimony was clear that you can't address the deficit challenge without modernizing the health security programs, unless you have large increases in taxes above even current law. But unless you change current tax policy, you can't address the deficit situation without deep cuts in health security programs.

Now I just want to have a quick question. You mentioned that there are some tax policies that generate more economic activity, some that generate less. You mentioned the payroll tax holiday is one that generated relatively more than some of the others because more money in people's pockets.

Isn't it also true that with respect to spending programs, there are some that generate more activity than others in the economy and that investments in the area of infrastructure and education provide for economic growth? Isn't that also the case?

Dr. ELMENDORF. Yes. But just give me one moment to say that I want to be careful about the pieces of the budget. There are revenues. There is Social Security and the major healthcare programs on my chart, and there is the rest of the budget. And I don't think you disagree with this, Congressman.

But the thing that is not possible to do is to maintain Social Security and the major healthcare programs in their current state and maintain the rest of the Federal Government at the same share relative to the size of the economy it has been in the past and maintain revenues at their historical average share of GDP.

Representative VAN HOLLEN. Right.

Dr. ELMENDORF. One needs to move at least one. One could also choose to move any two or three of those as you choose. What is not possible, as a matter of arithmetic, given the aging of population and rising healthcare costs, is to have all three of those pieces look like they looked historically.

And different policies on the spending side do have different effects in economic growth, and they do at different horizons. So some policies might be more effective this year or next. Others might be more effective over longer periods of time, and we can try to provide that sort of information to you and others if you are interested in that.

Representative VAN HOLLEN. I appreciate that, Dr. Elmendorf. I am just making the point that both tax policies, as well as investment, spending policies, both can have positive economic impact. Is that right?

Dr. ELMENDORF. Yes. That is right.

Representative VAN HOLLEN. Thank you.

Chairman MURRAY. Senator Toomey?

Senator TOOMEY. Thanks, Madam Chairman.

Dr. Elmendorf, one of the challenges that we face is how we can address these challenges in a credible way, right? How, for instance, willing will future Congresses be to abide by spending caps or other kinds of reductions or disciplines that we might try to impose? And of course, we cannot tie the hands of future Congresses.

So I wonder if you might reflect on ways that we could maximize the chances that future—that spending restraints that we would hope to achieve would, in fact, come to pass, whether that would be through strengthening existing budget enforcement mechanisms, creating new ones, or other ways that we might do that.

Dr. ELMENDORF. I think, Senator, the most effective way to ensure that changes you discuss today actually become—take effect later is to enact those changes into law today. Enforcement procedures are only a backstop. Ultimately, the Congress will need to

enact changes in the legislation governing certain programs or provisions to the tax code if it wants to make those changes.

And if specific changes are enacted into law this year, then I think there is a much greater chance that they will take effect when the time comes than if what is enacted into law this year is simply a set of objectives for total amounts of spending or total amounts of taxes or other sorts of benchmarks.

Senator TOOMEY. So structural reforms in a program are likely to have more enduring results than long-term caps designated. Would you agree with that?

Dr. ELMENDORF. Yes, I think that is right. And I think we have seen that historically. The original Gramm-Rudman legislation, Gramm-Rudman-Hollings, was cast aside because the overall target that it set for the deficit proved to be impossible to meet. Whereas the provisions of the early 1990s, the PAYGO provisions that tried to make it more difficult for the Congress to make deficits worse, seem, to most observers, to have been at least somewhat effective during the period when the Congress was very concerned about budget deficits.

So I think it is the important aspect of this for both the long-term effects and also for the shorter-term effects in terms of people believing the deficits will be smaller in the future comes from specificity in putting provisions into law today, even if they are timed to take effect, for various different reasons, at different points in the future.

Senator TOOMEY. Thank you.

Chairman MURRAY. Thank you very much.

I want to thank all of our committee members for being so accommodating. Dr. Elmendorf, certainly, for your input and your staff's input for today as well.

I want to remind all of our members that they have 3 business days to submit questions for the record, and I hope that the witness can respond quickly to that.

Dr. ELMENDORF. Yes, we will.

Chairman MURRAY. Great. Thank you.

And members should submit their questions by the close of business on Friday, September 16th.

[The information follows:]

Chairman MURRAY. Without objection, the joint committee stands now adjourned.

[Whereupon, at 1:10 p.m., the committee was adjourned.]

OVERVIEW: REVENUE OPTIONS AND REFORMING THE TAX CODE

THURSDAY, SEPTEMBER 22, 2011

UNITED STATES CONGRESS,
JOINT SELECT COMMITTEE
ON DEFICIT REDUCTION,
Washington, DC.

The committee met, pursuant to call, at 10:08 a.m., in Room 2123, Rayburn House Office Building, Hon. Jeb Hensarling [co-chairman of the joint committee] presiding.

Present: Representatives Hensarling, Becerra, Camp, Clyburn, Upton, and Van Hollen.

Senators Murray, Baucus, Kerry, Kyl, Portman, and Toomey.

Chairman HENSARLING. The committee will come to order.

One of the preliminary announcements, the chair wishes to again remind our guests that any manifestation of approval or disapproval, including the use of signs or placards, is a violation of the rules which govern this committee; and the chair wishes to thank our guests in advance for their cooperation and compliance.

Today's hearing of the Joint Select Committee on Deficit Reduction is entitled Revenue Options and Reforming the Tax Code. We want to welcome our witness, Dr. Tom Barthold, the Chief of Staff for the Joint Committee on Taxation.

Dr. Barthold, thank you for your time. Thank you for your service. We look forward to your testimony. I suppose, more precisely, testimonies.

We may have set a Congressional first today with two panels and one witness. We will have our first testimony by our witness on business tax reform. There will be a round of questions by our members. Then we will have a second testimony by our witness on individual tax reform.

Members of the joint committee have agreed to limit opening statements to those of the two co-chairs. So at this time I will recognize myself for an opening statement.

OPENING STATEMENT OF HON. JEB HENSARLING, A U.S. REPRESENTATIVE FROM TEXAS, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Chairman HENSARLING. In last week's testimony regarding the drivers of our structural debt, we heard Congressional Budget Office Director Doug Elmendorf say that, although government revenues are certainly temporarily down, he expects them to again reach their historic norm of a little over 18 percent of GDP in short order. However, he reminded us that spending is due to explode to

over 34 percent of GDP in the years to come, that principally driven by entitlement spending programs, some of which are growing at two, three, and four times the expected rate of growth of our economy.

As I have maintained since the first meeting of the Joint Select Committee, there are many actions that this committee can take that would be helpful in addressing our structural debt crisis. However, we simply cannot and will not succeed unless our primary focus is about saving and reforming social safety net programs that are not only beginning to fail, many of their beneficiaries but simultaneously going broke. If we fail to do this and choose to solely or primarily address our debt crisis by increasing the Nation's tax burden, I fear the consequences.

Former CBO Director Rudy Penner, in testimony before the Simpson-Bowles Commission, of which a number of us serve, stated, "the U.S. total tax burden, which is considerably below the OECD average, would be higher than today's OECD average by mid-century; and within a few years after that we would be the highest taxed nation on Earth."

Also appearing before Simpson-Bowles was former CBO Director and current Social Security and Medicare trustee Robert Reischauer, who stated, "the longer we delay, the greater risk of catastrophic economic consequences. The magnitude of the required adjustments is so large that raising taxes on the richer corporations, closing tax loopholes, eliminating wasteful or low-priority programs and prohibiting earmarks simply won't be enough."

Finally, when he served as CBO Director, Dr. Peter Orszag, in a letter to Budget Committee Chairman Paul Ryan, stated, "the tax rate for the lowest tax bracket would have to be increased from 10 percent to 25 percent. The tax rate on incomes in the current 25 percent bracket would have to be increased to 63 percent. And the tax rate of the highest bracket would have to be raised from 35 percent to 88 percent. The top corporate income tax rate would also increase from 35 percent to 88 percent."

So the ability, wisdom, and consequences of addressing our debt crisis through tax increases will continue to constitute a rigorous debate by our committee. My hope, though, is that we may be able to achieve rigorous agreement that fundamental tax reform, even just limited to American businesses, can result in both revenue from economic growth for the Federal Government and more jobs for the American people. Seemingly, both the President of the United States and the Speaker of the House agree.

Most Americans agree that there is something fundamentally wrong with our Tax Code when a small business in east Texas pays 35 percent and a large Fortune 500 company pays little or nothing. There is also something fundamentally wrong with our Tax Code when an American company pays 35 percent and its chief European competitor only pays 25 percent. We should seize the opportunity and correct this for the sake of both bringing in more revenues for economic growth and addressing our jobs crisis at the same time.

At this time, I will recognize my co-chair, Senator Patty Murray, for her opening statement.

[The prepared statement of Chairman Hensarling appears in the appendix.]

OPENING STATEMENT OF HON. PATTY MURRAY, A U.S. SENATOR FROM WASHINGTON, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Co-Chair MURRAY. Well, thank you very much, Co-Chairman Hensarling; and I want to thank our witness, Thomas Barthold, for taking the time to be here today, as well as all of our colleagues and the members of the public and the audience that are watching on television.

We all know the American people are looking at this committee with great optimism but also with real skepticism. They have heard the partisan rhetoric that has dominated our Nation's capital recently; and, quite frankly, they are tired of it. When it comes to this committee and its work, they don't care how it impacts one party's fortune versus the other. They don't care how it impacts one special interest versus another. Their only question to us is how will it impact their life. They want to know if we can help their spouse or family member or neighbor get back to work. They want to know if we can make a real dent in the deficit so their children are able to compete and succeed and can it be done in time for families that are losing faith with each passing day.

Answering those questions is going to take honesty from every member of this committee, honesty with one another and honesty with the American people about what it is going to take. It is going to mean looking at every part of our budget and realizing that there is spending that has grown too fast, job investments that still need to be made, entitlements that are expanding too quickly, and a Tax Code that has become riddled with corporate giveaways and special interest carve-outs for the richest Americans. But more than anything else it is going to take the shared realization that solving our deficit crisis and putting Americans back to work will mean taking a truly balanced approach.

Now, to this point, in Congress we have begun the process of addressing spending. In fact, the Budget Control Act that established this committee cut more than $1 trillion from our National deficit, and that was on top of caps to appropriations bills that had already been put in place.

But as the overwhelming majority of American families and economists and every serious bipartisan commission that has examined this issue has agreed spending cuts alone are not going to put Americans back to work or put our budget back in balance. We have to address both spending and revenue.

So I am looking forward to hearing from Mr. Barthold about the tax reforms and revenue this committee can explore. I am interested in hearing about the loopholes and tax expenditures my colleagues on both sides of the aisle have agreed are too often wasteful and market distorting but are options for broadening the base and lowering the rate, boosting the economy and bringing in additional revenue and about keeping our Tax Code truly progressive.

Revenue and the Tax Code is just one side of the ledger, but it is an important one, and it needs to be part of a balanced and bipartisan plan we owe it to Americans to come together on this com-

mittee and pass. I am pleased this committee has begun the hard work of negotiations over the last few weeks, and I am hopeful that we can come together and deliver the results that Americans deserve: a balanced plan that helps get our economy back on track, gives businesses the stability to hire again, and ensures that middle-class families and the most vulnerable are not bearing the burden of balancing our budget alone.

Thank you very much.

[The prepared statement of Co-Chair Murray appears in the appendix.]

Chairman HENSARLING. I thank my co-chair; and at this time, Dr. Barthold, I wish to yield to you for your testimony on business tax reform. You are recognized.

STATEMENT OF THOMAS A. BARTHOLD, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. BARTHOLD. Thank you, Mr. Hensarling, Ms. Murray, and members of the Joint Select Committee. I thought I would use the time on this first panel to try and give you a very brief overview of the Federal tax system with an emphasis on business taxation under our system. My submitted testimony provides substantially more detail than, of course, I will be able to go into here.

I am going to concentrate on just a packet of slides that has been placed at each of your chairs.

If you turn to the first page of that, Figure 1 really just tells you that the Federal revenue system in the United States is comprised of five tax sources, of which the individual income tax is the largest, the payroll taxes are the second, corporate income tax is the third largest component, followed by a series of excise taxes and the estate and gift tax.

Figure 2 then documents for you that in fact this has been the case. This has been the basic structure of the U.S. tax system for many, many, many, many years. The one broad trend that you will see in Figure 2 is that employment taxes have grown in importance largely with the expansion of the Social Security system through—over the decades and Medicare, and the importance of the corporate income tax has declined since the post-World War II era.

Figure 3 really just documents I think a point that Co-Chairman Hensarling made that Doug Elmendorf presented to you a week ago, and this is sort of the history of Federal receipts as a percentage of the economy.

Looking over the next decade, there is some significant changes in the tax system scheduled to occur with the expiration of many current tax provisions after 2011 and then again after the close of 2012; and Figure 4 shows you projected revenues by source, the increasing revenues from the individual income tax, the payroll tax, and the corporate income tax, et cetera, for the debt next decade.

And just to scale that to the economy, Figure 7 provides the same information scaled to GDP.

Now, these prior charts that I have turned through very quickly divided the tax world into an individual income tax and a corporate income tax. But I think it is important for us to recognize that many business enterprises in the United States are not C-corporations, and so that means they are not subject to the corporate in-

come tax. And in fact a significant amount of business income is taxed directly to the individual return.

And so what Figure 6 shows you is just the number of business entity types and how it has changed over the past 40 years or so, with Figure 7 providing particular detail on the growth of S-corporations and partnerships in comparison to C-corporations over the past 30 some years. As you can see in Figure 7, these pass-through entities, these alternative business forms, this includes State-chartered LLCs with which I know many of you are aware from your constituents, have become increasingly important in terms of the number of business entities.

But it is not just number of entities, of course, when we look at the tax system. It is the amount of revenue. And Figure 8 gives you a very quick look at the growth of net income reported by these entities and reported by C-corporations, again over the last 30 years. What this chart shows is the relative growth of non-C-corporate business income as a percentage of GDP.

The same information is really sort of emphasized in the projections that we are making for the coming decade. When you look at Figure 9, we project that the sum of income reported to sole proprietorships, to S-corporations and partnerships and other pass-through business forms will grow by 80 percent over the coming decade, comprising a larger and larger share of taxpayers' adjusted gross income.

Now, that said, it is also important to have a very good—I guess it will be very brief in this case—overview of how we tax business income in the United States. And the rules for taxing business income, whether it be through an S-corporation or a C-corporation, are really essentially the same. We look at the gross income of the enterprise less allowable deductions.

Allowable deductions include all ordinary and necessary business expenses such as salaries and wages, the fringe benefits for such things as retirement and health and other fringe benefits that employers provide employees, the cost of raw materials, advertising expenses, and an important expense for many business enterprises is the deduction for interest expense for borrowed capital. It is probably important to note in this case that interest expense is deductible to businesses, but dividend payments, another form in which capital invested is rewarded, is not deductible.

We provide rules for cost recovery for long-lived assets, referred to as the modified accelerated capital recost system makers. In other words, it accounts for the depreciation, the economic loss in value from long-lived assets.

Now, in addition, currently, there is a special deduction related to domestic production activities. This has the effect of lowering the effective tax rate on qualifying activities. Taxes on business income apply to the U.S. taxpayer's worldwide income wherever it is earned, but certain active income earned abroad may have its tax deferred until the income earned abroad is repatriated to the United States.

Currently, the top rate of tax for C-corporations, which applies to almost all large corporations, so just about any corporate name you can think of, the statutory rate is 35 percent. There are smaller—there are lower tax rates for smaller levels of income.

If you turn to Figure 12 in the packet before you it shows you a brief history of corporate income tax rates, and so you can see the 35 percent rate. The number inside the little bubble tells you the income level at which that rate becomes applicable, and so you can see both the bracket level as well as the rate and how that has changed since the mid-1970s.

Now, the co-chairman asked me to take a couple of moments and introduce the concept of tax expenditures and how they might be important, both in the context of business income and the individual income tax. The detailed presentation provides a large list and shows you some of the evolution of tax expenditures through time. Just to be clear, the notion of a tax expenditure is relative to sort of a theoretically pure income tax, what might be considered a special exclusion, a special rate, a special credit, or a special deduction.

And Table 5, the next page in your packet, shows you the largest tax expenditures as calculated by my staff colleagues for corporations encompassing the period 2010. We are projecting over 2010 to 2014, and you can see the 10 largest tax expenditure items are an estimate of those items.

One point I would like to note is that, although this list, this top 10 list, when you look in the detailed presentation, has changed over time, two items have been in the list of top 10 expenditures every time we have done the analysis since 1975, and that is some form of accelerated depreciation and the exclusion of interest on general purpose State and local debt held by business entities.

It has also been the case that the reduced rates for smaller levels of corporate income have been a feature of our tax expenditure analysis and our corporate tax system every year since the early 1980s. And generally also since the early 1980s one of the largest tax expenditures has always been either a deduction or a tax credit or you can take the sum of the two for research expenses.

I think at this point I have probably given you a very, very quick and rough overview, but it is probably time for me to turn it over to the committee so that you can ask specific questions, and I would be happy to answer any question.

Thank you very much.

[The prepared statement of Mr. Barthold appears in the appendix.]

Chairman HENSARLING. Thank you, Dr. Barthold, and we look forward to your second testimony as well.

The co-chair will yield to himself for the first round of questions.

On your Figure 3, Federal receipts as a percentage of GDP—as I understand it we, unfortunately, do not have these slides for our monitors—but what I appear to see is a chart that tells me that essentially since World War II that our Federal receipts as a percentage of GDP have been somewhere between 15 and 20 percent; and, as I understand it, the average is about 18, 18½ of GDP in the post-war era?

Mr. BARTHOLD. That is correct. Since 1950, the average is actually 17.9 percent; and since 1971 the average has been 18 percent. So it has been——

Chairman HENSARLING. Okay. So roughly 18 percent, and it has operated within a fairly, I guess, relatively speaking, narrow band.

It is also my understanding that during this same time period that we have seen marginal rates go as low as 28 percent and as high as perhaps 90 percent perhaps in the late 1950s, early 1960s, is that correct?

Mr. BARTHOLD. You are referring to the rates of the—the top rate.

Chairman HENSARLING. The top marginal bracket in the income.

Mr. BARTHOLD. And I actually have a—I think I have a nice picture of that for the second panel. But, yes, sir, you are correct.

Coming out of World War II and then during the Korean War, the top marginal Federal tax rate on the individual income tax—and this applied to ordinary income. There was a special treatment of income from the sale of capital assets—but was as high as 90 percent. It was then reduced to 70 percent in the Kennedy round of tax cuts in the early 1960s. The marginal tax rate individual income then was reduced further. In the mid-1970s, we made a split between earned and unearned income, with the top rate on unearned income remaining at 70 percent and on earned income dropping to 50 percent.

Chairman HENSARLING. Dr. Barthold, if I could—and I didn't see a chart here—but would the same correlation prove roughly true for corporate tax receipts?

Mr. BARTHOLD. We did have—one of the figures, Figure 2, sir, showed the Federal tax receipts as a share of total receipts.

Chairman HENSARLING. But not as a share of GDP.

Mr. BARTHOLD. I have a supplemental table.

Chairman HENSARLING. But to some extent does this not suggest that there are limits to the amount of revenue that are going to be gained by increases in marginal brackets if they have ranged from anywhere on the personal level from 28 to 90 percent. We still see roughly that revenues appear to be falling within this particular band. And so that was my question. And at some time I would like to see, if we could, that correlation of the corporate to GDP.

It is my understanding that—from data from the Joint Committee on Taxation—that roughly 50 percent of small business profits are taxed at the top two individual rates, is that correct?

Mr. BARTHOLD. I believe we have published that number, sir, yes.

Chairman HENSARLING. Okay. And one of your charts also shows that there has been a large increase, I believe, in—I am trying to find the chart—in the number of non-C-corp entities. I guess it is your Figure 6, perhaps.

Mr. BARTHOLD. Yes. In the packet before you, Figure 7——

Chairman HENSARLING. Oh, I am sorry. It is Figure 7. So certainly since the late 1970s there has been a huge increase in essentially what are known as pass-through entities?

Mr. BARTHOLD. That is correct, sir.

Chairman HENSARLING. So is it fair to say then that increases in the top two individual tax rates could impact—again, by your testimony—50 percent of small business profits—I don't know how many individual small businesses that is. Your Figure 7 would suggest that, again, we have a large number of pass-through entities that at least potentially could be impacted by that.

The next question I have really has to do with the pro-growth aspect that could be derived from some kind of fundamental business entity tax reform. I guess also to some extent your Figure 7 would suggest that tax reform in the realm of C-corps alone may prove problematic unless you deal with pass-through entities as well. Is that a fair——

Mr. BARTHOLD. Well, what I was trying to emphasize was that when we think of business income it is not just taxed in the Federal system through the tax on C-corporations, that there is a lot of business income that is reported on individual returns. But the concepts in terms of how we measure that income, the depreciation schedules, the treatment of research expenses, advertising expenses, are the same regardless of the entity cut.

Chairman HENSARLING. My time is about to wind down. I want to try to get in one more question.

I am curious about the type of model that JCT would use and what type of academic studies that have been researched regarding the potential pro-growth aspects of fundamental business entity tax reform.

I have seen a lot of information come over the transom. There was a 2010 Milken Institute Jobs for America report that concluded that taking our U.S. corporate tax rate to the OECD average of 25 percent could create 2.1 million private-sector jobs by 2019. I have seen a study by the *Journal of Public Economics* from a few years ago that found that a 10 percentage point reduction in U.S. corporate tax rate could boost GDP growth per capita by 1.1 to 1.8 percent per year. Can you give us a little bit more information concerning what model you use and how is it derived? What other studies have you looked at that might suggest to the committee the positive pro-growth aspects of fundamental business entity tax reform?

Mr. BARTHOLD. How long do I have, sir?

Chairman HENSARLING. Unfortunately, my time ran out. We will give you about 30 seconds, and then I will yield to my co-chair.

Mr. BARTHOLD. Well, I will give it very quickly.

We do multiple types of modeling for the members of Congress. The basic modeling that we do is based off of microsimulation models, and it is against the Congressional Budget Office macroeconomic baseline. And when we do that we look at many different changes in behavior in terms of choices that either individuals or businesses make. But for consistency in reporting to Congress and subject to the budget resolutions, we do not include a feedback effect in terms of this legislative package will increase or decrease the growth rate of the economy.

So for the past near decade now under House Rule 13 we have been providing, as part of House Ways and Means Committee reports on tax bills, supplemental information of macroeconomic analysis; and we have three different primary macroeconomic models that we use to emphasize different assumptions and to emphasize different features that people think are important in the macroeconomy. And in that analysis we look at the effect on changes in labor force participation rates, in savings rates, in cross-border capital flows, and changes in investment incentives and how businesses respond——

Chairman HENSARLING. Dr. Barthold, if I could, I am setting a poor example here. So at this time allow me to my co-chair, Senator Murray.

Senator KERRY. Mr. Chairman, I hope we are not being a prisoner of the clock where if any member asks a question—I am here to learn, and I hate to be truncating important data with such rigidity and ask that we allow the witness to answer.

Representative CAMP. Mr. Chairman, I would just say, having chaired committees, if we don't stay on the clock, we will never get through everyone's opportunity to have more than one chance at questioning. So I appreciate what the Senator is saying, but we are going to have to keep this moving. And we can always follow up with Mr. Barthold after. He is a government employee, and we can always talk to him after this hearing.

Chairman HENSARLING. We will have at least two rounds of questioning per member and two panels, so I appreciate that. And, again, I am not setting a particularly good example. And if other members wish to have the witness explore this particular question further they certainly can, but at this time allow me to yield to my co-chair, Senator Murray.

Co-Chair MURRAY. Thank you very much.

And thank you again, Dr. Barthold. I appreciate your testimony.

This hearing is divided into corporate and individual tax sections, but I really wanted to start with the key issue facing millions of Americans today, and that really is jobs.

We have heard a great deal about the negative impact the current economic situation and high unemployment rate has on the economy both in terms of demand for social services but also in reduced tax revenue. We have also heard this committee could have a positive effect on the fiscal situation of this country if we would support pro-growth policies in the short run, even if they result in greater spending, while promoting gradual and real changes to spending and revenues in the medium and the long term.

In terms of taxes, last week CBO Director Elmendorf testified that CBO had considered various tax proposals and weighed their effectiveness in stimulating the economy. He mentioned reductions in payroll taxes as among the most powerful, followed by expensing of investment costs for businesses, and then followed below that by just a little bit broader reductions in income taxes.

I wanted to ask you if JCT has performed a similar analysis of any kind and whether or not, if you did, your conclusions match or differ from CBO.

Mr. BARTHOLD. Thank you, Senator.

We have not tried to replicate work that the Congressional Budget Office did, but we have, in a number of different projects for the Ways and Means Committee and other members of the tax-writing committees, looked at some of the effects of payroll tax reductions expensing provisions. And so let me just address the way we approach that, and I think the Congressional Budget Office's approach is similar.

Expensing. Okay, expensing works to essentially reduce the cost of capital, reduce the cost of acquisition of new equipment by businesses. So it increases the after-tax return, makes it more attractive to make those investments. When we do our macroeconomic

analysis, then we show that that leads to an increase in investment.

Now, what becomes important also in that analysis is what is the context of the overall legislative package. Is it just providing expensing relief for expensing of capital equipment for a large number of years? Is it offset in some way?

It is also important to think about how the Fed might react in terms of its policy for trying to moderate inflation. We don't—of course, right now, in the current environment, we don't think of inflation as a real—real problem. So as a general statement, yes, expensing can be a very powerful pro-investment incentive.

You mentioned payroll tax. We have looked at payroll tax. It usually is the effect that it depends are we talking—and this would be true of expensing, also—is it a permanent reduction in the payroll tax or a temporary reduction in the payroll tax? Is it offset in some way? So there is those same general questions.

But then the principle, of course, is that if it reduces the payroll tax and increases the after-tax wage that has two effects. There is a cash flow effect. There is a short-run stimulus in terms of aggregate demand, more money in my pocket. I can potentially spend more, but it also makes it more attractive for me to work longer hours.

Now, me personally, you already have me work fairly long hours, so that wouldn't be a personal effect. But it could mean that my wife might decide to, as she is currently not in the labor force, but maybe she would say, well, there is a better after-tax return to being in the labor force. And so labor supply would increase. And that is pro growth.

But it is important to think in terms of the overall legislative package as well. We can't just say because a package has this in it that automatically you get one result all the time.

Co-Chair MURRAY. Well, let me talk on corporate tax reform. As you well know, the U.S. corporate tax rate is 35 percent at the Federal level, 39 percent when the average State corporate tax is included. The average rate for other industrial countries of OECD is 25 percent, and only Japan has as high a rate.

I think most people do agree that such high tax rates make the United States a less attractive place in which to do business. Our corporate Tax Code also distorts business decisions making. Instead of making and improving their widgets or hiring new people, they spend too much time and effort devising business strategies aimed simply at tax avoidance. I think we know that all of that reduces the number of jobs that are created here at home, where we are all focused, and puts greater strain elsewhere on us in terms of government spending.

Companies in my home State have consistently been telling me that they care less about keeping a particular tax expenditure, even when they benefit from it, than having a predictable system of taxes with lower marginal rates. Right now, they don't necessarily want to game the system to pay a lower rate. They will use every loophole that is available to them, obviously. But they tell me that they would rather focus their efforts on making things and selling products around the world.

So I think we all agree that our corporate Tax Code needs substantial reform, and I think it is important to do both the individual and the corporate side together because a significant number of businesses operating as pass-through entities pay taxes on the individual side. So to ensure the competitiveness of U.S. business it is important, I believe, to coordinate reforms for individual and corporate taxes; and I want to ask you if you agree that there are advantages to doing more comprehensive tax reform, as opposed to just looking at the corporate side.

Mr. BARTHOLD. In terms of business income, Senator, I think that was the point I was trying to emphasize in my brief run-through. It was to note that there are businesses that are organized as C-corporations.

I should note when you look at the supplemental material that I provided, while I have said there are a lot of non-C-corporate businesses in terms of assets, large C-corporations own the vast majority of assets and earn the vast majority of business taxable income.

Now, that said, I have noted that non-C-corporate entities are growing in number, and the income attributable to those entities is growing relative to the overall tax base. Because we define business income the same way, if we are looking—I think we should not look just at corporate reform but business income reform. And it would from a practical point of view, sort of a practical legislative point of view, from sort of the legislative weenie aspect, it would be very difficult to wall off a number of provisions and say we will have one set of rules if you are this type of entity and a potentially very, very different set of rules if you are another type of entity. Because then we would have to double back and have rules to keep people from—to restrict their entity choice, and that would be a bad outcome, to restrict entity choice.

Co-Chair MURRAY. Okay. Thank you very much. My time has expired.

Chairman HENSARLING. The co-chair now recognizes Senator Kyl of Arizona.

Senator KYL. Thank you.

Dr. Barthold, just to follow up on one of Senator Murray's questions with regard to the effect of short-term payroll tax deduction policy, in your studies did you find any evidence that either the payroll reductions—well, just take the most recent, but if you want to go back to the Bush administration, if you can recall that as well—did that have a stimulative effect on the economy and was it responsible for any job creation? Obviously, we had job reductions during that period of time. Did the temporary aspect of it reduce its effectiveness and was the need for people to deleverage such that, rather than spending a lot of that money, they ended up paying off debts or saving the money? Were those possible effects that reduced the effectiveness of that temporary policy?

Mr. BARTHOLD. Senator Kyl, just to be clear, you are talking about the tax rebates under the Bush administration.

Senator KYL. There was a tax rebate under Bush, and then more recently we had a payroll tax one-year policy, which some would like to see extended.

Mr. BARTHOLD. Since we have done some work recently on the payroll tax reduction, let me try and answer your question by addressing that.

As I think I noted to Senator Murray, there is really sort of two aspects to that in terms of macroeconomic analysis. An increase in take-home pay can have a stimulative effect. It increases the taxpayer's cash flow and the consumer can consume more, if it is short—and that is true in the short term. There is mixed empirical results on whether if someone just has a very short-term increase in pay how much is saved as opposed to how much is spent. So there is an effect in terms of the efficacy as opposed to a long-run change, but there still is that short-run demand effect.

Now, a second aspect that we talked about is, well, what is the supply effect, the labor supply response? To a short-run policy you would not expect a dramatic labor supply response, because labor supply decisions tend to be a little bit longer-run decisions. Now, we had used one of our macroeconomic models to analyze a proposal to extend by 1 year a payroll tax reduction comparable to the one that is in present law——

Senator KYL. Could I just interrupt you? Rather than speculating about what might happen in the future if the current policy is extended, what is the evidence of what has happened during the policy that is in effect now?

Mr. BARTHOLD. Well, there is no academic study or solid empirical evidence right now. I mean, there is only sort of casual empiricism, because the data is not available. One problem with economics and analyzing the effects of policies is it sometimes takes 2, 3, 4 years to get the data and do a good analysis. So I don't have a good answer for you in terms of the effect of the policy that is currently in place right now.

Senator KYL. So given that there are some of these other factors, temporary versus permanent, short term versus longer term, and obvious deleveraging that is going on in the country right now, all of those are factors that you would have to put into your analysis about what potentially might happen in the future.

Mr. BARTHOLD. As I had noted, it is important to think of the overall context of the legislative package. You can't just say because it has this one piece in it that you get a guarantee.

Senator KYL. Cause and effect is complicated in the economy.

Mr. BARTHOLD. Well, there is many—a number of the other things that you mentioned will also affect business decisions and potentially employment decisions.

Senator KYL. Could I—we are all going to complain about the fact our time is short.

I think I have got some yes-or-no questions, and I would like to ask you if you could just answer these true or false or yes or no. Let me just ask you about some general economic principles or statements. And these are, as you said, generally speaking, and then you qualified some of the other things that you said, and I totally appreciate that. But, generally, there is a positive relationship between economic growth and jobs, true or false?

Mr. BARTHOLD. Certainly.

Senator KYL. Right. True.

There is a positive relationship between economic growth and resulting revenues to government.

Mr. BARTHOLD. That is also true, sir.

Senator KYL. There is a positive relationship between economic growth and reduced Federal spending on need-based programs.

Mr. BARTHOLD. Well, that will depend—I have got to give you a qualified one there, because it depends on what is happening in terms of where income is being earned.

Senator KYL. Fair enough.

There is a positive relationship between economic growth and deficit reduction.

Mr. BARTHOLD. Well, that will depend on a lot of——

Senator KYL. Again, if we don't go spend all the money, all else being equal.

Mr. BARTHOLD. That would be true, sir.

Senator KYL. Right.

Senator Murray was saying tax policy affects economic growth.

Mr. BARTHOLD. That is what our macroeconomic analysis is trying—it tries to provide members with information about how it might or when it might not.

Senator KYL. It may do it in a lot of different ways.

The official revenue estimates from the Joint Committee on Taxation account for behavioral responses of individuals but not larger economic growth effects. Is that a fair way to state your revenue tables?

Mr. BARTHOLD. That is fair shorthand. We work against the Congressional Budget Office macroeconomic baseline and receipts baseline, and so we do not assume that the large economic aggregates of total income, total investment, employment, and inflation are altered.

Senator KYL. Right. But you also said earlier, I think in response to Representative Hensarling's question, that the Joint Committee on Taxation is capable of providing estimates of growth effects since it provides this analysis to the House. But these growth effects are not incorporated in the official score of a proposal, is that correct?

Mr. BARTHOLD. It certainly is the case they are not part of budget rules and budget scorekeeping. The information that we provide is a range of outcomes that reflect sensitivity to different assumptions. But, yes, we do provide that information to the House under Rule 13.

Senator KYL. Right. Where is our light or timer? So I am over. Sorry. Dadgum, I had a really good closing question.

Chairman HENSARLING. The Senator from Arizona will have another opportunity to ask that question.

At this time, the chair will yield to Congressman Becerra of California.

Representative BECERRA. Thank you, Mr. Chairman.

Mr. Barthold, good to see you again just 24 hours later. We saw you in Ways and Means, and we thank you for that testimony as well.

Let me ask if we can get your Table number—I am sorry—yeah, Table number 5 from your charts. And I would like to talk a little

bit about the tax expenditures, at least those in this chart that apply to corporations.

Expenditures seem to have quite a bit to do with the actual taxes paid by a company. And so while we hear about the corporate tax rate in America being around 35 percent, if you are able to qualify for some of these tax breaks, these tax expenditures, you can reduce what you effectively pay to the Federal Government in taxes so that your actual tax payments will be less than at a 35 percent rate.

And, actually, that is not the chart I am referring to. It is Table, not Figure 5. So if we can go to the—it was your last chart. That is correct. You have that one. Just so we get it correct on the screen. It should be the very last chart I believe you presented.

Mr. BARTHOLD. In the handout that I gave you, it was the last item before part two.

Representative BECERRA. Right. I am not sure if folks can see that clearly.

But I wanted to just move into that a little bit because, quite honestly, through the Tax Code we select winners and losers on the corporate side in terms of income taxes; and I suspect we will see with regard to tax expenditures these same kinds of tax breaks that are on the individual side of the Tax Code that we select winners and losers as well. And if I could ask a question. If we were to remove, for example, the first tax break that you list, a deferral of active income of controlled foreign corporations, $70 billion over a 4- or 5-year period, who would lose?

Mr. BARTHOLD. For the benefit of the committee, the particular tax expenditure line item that Congressman Becerra is referring to, deferral of active income of controlled foreign corporations, relates to the point that I gave in my overall testimony that the United States taxes business income on a worldwide basis. But in the case of active income earned abroad the taxpayer may elect not to repatriate that income, and if the taxpayer so makes that election the tax is deferred until the taxpayer chooses to do that.

So if the Congress were to decide to repeal deferral, just to take shorthand, it would mean that the income would all be taxed at the current statutory rates. Since this is about income that is earned abroad by corporations, we are largely talking about U.S.-headquartered multinational corporations, and so it is the income that is earned on overseas investments and overseas sales by those corporations.

Representative BECERRA. And just going through the list, you have a tax credit for low-income housing. I would assume if we were to remove that tax break the $27 billion that goes to those who take advantage of that tax break probably affects the housing market. And if you were to go to the expensing of research and experimental tax expenditure, where it is $25.5 billion, that it is those companies that do research and experimentation that can claim on their taxes that they did certain research or experimenting activities and therefore get to reduce their tax burden.

So we could decide, based on what we eliminate or leave, who becomes a winner and who becomes a loser. And so we have to be very careful how we do this, because we could influence actions of a lot of important companies that do business here and maybe do

business elsewhere but are American companies. And so how we decide to reform the Tax Code could have a major impact.

Obviously, those are all—the list of those different types of tax breaks list a good chunk of money that we don't collect because we give the tax break to those individual companies that could qualify. So as we talk about making changes we could pick—we could end up selecting the winners and losers.

Let me ask another question in the brief amount of time that I have with regard to tax collection. We know that there is owed tax money that is not collected. In some cases, it is not intentional. People make a mistake on their filing. In some cases we know, and we have had cases where it has been proven, that people intentionally try to avoid paying their fair share of the taxes.

There are estimates about how much we don't collect in taxes that is owed. I don't know if there is any recent estimate, but I know there was one from about 10 years ago that was somewhere around $345 billion or $350 billion. Has there been any update to that estimate of uncollected taxes?

Mr. BARTHOLD. The research division of the Internal Revenue Service runs what they call the National Research Project, and they are working on updating those estimates. But the estimates that you cite of about $350 billion in terms of what is referred to as the tax gap per year I think are the most recent, but they are a couple of—at least a couple of years old, sir.

Representative BECERRA. And with my time expiring I will see if I can explore this a little bit more when we come back and talk again about the individual income tax. So thank you very much for your testimony.

Mr. BARTHOLD. You are welcome, sir.

Chairman HENSARLING. The co-chair now recognizes Congressman Upton of Michigan.

Representative UPTON. Well, thank you, Mr. Chairman.

And thank you, Mr. Barthold, for not only being here with us today but, as I understand it, you will be with us a number of times in the days ahead answering some questions, so I appreciate that flexibility.

We know that the U.S. corporate tax rate is the second highest that there is. And as we look back at the size of the top 20 companies in the world 50 years ago, 17 of them were U.S. based; in 1985, 13 of the top 20 companies were in the U.S.; and, today, it is about six.

The companies that I talk to, particularly in Michigan and before this committee here in Energy and Commerce, one of the things that they talk quite a bit about is certainty in the Tax Code. There is a lot of—and there has been—discussion, working with Chairmen Camp and Baucus as well, to hear their comments from the many hearings that they have had,. But the R&D tax credit, which stops and starts and stops and starts, is a real frustration. Accelerated depreciation has been a bipartisan idea for a long time to encourage investment here in this country and export products overseas.

How would changes in these two, accelerated depreciation and R&D, and maybe moving the dials a little bit in terms of increased deductions or whatever, how would those help us with investment

in jobs in this country? What would you encourage us to do as you have examined the Tax Code? Have you done studies along these lines?

Mr. BARTHOLD. Well, Congressman, let me refer back to the example that Senator Murray raised and you said that Doug Elmendorf broached with you a week ago; and that is, what does expensing do?

Well, expensing is one form of accelerated depreciation. It is kind of like super-accelerated depreciation. Accelerated depreciation methods, again, they go to the cost of capital for business. Even from a sort of simple cash flow method it means that you have more cash available after tax from being able to recover more of your cost sooner. Or if you look at it in what economists refer to as the user cost of capital model looking over the lifetime of the asset, by having costs reduced early over the life of the asset, as opposed to later over the life of the asset, the present value of the returns to the asset are increased, so it makes it a better investment.

So accelerated depreciation is a policy that encourages investment in the United States.

Similarly, you mentioned the research credit and expensing of research activities. From sort of a—from a——

Representative UPTON. But do you have studies showing that if we did X or Y it would allow companies to do more investing here, allowing more people to work and pay taxes, a whole number of positive things for the economy? Is there a laundry list of things that can help us?

Mr. BARTHOLD. The joint committee staff responds to members' legislative initiatives, so we don't have really many formal studies that say do this as opposed to do that.

Now, we have—in some of our macroeconomic work that we have undertaken to provide supplemental information to the Ways and Means Committee, we have looked at the role of expensing, we have looked at the role of reduced corporate tax rates, some of the same points that I made to the Senator earlier.

There are a number of academic studies which we review to help inform our work, both in terms of our conventional estimates and our macroeconomic work, on the impact of incentives for research, on the impact of accelerated depreciation; and most of the economic findings are that there is an effect. There is differences of opinion as to how large the effect is. But the incentives generally are, as the theoretical discussion would suggest, that they are pro-investment, or pro-research in the United States.

Representative UPTON. Do you have any studies that show if we increased the capital gains rate from the current 15 percent, what it would do to capital investment by companies if we raised it to 20 or 25 percent?

Mr. BARTHOLD. Well, again, Congressman, no study per se on point. And you are asking about what would be the macroeconomic effect of that change.

So to walk through, that is tax on capital gains affects the—let's think of it on corporate stock—the shareholders after-tax return to investment. So there is a couple of ways in which the shareholder

gets returns through investment. There is a tax on dividends. There is——

Representative UPTON. But the company itself, if it——

Mr. BARTHOLD. Well, capital gain—remember, the capital gain, of course, relates to the change in the value of the company shares which can occur sort of two primary ways. The company is very profitable, and so its income earning potential increases, and so the value of the stock is, over the longer haul, sort of the discounted value of the potential net income of the company. So if the company is successful and its income goes up, the value of the stock should go up. And a higher tax on capital gains at then the individual level would say the return to me saving and putting my money in equities as opposed to maybe putting my money in the bank or buying debt instruments or some alternative investments makes that after-tax return a little bit less, so I may choose to do other things.

So our macroeconomic analysis tries to look at the more general portfolio effect of what are the different saving options that individuals have; what does this do to the taxation of the overall kind of net return to saving.

Net saving is important in the macroeconomy, because that is really the wherewithal to invest. Those are the funds to invest. And we think that taxpayers do respond to the net return to saving, and if the net return to saving is reduced there will be a little bit less saving. That works through the macroeconomy. It is hard to sort of trace one particular aspect of that saving return, but that would be an important aspect.

Chairman HENSARLING. The time of the gentleman has expired. The co-chair will now recognize Senator Baucus of Montana.

Senator BAUCUS. Thank you, Mr. Chairman. I would just like to just address a bit this point that the top two rates, if they were raised, hurt small business. It is true, as has been mentioned already here today, that 50 percent of small business income is subject to the top two rates, but it is not true that 50 percent of small businesses, employers, are subject to the top two rates. In fact, only 3 percent are. And it is also, isn't it true, Mr. Barthold, that again only 3 percent of taxpayers with pass-through business income are subject to the top two rates; is that correct?

Mr. BARTHOLD. I believe that is a statistic that——

Senator BAUCUS. About 3 percent of taxpayers, not 50 percent, but 3 percent of taxpayers?

Mr. BARTHOLD. There are a large number of businesses, pass-through businesses, the owners of which, so the recipients of the pass-through income, who are not in the top tax brackets.

Senator BAUCUS. And in addition, isn't it true that about half of the 3 percent are taxpayers like bankers or celebrities that earn large salaries and don't employ anybody but really invest a small portion of their income in publicly traded pass-throughs like, say, a REIT?

Mr. BARTHOLD. Could you——

Senator BAUCUS. About half of that, half of the 3 percent are people who don't really employ people, but they are businesses that invest their income?

Mr. BARTHOLD. Certainly a number of the recipients of what you would consider active business income are the passive investors in those businesses. That is certainly——

Senator BAUCUS. I was trying to make the main point that only about 3 percent of pass-through income is affected by the top two rates.

There is a lot of talk about corporate tax reform, which I think it is good. In general the talk is we need to broaden the base, lower the rates, et cetera, and there is a lot of talk about lowering the top corporate rate to make it more competitive with other countries in the world, and that is good, but a lot of that would include eliminating, reducing many of the tax expenditures. Some will point out that the effective U.S. corporate rate is roughly comparable to the effective tax rate of other companies in other countries.

I want to ask you if that is generally true, that our effective tax rate is competitive with other countries?

Mr. BARTHOLD. It is not always clear what some people mean by the effective tax rate, what some——

Senator BAUCUS. After you deduct all the credits, exclusions, and all that.

Mr. BARTHOLD. Well, but there is also—it is after you deduct and it is a little bit over what time period. So I have seen the studies that you cite that say that, and so what you say is true that there are studies that say that, but part of what they are calculating is if you look at book reported income and book reported taxes of U.S. public corporations, they would not include in the taxes the taxes that are deferred abroad on what they consider income——

Senator BAUCUS. Right. I don't want you to misunderstand. I am for going down this road. I think we should lower our corporate rates very significantly. However, I have also seen other data that show that today the different industries in the United States enjoy, there is a big difference among which industries in the United States enjoy tax expenditures compared with other industries. It is a big variation. For example, the manufacturing industry and the real estate industry take much better use of, because they are available, of the tax expenditures than, say, the services industry, the retail industry.

So I am really trying to point out that if there were very significant changes, base broadening, and rate lowering of the corporate tax income that there would be big dislocations. Some industries would be hurt a lot compared to others, and some would benefit compared to others, and I think it is only important for us to know which those industries are and if we go down this road then to know what the transition rules should be to affect these different industries and then try to decide which of these industries are really more important for jobs and growth in America compared to others.

Now, we don't want—nobody likes to pick winners and losers here, but it may be that some of these industries do provide more jobs than some others, and I think it is important that we note what they are. So it would help me, anyway, if Joint Tax could come up with some kind of a study that shows which industries benefit the most today compared to those that don't.

Mr. BARTHOLD. Senator, I will follow up with you and your staff. I think, as you know from work that we have done for you in the past, I mean, we do identify certain features of the Tax Code by the primary industry of the taxpayer, and we have done some analysis for you in the past. We can do some more.

Senator BAUCUS. In part I am just trying to point out, this is not an easy undertaking, corporate tax reform. It takes time, and often when we go down this road it is more complicated than we think, and there are unintended consequences of major changes that we might otherwise make. It is important that we think through what the intended consequences are to try to avoid some of the unintended consequences.

My time's expired.

Chairman HENSARLING. The co-chair now recognizes Senator Portman of Ohio.

Senator PORTMAN. Thank you, Mr. Chairman, and I appreciate Chairman Baucus' comments, both saying that he supports heading down the road of lowering these rates, which are high relative to our global competitors, but also the fact that this requires hard work, and I am hoping this committee can roll up its sleeves and with his guidance and Chairman Camp's guidance get into some of these tough issues because he is right, this is complicated.

I will tell you that as recently as yesterday a CEO of an Ohio manufacturing company that does business overseas came to me and said, I am at the point that I believe that a lower rate is a better deal for me and my company than me taking advantage of many of the current preferences that are in the code for industrial companies, as the chairman said, and that would be consistent with what Co-Chair Murray said earlier about companies in her State that have come to her.

So this is a path, I agree with Chairman Baucus, worth us pursuing, and with the extraordinary procedural opportunities before this committee, I am hoping that this committee will use this opportunity.

I have two sort of simple questions that I have about the tax reforms that we have been discussing today. One is, you know, what should the tax burden be on the economy? And I think that is sort of the fundamental question that we need to answer in this committee, and that goes right to your testimony, Mr. Barthold, because in Figure 3 you talk about the 18 percent historical average, percent of GDP of taxes, and then in Figure 5 you talk about what is going to happen over the coming decades, and you see that percent of GDP in Figure 5 going up significantly from 18 percent.

So, one, we need to figure out what is the right burden on the economy, and that I think is properly reflected as the percent of GDP, and then the second question is really the fundamental one everyone has been asking today, what is the best way to collect those taxes. I suppose some would say it is a VAT tax or maybe some other consumption tax. I don't think this committee has the time and ability to get into that level of reform, but I do think that there has been a lot of work done by Chairman Baucus, Chairman Camp, and others to look at this to know that there is a way to lower rates and broaden the base, and best is in the eye of the beholder I suppose.

Some have talked about distribution and fairness, some have talked about efficiency, the cost of compliance, which is really a separate issue from the impact on economic growth, although it relates to it, and then finally, you know, what is the most efficient way to allocate resources and what impact will that have, as Mr. Barthold has talked about today, on economic growth, and that is the sweet spot for this committee, as I see it, you know, how do we do smart tax reform that, one, does not provide additional new burdens on the economy that make an already weak economy even weaker, and we can't do that. President Obama has said that, President Clinton apparently said that today somewhere, but the second one that is smart so that it does generate more economic activity, and as a consequence of that more efficient Tax Code that generates more economic activity, generates more revenue.

So it is a consequence of the fact that it does have an impact on economic growth. This feedback has to be measured, and this is one of the frustrations that many of us have had over the years, is that although there is plenty of economic analysis out there showing this is true, and you have talked about it this morning, Mr. Barthold, it needs to be reflected somehow and measured so that good policy can result, and so in the short time we have on this committee, I am really hoping that we will be able to have those measurements and we will be able to, with the Congressional Budget Office, be able to show what the impact is of various tax reform proposals.

On the corporate rate, since we are talking about that now, we don't collect as much revenue as we should, due in part to the complex, inefficient, and loophole-ridden Tax Code we have got, and therefore most economists agree that fundamental corporate tax reform is going to produce more economic growth, and therefore, again, as a consequence, more revenues.

Can you just quickly go through how you can give us that information? Let me try to summarize what I heard you say earlier, and you can correct me. One, you have a standard model, and that model will provide us with some behavioral changes. We talked earlier about allocating resources more efficiently under a Tax Code that makes more sense, and individual and firm responses I understand you can incorporate within your standard model. Is that correct?

Mr. BARTHOLD. Our conventional estimates always include behavioral responses of many different types, sir, yes.

Senator PORTMAN. So we will get some feedback through your standard modeling, your conventional modeling. Second, you have a macroeconomic effect you now do, you talked about House Rule XI, and you provide that as a supplemental analysis to Chairman Camp of Ways and Means Committee. That macroeconomic analysis you do is something that is made public, correct?

Mr. BARTHOLD. It is included in the House committee reports on a reported bill, yes, sir.

Senator PORTMAN. And can you extrapolate from the macroeconomic effects that you are already studying—you have the model to do it—as to what the revenue feedback is going to be from, say, an increase in GDP?

Mr. BARTHOLD. Senator, we have reported, as part of the reports, changes in GDP, changes in employment, changes in investment, and changes——

Senator PORTMAN. Labor market?

Representative BARTHOLD [continuing]. In revenues from the resulting growth, again across a range of sensitivity assumptions, to give sort of the breadth of possibilities.

Senator PORTMAN. And labor market as well?

Mr. BARTHOLD. Employment, yes, yes, sir.

Senator PORTMAN. And so you have provided revenue estimates from those changes——

Mr. BARTHOLD. No, not revenue——

Senator PORTMAN [continuing]. In GDP and labor market?

Mr. BARTHOLD. No, I wouldn't want to call them revenue estimates. You could, I guess, you know, think of taking the next step and saying what is the feedback that was identified and add that back in.

Senator PORTMAN. So it could be done?

Mr. BARTHOLD. Chairman Camp of Ways and Means held a hearing yesterday, as Mr. Becerra had noted, and they discussed some of those issues, and I can provide the members here later with copies of that testimony. We gave some examples of some macroeconomic——

Senator PORTMAN. But Mr. Barthold, let me just say because my time is short, I know this committee would be very interested in knowing what that feedback is, and again you all do great analysis. We need to be sure we have that analysis that in the real world there is going to be changes that will result in revenue changes, and we need to be able to consider that, and we have to do it in a short period of time here, which is several weeks.

I know my time has expired, but let me also just put on the table, you also do a compliance analysis, and if you go from a compliance, say, 88 percent compliance to 89 or 90 percent compliance, that can have huge revenue changes, and then you do a complexity analysis which can also impact that; is that correct?

Mr. BARTHOLD. We do a complexity analysis. We are trying to study doing more comprehensive compliance analysis.

Chairman HENSARLING. The time of the gentleman has expired. The co-chair now recognizes Congressman Clyburn of South Carolina.

Representative CLYBURN. Thank you very much, Mr. Chairman. Mr. Chairman, it is my humble opinion that the overarching mission of this committee is to find common ground. Now, recently, the House Republicans released a jobs plan in which they referred to the Tax Code, and I quote, has grown too complicated and cumbersome and is fundamentally unfair. I could not agree more with this assessment. I think it is unfair that wages are often taxed at a higher rate than investments, I think it is unfair that the wealthiest among us get the most tax breaks, and I think it is unfair that a number of top corporations who are making record profits pay more to their CEOs than they do in taxes.

Now, as we pursue common ground, I want to know whether or not you would agree that the number I have seen is that those peo-

ple making over a million dollars a year, that is like three-tenths of 1 percent of our entire population.

Mr. BARTHOLD. That figure sounds correct, Congressman.

Representative CLYBURN. Okay. If that figure is correct, and you say that it is, I think the question before us today, one of the questions is, is it fair to value wealth more than we value work? Because if we are willing to say that our Tax Code reflects our value system, our Tax Code seems to currently put a greater value on wealth and dividends than it does on work and wages. Now, is it class warfare to seek some equity in the Tax Code? That is my question. Do you think it is tax warfare? I am not asking—I don't know whether it is or not, but do you think?

Mr. BARTHOLD. Well, Congressman, I don't offer an opinion on that sort of a question. I try and my staff tries to provide information to Members such as yourself so that you can make appropriate judgments for the American people.

Representative CLYBURN. Thank you. That is fair. Let me ask something about—I am a great believer that there is something that we ought to pursue in this committee called, we may call it consumption tax, we may call it a value-added tax, I don't know what we might want to call it, but isn't it true that every major economy with which the United States competes really funds their government through consumption taxes?

Mr. BARTHOLD. All the Western European economies have individual income taxes, payroll taxes, corporate income taxes, some excise taxes such as we do, some estate or inheritance taxes such as we do, and in addition they all have a value-added tax.

Representative CLYBURN. Well, then, if CRS's estimates are correct that a value-added tax could be levied on a taxable base of $8.8 trillion, if we exempt food, health care, housing, higher education, and social services, that would leave a taxable base of around $5.1 trillion. Do you agree that a VAT is a viable option?

Mr. BARTHOLD. Through time, Congressman, a number of Members of Congress and, in fact, the Ways and Means Committee in the late 1990s held a series of hearings. They asked us to explore a number of issues related to value-added taxation. Our staff has identified for Congress a number of policy issues for them to think about. Conceptually, legislatively, yes, it would, you know—it is a viable option to create a VAT. It would take a lot of work, a lot of decisions by the Members, and a lot of technical work to get the law up and functioning for taxpayers.

Representative CLYBURN. Thank you. In the 50 seconds I have got left, let me be clear, when we talk about a 35 percent corporate tax rate in this country and comparing that with the rates in other countries, we really are not comparing apples to apples, we are actually comparing our rate to countries that have a value-added tax?

Mr. BARTHOLD. As I noted, sir, most of the——

Representative CLYBURN. In addition.

Mr. BARTHOLD. Those countries do have a value-added tax in addition to their corporate tax.

Representative CLYBURN. Thank you very much. I will yield back my 16 seconds to someone else.

Chairman HENSARLING. We thank the gentleman for yielding. The co-chair now recognizes Congressman Camp of Michigan.

Representative CAMP. Thank you, Mr. Chairman, and thank you, Mr. Barthold, for your testimony yesterday on economic models for analyzing tax reform.

Figure 1 of the handout that you gave us shows the Federal receipts by source, and I just want to underscore, it shows more than 47 percent of those receipts to the Federal Government come from individuals, and only just over 8 percent come from corporations or what we call C corporations.

Mr. BARTHOLD. That is correct, sir.

Representative CAMP. Corporate income. And in Figure 4 in your projection of Federal revenues to come, which I think goes through 2021, it basically shows receipts from corporations being flat going forward, but yet revenue from individuals is shown to be increasing over time. Is that a fair statement of the two charts? I see another line on individual——

Mr. BARTHOLD. It is a little bit a matter of scale. You can see the green line, the corporate tax, does increase.

Representative CAMP. Slightly.

Mr. BARTHOLD. As expensing. It is currently slightly lowered by the fact that we have had bonus depreciation followed by expensing.

Representative CAMP. But the point is the individual is going to go up at a faster rate, receipts to the Federal Government, projection of Federal revenues to the government is going up greater from individuals than from corporations?

Mr. BARTHOLD. Yeah, I believe that is consistent with our projection.

Representative CAMP. And some of that is related to your testimony about the number of entities that are organized as pass-throughs, which pay taxes as individuals, so some of that is business activity that you are seeing increase in that chart, and isn't the United States somewhat unique that so much business activity takes place in the form of pass-through entities, S corporations, LLCs, partnerships, and isn't it fair to say that other countries do not have as much business activity taking place in a pass-through form?

Mr. BARTHOLD. These sorts of entities are more prevalent in the United States, but I am not expert enough in all the other countries to make a blanket statement.

Representative CAMP. All right. But corporate reform alone would then leave out many employers, leave them out of the equation because of the way that business activity is organized in the United States. So as we compare around the world, we need to understand that.

Moving to corporate rates, which are a major factor in where businesses decide to invest and to locate, it has been said by yourself and others we have this high statutory rate, and with capital being increasingly mobile, it has become a much more important factor. The high corporate rate makes investment and job creation in the U.S. less likely as we compare around the world, and if you look particularly at Canada, who is certainly a key ally of ours but also a key trading partner, one of our largest trading partners, but when it comes to trade, they are one of our key competitors, you look in 1990 they had a 41½ percent corporate rate, in 2010 it was

29, 2011 it is 16.5, in 2012 their corporate rate is going to go to 15 percent.

Now, we have a high statutory rate, second highest in the world, in the OECD countries, but we have a number of expenditures, tax expenditures that then lower that rate, and that affects different sectors, as Chairman Baucus pointed out, in different parts of our economy in different ways, but aren't these other nations getting to their lower rates by eliminating these tax expenditures around the world?

Mr. BARTHOLD. Some of the other tax reforms that I am familiar with have made trade-offs of that sort. For example, Germany has lowered their statutory rate, and they made the, one of the trade-offs they made was to lower their statutory rate while lengthening cost recovery, cost recovery periods. That was a policy choice that they have made. So the reduction in special provisions I think as reported by the OECD, that they have noted that that has been a factor in a number of worldwide tax reforms.

Representative CAMP. And as Chairman Upton pointed out, the number of large companies headquartered in the U.S. has declined as other economies have emerged or changed their tax policy, and we are finding that many major employers are located in other countries rather than the U.S.

Mr. BARTHOLD. It is certainly a fact that worldwide large corporations, that fewer of the top 50, the top 100 are U.S.-headquartered companies. So I am sure there is many factors that have accounted for that, you know, the growth of other countries, but that is certainly a fact, sir.

Representative CAMP. The other factor we face as a nation is the number of expiring business tax provisions, and can you comment on how that has grown? I mean, I remember as they used to call it the Rostenkowski 13, the 13 business tax expenditures that were expiring. How many do we have now that expire on a regular basis? Do you have that?

Mr. BARTHOLD. Okay, well, we actually, as I know you are familiar, Mr. Camp, we publish annually a list of expiring Federal tax provisions. Just for the other members, and I will get a copy of this for all the joint select committee, it is our document JCX2-11. We have done this annually for more than a decade, and it used to be a lot thinner publication. I think we are up to expiring within the next 2 years 150 or more different provisions of law.

You know, it certainly creates uncertainty both at the individual level and at the business level of what is the law going to be next year, what is the law going to be 2 years from now, and obviously there are a lot of important policy choices that go into—that the members have to face as well.

Representative CAMP. Thank you, Mr. Barthold.

Chairman HENSARLING. The co-chair now recognizes Senator Kerry of Massachusetts.

Senator KERRY. Thank you very much, Mr. Chairman. I want to focus later on some of the tax expenditures probably more on the individual, but I think it is important to note that 80 percent of all of the money the Federal Government raises in taxes, 80 percent of it goes out right back into tax expenditures. Only 20 percent of what we raise actually goes into things we spend, pay for at the

Federal level. 95 percent of those tax expenditures, 95 percent of that 80 percent goes to 10 top expenditure items.

So I have got a lot of questions about the efficiency of that, among other things, and the choices that are made, which I think we have to look at, but I want to just say at the outset I second powerfully what Senator Portman said about our opportunity here, given the mandate and given the structure of this committee and its presentation to the Congress to take advantage of this to try to get that sweet spot which he talked about, which is really simplifying this, putting in place the most efficient choices that will drive our economy, that therefore will raise revenues and help us deal both with the deficit as well as jobs at the same time, and I think that is the key thing here.

One of the things I would like to focus on very quickly is just this question, simple question. We hear a lot about the top tax rate with respect to corporations, and, yes, it is the second highest statutory rate, but the effective rate is what matters to people. Business people know how to judge the bottom line, and they make judgments accordingly, and we fall in the middle on that.

Can you just say very quickly whether the committee should in its thinking here be looking at the top statutory rate or is it the effective rate that is more important?

Mr. BARTHOLD. Senator Kerry, as an economist, I think it is the effective marginal tax rate on investments that is really a key factor in terms of both growth and economic efficiency allocation across sectors. Now, that said, the effective marginal tax rate depends on the statutory rate. It also depends upon cost recovery, so it depends on how this is structured.

Senator KERRY. The key would really be the interplay with whatever the expenditures and incentives and other pieces are, that is the important piece?

Mr. BARTHOLD. Yes.

Senator KERRY. But we have to always keep that in mind, not just be frozen on the rate, but look at the overall complexity of what we create underneath it.

Mr. BARTHOLD. You want to look at the overall structure of how you are taxing the income.

Senator KERRY. Now let me jump to that for a minute. I have been concerned for a long time about this issue of whether or not we inadvertently and in some cases maybe purposefully incent investment in other countries, that we are creating jobs in other countries because of the structure of the Tax Code, and the Fiscal Reform Commission recommended that we move to a territorial system and replace the current practice of taxing active foreign source income when it is repatriated, and this is obviously a current struggle. It is potentially a source of income as well as a better Tax Code and maybe a more competitive one.

Could you share with the committee whether we can strike the right balance and have a system that is globally competitive, but encourages job creation and investment in the United States even as we were to create a territorial structure? Is that doable?

Mr. BARTHOLD. Well, strike the right balance is a difficult assessment for me, Senator. That would—that is——

Senator KERRY. Well, can you envision a tax structure that does do that?

Mr. BARTHOLD. Let me, to be responsive to your question, highlight a few issues, some of which we have already talked about. Investment in the United States, things that are important to investment in the United States can be the effective marginal tax rate on the income earned by those investments, so the statutory rate, cost recovery matter. Research in the United States, many countries provide research incentives. We provide research incentives, so sort of weighing the relative, again the return to what is the return to income earned from research undertaken in the United States as opposed to research undertaken abroad would be a factor.

When we look at territorial systems, we have to think about, well, what does it say about location of any—some investments in the United States as opposed to abroad. One feature of a territorial system which I will take generically as a dividend exemption system so that income earned abroad would only be taxed at whatever rate the foreign country has brought. If we lower our domestic rate and all other countries leave their rates the same, then under a territorial system the U.S. is relatively more attractive than it was before.

Senator KERRY. But some of those countries—if I could just interrupt you for a minute, isn't it a fact that none of our major U.S. trading partners have a complete exemption with all taxes?

Mr. BARTHOLD. It is typically—there are some that are 95 percent exemption, let's call it substantially complete.

Senator KERRY. Is there a particular country you would point to where you think the model has sort of struck that balance?

Mr. BARTHOLD. I think there is a number of interesting features with policy decisions for the members to consider from a number of different countries, so I would——

Senator KERRY. Could you perhaps share with us? I think it would be great if you and your terrific staff could present us with a sense of how to perhaps strike this balance, whether there are some provisions. What we don't want to do, what we are currently doing, everybody is talking about this massive amount of American corporate revenue sitting abroad that doesn't come home because it doesn't want to be taxed. We have had one round of sort of a grace amnesty, so to speak. It didn't work so well. And the question is whether or not we can find a way to see that money more effectively, the capital formation component put to better use, and still not wind up encouraging a company to go abroad to create the jobs. I mean, there is a balance there, it is difficult.

Mr. BARTHOLD. It is definitely a policy balancing act, sir. I am happy to try and work through options with the members of the committee if that is the direction you want to go. It is complex because——

Senator KERRY. It is complex, but you have to acknowledge that what we are living with today is not effective or efficient.

Mr. BARTHOLD. What we have today is also complex and certainly has some incentives that people find creating inefficiencies.

Senator KERRY. Thank you.

Chairman HENSARLING. The co-chair now recognizes Senator Toomey of Pennsylvania.

Senator TOOMEY. Thanks, Mr. Chairman. I am glad to be following Senator Kerry, and I want to underscore my agreement with him and Senator Portman on how important it is that we really make every effort to do something substantial on the tax reform side. This is the most pro-growth thing we can do is to fundamentally reform our Tax Code. It is a way to generate very substantial revenue while lowering marginal tax rates. That creates jobs, that helps reduce our deficit problem. It can enhance fairness, which we desperately need to do.

So I appreciate your testimony. I am glad we are focusing on this.

I wanted to follow up a little bit on the vein that Senator Kerry was just discussing. You know, tax expenditures justifiably get a bad name because so many of them are, in my view, egregious flaws in the code, especially those that are narrowly targeted and have a distorting impact. But not all tax expenditures, not everything that we described as tax expenditures meets that description.

The first one on the list here on Table 5 is the deferral of active income, right?

Mr. BARTHOLD. Correct.

Senator TOOMEY. This reflects, of course, the fact that we choose not to tax at the time that it is earned income that is earned by overseas subsidiaries. If you looked at this as number one on the list and the biggest number by far on the list, you could superficially at a quick glance suggest, well, maybe this is a good source of revenue. But, in fact, I would argue that our current system puts us at a competitive disadvantage because despite whatever number there is on this form, we tax foreign income when it is brought home to a much larger degree than most of our competitors; isn't that true?

Mr. BARTHOLD. That is correct, sir.

Senator TOOMEY. So if we were to actually tax it at the time that it is earned, we would be taking the competitive disadvantage we have now and making it worse, right?

Mr. BARTHOLD. You would be creating a higher tax rate on the total income of the U.S. corporation.

Senator TOOMEY. Well, exactly, and we would be increasing the disparity, the difference between that tax rate that we charge on overseas income and that which our competitors charge?

Mr. BARTHOLD. To the extent that the competitor is in lower tax locations.

Senator TOOMEY. Which most are?

Mr. BARTHOLD. Yes, sir.

Senator TOOMEY. So one of the things that—well, I just think we should be very conscious of the fact that reducing tax expenditures, it matters very much which ones and how we were to go about doing it. I am in favor of moving in the direction of a territorial system, and I think of a lot of Pennsylvania companies, whether it is U.S. Steel or Heinz or Air Products and Chemicals, companies that have substantial operations overseas, they exist to serve local markets overseas, and what I would hate to see us do is a move in the direction that creates an even greater incentive than there already is to have corporate headquarters somewhere else because that costs us jobs, it costs us a lot of good jobs. So my preference

would be that we move in the direction of a more territorial system.

I would like to get back to another line of questioning that Senator Portman raised, and that is how your methodology quantifies the feedback of variations in policy. So as I understood you, you acknowledge that personal incentives affect behavior, and so you used an example of a reduction in the payroll tax might create an incentive for someone to enter the workforce because their after-tax earnings would be that much higher. Of course that is true of any reduction in marginal income tax rates, payroll or ordinary income.

Mr. BARTHOLD. That is correct, sir.

Senator TOOMEY. And so my question is, when you analyze something like that, do you actually attempt to quantify the number of people who would enter the workforce in response to that greater incentive to work?

Mr. BARTHOLD. When we undertake our macroeconomic analysis, we report employment effects. Now, the employment effects are usually in terms of hours of work, which you can then loosely translate into, you know, numbers of individuals, but hours can also be overtime by currently employed individuals.

Senator TOOMEY. Okay. So you acknowledge that. Do you also, then, in your calculation attribute a new source of revenue from these new workers, the fact that they are paying payroll tax, at a somewhat lower rate perhaps, but they are paying tax and they didn't before?

Mr. BARTHOLD. This goes to a point we have broached a couple of times. Our macroeconomic analysis that we have been undertaking for about a decade is geared at providing supplemental information to the Members of Congress relating to tax policy changes that they are considering, and so what we routinely report are changes in gross domestic product, changes in employment, changes in investment, and we also report what this would, could mean in terms of feedback effects on revenues because general, a general premise is if national income grows, the tax base will grow, and so there will be more income subject to tax.

So in very loose terms, the answer to your question is yes. This is not reported for budget scorekeeping purposes or for House or Senate rule scorekeeping purposes, points of order, and the like.

Senator TOOMEY. Okay. I see I am running out of time. I just want to underscore, I think this is a problem with the scorekeeping methodology. I mean, your analysis, you acknowledge that a reduction in a marginal income tax rate does not have a linear impact in reducing revenue because of the positive feedback effect that offsets at least some of that, but yet we don't capture that, we don't quantify that, as I understand you to describe your process of scoring a given change in tax policy.

Mr. BARTHOLD. The macroeconomic analysis we do is not part of scoring for Congressional scorekeeping and rule purposes.

Senator TOOMEY. Thank you, Mr. Chairman.

Chairman HENSARLING. The co-chair now recognizes Congressman Van Hollen of Maryland.

Representative VAN HOLLEN. Thank you, Mr. Chairman. Thank you, Mr. Barthold, for your testimony. I just want to briefly turn to the question of pass-through entities because a lot of people have

described these pass-through entities as if they were all small businesses, and I would just like to read from your testimony before the Senate Finance Committee July 14, 2010, where you say "the staff of the Joint Committee on Taxation estimates that in 2011 just under 750,000 taxpayers with net positive business income, 3 percent of all taxpayers with net positive business income, would have marginal rates that fell above $250,000;" is that correct?

Mr. BARTHOLD. If you are reading from something I said.

Representative VAN HOLLEN. I just want to make sure that fact remains true. And you have this very important caveat right here in your testimony then. "These figures for net positive business income do not imply that all the income is from entities that might be considered 'small,' in quotations. For example, in 2005, 12,862 S corporations and 6,658 partnerships had receipts of more than $50 million."

Now, my point here is not—isn't that these aren't good businesses. We should get over this conversation that all of these are small mom and pop entities because they are just not. If you had a Washington law firm with 500 partners, and those partners each took a draw of a million dollars, under this analysis they would be included as 500 distinct business entities, correct?

Mr. BARTHOLD. They would be——

Representative VAN HOLLEN. They would be included in your figure of 750,000?

Mr. BARTHOLD. How did you structure your law firm?

Representative VAN HOLLEN. As a partnership.

Mr. BARTHOLD. The partnership, we did a number of counts, and actually just to refer you to some more recent work that we have done, appendix tables in the prepared testimony that you have before you today, 10, 11, and 12, show you some ways that you can distribute partnerships and S corporations by size, either by the——

Representative VAN HOLLEN. I was just going to ask you that, Mr. Barthold.

Mr. BARTHOLD. Well, that is why I——

Representative VAN HOLLEN. Just so members realize as we have this conversation, on page 54, if you look at your charts, you will see that the top 2.2 percent of S corporations with gross receipts of more than $10 million received 61.7 percent of all the gross receipts of S corporations. Very small group. And if you look at the top 0.8 percent of partnerships with gross receipts of more than $10 million, they received 83.4 percent of all gross receipts, all gross receipts. 83.4 came from the top 0.8 percent of the partnerships. So we should remember when we are talking about this issue that we are talking about in many cases individual partners at big law firms and big lobbyist firms and considering each one of them some kind of small business generator. I just don't think—I think people need to take that into account.

Now, I want to ask you about the modeling.

Mr. BARTHOLD. Mr. Van Hollen, the only thing I wanted——

Representative VAN HOLLEN. Mr. Barthold, let me just—I am sorry, I have got 2 minutes. I want to ask you about the modeling here because Dr. Elmendorf testified before our committee, and he said that if we are to keep in place the tax cuts that were imple-

mented in 2001, 2003 rather than allow them to lapse in our current law, we would have much larger deficits in the outyears, cumulatively 4.5 percent deficits.

Now, as I understand your testimony, higher deficits, especially during a period of time of full employment, which we all hope to get back to, that those higher deficits can have a drag on the economy; is that correct?

Mr. BARTHOLD. The higher deficit requires higher government financing, and so potentially long run crowding out of private investment.

Representative VAN HOLLEN. And that crowding out is especially true when you have full employment, correct?

Mr. BARTHOLD. Well, it is not good anytime.

Representative VAN HOLLEN. That is right. So now to get back to your scoring, though, when tax cuts are scored, whether they were 2001, 2003, because you do not take into account some of those macroeconomic effects, you also don't take into account the fact that those tax cuts could contribute to larger deficits in the outyears and slow down the economy in terms of GDP, right?

Mr. BARTHOLD. Our macroeconomic analysis, when we provide it to the Ways and Means Committee, as you know, sir, accounts for what is happening with the deficit, how the package is funded, and so it does reflect potential crowding out, if that would occur.

Representative VAN HOLLEN. Right. But I guess it does not take the next step, which would be analogous to some of the points that are being raised, which is that that crowding out leads to lower GDP, which then leads to lower——

Mr. BARTHOLD. Our macroeconomic analysis will show that.

Representative VAN HOLLEN. Right, but will it show the feedback, then, the feedback loop in terms of growth, in terms of your scoring? I am talking about your scoring.

Mr. BARTHOLD. On scoring, again, to emphasize the point just made to Senator Toomey, we use our conventional, as does the Congressional Budget Office, we use our conventional models, which are scored against the Congressional Budget Office macroeconomic baseline where we are not assuming that GNP aggregate investment, aggregate employment, inflation rate, none of those factors.

Representative VAN HOLLEN. Thanks. I hear you. So you don't take that into account, the low growth rate?

Mr. BARTHOLD. Or conventional.

Representative VAN HOLLEN. On CBO, when they score investments, when CBO looks at the investment side, investment infrastructure and education, they don't take into account either the positive economic growth benefits of that in terms of receipts, do they?

Mr. BARTHOLD. In their conventional estimates, they do not account for positive effects or the potential crowding out, depending on——

Representative VAN HOLLEN. Right. It is analogous on the CBO side in terms of investment to what you do on the tax side, correct?

Mr. BARTHOLD. Correct, sir.

Representative VAN HOLLEN. Thank you. Thank you, Mr. Chairman.

Chairman HENSARLING. That completes the first round of questioning for the first panel. We will go to the second round of questioning. The co-chair will yield to himself.

Dr. Barthold, in my opening statement I quoted from a letter from former CBO Director Dr. Peter Orszag that I believe under a current policy baseline, if solved on the tax side, that the tax rate for the lowest tax bracket would go from 10 to 25, the 25 to 63, the 35 percent bracket to 88, the top corporate income tax rate would also increase from 35 to 88 percent. Has the Joint Committee on Taxation performed any analysis that is similar to Dr. Orszag's analysis or would you have an opinion on his opinion?

Mr. BARTHOLD. I can very clearly say no because I am actually not even sure what he did and what you quoted, so I know we haven't done anything quite analogous to that. I would be happy to have my staff colleagues—I mean, we can take a look if you would like.

Chairman HENSARLING. Perhaps at a later time. I would appreciate that.

Let me go to another subject matter, and that is who actually ends up paying our corporate tax rate in America? I suppose as a practical matter many view corporations as tax collectors and not taxpayers, so clearly there is some impact on consumers perhaps in the form of higher prices, depending upon the elasticity of demand for the product or service, workers in lower wages, and then certainly to shareholders in the form of potentially lower stock prices.

Now, the last data that has come across my desk is a Congressional Budget Office analysis of about 4 or 5 years ago entitled International Burdens of the Corporate Income Tax that seemed to indicate in their analysis that 70 percent of the burden of the corporate income tax falls on labor in the form of lower wages. I don't necessarily believe you would be familiar with that particular study, but has JCT undertaken a similar study? Do you have opinions? Have you reviewed the academic literature on the subject? Do you have an opinion?

Mr. BARTHOLD. I mean, you are discussing really one of the big long-time important questions in economics, and that is what is the incidence of any tax or in particular the incidence of the corporate tax. In some of the economic literature there has been some ebb and flow in terms of its view. It is often—it had long been thought that perhaps substantially all the burden of the corporate tax fell not just on corporate shareholders because at its sort of simplest terms the corporate income tax is a tax on the income earned by the equity owners of the firm, but more generally that it would have an effect on the overall, on all owners of capital, but some of the more recent empirical work and theoretical work, some of which you just cited, has looked at the increased cross-border mobility of capital and even fixed capital, relocation of factories from one country to another country to suggest that there is a greater responsiveness to after-tax returns of capital than perhaps after-tax returns of labor, and by that they have attempted to measure and come up with results such as you have noted that perhaps a substantial amount of the burden of the corporate tax actually falls on labor, by, if we make capital flee the U.S., there is less capital

in the U.S., it is capital that is key to generating labor productivity, and it is labor productivity that helps determine wages.

Chairman HENSARLING. Dr. Barthold, my time has expired. So at this time let me yield to my co-chair, Senator Murray of Washington.

Co-Chair MURRAY. Thank you very much. We hear that corporate tax reform or any tax reform must be revenue neutral, and as our Nation faces $14 trillion in debt, I think we need to be focused on job creation and long-term debt reduction. Your predecessor on JCT, Dr. Kleinbard, testified to the Senate Finance Committee last week, and he said, quote, we have to abandon our nostalgia for the Tax Reform Act of 1986. That tax reform effort was revenue neutral because it could afford to be, and that was also of course preceded and followed by major tax increases.

We hear today a lot of stories about profitable corporations, even major corporations that are using tax expenditures in order to reduce and in some cases eliminate their tax bill completely. This is infuriating for average taxpayers who are dutifully paying their taxes and don't benefit as much from these big loopholes, and I am not talking about failing companies here who might need a break. I am talking about large, profitable companies.

During this economic downturn Congress has provided generous incentives to encourage business activity; namely, through the Tax Code, and even before the downturn there were corporations that were very profitable but paid no share of Federal corporate income taxes.

So I want to ask you if you have an assessment of what it costs our Treasury in terms of lost revenue from profitable corporations that don't pay corporate income taxes.

Mr. BARTHOLD. Basically our tax expenditure analysis provides most of the assessment that you are asking about, but it does it on a provision-by-provision basis. You can't—because of interactions between them, you can't really add them up and say this is the aggregate amount lost, but the way we estimate, measure the tax expenditure is we look at what the business' tax liability would be with and without the provision in question, and so if it is a corporation that is in a loss position, there would be no tax liability regardless of the provision, so it is only looking at where there are otherwise, it would be positive taxable income. I hope that is responsive to your question.

Co-Chair MURRAY. It is a response. In my last 30 seconds I just wanted to ask you about this repatriation issue because we are hearing a lot about that. Some people say it will raise revenue, some people claim it loses revenue. What is your take?

Mr. BARTHOLD. We have undertaken some estimates of a particular proposal or a couple of different proposals, and our assessment is that if we repeated the Section 965 repatriation holiday that was enacted in 2004, that under the current baseline that that would lose revenue. There would be short-run revenue increases but long-term revenue losses, generally from longer term erosion in the corporate tax base.

Co-Chair MURRAY. Okay, thank you very much. Appreciate it.

Chairman HENSARLING. The co-chair recognizes Senator Kyl of Arizona.

Senator KYL. Thank you, Mr. Chairman. Let me just ask one follow-up question to the other questions I was going to ask in the interest of time here. You have heard a lot of frustration up here about the fact that while you can provide estimates to us of some of the behavioral impacts, that they are not reflected in the official estimates that you provide to us.

My question is how we could change that or how we could better take advantage of the behavioral estimates that you do provide. Would it require a statutory change or simply some kind of change within Joint Tax Committee to provide those behavioral effects, those feedbacks that you talked about as part of your official scoring estimates?

Mr. BARTHOLD. Well, just as a reminder, I mean, we do provide information to the Members now, and——

Senator KYL. Understood, but you made it clear that they are not part of the official scoring.

Mr. BARTHOLD. So, I mean the Members—the budget rules are. I am not a budget rule expert, and I am not sure if you wanted to change budget rules or have information reported in a different fashion for us. I mean, we try to provide information to Members in a form that is useful to them. So I am really not sure how to answer your question about what to do about budget rules or decisions that the Select Committee might want to tackle.

Senator KYL. Appreciate that. What would it take for us, for you to include those estimates that you talked about, the feedback effects and so on, in your official revenue tables, in your official scores of tax changes?

Mr. BARTHOLD. Well, as I said, for the Ways and Means Committee now on a reported bill, we do provide the macroeconomic analysis with sensitivity. So it is available for Members of Congress to read the conventional estimate and the macroeconomic analysis and then make their decisions based upon that. So as a mechanical, just as a mechanical feature, there is really nothing. I will——

Senator KYL. Well, but there——

Representative BARTHOLD [continuing]. Note there are certain time constraints.

Senator KYL. If I could just interrupt, I understand—you understand our problem——

Mr. BARTHOLD. Right.

Senator KYL [continuing]. Which is that people are going to look at the score, how much of a 10-year savings have we achieved, did we meet our goal of 1.5, and if we can't score—you and CBO are the arbiters here in some sense of the success of our policies in terms of everybody being willing to agree that it had that effect. The estimates that you give us are very useful to us, but it is not going to count in the score if there isn't a way to include it. So I am just asking, is it a matter of policy or practice? Is it something that CBO has as a policy that we would need to change? Is there a statutory change that we would have to make to include this? And if you don't know and would need to think about it, then could we visit with you some more so that we could help figure it out?

Mr. BARTHOLD. Certainly help. I might suggest that Mr. Van Hollen, who is on the House Budget Committee, might—would probably know more about this than——

Senator KYL. We will put the burden on him to answer the question then.

Mr. BARTHOLD. I am not trying to shrug the responsibility.

Senator KYL. You don't have to know the answer, but we need——

Mr. BARTHOLD. I am not a budget law expert. I mean, I think the question that you are posing, Senator, is one about House and Senate rules and about the budget law. The macroeconomic analysis that we provide currently is under a requirement under House rules. The complexity analysis that we provide with any bill was a result of legislative action, statutory action that Senator Portman was one of the primary movers on back in the late 1990s. So some of the things that we report to Members are a result of statute, some are as a result of rule.

Senator KYL. We can answer that question. I appreciate your response. Thank you very much.

Thanks, Mr. Chairman.

Chairman HENSARLING. The co-chair now recognizes Congressman Becerra of California.

Representative BECERRA. Mr. Barthold, I think we have entered this interesting realm of asking you to predict the weather. We know this is a large economy, and when it is intertwined with the economies of the rest of the world it becomes very difficult for you to come up with estimates of what a tweak here will do or a tweak there will do, but you do have conventions that you use to help you make decisions, and we have to rely on those. We have to rely on the Congressional Budget Office working with you to help us come up with these as good as you can estimates of what might happen. You have developed these over the years, have you not?

Mr. BARTHOLD. Yes, sir, and we try to, you know, update the modeling, the data, the thinking on a continuous basis.

Representative BECERRA. Are you using what you believe are the best models that we have to date?

Mr. BARTHOLD. We think we are doing—I mean, we think we have very good models. They are more sophisticated than they were 10 years ago, 15 years ago. We have upgraded in a number of areas.

Representative BECERRA. You could use some of the less conventional, some of the unconventional models that are out there that haven't been as road tested as the models you use. They may show in the future to be more accurate than yours, but they also may show that they will have been less accurate than the ones that you use?

Mr. BARTHOLD. We look at work by outsiders all the time to help inform ourselves.

Representative BECERRA. Let me ask you this. In 30 days can you come up with a better model than what you are using now to tell us what the impact will be of anything we do on tax policy or budgetary policy?

Mr. BARTHOLD. Well, I am sorry to say, Mr. Becerra, but in a 30-day time period you are probably stuck with us as we are.

Representative BECERRA. Okay.

Mr. BARTHOLD. I mean, and as you had noted, yesterday I tried to outline some of the breadth and I believe sophistication of our modeling.

Representative BECERRA. And what you do will inform us as we try to move forward. We may look at what you do and say we agree completely, we may disagree, but at some point we have to make a decision what we will use as the model. And what you are saying to us is that you have given us the best model that you can, at least within the next 30 days.

Let me ask you another question. Using that model, we have heard discussion about corporate tax reform. There is talk about eliminating those tax breaks that certain companies get over other companies and then using the money to plow back into the system to help reduce the rates for all the companies. That way you broaden the base, and you make it a fair Tax Code for all companies. If you were to eliminate all the tax breaks that right now corporations take advantage of and put the money into lower rates, using the model we have, does that help us, the 12 of us, reduce the deficits that we currently see?

Mr. BARTHOLD. Lowering—if you did something to——

Representative BECERRA. You plow back all the money that you get from removing all the tax breaks into just lowering rates, using the current model that you use, do we reduce the deficits?

Mr. BARTHOLD. Let me make an important point, and I hope I don't—I guess I will probably exhaust your time, for which I apologize.

As we have noted a couple of times, one of the large corporate overall business tax expenditures is accelerated depreciation. As I have noted, cost recovery is important in terms of determining the effective marginal rate or the user cost of capital. So it is not just looking at the statutory rate. It is also what is the statutory rate and over—and how do you get to recover costs for invested capital that determine the profitability of investments and so the decision to invest.

So if you scale back accelerated cost recovery and use the benefits of that to reduce the corporate rate, you are, on one hand, saying you are making investment less attractive by scaling back the capital cost recovery and, on the other hand, saying you are making it more attractive by reducing the marginal rate on the income when it is ultimately taxed. And that in itself is not automatically pro growth, because you are going in one direction with cost recovery and the other direction with rate.

We have—can I have a—I am sorry, sir.

Chairman HENSARLING. The witness can finish, please.

Mr. BARTHOLD. We have done some preliminary work. A couple of my colleagues presented some of this work just this last spring at a symposium at a national tax association. And it suggested within our corporate model that getting rid of accelerated depreciation and plowing just that money back into corporate tax rate is probably not going to be pro growth. It is going to be much more neutral.

Chairman HENSARLING. The time of the gentleman has expired.

The co-chair wishes to announce to members that a vote for House Members is expected at 1:30. Doing a rough calculation and

in consultation with my co-chairman, I would like to ask unanimous consent that for the second panel that the first round of questioning be limited to 5 minutes and the second round of questioning be limited to 1 minute. In a rough calculation, it means that all members would be able to ask their questions.

Without objection, so ordered.

Members are also encouraged, if they so choose, to consolidate questions they may have on both panels at this time in the interest of time.

The chair now recognizes Congressman Upton of Michigan.

Representative UPTON. Thank you, Mr. Chairman.

I just want to say I am one of those folks not only on this panel but I think in the entire Congress that wants to simplify the tax code, that knows that we need real tax reform, we want to simplify the code, we want to broaden the base, we want more people working, we want to add to economic growth. It would be great if we could do it in this panel. I don't know if we can. And if we can't, we will do a long-term plan to work with Chairman Camp to make sure that that happens.

In Michigan, we have had some really tough times. You may know that our unemployment is over 11 percent, and we have had 32 consecutive months at double-digit unemployment.

My district is right on the State line. We have a new Governor. We have a new legislature. And they began to pick up the pieces and passed some tax reform and got rid of some business taxes. The person that was most upset was the Governor of Indiana, because he had billboards in my district that said "Michigan businesses, come on down", and they did.

So as I look at what we have to do on tax reform, we know that we have to compete with other nations around the world. And to comment on one of the things. I am going to yield back to you on some of my time. In the last Congress we passed a currency manipulation bill aimed at China, H.R. 2378. And I know I saw a headline today in some of the news that some of the business groups are very concerned that if this legislation came about again it would perhaps lead to retaliation by Chinese companies against American firms.

I am wondering, if you all did a study as to what the impacts of the Chinese currency manipulation really mean as it relates to U.S. businesses that export or involve trading partners in China. Have you all done anything on that?

Mr. BARTHOLD. We work with the Congressional Budget Office on what we call indirect tax effects of nontax legislation, but I do not think that we did any work on the currency bill, sir.

Representative UPTON. Would it be possible to ask you maybe or do I have to go through Chairman Camp to get a request in on that?

Mr. BARTHOLD. No, we work for all the Members of Congress. I am not that familiar with the legislation, so I will ask a couple of my colleagues to look into it.

Representative UPTON. Okay. I yield back.

Chairman HENSARLING. The co-chair recognizes Senator Baucus of Montana.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Barthold, it has been thrown around here by several people that there is about $1 trillion worth of tax expenditures annually. Could you tell me, I assume that is just a total, that it has not been—those provisions are not all scored. Because if you were to score all those, you reach a number maybe the same as or slightly different than just adding them all up.

Mr. BARTHOLD. The tax expenditure estimates are nonbehavioral estimates, and they are taken—and they are really just a measure of, if you are claiming this particular tax benefit, given your current tax position, what is the value of that benefit to you. It is not to say that if you were to eliminate that benefit that everything else that that taxpayer is doing would remain the same and you would be able to recoup all of that money.

For example, I mean, in the business tax expenditures, just to pick on one, the low-income housing tax credit, now, some businesses that invest in these low-income housing partnerships through which they earn the tax credits they generally view that as a profitable investment. So if we were to repeal that—and part of the way it is profitable is because it is tax sheltered. Well, we asked the question, where does that money go? What else happens?

Senator BAUCUS. I know. But that does raise revenue. The repeal would raise revenue.

Mr. BARTHOLD. The repeal would raise revenue, but it would not raise revenue equal to the value that——

Senator BAUCUS. That is my question. That is the point I am making. So if you total up all the deductions, the credits—let's just take the deductions, itemized deductions, the standard deductions, what would that be, roughly?

Mr. BARTHOLD. We will have to get it for you, Senator.

Senator BAUCUS. Okay. Therefore, you can't answer the next question, which is, if we want revenue neutrality, how much would that lower rates, individual rates?

Mr. BARTHOLD. I will have to—we will have to undertake that analysis. Some members have asked. We are actually in the process of trying to do something close to that.

Senator BAUCUS. The first cut is just the itemizers or the standard deduction.

Mr. BARTHOLD. Uh-huh.

Senator BAUCUS. The next level let's add, okay, exclusions and above-the-line measures. Let's say we repeal those.

Mr. BARTHOLD. Okay.

Senator BAUCUS. And then, to some degree, you get the business income. We have got interest, expense, and was it 199 deferral and so forth. It is difficult, because some of this applies to C-corps only and some doesn't.

So if you could just—the major categories show what the revenue effect is. If Category 1, if they were all repealed in Category 1, those are the standard deduction and itemized deductions, that is one. Next is exclusions and so forth, employee health care exclusion, for example. And then the other would be other business income. And what the corresponding rate reduction would be for——

Mr. BARTHOLD. I will follow up with your staff on that for you, sir.

Senator BAUCUS. Thank you.

Chairman HENSARLING. The co-chair now recognizes the Senator from Ohio, Mr. Portman.

Senator PORTMAN. Thank you, Mr. Chair.

I think all of us are going to be really interested in that information because that goes to all the issues we talked about earlier about a more efficient Tax Code and how low can the rate get, how much can you broaden the base.

I want to go through some specific corporate tax reform ideas that have come up today and maybe some concerns that have been raised and get your quick response, if I could. Because I think we have got a good hearing today on the big picture, but we left some things unanswered.

First is the impact on so-called pass-throughs. And I know there has been a discussion about pass-throughs. It is more than 80 percent of U.S. businesses. I believe that is the latest number. It is sole proprietors and partnerships, sub-Ss and LLCs in my State.

If you lowered the corporate rate and did so by getting rid of some of the existing preferences and those preferences also applied to the pass-throughs, it would seem unfair. They would still have a relatively high rate and yet they would not get the advantage of any of the changes and preferences. How would you address that apparent inequity to be sure that our smaller businesses who are pass-throughs and organized not as C-corps do not find themselves disadvantaged by corporate reform?

Mr. BARTHOLD. Well, Senator Portman, I noted earlier that I thought that it would be technically extremely, extremely difficult to wall off the elimination of preference items to one business entity and not—that it would create a lot of behavioral questions that you might or might not want to address about are you forcing people to change their choice of their preferred business entity, would you try to prohibit people from switching entity form.

As to other options, I imagine you could think of things that you might do that could provide a new preference of some sort for the pass-through—for pass-through entities. We could explore options with you on that one.

But one of the reasons I emphasize that business income is taxed as a C-corporation and business income is also taxed on the individual return was to make exactly that point, that you want to think of business income when you look at some of the reforms that you might have in mind and not——

Senator PORTMAN. Mr. Barthold, my time is short, and I apologize.

One way to do it, it seems to me, is to look at the C-corp separately so you wouldn't apply it to individual rates. You just apply it to the——

Mr. BARTHOLD. But it is very difficult to wall that off. I mean, C-corporations participate in partnerships, for example, on research ventures with individuals and other non-C-corporations.

Senator PORTMAN. Well, this is something, if you can get back to us on that, it would be very helpful. Because I know there are a number of us who have concerns about that and have some ideas about it. But we need to follow up on that.

Second is the expiring provisions. You talked about 150 over the next couple of years. Certainly the issue of certainty and predict-

ability that everyone has raised here today should enter into that. In other words, some of these expiring provisions aren't nearly as effective as they should be because companies can't rely on them. And what is that impact in terms of economic growth and again in terms of extrapolating to revenue.

On depreciated and expensing, you talked about that in response to Mr. Becerra. I think we would love to see something on the complexity of current depreciation rules and some of the inefficiencies in the current system. So it is not just accelerated depreciation we are talking about, it is the whole system. Although you indicate it reduces cost of capital for investment and capital formation. It has also got a lot of complexity involved with it, which makes it less efficient than it could be.

And then, finally, the territorial side, which we don't have time to go into, evidently, since the chair is rightly stopping me, but we would love more information on, as Senator Kerry said, other ideas there.

Chairman HENSARLING. The gentleman from South Carolina, Congressman Clyburn, is recognized.

Representative CLYBURN. Thank you, Mr. Chairman.

Mr. Chairman, in 1986, a Republican President and a Democratic Congress found common ground and came to a bipartisan agreement that is similar to the one we are trying to get to today. In that agreement, capital gains rates as well as income tax rates were the same—I think it was 28 percent—and it stayed the same for about 4 years. Can you tell us whether or not there was any significant decrease in investments in the United States during that 4-year period?

Mr. BARTHOLD. I don't know the answer to that question off the top of my head. Between 1986 and 1990, the economy generally grew at a reasonable pace.

Representative CLYBURN. That same 4-year period there was growth.

Now, since 1990, we have had subsequent reductions in the capital gains tax rate. Have we seen any significant increase that can be attributed to that—to that reduction?

Mr. BARTHOLD. Well, attributing broad macroeconomic outcomes to specific provisions is always very difficult. I mean, of course, in 1991 we did have an economic downturn. We then had strong, strong growth. We had a downturn again at the turn of the century.

Representative CLYBURN. Thank you, Mr. Chairman.

Chairman HENSARLING. The co-chairman recognizes Congressman Camp of Michigan.

Representative CAMP. Thank you, Mr. Chairman.

The administration has expressed some interest in reducing the corporate rate, although we have not seen any detailed proposals or form of proposals. But most analysis is suggesting a corporate rate somewhere in the mid 20s. And the administration has suggested raising the top rate on individuals and pass-through entities to 40 percent or more.

Figure 7 of your handout shows how many more pass-through returns than C-corp returns, and the number of pass-through returns are increasing while C-corps are declining. And figure 8 shows the

aggregate net income as a percentage of GDP of pass-through entities as being a significant player in the economy. So, regardless of size, I guess my point is there is a lot of economic activity and a lot of jobs in the U.S. that are connected to pass-throughs.

My question for you is, what would be the economic consequences of taxing individuals in pass-throughs at a rate that is about 15 percentage points higher than would be a rate on C-corps if in fact we did tax return and how might that distort decisions on how businesses were organized, if you have an opinion on that.

Mr. BARTHOLD. Well, I think the economics are largely as you laid out, Mr. Camp. I mean, one additional factor to add in is, remember, C-corporation income tax is a second level of tax. Shareholders receive distributions, dividends, or capital gains. So there is corporate tax and then there is a tax at the individual level.

So the sum—if we were to reduce the corporate tax, that would make a C-corporation relatively more attractive than other business entities. We might see some change, might see some diminished growth in one form at the expense of the other.

Representative CAMP. All right. Thank you.

The other question I have is, again, since 1940, there has been a budget surplus about 11 years in the U.S., looking at your Figure 3 chart on Federal receipts as a percentage of GDP. In only one of those years, 2000, was it over 20 percent, and that was largely the result of capital gains. Now, outlays or spending in that same period since 1940 never exceeded 19.4 percent of GDP of our economy, is that correct?

Mr. BARTHOLD. That sounds right, but I did not reproduce the figure, so I assume Doug Elmendorf presented that to the Joint Select Committee.

Representative CAMP. Doesn't that suggest then if we have been able to have a budget surplus in 11 years since 1940 yet we never had spending above 19.4 percent in those years and revenues were only above, as a percentage of our economy, only once in the year 2000 above that amount, doesn't that suggest that the answer has been—to controlling deficits has been to control spending, rather than to increase revenue to unsustainable levels?

Mr. BARTHOLD. Well, I am here just to be the tax weenie, Mr. Camp. I really don't have a good answer for that.

Representative CAMP. Thank you.

Chairman HENSARLING. The chair recognizes Senator Kerry of Massachusetts.

Senator KERRY. Thank you very much.

Dr. Barthold, have you, given the nonpartisan status of the Joint Tax Committee, ever compiled a list of those, quote, incentives that are not having either the intended economic impact or that don't—you know, aren't worth the level of foregone or forgiven revenue? Do you have a list of suggestions you might make to the committee about——

Mr. BARTHOLD. Not in recent memory have we really published a hit list of the type that you are suggesting. I mean, we have—as background work for both the Ways and Means Committee and the Finance Committee when they have reviewed different provisions in the, Code we have presented--

Senator KERRY. Would it be possible for you in these next weeks, given the work, the analysis and, the various modeling that you have done, do you not have already a foundation of conclusions and evidence with respect to those things that are sort of most productive?

Mr. BARTHOLD. Probably not on as many as there are.

Senator KERRY. On some, would you give us some?

Mr. BARTHOLD. We did work on some. We can present——

Senator KERRY. It would be helpful to have your judgment on that.

For instance—let me ask you a question. Are companies able to significantly lower their effective tax rate by using offshore subsidiaries to reassign the licensing of their intellectual property?

Mr. BARTHOLD. We have done some exploratory work on that, and there are certainly cases where that appears to be the case. We can't conclude that that is generally the case of all multinational corporations, but there certainly is evidence that income is being shifted abroad to foreign jurisdictions to lower overall worldwide tax revenue.

Senator KERRY. Well, we know, for instance, there is one single famous building in the Cayman Islands which has maybe 35,000, 40,000 registered companies that are not companies at all.

Mr. BARTHOLD. You are referring to Ugland House, I believe is the name.

Senator KERRY. Yes, I am.

But, clearly, those are——

Mr. BARTHOLD. But the point that you are making is what is the availability under present law to take income that would otherwise be part of the U.S. tax base and have it be reported offshore. And that is just not—that is not as simple as the existence of Ugland House, but there is a number of factors at play.

Senator KERRY. Could you share with the committee those factors. Congressman Camp just asked you I think an important question about the pass-throughs and how they are treated and how they might be treated relative to the C-corps. Could you share with us your perception of is there one factor or what are the most critical factors that have contributed to the growth of the pass-throughs and the limited liability corporations?

Mr. BARTHOLD. Well, I think there is actually—there is not one. I think there is a number of factors.

You used to do C-corporations—all public corporations basically are C-corporations. And so if you were seeking at some point the public capital markets you organized yourself as a C-corporation.

Now, there has been a lot of financial innovation. The ability of new start-ups, be they small or be they large, to access broader pools of capital has not necessitated them to necessarily go to the public market. So that has certainly been one factor.

The 1986 Tax Reform Act repealed the general utilities doctrine which was one legal doctrine that essentially made it potentially more favorable to operate in C form.

And I will defer on a third and fourth.

Senator KERRY. Well, we will follow up with you.

Chairman HENSARLING. The chair recognizes Senator Toomey of Pennsylvania.

Senator TOOMEY. Thank you, Mr. Chairman.

Mr. Barthold, we both discussed the fact that there are some very broad items that are often described as tax expenditures, the reduction of which wouldn't necessarily, obviously, be pro growth. You know, in the case of how we would treat income that is earned overseas, you make the point of how we treat depreciation.

But there is another entire category that is just egregious, it seems to me, and that does cost us economic growth by virtue of their being there. It seems to me we have as many—maybe more than a dozen different subsidies for various kinds of green energy amounting to over $2.5 billion a year. We have ethanol tax credits that are nearly $6 billion a year. We have domestic manufacturing deductions that you can get by making a movie. We have credits for rehabilitating privately owned houses. My question for you is, don't these certainly amount to the government picking winners and losers within the economy?

Mr. BARTHOLD. Well, I think that precise point was made earlier by one of the other members of the joint committee. Winners, losers, they all reflect policy decisions made by Congress at some point.

Senator TOOMEY. Right. Okay. So let me ask it this way. Do these features distort economic activity compared to what it would otherwise be?

Mr. BARTHOLD. Certainly. And that is actually part of what the tax expenditure notion is about if you favor one sector over another sector.

Senator TOOMEY. Right. Isn't it generally likely that if we use the Tax Code to distort economic activity on balance we are going to have less economic growth than we would have if we allowed the marketplace to allocate capital instead of political people?

Mr. BARTHOLD. As a general matter abstracting from the potential for what economists call externalities, the general economic thinking is that the market outcome allocates capital most efficiently.

Senator TOOMEY. And, for instance, in a specific case when it comes to these credits as they apply to energy, if you step back and look at it, if we as a society decide we are going to use the Tax Code to drive people toward the use of less efficient sources of energy, aren't we poorer as a society on balance as a result of that?

Mr. BARTHOLD. Again, if you—up to whether there might be market externalities involved, you are saying that by favoring one sector over another you are distorting choice, which means you are not getting as much total outcome as you otherwise possibly could.

Senator TOOMEY. Well, yes.

Mr. BARTHOLD. But you have made that choice for the Congress——

Senator TOOMEY. Right. For whatever other reasons, from a purely economic consideration, if you choose to use a less efficient source of energy, you have less prosperity, therefore, less growth and fewer jobs.

Mr. BARTHOLD. That is correct, sir.

Senator TOOMEY. Thank you.

Chairman HENSARLING. The chair now recognizes Congressman Van Hollen of Maryland.

Representative VAN HOLLEN. Thank you, Mr. Chairman.

I just want to agree with Mr. Camp and really with some of the observations you made earlier, Mr. Barthold, with respect to the need to consider corporate tax in conjunction with the individual tax side, given the increasing use of pass-through entities, so that we can make sure we understand the interrelationship between those things.

Looking at the corporate side, because I think there is consensus that, at the top rate, 35 percent, as has been said, is obviously higher than a lot of our competitors, much higher. Effective rates aren't necessarily all higher. But just so that we know where we are heading here in terms of the revenue and deficit impact that we have to make up if we want to do this in a revenue neutral way, is there a rough rule of thumb as to what it would cost in terms of lost revenue for every percent, you know, reduction from, say, the 35 percent rate? I have heard a rough rule of thumb about $100 billion a year.

Mr. BARTHOLD. I will have to check that for you, Mr. Van Hollen. We did a calculation like that in the past couple of years. But the enactment of expensing, which sort of changes a lot of the business cash flow over the 10-year period over which we have measured this, changes that calculation a bit. So I will get a new calculation.

Representative VAN HOLLEN. It would be helpful for us just to sort through this. Because if we wanted to do this within, say, the corporate Tax Code we would have to look at which tax expenditures we thought we should prune or eliminate in the process.

Let me just go back—circle back to a question that has been asked of you in different ways but with respect to scoring. And you have mentioned the House rules, and I have looked at some of the analyses that you have done with respect to taking into account the GDP effects. And as I understand your analyses, one of the reasons you might be reluctant to include a set rule within the score is that they take into account so many different factors in the economy, what decisions the Fed makes, whether or not deficits—you know, the cost of the tax cut is offset. I mean, is that one reason why it is complicated—it complicates being able to have a hard and fast rule on this?

Mr. BARTHOLD. There is uncertainty. And the analysis that we provided to the Ways and Means Committee is just reflective of the uncertainty.

One of the points that you made, the uncertainty can arise from when you are dealing with changes in tax policy, changes in expenditure policy, you are dealing with what economists call fiscal policy, and there has been always the uncertainty of, well, if Congress takes one path of fiscal policy, what is the Fed's monetary policy? Do they accommodate that fully or do they partially offset that? That affects the macroeconomic outcomes.

Representative VAN HOLLEN. Thank you.

Thank you, Mr. Chairman.

Chairman HENSARLING. Dr. Barthold, before you begin your next testimony, I would inform you and other members we would anticipate that the hearing would conclude 1:30-ish, 1:45 perhaps. As a courtesy to you, the chair is certainly willing to declare a 5-minute recess.

I see you are ready to plow on. You are recognized for your second round of testimony.

Mr. BARTHOLD. Well, thank you again.

What I thought I would do, if you can turn back to just the little packet of pictures and tables, is I will try and give a very, again, a brief overview of the structure of the individual income tax, some prominent features. And then I wanted to maybe address in a little bit more detail the notion of going to our tax expenditure analysis that our staff prepares annually as the ultimate template for considering tax reform.

But, first, the basic structure of the individual income tax.

An individual computes his or her taxable income by starting from gross income. You reduce that by the sum of deductions allowable to get to adjusted gross income. Those are referred to as the above-the-line deductions. The taxpayer may then choose to either claim the standard deduction or itemized deductions, and then there is a deduction for personal exemptions depending upon the taxpayer's family size.

Then graduated rates are applied to the taxpayer's taxable income to determine a preliminary tax liability. We have at present and have had for several years special lower maximum rates on income from capital gains—realized capital gains and qualified dividend income. And then the taxpayer from the preliminary tax liability may reduce that tax liability by certain allowable tax credits.

Overlaying this, as I know all the members are aware, we have an individual alternative minimum tax, which is a separate calculation which in concept was designed to limit the overall ability to claim—and I will speak very loosely—too many deductions or too many credits.

If you turn to the first page in the second part of the pamphlet, these are just really kind of the key parameters, the beginning of the key parameters through time in terms of defining the individual income tax. We have reported here from 1975 through the current year the value of personal exemptions and the standard deduction. The reason to note these is to note that the individual income tax is a personalized income tax and that it depends upon filing status—married, single, head of household—and essentially the family size, the number of personal exemptions.

Senator PORTMAN. Would you tell us what page you are on? Are you on 71?

Mr. BARTHOLD. Senator Portman, if you go back to the special packet of figures, there was a break page that said part two. And it is because I organized the testimony as individual and business, but the co-chair said they would like to talk business first, so I put together this separate packet.

So if you go to the—if you then go to the second page that is labeled Table 2, Federal individual income tax rates for 2011, I reproduced this here just to show you the rate structure which begins with a bottom rate of 10 percent. But, remember, you don't get to that 10 percent rate until you are above the level of the sum of the standard deduction and the personal exemption. So there is effectively what is known as a zero bracket. Our top rate, as you can see, is 35 percent.

But I do want to note that, as you are well aware, effective in 2013 under present law the current rate structure of 10, 15, 25, 28, 33, and 35 becomes 15, 28, 31, 36 and 39.6.

For a little bit of history, the next page of your packet, Figure 10, reproduces for joint filers for some selected years the introductory point, the bracket point, and the value of the rate of the highest statutory marginal rate. And so what you can see is the history of the top bracket and the top rate through time since 1975.

The top rate has declined from 70 percent to 35 percent, soon to be 39.6. But the entry point at which you get to that top rate has also declined. So the top bracket in real 2010 dollars used to be at an income of—taxable income of over $800,000. Today, it is approximately $375,000.

Comparable to that on the next page is Figure 11, sort of the history of where the bottom bracket begins. And you can see through time that there has not been as much change in the bottom bracket's rate, but the entry point in real dollar terms has increased. Whereas in 1975 it was approximately $13,750, measuring in today's dollars, now you have no tax liability at all until an income as a joint filer of over $18,700.

Now, an additional feature of the last 35 years is that the Congress has enacted a number of tax credits. Some are specific to specific types of activities. In the previous discussion, some energy discussions were noted. The two most significant credits are the refundable credits, the earned income tax credit and the child tax credit.

Turning now to the next page, on Table 3 I identify under our current projections the 10 largest individual tax expenditures as part of the Internal Revenue Code today. And I wanted to note, as I did for business, that several of these items have consistently been among the top 10 tax expenditure items that we report and measure since we began this exercise in 1975. Four have made the top 10 lists in eight of the sample periods that we have taken over this period: the exclusion of employer contributions for health care and health insurance premiums, the net exclusion of pension contributions and earnings from employer pension plans, the deduction for mortgage interest on owner-occupied homes, and the deduction for nonbusiness State and local taxes. That would be sales taxes and/or State income taxes.

Now, earlier—I guess it was last December now—the National Commission on Fiscal Responsibility and Reform suggested that one approach to deficit control was to undertake a serious tax reform and to do that by looking at what is actually a long list of tax expenditures that the joint committee staff publishes annually. The appeal of that is probably made most clear in Figure 13, which is the very last page of the pamphlet—of the packet.

It just shows in a simple numerical count—this is not measuring dollars, and we have had a little bit of a methodological change. I can explain that later, if you would like. But that, basically, the number of tax expenditures has grown through time. That what have may reasonably be deemed special provisions of law that deviate from a more theoretically pure income tax, that we have added additional special provisions through time. And that is what the line graph on page 13 shows.

The National Commission suggested, let's take a clean slate, eliminate all or almost all the tax expenditures. And one thing I would like to emphasize for the committee—and this is coming from I guess persons must characterize themselves as sort of a tax technician—there is a lot of decisions that the members have to make to get to that clean-slate proposal. It is really not as easy I think as a simple read of the Commission report suggests of taking a clean slate.

First of all, it is not clear as a matter of crafting legislation what it means to eliminate a tax expenditure and take a clean slate. For example, I will take a very minor tax expenditure but a tax expenditure nonetheless.

A number of employers provide fitness and weight equipment in the workplace for their employees to use as a working place fringe benefit. Well, in tax principle that is compensation to the employee, and it is compensation that goes untaxed under the individual income tax.

And so if we were to say, well, let's wipe out that tax expenditure, how do I do that? Do I have to take a valuation of the value of the weight equipment and attribute that to the employees? You know, if someone is, you know, the classic couch potato and they wouldn't touch an exercise machine for anything so they don't go to the one at the workplace, does that person get the inclusion or not? Or do we do some second-best approach and say, well, we know that the employer incurred expenses to provide those facilities. Let's deny a deduction to the employer.

Those are—if we wanted to have a clean slate, those are a lot of important decisions both in terms of how we craft the law and in terms of what the ultimate revenue effect would be. And that is the second point that I want to make. In looking at our list of tax expenditures, the dollar value of a tax expenditure, as calculated by my staff and colleagues, is not the same as the estimated revenue effect to the Federal Treasury from elimination of that provision.

As another example, home mortgage interest deduction, it is on the top 10 list that I posited there. If we were to eliminate the home mortgage interest deduction, it doesn't mean that we automatically capture the full value of all that deduction. You will see a lot of different behavioral effects. I might decide to take some additional funds out of my savings accounts and prepay part of my mortgage, reducing future interest payments that I would be making and thus affecting the tax liability and the tax revenues increases that would result in denying me a deduction for my home mortgage interest. A new home buyer might decide to buy a smaller home and thus incur a smaller mortgage than they would under the present law baseline.

So two key points I would like to keep in mind is a lot of important decisions—because it is not obvious what it means to eliminate some tax expenditures and we can't just add up the dollars that we have—that my staff and I have reported as tax expenditure values and say we can get all that and reduce the deficit dollar by dollar by an elimination—we take into account a lot of important behavior, and how the legislation is crafted also affects that estimate.

Chairman HENSARLING. Thank you, Dr. Barthold.

Before the co-chair recognizes himself, again in anticipation of pending votes in the House, with the indulgence of our friends from the Senate, the chair would like the take the liberty of calling upon House Members first and then yielding the gavel to my co-chair, Senator Murray, to conclude the hearing.

So at this time I will yield to my——

Co-Chair MURRAY. To the co-chair, many people think that this is a partisan divide. I want to just concede that the Senate is being conciliatory in the manner of this committee in allowing that to occur.

Chairman HENSARLING. Duly noted for the record.

Dr. Barthold, I want to go back to your Figure 3, Federal receipts as a percentage of GDP. And you have graced us—and I mean that sincerely—with a number of charts that are very helpful. I did not—do you have a similar chart that just deals with Federal income tax receipts as a percentage of GDP with a historical retrospective to the post war? I did not see one.

Mr. BARTHOLD. I have it in the—not a picture, but I have the back-up data for it, I believe, in the Appendix around page 7. If it would be helpful to have it in figure form, I can get that.

Chairman HENSARLING. At some point.

Because, again, I want to return to a question I had earlier. Regardless of the ongoing debate about the wisdom of raising individual marginal rates, I am just questioning from a historical perspective just how promising of a reservoir of revenue that may prove to be. Because I have looked at other data—and, again, you don't have data right in front of me that totally correlates—but I believe somewhere in the early 1950s marginal rates were as high as 90 percent, yet income tax revenue as a percentage of GDP was roughly 10 percent. Somewhere in the late 1980s I believe the top marginal rate dropped as low as 28 percent, and income tax revenue as a percentage of GDP was somewhere in the 10½ to 11 percent range, I believe. And at least the data I have seen that shows wide disparities in the top marginal bracket yet income tax revenue as presented to GDP has been roughly 9 to 10 percent. Is that a fair reading of the data? Do you have data that is similar or contrary to that——

Mr. BARTHOLD. Page 49 of the large version of my testimony has the individual income tax and the other Federal taxes as a percentage of GDP year by year from 1950 to 2010.

And just to confirm your recollection, as you did note earlier this morning, in coming out of World War II and then at the time of the Korean War top individual marginal tax rates were 90 percent or above. The 1986 Tax Reform Act lowered the top individual tax rate to 28 percent, although there had been other legislation prior to that. It didn't drop from 90 to 28. There had been other legislation prior to that.

There were at the time, both in the 1950s and then later in the 1960s, 1970s, 1980s, a lot of other things going on, both in terms of the economy and, of course, in terms of tax policy. Part of the 1986 Reform Act broadened the base, so it lowered the rate and broadened the base. In the 1950s and 1960s, there was some tax sheltering activity. Part of the 1986 Act was to try and moderate, mitigate, tax sheltering activity with a broader base and attract

people into more regular investments, as opposed to tax shelter investments.

Chairman HENSARLING. Forgive me, Dr. Barthold, but my time is running out here. I want to get in one or two more questions.

In data we have seen from the Congressional Budget Office under their alternative fiscal scenario, essentially their current policy baseline, they show revenues growing in nominal terms by $2.1 trillion over the next decade. Under a current law baseline, they show tax revenues growing by $2.6 trillion over the next decade. Do you have a similar analysis? Do you agree or disagree with their figures that, either under a current policy baseline or a current law baseline, that tax revenues are predicted to increase?

Mr. BARTHOLD. Just to reemphasize, Mr. Hensarling, we do all our work consistent with the Congressional Budget Office macroeconomic and receipts baseline. So, yes, we concur. If that is how they characterized the current policy baseline, I concur in Doug Elmendorf's projections. Those are the projections that we use.

Chairman HENSARLING. In the limited time that I have, with respect to individual income tax rates, one of my colleagues brought up the question of tax fairness, which is a very important subject. It tends to be a subjective subject. It is important for a number of reasons, I assume not the least of which is compliance.

But with respect to the facts, the latest data I have seen from the IRS I believe dates back to either 2007 or 2008 and would indicate that the top 1 percent of wage earners pay approximately 40 percent of the income taxes; the top 5 percent pay approximately 60 percent of the income taxes. Do you agree with that analysis?

Mr. BARTHOLD. I will produce separate tabs for you on that——

Chairman HENSARLING. I appreciate that.

My time has expired. And, again, the gentleman from California has perfect timing, so the co-chair will yield to the gentleman from California, Congressman Becerra.

Representative BECERRA. Thank you, Mr. Chairman.

Mr. Barthold, thanks again, and let me focus on a couple of things.

We have heard quite a bit in the last several days about the Buffett rule, that someone like Mr. Buffett, one of the wealthiest men in the world, pays at a lower rate of taxation than does his secretary. Could you tell us a little bit about the features of the Tax Code that makes something like this possible, that someone who is making so much money, not a millionaire but a billionaire, could actually have an effective tax rate that is lower than his secretary?

Mr. BARTHOLD. I assume that what Mr. Buffett is referring to is his average tax rate, which is the total amount of tax that he pays over his total amount of income, although it is possible he might be referring to his marginal tax rate. I am honestly not clear on what he is claiming.

But let's assume that his secretary is paid less than approximately $106,000 a year. So that would mean that the secretary is—each additional dollar—and I will talk marginal tax rate—is subject to the individual income tax rate and is subject to the payroll tax rate. Now, Mr. Buffett, as you posited, I don't know what sal-

ary he is paid, but his total income is not all subject to the payroll tax rate, the Social Security part of payroll.

Representative BECERRA. So any individual that has an income that exceeds $106,000, $107,000——

Mr. BARTHOLD. That exceeds the wage base is not subject to the Social Security part of the payroll tax. Their wage income is still subject to the Medicare part of the payroll tax. So that would be one factor.

Representative BECERRA. So that helps lower the rate a bit for those who are wealthier or who make over $107,000 in income.

Mr. BARTHOLD. In terms of a marginal rate.

Now, if we are looking at average tax rate it becomes a little bit more complex. Because, as I noted here, depending upon your filing status and number of dependants, the first $10,000 to $15,000 to $18,000 of income is not subject to any tax and, in some situations, you are eligible for the earned income tax credit. Those features would go into calculating an average tax rate.

Representative BECERRA. Let me see if I can concentrate you a little bit, because I know my time will expire.

Someone who has a lot of investment income, passive income, you have got dollars in stocks or bonds, does the fact that part of your income or a great portion of your income is generated through those investments, through passive income, have a great deal to do with the distortion we see in someone very wealthy, having a high income paying at a lower rate than his or her secretary?

Mr. BARTHOLD. Both the relative average and/or effective marginal rate would be affected by the composition of income. Under present law, there is a top statutory tax rate on income from capital gains of 15 percent.

Representative BECERRA. So let me make sure. So capital gains, right now, 15 percent is taxed. There is a 15 percent tax on the gain on a particular investment, capital gains investment.

Mr. BARTHOLD. If you realize an asset that has a gain so your stock appreciated in value and you sold it, the gain would be taxed at a maximum of 15 percent.

Representative BECERRA. Right. Let me see if I—okay. Because I am going to quickly run out of time.

So your stock appreciated, you sold it, you had a gain on it, a profit, you are taxed at 15 percent.

Mr. BARTHOLD. That is correct.

Representative BECERRA. The secretary gets a paycheck every 2 weeks, every month, sees the payroll deduction, pays taxes on the income, could be at the higher level of up to 28 percent. She is paying at 28 percent if she has got income that takes her to that tax rate, but the profits on that stock that was sold will only pay at the 15 percent. That could account for part of why some folks who are very wealthy have a lower rate.

Now, another question. We often hear people say, well, some Americans don't pay any taxes. What they are I think really saying is they don't pay any Federal income taxes. Because most Americans will tell you, I just went to the grocery store, and I pay taxes, the sales tax. Every time I take a look at my property tax bill and I have to make that payment, I pay taxes on the property. There

are certain excise taxes. So even modest-income Americans are paying taxes of some sort, is that correct?

Mr. BARTHOLD. We have a lot of different taxes in the United States, yes, sir.

Representative BECERRA. Thank you.

I yield back my time. Thank you, Mr. Chairman.

Chairman HENSARLING. The co-chair recognizes Congressman Upton of Michigan.

Representative UPTON. Thank you, Mr. Chairman.

Again, I want to reiterate and put myself firmly in support of tax reform. Though I wasn't here for Kemp-Roth I would love to vote for Camp-Baucus at some point down the line, maybe in the next 2 months.

Let me ask a couple of questions. One, you talked a little bit about the mortgage interest deduction and the fact that it may not be scored—if that was removed, it may not be scored at the $484 billion, as you have reflected here on Table 3. Have you actually—has Joint Tax actually done an analysis on if that was removed what the impact would be, the jobs and economic impact on home builders and roofers and the whole impact on the construction sector across the country if that was taken away?

Mr. BARTHOLD. We have not been asked to do that, sir.

Some of our macroeconomic capability in the modeling we do separately model a housing sector, but we have not looked at a proposal that targets a large swath of mortgage interest deductions either for new loans or existing loans.

Representative UPTON. I think that would be very important for the committee to understand in terms of the economic impact if that was removed.

The second thing, I want to get back briefly to this cap or if the 15 percent on capital gains was increased. Again, you mentioned earlier my question—there is a question as to how many folks, if you raised that percentage, would it be—would folks not bank as much or save as much? Would they spend it? What is the impact on jobs if that 15 percent capital gains tax was raised in terms of the spending power that folks will have taken away because they won't have that income for themselves? Have you done any studies on that at all or not, particularly maybe as reflected when we added a higher tax rate in earlier years?

Mr. BARTHOLD. Well, Congressman, under present law, that 15 percent rate moves to 20 percent in 2013.

And, again, we have not recently had any—really any request to analyze a broader change to raise that rate, so we have not undertaken a macroeconomic analysis. I don't even think we have done one of our conventional estimates recently for a change in that rate.

Representative UPTON. The last question that I have is, I know earlier this year former Assistant Treasury Secretary Pam Olson told the Senate Finance Committee that if the AMT survived tax reform that the committee should go back and start over. I would like to think that we would have the same view among the 12 of us here.

What are the compliance and complexity issues involved as it relates to removing the AMT? I know, as I understand it, when it

first was put into place the view was that it was going to impact about 16 American families, and today obviously it is tens of thousands. So what advice do you have as it relates to that?

Mr. BARTHOLD. Well, the AMT was redesigned in 1986. And really kind of the intent of Congress in 1986, it wasn't per se a small number of higher-income families. It was really to say we are broadening the base, and we wanted to put some overall cap on the ability of people to take the deductions or special credits or exclusions that remain. Now, that in and of itself didn't automatically target it at any particular income level. The targeting was by the exemption.

Complexity, the fact that you run a dual tax system and that you plan or you have to prepare your taxes under one schedule and then go recompute under a different schedule, obviously additional time taken, additional complexity, additional chance for error.

I think everyone on our staff, of course, recognizes that a number of people are frustrated with sort of a dual system. It is a difficult policy problem that I know the members face.

Chairman HENSARLING. The co-chair now recognizes Congressman Clyburn of South Carolina.

Representative CLYBURN. Thank you, Mr. Chairman. Mr. Barthold, thank you so much. I have two quick questions.

When Dr. Elmendorf testified last week, I asked him a question about unemployment and what impact that number has on the deficit. Could you give me some idea as to whether or not you think there is any correlation between that unemployment rate, job growth, and the deficit.

Mr. BARTHOLD. Between job growth and——

Representative CLYBURN. Job growth. Let me ask it another way. The impact, reducing the unemployment. If you were to drop unemployment from 9.1 to, say, 8.6, can you give us some idea of what impact that would have on the deficit?

Mr. BARTHOLD. Well, I am sure that Doug Elmendorf probably gave a more precise estimate. I think the point that he——

Representative CLYBURN. I assure you he didn't. He said he would have to get back to us.

Mr. BARTHOLD. Oh, he did, okay. Well, then, I will wait for that, too, but I will tell you the general principle that is going to, to get lower unemployment, you are getting stronger economic growth. Stronger economic growth means that there is more national income, which means that our tax base is expanding, so if we could magically get more economic growth, you know, doing nothing, then the deficit would decline from increased economic growth, and so——

Representative CLYBURN. So there is a correlation.

Mr. BARTHOLD. I, too, will wait for Doug's analysis on that.

Representative CLYBURN. Let me ask you, what impact would lifting the payroll taxes have, if you were to lift that cap, I know it is $106,800 today, if that were moved to 212, 215?

Mr. BARTHOLD. We have not had any cause to estimate a proposal such as that. If the Joint Select Committee wanted to explore that, we could provide an estimate of that proposal.

Representative CLYBURN. Mr. Chairman, would it be okay to ask for? I would like to see some analyses——

Mr. BARTHOLD. Okay, we will provide that.

Representative CLYBURN [continuing]. Incrementally up to doubling it.

Mr. BARTHOLD. Okay. So to a wage base of $212,000 was your——

Representative CLYBURN. Maybe 150, 175, 212, some incremental steps.

Mr. BARTHOLD. Okay, a couple of different halfway marks.

Representative CLYBURN. Yes, sir.

Mr. BARTHOLD. Okay, we will respond.

Representative CLYBURN. Thank you. Finally, I also would like to see, I understand you are going to get back to us with the numbers as to who is paying how much, and I know I have been hearing talk of late about whether or not the low income pay their fair share of taxes. Could you provide us with some kind of a profile of who the taxpayers are and what kind of taxes they are paying?

Mr. BARTHOLD. Okay. We have for both Ways and Means and Finance for some hearing work have provided some analysis like that. I will assemble that and I will get that to the Joint Select Committee members.

Representative CLYBURN. I would very much like to see that. Thank you so much, and I yield back.

Chairman HENSARLING. The chair recognizes Congressman Camp of Michigan.

Representative CAMP. Thank you, Mr. Chairman. The Joint Committee on Taxation regularly publishes data on average tax rates paid by Americans, do they not?

Mr. BARTHOLD. Well, actually we don't make it a routine practice, but we end up for work for your committee and for the Finance Committee often preparing that information.

Representative CAMP. And you have recently published the data on that?

Mr. BARTHOLD. Yes, we have.

Representative CAMP. And it is made available to the public?

Mr. BARTHOLD. Yes, it is.

Representative CAMP. And you are not alone, the IRS also does this?

Mr. BARTHOLD. The IRS reports with a lag because they report on actual, compilations of actual tax returns filed.

Representative CAMP. And the Congressional Budget Office also does this, do they not?

Mr. BARTHOLD. CBO does some distribution work using slightly different modeling assumptions, but yes, they do.

Representative CAMP. And according to the recent Joint Committee on Taxation, and I just want to go at this point of millionaires and billionaires pay lower rates than middle class families, which has been out there in the public domain, and I just want to go at this point.

Mr. BARTHOLD. Certainly.

Representative CAMP. According to your recent Joint Committee on Taxation data on income, social insurance and excise taxes, Americans with incomes between $50- and $75,000 pay an average tax rate of 12.8 percent, and Americans with incomes over a million dollars pay an average tax rate of 23.6 percent?

Mr. BARTHOLD. That is income and payroll taxes combined.

Representative CAMP. Yes.

Mr. BARTHOLD. Yes, sir, that sounds——

Representative CAMP. That sounds correct? And the IRS backs this up. Every agency does a little bit different analysis, but they also have the most recent data saying on individual income tax rates Americans making a million dollars or more pay an average of 23.3 percent, so it pretty closely tracks what you say, but they say Americans between $50,000 and $100,000 pay an average rate of 8.9 percent.

Mr. BARTHOLD. Okay.

Representative CAMP. And CBO has a similar analysis. According to their most recent data on Federal taxes, and that is income, social insurance, corporate income taxes, and excise taxes, and household income, the top 1 percent of American households who earn an average, and they have a category of 1.7, above $1.7 million, pay an average tax of 31.2 percent, and middle income families pay an average—and that is between an average income of $60,700—pay 14.2 percent. So in America it is just not the case that millionaires and billionaires pay at a lower rate than middle class families.

Mr. BARTHOLD. I was going to say that is why I was trying to clarify for Mr. Becerra's question whether Mr. Buffett was talking about marginal tax rates or whether he was talking about average tax rates. What you are reporting are all what we refer to as average tax rates, taking total amount of tax paid and dividing it by your total income.

Representative CAMP. Well, frankly, Mr. Buffett needs to give his secretary a raise. But, I also want to talk about the comparisons in income of salary versus capital gains, and they are different, aren't they?

Mr. BARTHOLD. One is return to investment, the other is return to labor effort.

Representative CAMP. And in common parlance, one is taxed twice?

Mr. BARTHOLD. Capital gains from equities, from stock, the growth in the value that gives rise to the gain is in most cases from increased earnings by the business, and the business is taxed at the business level, as you noted. You can also have capital gains on other capital assets that are not in corporate form.

Representative CAMP. But for the average American in terms of the rhetorical discussion here, capital gains is taxed twice, salaries are not. Now, salaries are deductible by business entities, are they not?

Mr. BARTHOLD. That is correct.

Representative CAMP. And that is another difference; is that correct?

Mr. BARTHOLD. Well, that is your single level of tax.

Representative CAMP. Right. So the comparison of the two is not actually comparing two like commodities or two like things, which is the point I wanted to make. So I appreciate your comments, and I appreciate the work that the Joint Committee on Taxation does analyzing tax data. It does track what the IRS and the Congressional Budget Office are also saying about average tax rates paid

by both middle income and high income Americans. So thank you for your testimony.

I yield back.

Mr. BARTHOLD. Thank you, Mr. Camp.

Chairman HENSARLING. Congressman Van Hollen of Maryland is now recognized.

Representative VAN HOLLEN. I thank you, Mr. Chairman. We are talking about averages of averages. In other words, average tax rates for average taxpayers over certain income levels. One of the ideas of trying to make this fair is to make sure that no individual taxpayer can take advantage of a lot of special preferences, and I would point out that the top 400 richest Americans, all making over $110 million per year and making an average of $271 million a year, paid only 18 percent of their income in income tax in 2008, the effective rate.

But what I really want to turn to is the larger conversation about tax expenditures that has been discussed by many tax experts for a long time but has gotten more popular discussion as a result of Simpson-Bowles and some of the other commissions that have looked at this. And there are a number of ways to deal with the tax expenditure issue. One is to look them over and decide to eliminate them or a subset of them. That could be used to reduce the deficit, raise revenue, and also to buy down rates.

Another way to do it is along the lines of one of the proposals the President made, which is for higher income earners, for example at the 35 percent rate you would say their deductions, regardless of what specific deduction it was, would get the 28 percent deduction level as opposed to 35 percent so that higher income individuals weren't getting, you know, a disproportionate benefit from the deduction.

A third way, and this is what I want to focus on, is to not look at any particular deduction but to find a way to limit the overall number of deductions. Then you don't have to necessarily get in a fight over whether this has important social policy or another policy. One way that has been done in the past was something named after former Congressman Pease, Don Pease, which is still an aspect of the Tax Code which sort of phases out your deductions based on your income, and one of the concerns that have been raised by some people about that, including some of our Republican colleagues, is it changes indirectly your marginal, your top marginal rates.

But there is another way to go about this, and I want to explore that, and this is in the interest of searching for common ground, and Martin Feldstein, who was of course the Chairman of the Council of Economic Advisers under President Reagan, has written about this. He has written about it in *The Wall Street Journal,* the headline of the article, "The Tax Expenditure Solution to Our National Debt;" written about it in *The Washington Post*, headline "How to Cut the Deficit Without Raising Taxes;" and I do want to just read a portion of his article.

It says, "There is a way to cut budget deficits without raising taxes. Tax expenditures are the special feature of the U.S. income tax law that subsidize a variety of things," and he says "with respect to the Simpson-Bowles proposals, their most extreme sugges-

tion is to eliminate all tax expenditures raising a trillion dollars a year in tax revenue, and then use all but $80 billion of that to cut taxes." He goes on to comment, "I think that devotes too little money to deficit reduction at a time when fiscal deficits are dangerously large," and then he goes on to present another alternative because, as you pointed out, there may be tax expenditures that whether for policy or political reasons people aren't going to want to go after. So rather than picking one, he says "let's try and get at this overall issue," and here is his practical alternative, and I am quoting, "Congress should cap the total benefit taxpayers can receive from the combined effect of different tax expenditures. The cap could be set as a percentage of an individual's adjusted gross income and perhaps subject to an absolute dollar amount."

Mr. Barthold, my question to you is, that approach, does it address the concerns some have raised with respect to the so-called Pease approach in that the approach being presented by Martin Feldstein does not affect the top marginal rates or the marginal rates?

Mr. BARTHOLD. The short answer is yes. Do you want me to explain why?

Representative VAN HOLLEN. Yes, if you could, because again I am offering this in the spirit of common—you know, trying to find some common ground here.

Mr. BARTHOLD. By contrast, the Pease provision basically says if you earn more income, I take more of your itemized deductions away. So that has the effect, as it is drafted, of increasing your marginal rate by 3 percent. So if you were otherwise in a 31 percent bracket, your effective marginal tax rate on earning additional income, and if you are subject to the Pease provision, would be 31 percent.

Now, what Professor Feldstein has proposed is a cap that is based against—on adjusted gross income, and so as you earn more income, as your adjusted gross income goes up, the cap actually goes up, and so if the cap were binding on some taxpayers, the effect of the Feldstein proposal would be to I earn an additional $100, well, that will increase my allowable deductions by whatever the percentage cap is, so that I maybe even increase my deductions a little bit, which means my taxable income goes up by $100 or if the cap is binding, slightly less than $100. So that leaves the marginal tax rate either unchanged or in some cases will reduce it.

Now, I, too, read *The Wall Street Journal* op-ed piece by Professor Feldstein, and he had proposed a cap of 2 percent.

Representative VAN HOLLEN. Right.

Mr. BARTHOLD. Now, most of our States do have State income taxes which are deductible against the Federal income tax, and the State income taxes are generally at a rate above 2 percent, so the State income tax would generally go up and increase your itemized deductions, which means it is really sort of a wash. You wouldn't get that reduced marginal rate effect, but you would be held constant.

Representative VAN HOLLEN. At the Federal level you could actually have a reduction in your marginal tax rate?

Mr. BARTHOLD. Well, not if you are in a State with State income——

Representative VAN HOLLEN. Okay, and I would just——

Mr. BARTHOLD. It would never increase the marginal rate.

Representative VAN HOLLEN. Right.

Mr. BARTHOLD. It would only hold it constant or reduce it.

Representative VAN HOLLEN. Thank you. And I just urge my colleagues to take a look at this concept.

Chairman HENSARLING. The co-chair recognizes his co-chair, Senator Murray of Washington.

Co-Chair MURRAY. Thank you very much. I wanted to ask your opinion about this notion that tax expenditures are just another form of government spending. I have heard Chairman of the Federal Reserve, former Chairman Alan Greenspan, Martin Feldstein that was just being referred to. Both have argued that tax expenditures are simply a difference in form than in-kind as direct government spending, and I wanted to ask you, what is your assessment on whether or not tax expenditures are just simply government spending in an alternative package?

Mr. BARTHOLD. Well, Senator, that is—the construct of the tax expenditure is to say where am I doing something special, and there is a lot of different ways that government policymakers can choose to do something special. I mean, you could have a direct subsidy or you could have implicitly a subsidy through the Internal Revenue Code. So in that sense you think of tax expenditures as spending by another name.

Now that sort of begs the question of why on policy merits, you know, you decided, you know, the Congress decided to do it, why they decided to do it this way. In some cases a direct spending program could be easier to administer and more efficacious, could require fewer rules. It is possible that the opposite could also be the case, that it could be, you know, easier to administer a tax benefit than, you know, a specific new government program.

So, remember, it is a notion measured against a more, an idea of a more theoretically pure income tax and saying where I am deviating from that is I am not measuring income correctly or I am not measuring income theoretically correctly, and I am putting a value to that deviation, and so I could have said, here, measure someone's income correctly and then provide a subsidy related to whatever the activity is that you wanted to do.

Co-Chair MURRAY. Okay. Well, we have heard over and over and over again about the need to review and reduce redundant, wasteful, inefficient government spending. The Budget Control Act, which we just did, cuts a trillion dollars over the next 10 years, that is a very important step in that direction. These budget discussions and cuts are impacting directly a lot of people now as we try to put together our appropriations bills, those of us who are on that committee are watching the pain. We have reduced and eliminated programs that benefit students, we have cut support for police officers on the street, we have reduced support for programs that keep people in emergency shelters rather than homeless. I mean, these cuts are having an impact.

However, we have still largely left untouched whether it makes sense to keep a whole host of these tax expenditures, whether we should continue mortgage interest tax breaks for a yacht that qualifies as a second home, whether the entire amount of Leona

Helmsley's $8 billion charitable bequest for the care of her dogs should be left untouched, whether Kentucky thoroughbred horses should be given special tax breaks. We actually even have a tax credit for employees on former Indian lands in Oklahoma, which is now covering two-thirds of that State.

So, you know, maybe some of these tax credits make sense, maybe they don't. We have had an intense discussion here about earmarks. We have not had an intense discussion about these tax expenditures.

I wanted to ask you if you see any policy reason why we could not analyze or consider individual tax expenditures as candidates for elimination or modification outside of comprehensive reform or do we have to wait for reform of this whole system?

Mr. BARTHOLD. Senator, those sort of decisions are in your hands. I mean, the tax writing committees in their oversight role are looking at a number of these provisions all the time, so I mean, I guess I don't have an answer that is better than that for you. You certainly can explore the merits of different provisions.

Co-Chair MURRAY. Okay, thank you. I yield back my time.

Chairman HENSARLING. The co-chair now recognizes Senator Kyl of Arizona.

Senator KYL. Just a couple questions, but following up on Senator Murray's question, are tax expenditures just another form of government spending? In looking at the 10 items listed under tax expenditure in your Table 3, isn't it the fact that only one of those, the earned income tax credit, is actually scored as outlays, government outlays?

Mr. BARTHOLD. That is true.

Senator KYL. Second, relative to Representative Becerra's line of questioning, just to put a little bit of an exclamation point on this, let's say you are a teacher, you hold some stocks or you have got a pension, it has got stocks in companies, you get a dividend from that. The value of what you receive is affected by what the corporation first had to pay in its corporate taxes; isn't that correct?

Mr. BARTHOLD. That is the point.

Senator KYL. So the old saw that corporations don't pay taxes, people do is actually true, and so when—and I presume that Warren Buffet's income is largely derived from passive income of one kind or another, dividends, capital gains, whatever other kind of corporate earnings there may be on his significant investments. So to really calculate what he pays in taxes, you would also have to know what the companies that he is invested in have paid in the way of corporate income taxes, would you not?

Mr. BARTHOLD. To figure out the full burden.

Senator KYL. And that is true of anybody else with investment, with stock investments, for example?

Mr. BARTHOLD. Yes.

Senator KYL. Thank you very much.

Co-Chair MURRAY [presiding.] I will yield to Senator Portman.

Senator PORTMAN. Thank you, Madam Chair. I would like to, if I could, dig a little deeper on the individual side now that we are over there, and I would go back to the basic question, you know, what should the burden be, we have talked about that, of taxation on a weak economy, and then what is the best system.

Looking at your testimony, starting on page 35 you talk about the Simpson-Bowles approach, and you make the point that some of the revenue estimations from the Joint Committee on Taxation are going to be different than some of the general reporting from the Simpson-Bowles committee because there are some interactions between some of these tax preferences.

However, my general question for you is, have you all had the opportunity to do an analysis, to do a revenue estimate of the Simpson-Bowles proposals? I know it is a menu, in essence. If you could answer that, it would be helpful.

Mr. BARTHOLD. Well, the short answer, Senator, is no, and that is for the one reason that I elaborated on in the testimony, and that is because underlying the idea of eliminating tax expenditures is, need some policy calls on, you know, what the Members intend to do, what effective date the repeal mortgage interest deduction, would it be just for new mortgages or would it be for all?

Senator PORTMAN. I didn't provide you enough specificity to be able to come up with a score, but you could come up with a score if certain decisions were made on timing?

Mr. BARTHOLD. There is a long—if decisions were made, we would get to work, but there are a lot of decisions to be made.

Senator PORTMAN. But do you disagree with their menu? In other words, do you think that their analysis is accurate as to the various rates that you could get to based on the reduction of certain preferences?

Mr. BARTHOLD. Well, I think I have to disagree some. What they are saying is if you gave, you know, if you started with several hundred billion dollars over, let's say, you know, a 10-year period, that that would enable you to achieve, you know, X percentage point reduction in individual rates. That part of the analysis is probably, you know, reasonably consistent with the analysis that we would do.

The point that I was making was that you can't take this, my top 10 list here and add it up and say, ah, that money is available to reach that same amount of——

Senator PORTMAN. Because there will be transitions, there will be some timing issues.

Mr. BARTHOLD. Well, not just transition, but our tax expenditure calculations do not account for taxpayer behavior that would occur if you eliminated them.

Senator PORTMAN. Right, some of the interactions. Well, I think that would be very helpful, if we could give you some more specificity as to timing and specifically, you know, which preferences we are talking about because those sorts of scores are very valuable. I know you have done some of this for Senator Wyden and his good work, he did with Judd Gregg last year and with Senator Coats this year, I know you have some joint tax estimates on both the individual and corporate side there; is that correct?

Mr. BARTHOLD. Well, you know, officially we never comment on any work that we do for any individual Member, but if Senator Wyden told you that we did work for him, I am sure we did.

Senator PORTMAN. I just revealed a great secret here. My point is simply that there has been a lot of work done on the impact of

some of these changes and preferences and how it would affect rates.

Mr. BARTHOLD. We have done work on a number of provisions that are like a number of things that people want to look at when they talk about modifying tax expenditures, but, again, it matters a lot what you want to do.

Senator PORTMAN. Quickly, can we talk about AMT for a second? Can you tell us what the cost is of eliminating AMT over the next 10 years under the current law baseline?

Mr. BARTHOLD. Yeah. I think we are a little bit above $1.1 or $1.2 trillion.

Senator PORTMAN. Okay, and is that with or without extension of the tax cuts? Are you talking current policy or current law? Are you talking about under the current law baseline?

Mr. BARTHOLD. That is under present law, which assumes that the current——

Senator PORTMAN. Elimination of all the Bush tax cuts?

Mr. BARTHOLD. Well, that the current—yes, that is letting EGTRRA/JGTRRA expire and also the current AMT patch would expire.

Senator PORTMAN. Which affects the AMT costs, correct?

Mr. BARTHOLD. That is correct. There is interaction——

Senator PORTMAN. What about a patch, what is a patch under the scenario of current law assuming that we are—it is about 600, 650?

Mr. BARTHOLD. I don't recall. I think it is closer to $800 billion.

Senator PORTMAN. Okay, and that again assumes—that sounds like it might assume that the top two rates do not expire or does that assume current law?

Mr. BARTHOLD. Under—I think that is under current law, yeah.

Senator PORTMAN. Okay, we would love to have those numbers. I think there is a consensus on the committee here that we want to look at least at the idea of patching the alternative minimum tax for all the reasons we talked about today.

Mr. BARTHOLD. We will provide all the members with an estimate of—when you say the patch, would you propose just indexing the current——

Senator PORTMAN. As Congress has done over the last several——

Mr. BARTHOLD. Well, Congress has done it three different ways. We will come up with something for you.

Senator PORTMAN. Okay. And in terms of AMT, have you also looked at the impact on your macroeconomic analysis we talked about earlier? In other words, if you keep the Tax Code as it is and allow the AMT to hit another 20 or 30 million Americans, what would the impact be on the macroeconomic side, including GDP?

Mr. BARTHOLD. Some of the AMT effect has been built in to past work that we have done. Since the AMT is part of present law, the way our macroeconomic analysis is undertaken is we take our conventional modeling analysis and use that to determine what the effective marginal tax rates are on different classes of taxpayers, on wage income, on their return to saving. So that is built in.

If your specific question is if we—have we done an analysis that says maintain present law except for some change in the AMT, no, we have not done such a macroeconomic analysis isolating on——

Senator PORTMAN. Okay. Thank you, Madam Chair.

Co-Chair MURRAY. Thank you. Senator Kerry.

Senator KERRY. I was reminded a little while ago, somebody mentioned the Tax Reform Act of, I guess, 1986, the rates at 70 percent, I had the pleasure of voting to get rid of the 70 percent and come down to—I think originally we chose two rates, as I recall it was 28 and 14 under the Reagan proposal.

Mr. BARTHOLD. 14 and 28.

Senator KERRY. Yes, and then we found we couldn't make it work, there wasn't sufficient revenue, et cetera, and we popped it up to the 33, and then there were sort of these incremental changes, so we have had some experience with this process.

What I would like to ask you first of all is, the tax expenditures are substantially higher today, are they not, than they were immediately after the Tax Reform Act of 1986?

Mr. BARTHOLD. Senator Kerry, tax expenditures, remember it is a measure of the value of, for example——

Senator KERRY. Well, both in total size and as a percentage of tax receipts, they are substantially higher than they were immediately after 1986?

Mr. BARTHOLD. Well, one—a nuance I want to put to that is the calculation of the tax expenditure depends upon the tax rates. Since tax rates today are higher than they were immediately after the 1986 act, absent anything else, the measure of tax expenditure——

Senator KERRY. But the tax expenditure per se hasn't been responsible for the growth? It is not the tax expenditure that has suddenly changed; it is other things, is it not? Choices we made about what to provide as a preference, perhaps?

Mr. BARTHOLD. And that is what the last figure in my short packet, you know, indicated was that Congress has made policy decisions.

Senator KERRY. Exactly, and I want to come to that for a minute because I think it is important for all of us to connect those. I think we have got to understand the relationship between those choices, that the actual tax expenditure itself post-1986 is substantially the same as the one we have today, but other things have happened. For instance, are some of the growth of tax expenditures attributable to the increase in the tax rates?

Mr. BARTHOLD. Yes, that was the point I was just making, in terms of measuring the value.

Senator KERRY. So that is one increase. Another increase, didn't we contribute to them relatively substantially when we passed the preferential treatment on capital gains and dividends?

Mr. BARTHOLD. That is one of the larger tax expenditures.

Senator KERRY. That increased that expenditure?

Mr. BARTHOLD. Yes.

Senator KERRY. Likewise, the incentive on retirement savings?

Mr. BARTHOLD. Retirement savings, as I noted here, it makes our top 10 list.

Senator KERRY. Right. And in total those are the things that have most substantially contributed to the growth of the tax expenditures, the policy choices we made?

Mr. BARTHOLD. The policy choices that Congress has made are the factor that make, that have changed the tax expenditure budget. I will note that we did include in the appendix to the submitted testimony a list of all the tax expenditure items added since the 1986 act.

Senator KERRY. Right, and that is very helpful, and I think we need to bear through it. What I want to bear down on, Dr. Barthold, is all of the major proposals—I mean, I consistently hear colleagues on both sides of the aisle, and I share this, it would be great if we could simplify, it would be great if we could create pro-growth outcome, it would be terrific if we could broaden the base and reduce the rates. I think that—are those worthy goals that we ought to be pursuing?

Mr. BARTHOLD. Improved efficiency, more growth, it all sounds pretty——

Senator KERRY. Right. Now, most of the proposals to do those kinds of things envision reducing the sort of six marginal rates, bring them down to three rates, and that is what you hear most often, and a lower rate, corporate rate, the 25 percent seems to be the one that is sort of ringing bells these days. Is it possible, in your judgment, to structure a system that lowers the rates, broadens that base, and improves progressivity and creates growth in your judgment? Can you envision that based on your experience all these years in doing this?

Mr. BARTHOLD. It is feasible. You know, as a tempering factor, you remember that it is often the case in policy-making that goals will be in conflict. Reducing tax rates sometimes is in conflict with reducing what you perceive to be the overall fairness or equity of outcomes. Improving efficiency can mean that sometimes things are made more complicated rather than less complicated. So there can be lots of trade-offs. There is lots of different policy decisions. But it is a worthy thing to try.

Senator KERRY. Is it—well, in 1986, for instance, we tried to get really super simple, we created those two rates, but then we had that tax bubble that got created as a result. Can you sort of just as a matter of helping people understand the difficulty here just talk about that for an instance, of how that bubble came about?

Mr. BARTHOLD. How the bubble came about?

Senator KERRY. Yes.

Mr. BARTHOLD. The bubble——

Senator KERRY. What I am getting at is, can we create a system where you have two or three rates and you don't create a bubble?

Mr. BARTHOLD. The bubble sort of—remember the bubble was marginal, was about marginal rates. What the bubble did was it phased out the benefit of the standard deduction and the lower rates if you were above certain income levels. So while the bubble had this range of income over which the marginal rate of tax was 33 percent and then the marginal rate of tax dropped down to 28 percent, the effect of the bubble, by eliminating essentially to such a taxpayer the benefit of a zero rate of tax, the standard deduction or the personal exemption or the 14 percent bracket, had the effect

of by the time you were at the end of the bubble, your average tax rate was 28 percent, but everywhere in the bubble your average tax rate was less than 28 percent, less than 28 percent but increasing. So the bubble promoted overall progressivity but had the appearance—well, it didn't have the appearance, it had the actual effect of a marginal tax rate of 33 percent for someone in the bubble range and then the marginal tax rate dropped back down to 28 percent beyond the bubble range. But the person beyond the bubble range had a higher average tax rate than a person in the bubble or a person beneath the bubble.

Senator KERRY. So it is all very simple. We will get there.

Mr. BARTHOLD. I hope that was responsive. It was sort of a technical point.

Senator KERRY. No, it is an important point and I appreciate it. Thank you.

Co-Chair MURRAY. Senator Toomey.

Senator TOOMEY. Thanks very much, Madam Chairman. I want to go back to the topic of capital gains because I just think this is very, very important, and the one observation that I want to make is that I think it is abundantly clear that it is the investment of accumulated capital that makes economic growth possible, and any policy that diminishes that accumulated capital is very, very dangerous in terms of its implications for economic growth. Congressman Camp and Senator Kyl both observed that when capital gains are imposed on the appreciated value of a stock, it is almost certainly a form of double taxation because the underlying stock has been—had the income associated with it taxed in the first place, and that is certainly completely true.

I would like to make another point about this which has to do with inflation. Mr. Barthold, I am sure you would agree that in the post-war era our economy has had no sustained periods of deflation. We have had inflation of varying levels, but consistently. And we charge, we impose a capital gains tax on a nominal gain in value of an asset, not on the real gain. So that is to say that we impose the capital gains tax on the inflationary gain. Is that true?

Mr. BARTHOLD. Yes, it is correct. We tax nominal values throughout the Internal Revenue Code.

Senator TOOMEY. So if you had a sustained period where inflation averaged just 3 percent, as the math works out in 24 years, the value of assets doubles. I shouldn't say the value, the nominal price doubles, but yet the real value hasn't gone up at all in that scenario, and yet we would still impose a capital gains tax, wouldn't we?

Mr. BARTHOLD. That is correct.

Senator TOOMEY. So, in effect, what we are doing in the case of assets that appreciate in value, if the appreciation were due only to really the loss of value of the dollar and inflation, you would have zero real gain, and yet you would pay a tax, so you would literally be paying a tax, despite having no gain in real terms; isn't that true?

Mr. BARTHOLD. That is correct, sir.

Senator TOOMEY. So it seems to me that this phenomenon has long been part of the reason that at least we try to mitigate that

by having a capital gains rate that is lower than ordinary income tax rates, just one of the rationales?

Mr. BARTHOLD. That has been one of the stated policy rationales, sir.

Senator TOOMEY. Thanks, and I will yield the balance of my time.

Co-Chair MURRAY. Thank you very much. Under our agreement we had agreed that each member would have an additional minute. But, Mr. Barthold, you have been generous with your seat time here. In the interest of being a good example, I will yield back my time.

Representative Becerra, do you have one additional question?

Representative BECERRA. I do, I will make use rapidly of my one minute.

Mr. Barthold, very interesting here because I think everyone would agree that the Tax Code is neither simple or transparent, and the reality is that complexity, the opposite of simplicity, is what helps people hide what they should pay in taxes, and so if you have complexity and at the same time you don't have transparency, which is, acts like complexity in helping you hide your income, you can get away without paying what would be your otherwise fair share.

Now, it is really fascinating the way we treat corporations because there is this concern that we tax twice income that comes from a corporation because ultimately the individual is the one that pays the taxes. Are any Americans forced to form a corporation?

Mr. BARTHOLD. No, sir. Corporate is an elective form of business.

Representative BECERRA. Right. So if it is so bad, why are so many people forming corporations? Because they get certain benefits by doing so, whether it is on the tax side or otherwise. So I think we have to recognize that complexity and transparency, whether it is on the corporate side or individual side, should be removed so we can truly understand how we get to a fair Tax Code.

I yield back.

Co-Chair MURRAY. Representative Van Hollen.

Representative VAN HOLLEN. Thank you, Madam Chairman. Just to pick up on Mr. Becerra's question, because we have heard a lot about the double taxation of capital gains, but isn't it true that there are many assets that get the preferred 15 percent capital gains rate that are not subject to another layer of taxation, real estate, commodities, S corporations; isn't that true?

Mr. BARTHOLD. Yes, I made that point briefly when Mr. Camp was discussing the issue.

Representative VAN HOLLEN. Do you have any idea, you know, how that compares in magnitude to the overlapping?

Mr. BARTHOLD. Off the top of my head, I don't. Our staff has looked at that, and I can report from—back to the committee on, from what—the IRS creates a sale of capital asset files where we get some detailed information on what sort of assets do people realize in reporting capital gains. We will run some tabulations on the SOCA file, and I will make that available to the members of the Joint Select Committee.

Representative VAN HOLLEN. Thank you, Mr. Barthold. Thank you.

Co-Chair MURRAY. Thank you very much. I want to thank the witness today for participating and all of our members who were here today as well. I remind all of our members that they have 3 business days to submit questions for the record, and I would ask the witness to try and respond as quickly as possible. So all of our members should submit their questions by the close of business on Tuesday, September 27th, and with that without objection, the joint committee stands adjourned.

[Whereupon, at 1:45 p.m., the committee was adjourned.]

OVERVIEW: DISCRETIONARY OUTLAYS, SECURITY AND NON-SECURITY

WEDNESDAY, OCTOBER 26, 2011

UNITED STATES CONGRESS,
JOINT SELECT COMMITTEE
ON DEFICIT REDUCTION,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m., in Room SH–216, Hart Senate Office Building, Hon. Patty Murray [co-chairman of the committee] presiding.

Present: Senator Murray, Representative Hensarling, Senator Baucus, Representative Becerra, Representative Camp, Representative Clyburn, Senator Kerry, Senator Kyl, Senator Portman, Senator Toomey, Representative Upton, and Representative Van Hollen.

OPENING STATEMENT OF HON. PATTY MURRAY, A U.S. SENATOR FROM WASHINGTON, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Chairman MURRAY. This committee will come to order.

Before we begin, let me just remind all our guests that the manifestation of approval or disapproval, including the use of signs or placards, is a violation of the rules, which do govern this committee. So I want to thank all of our guests in advance for their cooperation in maintaining order and decorum.

First of all, thank you to my co-chair, Representative Hensarling, all of my fellow committee members, and Dr. Elmendorf for joining us here today, as well as the members of the public here in person or watching us at home.

This committee has been working very hard over the last few weeks to come together around a balanced and bipartisan plan to reduce the deficit and rein in the debt. We have heard from our colleagues. We have heard from the standing House and Senate committees, from groups around the country, and close to 185,000 members of the public through our Web site, *http://www.deficitreduction.gov*.

We continue our work now today with a hearing on "Discretionary Outlays, Security and Non-Security." And I am glad we are talking about this today because it is important for us to understand how these policies fit into our overall deficit and debt.

Nondefense discretionary spending represents less than one-fifth of total Federal spending. Listening to the debates here in D.C. over the last few months, you would think this small piece of pie

was a whole lot bigger. As I expect, we will hear more about that from Dr. Elmendorf today.

Congress has gone to this relatively small pot with cuts and spending caps again and again while leaving many other pieces of the budget essentially untouched, including the law that created this joint committee, which cut roughly $800 billion in discretionary spending. And all the focus on this one area is especially striking, given that we are spending about the same on nondefense discretionary programs in 2011 as we did in 2001. Meanwhile, mandatory programs increased, defense spending increased, and revenues plummeted.

So as this committee works together on a bipartisan plan to reduce the deficit, we need to keep in mind the cuts that have already been made, the role discretionary spending plays in our overall deficit and debt problem, and the impact irresponsible slashing could have on our economic recovery and middle-class families across the country. As we all know, these aren't just numbers on a page. They affect real people in real ways.

When food assistance for women and infants is cut, that means greater challenges for struggling families. When infrastructure investments are shelved, that means fewer jobs and more crumbling bridges and roads. And when research, education, and student loans are slashed, that means fewer opportunities for our businesses and the next generation of workers, which is really no savings at all since we end up paying for it in the future.

So while we should certainly examine every piece of the budget to see where we can responsibly make additional cuts, it doesn't make sense to simply keep going after one small part of the budget that disproportionately affects middle-class families and the most vulnerable Americans. There has to be balance.

Today, Dr. Elmendorf will be discussing discretionary security spending, which has grown significantly in the years since 9/11. This is an area where the stakes for our Nation are high. From both a national security as well as a budgetary perspective, we have to get this right.

As many of my colleagues have noted over the past few weeks, it is an area that would be hit especially hard if this committee doesn't come to a deal, and we move to sequestration. So I am looking forward to a robust conversation today with Dr. Elmendorf about these critical pieces of our Federal budget.

And before I turn it over to my co-chair, I just want to say that over the last few weeks, this committee has been working very hard to find common ground and a path toward a balanced and bipartisan plan that can pass through this committee, through Congress, and get signed into law. We aren't there yet, but I am confident that we are making progress. And I am hopeful that we are moving quickly enough to meet our rapidly approaching deadline.

As I said from the start, if this committee is going to work—and I believe that it must—we all need to be willing to make some tough decisions and real compromises. I am willing to do that, and I know many of my colleagues are as well.

Every day, we hear more and more about the effects of failure that would be on our Nation's long-term fiscal health and creditworthiness. Over the next few weeks, it is going to be up to all of

us to demonstrate to the American people that we can deliver the kind of results that they expect and that they deserve.

[The prepared statement of Chairman Murray appears in the appendix.]

With that, I would like to recognize my co-chair, Representative Hensarling, for his opening statement.

STATEMENT OF HON. JEB HENSARLING, A U.S. REPRESENTATIVE FROM TEXAS, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Co-Chair HENSARLING. Well, I thank the co-chair for yielding, and I want to thank her again for her leadership on this committee and the spirit of negotiation that she brings.

There is no such thing as an unimportant hearing when it comes to dealing with our Nation's structural debt crisis. And certainly, within our Nation's discretionary budget are contained many challenges and, frankly, many important priorities that have to be debated and negotiated.

Not the least of which is what many of us view as the number-one function of our Federal Government, and that is to protect us from all enemies, foreign and domestic, and specifically, our National defense budget, which continues to shrink as a percentage of our economy, shrink as a percentage of our budget, as we continue to live in a dangerous world.

When I look at the totality of our discretionary budget, I do, again, find some common ground with my co-chair. And again, although there is no such thing as an unimportant hearing or unimportant section of the budget, in many respects, today we may be debating the pennies, nickels, and dimes in a debt crisis that is demanding half dollars and dollar bills.

There has been huge run-ups in our discretionary spending since the President has come to office. This is not the forum to debate the policies, but I think the numbers speak for themselves.

Without the stimulus program, the Commerce Department has increased from '08 to '10 102.9 percent. Without the stimulus, EPA has increased 35.7 percent. Subtracting the stimulus, Housing and Urban Development increased 22.2 percent. State Department without the stimulus, up 132.2 percent, and the list goes on.

Again, it is not at this forum to debate these particular policies, but it is important to note the numbers that when these particular budgets are growing, the family budget, which pays for the Federal budget, has, unfortunately, contracted. And it is the family budget that has to pay for the Federal budget.

As an order of magnitude, we know that the discretionary spending of our Nation is roughly 40 percent and shrinking. Our entitlement spending is roughly 60 percent of the budget and growing. We know outside of interest payments on our National debt that our mandatory spending is principally driven by our healthcare and retirement programs that are simultaneously starting to disserve their beneficiaries and driving the Nation broke as they grow at 5 and 6 and 7 percent a year, where, unfortunately, our Nation, over the last few years, have actually seen negative economic growth.

So, to put this in even a larger context, under the Budget Control Act, we collectively have a goal, a goal of $1.5 trillion in deficit reduction. But we have a duty, a duty to provide recommendations in legislative language that will significantly improve the short-term and long-term fiscal imbalance of the Federal Government.

Thus, the challenge before us remains that we must find quality healthcare solutions, quality retirement security solutions for our Nation at a cost that does not compromise our National security, does not compromise job growth and our economy, and does not mortgage our children's future.

Everything else we do, including dealing with the discretionary budget, will be helpful. Nothing else will solve the structural debt crisis or allow this committee to meet its statutory duty, only these reforms. And so, prudent stewardship of our discretionary budget is going to be helpful. It alone cannot solve the crisis. It continues, though, to be an important matter.

I look forward to hearing from our witness, and with that, I will yield back, Madam Chairman.

[The prepared statement of Co-Chair Hensarling appears in the appendix.]

Chairman MURRAY. Thank you very much.

With that, I will turn it over to Director Elmendorf for your opening statement. And we all appreciate your taking the time out of what we have given you as a very busy life, to take time to come today and answer our questions. So thank you very much, Dr. Elmendorf. Turn it over to you.

STATEMENT OF DOUGLAS ELMENDORF, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. ELMENDORF. Thank you, Senator Murray, Congressman Hensarling. I and the other folks at CBO are happy to be trying to help this committee in its very challenging task.

To all the members of the committee, my comments today will focus on four questions that are addressed in the written testimony. First, what does discretionary spending comprise? Second, what has been the historical trend in discretionary spending? Third, how will discretionary spending evolve over the next decade under current law? And fourth, how might the path of discretionary spending be altered?

Before digging into that substance, though, let me briefly clarify some of the terms I will use. When I talk about discretionary funding, I am adding together the budget authority that is appropriated for those programs and the so-called obligation limitations that govern spending for certain transportation programs. Those two types of funding provide agencies with the authority to spend money. When the funds are actually disbursed, they become outlays.

Also, through the testimony, I will focus on defense and non-defense discretionary spending, rather than security and non-security spending. Defense spending is a traditional category that includes all of the spending on military activities of the Department of Defense, plus spending for the Department of Energy's atomic energy defense activities and some defense-related activities of

other agencies. Nondefense spending is everything else in the discretionary category.

The Budget Control Act sets caps on discretionary spending for 2012 and 2013 using different categories, security and non-security, where security includes most, but not all of defense and also includes appropriations for the Department of Homeland Security, the Department of Veterans Affairs, and the international affairs budget category.

However, in 2014 and beyond, the Budget Control Act specifies a single cap on discretionary funding. There is an entirely different set of caps in the law that would come into play if legislation from this committee does not generate sufficient deficit reduction. In that case, the further cuts in spending that would be required are based on the traditional defense and nondefense categories. Although to make the situation truly confusing, the act labels those security and non-security as well. We thought it would be most useful for this testimony to focus on the familiar defense and nondefense categories.

Let me now turn to the first substantive question, which is what discretionary spending comprises. In fiscal year 2011, total funding for discretionary programs was about $1.3 trillion, of which more than half went to defense and less than half went to nondefense programs. If you turn now to the second page of the handouts in front of you, you will see a big donut that is labeled "Defense Discretionary Funding for 2011."

Of total defense funding for 2011, 43 percent, the biggest piece on the right of the donut, went to operation and maintenance, which pays for the day-to-day activities of the military, the training of military units, the majority of costs for the military's healthcare program, and compensation for most of DoD's civilian employees. Another 22 percent of defense funding went to compensation of military personnel, including pay and housing and food allowances.

Procurement, representing 18 percent, funds the purchase and upgrade of weapons systems. Appropriations for the wars in Afghanistan and Iraq and related activities accounted for about a quarter of total defense funding. They were distributed across the categories shown here, are included in the amounts reported.

If you turn to the next page of the handout, it shows a comparable picture for nondefense discretionary funding for 2011. Seven broad categories accounted for about 80 percent of the total. Education, training, employment, and social services programs together claimed 16 percent. Transportation programs received 15 percent of the total, with about half of that going to highway programs.

Income security programs, mostly for housing and nutrition assistance, represented 11 percent. That amount does not include unemployment compensation, food stamps, or temporary aid to needy families because they are all part of mandatory spending.

Discretionary appropriations for veterans benefits, primarily for the Veterans Health Administration, were 10 percent of total nondefense discretionary funding last year. Health was another 10 percent, with about half of that amount devoted to the National Institutes of Health.

International affairs and the administration of justice were each about 9 percent, and a collection of smaller categories makes up the remaining 20 percent.

Looking at nondefense discretionary spending as a whole, about one-third is disbursed in grants to State and local governments. Of those grants, about a third are devoted to education and training programs and a quarter to transportation programs, with the remainder going to environmental protection, law enforcement, economic development, and various other purposes.

Let me now turn to the second question in the testimony, which is the historical trend in discretionary spending. This is depicted in the next page of the handout.

Discretionary spending declined noticeably as a share of GDP from the early 1970s to 2000, mostly because defense spending declined relative to GDP from about 8 percent in 1970 to a low of 3 percent between 1999 and 2001. Defense spending then climbed again.

Outlays for nondefense discretionary programs have averaged about 4 percent of GDP during the past 40 years, with considerable variation, as you can see, but no evident trend. Thus, on average, such outlays increased during that period roughly in line with the size and income of the population.

Nondefense discretionary outlays were elevated in the past few years in part, as has been noted, because of funding from the 2009 Recovery Act.

Altogether, discretionary spending amounted to about 9 percent of GDP in the past 2 years, higher than the 6 percent in 2000, but lower than the 11 to 12 percent of the early 1970s.

The third question addressed in the testimony is how discretionary spending will evolve over the next decade under current law. To illustrate the potential impact of the caps on discretionary appropriations set in the Budget Control Act and the automatic enforcement procedures contained in that act, we projected appropriations under several different assumptions, including the three listed on the next page of the handout.

I apologize for those who don't have the handout. I think that members of the committee should have it in front of them. For other people, I am referring to figures and tables that are in the written testimony, and there are a couple of slides that are words also from the written testimony. Nothing I am saying is new and is not in that testimony.

The largest numbers that we looked at, about $12 trillion over the next decade, would come from extrapolating funding for 2011, adjusted for inflation. That is the way CBO constructed its baseline projections in recent years before the caps in the Budget Control Act.

The next set of numbers I will talk about assumes that funding is equal to the new caps set in law, about $11.3 trillion over the decade. For illustrative purposes, I will focus in a moment on the scenario under which the caps are met through proportional reductions in defense and nondefense spending. But many other combinations are possible, and the written testimony offers a range of possibilities.

And the third and smallest numbers I will talk about, totaling $10.4 trillion, incorporate the sequestration and reduction in caps that we estimate would occur if no savings resulted from the work of this committee.

The next page of the handout is Table 3 from the written testimony and deals with defense spending. I will focus on just the two rows of numbers near the bottom highlighted in blue.

I want to emphasize that the caps on defense spending do not constrain appropriations for the war in Afghanistan or for similar activities. And the automatic enforcement procedures would not affect funding for such purposes either. So what you are seeing here are numbers for the base defense budget.

The upper of those two blue rows shows the reduction in defense spending moving from the path where the amount of funding in 2011 has grown with the rate of inflation to a path of proportional reductions in defense and nondefense spending funding to meet the caps. Between 2012 and 2021, such reductions would total $445 billion, the number shown at the far right end of the blue bar, or about 7 percent.

The lower of the two blue rows shows the larger reductions in defense funding and moving from the path where the amount of funding jumped off 2011 and grew with the rate of inflation to the path that would occur if this committee's work resulted in no savings. Between 2012 and 2021, the cumulative reductions on this path would total $882 billion, or 14 percent. In 2021 alone, defense funding, excluding war funding, would be $110 billion, or 16 percent, lower than it would be if such appropriations kept pace with inflation.

If you skip the next page of that handout, which is a continuation of the table, the figure beyond that shows defense spending as a share of GDP. The light blue line on the left-hand side shows the history of funding for the base defense budget. The middle line on the right with the short dots shows our projection, assuming proportional cuts in defense and nondefense spending to meet the caps. The lowest line shows our projection if the maximum automatic reductions are triggered.

Under those two assumptions, in 2021, funding for defense, excluding war funding, would represent 2.7 or 2.5 percent of GDP, compared with an average of 3.4 percent during the past decade.

The next page of the handout is Table 4 from the written testimony and deals with nondefense spending. Again, I will focus on just the two rows of numbers highlighted in blue.

The upper of the two blue rows shows the reduction in nondefense funding again and moving from the path where 2011 funding grew with the rate of inflation down to the path that would result if the caps were met through proportional reductions on the defense and nondefense sides. Between 2012 and 2021, such reductions would total $418 billion, or 7 percent.

The lower of the two blue rows again shows the larger reductions in this time nondefense funding moving from this inflation-adjusted path to the path if no savings result from the work of this committee. Between 2012 and 2021, the cumulative reductions would total $794 billion. In 2021 alone, nondefense budget author-

ity would be $99 billion, or 15 percent, lower than it would be if such appropriations kept pace with inflation.

The next page of the handout shows nondefense funding as a share of GDP, again Figure 6 from the written testimony. The line on the left side shows the history of such funding. You can see that nondefense discretionary funding spiked upward in 2009 but then fell back sharply in the past couple of years to roughly its average share of GDP during the preceding decade.

The upper line on the right shows our projection, assuming proportional cuts in defense and nondefense funding to meet the caps. The lower line shows our projection if the maximum automatic cuts are triggered. Under those two assumptions, in 2021, nondefense funding would represent 2.8 or 2.6 percent of GDP, compared with an average of 4.1 percent during the past decade.

The fourth and last question addressed in the testimony is how the path of discretionary spending might be altered. Let me make two quick points, which are summarized on the last page of the handout.

First, for some programs, reductions may be particularly challenging because funding increases that are greater than the rate of inflation would be necessary to maintain current policies or plans. For example, implementing the administration's multiyear defense plans would require nearly $500 billion more defense funding over the coming decade than would occur if current funding increased at the rate of inflation.

Other examples where an inflation-adjusted extrapolation of current funding would be insufficient to fund current policies include veterans healthcare and Pell grants for higher education. Moreover, some observers believe that current policies in some areas are insufficient to meet the Nation's future needs.

For example, many analysts believe that current national spending on infrastructure is inadequate to provide enough roads, bridges, and other capital assets to maintain the current level of services or to fund all the projects for which benefits exceed costs. Of course, if spending on certain programs is allowed to grow faster than inflation, then even less room under the caps will be available for other discretionary activities.

Secondly, CBO assumes in its baseline projections that funding subject to the caps will be equal to the amounts currently specified in law for those caps. That means that legislation that reduced the funds available for a particular discretionary activity or that achieve savings in undertaking a particular activity would only reduce projected total appropriations if the legislation also lowered the caps. Without a reduction in the caps, funding for other discretionary activities would probably fill the gap created by any specific reduction or savings.

I hope this information is helpful to you, and I am happy to answer any questions that you have.

Thank you.

[The prepared statement of Dr. Elmendorf appears in the appendix.]

Chairman MURRAY. Thank you very much, Dr. Elmendorf. And again, thank you for being here today and taking our questions.

As you know, this committee is working very hard together to try and find a balanced plan to reduce our deficit and rein in our debt. It is not an easy task. We all believe it is necessary.

Over the past 10 years, domestic discretionary spending has remained essentially flat after adjusting for inflation, and this spending has remained stagnant despite the growing need to have investments to spur job creation and assistance for those in our country who have been hit the hardest because of this recession.

In your testimony, you mentioned that discretionary outlays during the past decade increased primarily due to the increase in security spending after 9/11. So let me start by asking you a few questions about the impact of past and potential cuts to discretionary spending on our overall budget picture.

Would you agree that with the negotiations on the fiscal year 2011 appropriations bills and discretionary spending caps in the recent Budget Control Act, that Congress has already made significant efforts to reduce discretionary spending?

Dr. ELMENDORF. Yes, Senator. The current path of discretionary spending under existing law is a good deal lower than it would have been without the actions you described.

Chairman MURRAY. And isn't it the case that even if we completely eliminated discretionary funding—everything from NIH to elementary and secondary education, military base construction, national parks, processing Social Security checks—all of it, we would still face deficits of hundreds of billions of dollars because we have not addressed entitlements and revenues?

Dr. ELMENDORF. I have not done that precise calculation, Senator, but you are most definitely right that discretionary spending is, and as Congressman Hensarling also noted, a shrinking share of Federal outlays over time. And entitlement programs, mandatory spending is a growing share of Federal outlays, in some cases growing rather rapidly.

And without addressing that path of spending, it would be extremely difficult to put the budget on a sustainable path.

Chairman MURRAY. Okay. Well, given the discretionary spending cuts that Congress has already made, can you talk about what the economic impact or effect of further efforts to cut discretionary spending, both in fiscal year 2012 budget process and in this committee's final product?

Dr. ELMENDORF. So, over time, cuts in discretionary spending reduce in general the services that the American public receives, services in protection against foreign enemies, services in the highways they can use or the national parks they can visit, or other sorts of programs.

Those cutbacks have a variety of human costs. They can also have economic costs depending on the nature of the cutback. Even infrastructure spending, for example, where many analysts think that the country should probably spend more, some sorts of projects could have a very high economic return. Other projects could have a very low economic return. So the nature of the economic effects depends very much on the particular changes in policy.

In addition, in the short term, given the large gap between our economy's potential to produce output and the level of goods and services being demanded and being produced, cutbacks in Govern-

ment spending or we believe increases in taxes in the near term would reduce the level of economic activity and employment relative to what would otherwise happen. I view that as really a separate sort of effect from more of the medium-term or longer-term effects, where the effects, as I said, vary a good deal depending on the nature of the program being cut.

Chairman MURRAY. Okay. Well, all of us on this committee know that we need to address the large, long-term drivers of our unbalanced Federal budget. But I also really believe that we have to take steps to strengthen that economic recovery and address the jobs crisis that we are seeing today.

Now according to CBO's rule of thumb regarding economic growth and its relationship to budget projections, CBO states, and I quote, "Stronger economic growth improves the budget's bottom line. Weaker growth worsens it."

Now CBO's projections for economic growth are now weaker for 2011 and 2012 than CBO projected just earlier this year. Correct?

Dr. ELMENDORF. Yes, that is right. We have not written formal projections. But if we would do a forecast today, yes, it would be weaker than we wrote in August.

Chairman MURRAY. Okay. Well, nearly all of the economists are telling us that growth continues to suffer from a significant weakness in demand, and many are warning against pursuing overly aggressive measures of austerity in the short term. And I wanted to ask you, do you agree that a lack of demand is one of the key factors holding back our economic recovery?

Dr. ELMENDORF. Yes. I think it is a widespread view among analysts that lack of demand for goods and services is the key factor holding back the recovery. The further question, of course, is the source of that lack of demand.

Chairman MURRAY. Okay. So how does a reduction in Government spending generally affect demand on the economy and during an economic downturn?

Dr. ELMENDORF. Reduction in Government spending will generally reduce the demand for goods and services, either because the Government is buying less itself or because it is providing lower transfers to individuals to purchase goods themselves.

Chairman MURRAY. Does tax increases or spending cuts have a larger impact in reducing that demand and the economic growth?

Dr. ELMENDORF. Depends on the specific tax increase or spending cut that you have in mind, Senator. Certain forms of Government spending, we think, have a large bang for the buck in terms of effects on demands. Others have lower effects. Certain kinds of tax increases would restrain demand by more than other kinds of tax increases. It depends on the nature of the spending or tax change, often on the recipient of the spending or the payer of the tax.

Chairman MURRAY. Okay. Thank you very much. I appreciate it.

Representative Hensarling?

Dr. ELMENDORF. Thank you, Senator.

Co-Chair HENSARLING. Thank you.

And Dr. Elmendorf, again, on behalf of the entirety of this committee, I want to thank you and thank your staff. We know that you are sorting through a number of homework assignments, if you will, from various and sundry members here. And again, we want

to thank you with the diligence and professionalism you bring to that task.

Dr. ELMENDORF. Thank you, Congressman.

Co-Chair HENSARLING. Again, when I look at the statutory duty, as opposed to the statutory goal for this committee, our duty is to, frankly, offer recommendations in statutory language to address both the short-term and long-term imbalance.

With respect to the short-term imbalance, is it not true that the stimulus bill with interest amounts to over $1 trillion of spending, which accounts for a large temporary growth in our discretionary budget?

Dr. ELMENDORF. Yes. Although, as you know, Congressman, only a part of the Recovery Act was about discretionary spending. There were also increases in mandatory spending and reductions in taxes. In total, we put it a little over $800 billion, and including interest, I think you are right, about $1 trillion.

And it did lead to a bulge in discretionary funding and then to an attenuated bulge in outlays because not all the money got spent right away.

Co-Chair HENSARLING. I don't know if you have at your fingertips numbers with respect to agency growth? I had quoted a few, and now that I look down, apparently the source is your office. So I hope I am quoting your office correctly.

Dr. ELMENDORF. I don't have those at hand, Congressman. But if they are numbers from us, then you can certainly trust them. [Laughter.]

Co-Chair HENSARLING. So I can trust them. Well, then I trust that when you add in the stimulus, the Commerce Department has grown 219 percent from '08 to '10. That with the stimulus, EPA has grown 130.8 percent. The Energy Department has grown 170.7 percent with the stimulus. Education has grown 180.6 percent, at a time when the economy has actually seen negative economic growth, and family paychecks have shrunk.

And unfortunately, again, this is not the forum in which to debate the stimulus, but I think it has to be noted when we are talking about areas of the budget where savings could be had, at least the American people certainly deserve the facts.

I want to follow up on, to some extent, a point that my co-chairman was making, and I believe I have this right. Correct me if I am wrong. Under your alternative fiscal scenario, which essentially is a current policy baseline, I believe it is at 2024 that all Federal revenues will simply be used to fund the mandatory portion of the budget, which is essentially our entitlement and interest. Is that correct?

Dr. ELMENDORF. I am sorry. Again, Congressman, you have a better hand around our facts than I have. But the qualitative point you are making is certainly right that mandatory spending just dominates the Government budget in an increasing way, in a rapidly increasing way over time.

Co-Chair HENSARLING. This actually came up in our earlier hearing with you, and I think I have this correct. Under your alternative fiscal scenario, you assume a growing revenue base, do you not? Do you not assume revenues increasing to their historic level of roughly 18, 18.5 percent of GDP?

Dr. ELMENDORF. Yes, that is right.

Co-Chair HENSARLING. And don't you also assume, in your alternative fiscal scenario, the tax increases that are contained within the Patient Protection and Affordable Care Act? Do you recall if those are assumed in your fiscal——

Dr. ELMENDORF. So what we do, as you know, in our extended baseline scenario, we try to follow current law. The alternative fiscal scenario is meant to track more closely what many people think of as current policy.

What we do for revenues in that scenario is simply to hold them at the historical average share beyond 2021 without trying to specify ourselves what combination of specific tax policies the Congress might enact to hold revenues at that level. So there is no specific answer to whether any given tax is in or out of that alternative scenario beyond 2021. We have just set revenue at the historical average to provide information for the Congress of what might happen if that sort of policy or set of policies were continued.

Co-Chair HENSARLING. I have a question about the overseas contingency operation, the OCO funding. I believe that you have recently readjusted your baseline, but we all know that the President announced that our military engagement in Iraq will end this year. And the President plans to completely reverse the surge in Afghanistan, I believe, by this time next year.

But I still think you are showing a pretty hefty sum in the overseas contingency operation line item. So can you explain to us the assumptions underlying this OCO number?

Dr. ELMENDORF. Yes, Congressman. What CBO does for any part of discretionary spending that is not capped under law is to take the latest funding that has been provided by the Congress and to extrapolate that over the decade to grow with inflation.

So when we estimated the effects of the caps under the Budget Control Act at the end of July and in early August, we compared those caps not with the latest baseline projections we published in March, but with the later level of funding that the Congress had enacted at the end of March as part of the deal to get through the rest of the fiscal year.

So, similarly now, although our latest baseline projection was published in August, we would focus in estimating any caps that one might impose on overseas contingency operations on the difference between those caps and the level that is the latest level that has been appropriated by the Congress. And that latest level is about $119 billion on an annual basis.

If one extrapolates that $119 billion with growth for inflation, one ends up with about $1.3 trillion over the coming decade. And for that, as for other complements of discretionary spending, we don't make an evaluation about how those numbers compare with the likely demand for funds or with any particular evaluation of the appropriateness of the spending. It is a mechanical extrapolation.

If you thought we would spend less than that over time, then one could——

Co-Chair HENSARLING. If I could, Dr. Elmendorf, I see I am already over my time. But I guess it is fair to say that under your protocols and your rules, the President's recent announcement that

this money is essentially not going to be spent anyway does not come into your calculation?

Dr. ELMENDORF. Not until the Congress enacted a different level of appropriations, Congressman.

Co-Chair HENSARLING. Thank you. Thank you.

Chairman MURRAY. Thank you very much. Can I just ask how closely has that extrapolation tracked over the last 5 years?

Dr. ELMENDORF. Well, the written testimony shows the pattern of funding the Congress has provided. For the past several years, the annual funding was on the order of $160 billion. So this new level is about $40 billion below the level that has prevailed in fiscal years 2009, 2010, and 2011.

Chairman MURRAY. Okay. Thank you.

We will now move to each of our committee members for 6 minutes, and we will begin with Representative Becerra.

Representative BECERRA. Dr. Elmendorf, thank you very much for being here, and thank you for the work you are helping us do over these last several weeks and, hopefully, over the next few weeks as well.

Let me just try to dispose of one question real quickly. One of our major problems is the drop in revenues we have seen over the last several years, and we are trying to tackle the issue of how to best increase those revenues.

One of the ways you do that is through economic growth. If folks are back at work, unemployment rates go down. That means you are paying less in unemployment benefits, which is an outflow of money, and you are also increasing your revenues because people are paying taxes again.

My understanding is that if you increase the level of employment by a certain amount, you will see a commensurate decrease in the level of deficits and, of course, a commensurate increase in the GDP. Can you give us a real quick synopsis of what happens if we put people back to work?

Dr. ELMENDORF. So the stronger the economy is, as you say, Congressman, the more the Federal Government and other governments collect in revenue and the less it pays out in benefits of certain sorts. The biggest response is on the revenue side.

If one is looking for a rule of thumb, people often say that the Federal Government's effective tax rate on the margin for an extra dollar earned is to collect about 25 cents of that in Federal revenue. So an extra dollar of GDP might induce another 25 cents or so of extra revenue. That is, of course, a very, very rough rule of thumb, and the actual number would depend very much on the way in which the economy improved and who received the income and how it was taxed and so on.

Representative BECERRA. So the more you put those 15 million Americans back to work, each of them earning even if it is only an average American salary, that is thousands of dollars per worker. That effect of a quarter of that dollar that each one of those workers earns could be revenue to the Government, which would help us decrease these deficits?

Dr. ELMENDORF. That is right, Congressman. It depends, of course, on what policies one invokes to move the economy back closer toward full employment.

Representative BECERRA. And that is where we invite you part of this 12-person panel to help us with those answers.

Let me move on to another question with regard to discretionary spending. My understanding is that your projections, and you showed us through some of these charts, are what you think might happen if the reductions in some of these outlays and in the investments would occur both in defense and nondefense over the next 10 years as a result of the caps and then, if we are not able to come to some agreement, as a result of the triggers in sequestration.

My understanding is under the caps, there are firewalls which separate the savings that we would extract from defense from nondefense, but that those firewalls exist for only 2 years. Your projections go out for 10 years. So are you saying that the savings that you show in defense are guaranteed, or that is what we presume if the projections continue forward, that half of the savings will come from defense and half of the savings in the caps will come from nondefense?

Dr. ELMENDORF. So what the Budget Control Act does is to establish separate caps on security and non-security funding for fiscal years 2012 and 2013, and security funding is both defense funding and some other pieces of funding as well. But you are right. Beyond those first 2 years, there is no cap on overall funding.

What we looked at in the written testimony was three alternatives—one in which the reduction from the inflated former baseline with inflated amounts, one in which that was taken up almost entirely through cuts in defense spending; one in which it was absorbed almost entirely through cuts in nondefense funding; and one where it was met through a combination, proportional cuts in defense and nondefense funding. I presented the middle of those here for simplicity. But we looked at the range because, in fact, it will be up to future Congresses to decide.

Representative BECERRA. And that is the point I was hoping you would make is that it really depends on what Congress does where we will see the savings occur?

Dr. ELMENDORF. Yes. Absolutely.

Representative BECERRA. Another quick question. Total up all discretionary spending, whether it is for Pentagon, whether it is for education, environmental protection, clean water, clean air, food safety inspection, total that up. How does it compare to the amount that we spend through the tax code through what are known as tax expenditures, the tax earmarks?

Dr. ELMENDORF. We haven't published an estimate of that, Congressman. I have seen estimates that the sum of tax expenditures is about $1 trillion a year. As I mentioned, the total funding for discretionary purposes last year is about $1.3 trillion.

Representative BECERRA. So we spend almost as much through the tax code for certain constituencies as we spend through the entire appropriations and allocations process through the regular budgetary process. That is the type of spending that we are not talking about today, the tax expenditures. But you did discuss it some the last time you were here.

Dr. ELMENDORF. Yes. Yes.

Representative BECERRA. Appreciate that very much.

Final question. I want to thank you for the report you just issued on the distribution of income in America and comparison over the years. You, I think, highlighted some pretty startling numbers about the disparity in income and wealth in America today where the top 10 percent, 20 percent of Americans, and actually, the top 1 percent of Americans, have really seen a concentration of wealth go in their direction, as opposed to essentially the very middle of America.

Can you give us a quick synopsis of what you found?

Dr. ELMENDORF. So we have found, as other researchers have found, Congressman, very pronounced widening of the income distribution in this country, with reductions in the share of national income going to the bottom four quintiles over the 1979 to 2007 period. And a very large increase, roughly a doubling, in the share of national income going to the top 1 percent of the population.

Representative BECERRA. Thank you. And I see that my time is about to expire. So I thank you very much for all your assistance.

Dr. ELMENDORF. Thank you, Congressman.

Representative BECERRA. Yield back.

Chairman MURRAY. Thank you.

Senator Kyl?

Senator KYL. Thank you, Dr. Elmendorf.

Let me read to you an email that was sent to interested Hill staff by the Associate Director for Legislative Affairs at the Congressional Budget Office on October 17th. The subject of the email is "HHS CLASS Announcement on CBO's Baseline."

"On Friday, the Secretary of HHS announced that the department does not plan to implement the CLASS Act long-term care insurance program under current law. Therefore, in its next baseline budget projections, which will be issued in January, CBO will assume that the program will not be implemented unless there are changes in law or other actions by the administration that would supersede Friday's announcement.

"Furthermore, following longstanding procedures, CBO takes new administrative actions into account when analyzing legislation being considered by the Congress, even if it has not published new baseline projections. Beginning immediately, therefore, legislation to repeal the CLASS provisions in current law would be estimated as having no budgetary impact."

Now this says that your longstanding policy is to take new administrative actions into account. And as you testified in response to Representative Hensarling's question, this would suggest that you wouldn't necessarily wait for Congress to act.

The President is commander-in-chief. His troop announcement that Representative Hensarling talked about is tantamount, in effect, to a Congressional action. He has the ability to withdraw the troops down.

What is the difference between his announcement that we will have no presence in Iraq after Christmas and his previous decision and announcement that we would withdraw in stages the troops from Afghanistan over the ensuing year, what is the difference between that announcement and the CLASS Act announcement in terms of CBO baseline decisions?

Dr. ELMENDORF. I think the difference, Senator, is a difference between the treatment of mandatory spending and discretionary spending, laid out at least by 1985 in the Balanced Budget and Emergency Deficit Control Act and followed since then by CBO in conjunction with the Budget Committees.

For mandatory spending, and the CLASS Act falls in this category, a program where Congress has established certain rules, parameters within which administrative actions can be taken, we are always trying to provide our latest estimate of the effects of that set of authorizations on the Federal budget. And if there is news in the form of a very distinct announcement that some program has been abandoned, then we adjust the scoring base for those mandatory programs.

But for discretionary spending, our projections don't respond to particular sets of programs or objectives because the Congress can choose every year how much to provide for certain purposes. So——

Senator KYL. But if I could interrupt, this is a distinction without a difference. The President is the commander-in-chief. He is the person that deploys troops, not Congress. So are you saying that that difference requires you to wait until Congress acts, even though the commander-in-chief has already made his announcement and begun the program for withdrawal?

Dr. ELMENDORF. Yes, Senator——

Senator KYL. They have—in theater, they are making plans as we speak on how they are going to withdraw the troops from Iraq.

Dr. ELMENDORF. But, Senator, with respect, I think it is a distinction with a difference. We are not equipped to project what defense funding the President will request in the future or what funding the Congress will enact in the future.

Senator KYL. So are you——

Dr. ELMENDORF. This news from the administration is a factor that will presumably affect the funding they request and the funding Congress enacts, but not necessarily in a one-to-one way that we could analyze.

Senator KYL. So this memorandum that was sent should have distinguished between mandatory and discretionary spending when it talks about CBO's policy. "CBO will assume the program will not be implemented unless there are changes in law by the administration that would supersede the announcement. Following longstanding procedures, it takes new administrative actions into account."

So they should have distinguished between mandatory and discretionary. Is that what you are saying?

Dr. ELMENDORF. I think you are right, Senator. I should have put that word in. But just to emphasize, the things I am describing on both the discretionary and mandatory side are procedures that go back at least a quarter century.

Senator KYL. So then with regard to the so-called OCO savings that the President included in his alleged budgetary savings, it all depends upon whether the defense appropriations legislation is passed or when that legislation is passed as to whether you would change your baseline? Is that correct?

Dr. ELMENDORF. Yes. So Congress enacts a different level of appropriations at any point, then anything we would do after that point would respond to that new level of enacted appropriations.

Senator KYL. Thank you.

So if we are able to get the appropriations bills completed before the December 23rd deadline for this committee to act, much of the alleged OCO savings would no longer be available because of an adjustment in your baseline projections. Would that be correct?

Dr. ELMENDORF. Well, I don't know, Senator. It depends what level appropriations you enacted.

Senator KYL. To the extent they are lower than the previous year's, would it not cut that amount from your baseline?

Dr. ELMENDORF. To the extent that they are lower than the $119 billion that has already been enacted for this fiscal year——

Senator KYL. Correct.

Dr. ELMENDORF [continuing]. That is a good deal lower than the $159 billion from the last fiscal year. If, in fact, the Congress decided to enact appropriations for the rest of this fiscal year that were below $119 billion for overseas contingency operations, then that would bring down our projection of those and the base against which we would estimate further reductions, importantly.

Senator KYL. Thank you very much.

Dr. ELMENDORF. Thank you.

Chairman MURRAY. Senator Baucus?

Senator BAUCUS. Thank you, Madam Co-Chair.

I would like to just focus a little bit on defense spending. Is it true that our current level of defense spending, including OCO—otherwise known as overseas contingency operation, otherwise known as war funding—is higher now in historic terms compared with any other time in American history except for World War II?

That is, is the current level of defense spending, including war funding, greater now than during the Korean War?

Dr. ELMENDORF. Yes, I believe that is true, Senator.

Senator BAUCUS. Okay.

Dr. ELMENDORF. As I showed in my testimony, as a share of GDP, that spending is——

Senator BAUCUS. No, I am not talking about—no, no. I am not talking about share of GDP.

Dr. ELMENDORF. In dollars——

Senator BAUCUS. Dollars.

Dr. ELMENDORF. Dollars adjusted for inflation?

Senator BAUCUS. Dollars. Dollars. Dollars adjusted for inflation.

Dr. ELMENDORF. Yes. So, in dollars adjusted for inflation, DoD spending was about $240 billion during the Korean War, and in 2011, it is nearly $700 billion.

Senator BAUCUS. Okay. So the same would be true for the Vietnam War? That is, we are spending more dollars——

Dr. ELMENDORF. Yes.

Senator BAUCUS [continuing]. Than we did in Vietnam, adjusted for inflation?

Dr. ELMENDORF. Yes, Senator.

Senator BAUCUS. Adjusted for inflation. Thank you.

And more than we ever did during the Reagan administration, adjusted for inflation?

Dr. ELMENDORF. Yes, Senator.

Senator BAUCUS. And more than the Cold War average?

Dr. ELMENDORF. Yes, Senator.

Senator BAUCUS. Which is the highest since World War II. Is that correct?

Dr. ELMENDORF. So by our—I think during the Reagan administration, yes, that was higher than in the Vietnam War or Korean War.

Senator BAUCUS. Okay. We have already touched on this, but I just want to nail this down. The Budget Control Act, as you mentioned, had two separate caps—for what is it, 2012——

Dr. ELMENDORF. 2012 and 2013.

Senator BAUCUS [continuing]. And 2013, but no separate caps for security and non-security thereafter?

Dr. ELMENDORF. Yes, Senator.

Senator BAUCUS. Which means that the Appropriations Committees of the Congress could decide to spend more on security than is allowed under the caps in the first 2 years?

Dr. ELMENDORF. Yes. It can pick any allocation under those total caps that it chooses.

Senator BAUCUS. Anything they want to do under those total caps?

Dr. ELMENDORF. Yes. Now if this committee doesn't achieve any additional savings, then the enforcement procedures establish separate caps for defense and nondefense discretionary spending.

Senator BAUCUS. Okay.

Dr. ELMENDORF. But under the basic caps, you are right, Senator.

Senator BAUCUS. Okay. So there are basic caps. There are base caps in the act. Are there any caps on war spending?

Dr. ELMENDORF. No, Senator. The caps do not constrain war spending.

Senator BAUCUS. There are no caps on war spending?

Dr. ELMENDORF. No. I think, technically, the caps would be adjusted upward by any amount of spending that was designated by the Congress for overseas contingency operation.

Senator BAUCUS. That is a technical point. The main point is there are specific caps for security and non-security at least for 2 years, then no caps in the act for subsequent years, and no caps whatsoever on OCO.

Dr. ELMENDORF. That is correct, Senator.

Senator BAUCUS. Nothing.

Dr. ELMENDORF. Yes.

Senator BAUCUS. Okay. No caps on OCO.

Now has the Appropriations Committee sometimes gone to OCO to spend dollars that are really arguably not war funding because that is a kind of an extra pot of money to use? It is there, and there are no caps on it. Has that ever happened?

Dr. ELMENDORF. Senator, I can't speak to the motivations or thought process of the Appropriations Committee. Certainly, there will be inevitably some ambiguity in any effort to allocate costs, and what costs are truly attributable to these wars and what costs are not will be a matter of judgment. And——

Senator BAUCUS. Okay. Didn't the Senate Appropriations Committee propose—maybe they actually did—to move $9.9 billion of base programs requested by the President to this account?

Dr. ELMENDORF. I think over the past few years, Senator, there have been some movement of money that used to be designated as OCO into base budgets, and I think some movement in the other direction as well. I am afraid I don't have an overall assessment of the numbers involved.

Senator BAUCUS. What about there are reports that—and this obviously double-checked—$100 million was taken out of OCO for migration and refugee assistance for places like Kenya and Pakistan?

Dr. ELMENDORF. I am sorry, Senator. I don't know.

Senator BAUCUS. But we do know that there is no limit on the OCO account. And let me ask, how is it defined? What are the definitions of what constitutes and does not constitute appropriate spending out of the war account?

Dr. ELMENDORF. So, in our presentations, we follow the labeling provided by the Congress, and it is up to you and your colleagues to decide what you support under various categories.

Senator BAUCUS. But it just kind of sounds like it is what Congress wants to do.

Dr. ELMENDORF. That is our—yes, Senator.

Senator BAUCUS. And that sometimes happens around here. But you are saying there are no scoring rules under the Budget Control Act that would restrict the migration of base defense spending to OCO in the future?

Dr. ELMENDORF. I think that it is up to the Congress, as I said, to designate what it views as related to those operations and what it views as part of spending that would happen anyway.

Senator BAUCUS. And if this committee were to say dollars could not be spent on a certain program, my understanding is that that would not be scored by your office?

Dr. ELMENDORF. Again, a certain discretionary program—Senator Kyl has taught me to be very careful about that. Changes to mandatory programs, of course, we would do estimates of. But changes in individual discretionary programs, we would not take account of because we are relying on the overall level of the caps.

Senator BAUCUS. Correct. Correct.

Dr. ELMENDORF. And the squeezing of one particular program without a change in the cap level——

Senator BAUCUS. Right.

Dr. ELMENDORF [continuing]. We think would be filled by other——

Senator BAUCUS. What if this committee were to establish caps? Would that be scored? What if there were a cap on OCO?

Dr. ELMENDORF. If the committee established caps on OCO that were below the level of funding that is based on the extrapolation with increases for inflation from the latest enacted appropriations, then we would estimate savings from that.

Senator BAUCUS. And you are suggesting about one-point—what did you say?

Dr. ELMENDORF. About $1.3 trillion.

Senator BAUCUS. About $1.3 trillion.

Dr. ELMENDORF. Yes.

Senator BAUCUS. Uncapped?

Dr. ELMENDORF. Yes. And that is just the—it is not magic. That is the $119 billion, the most recently enacted, extrapolated with inflation.

Senator BAUCUS. Extrapolated forward with no caps?

Dr. ELMENDORF. Yes.

Senator BAUCUS. Okay. But if we were to set a cap, then that would be scored?

Dr. ELMENDORF. We would estimate the effects. Yes, Senator.

Senator BAUCUS. Thank you.

Chairman MURRAY. Thank you, Senator Baucus.

Representative Upton?

Representative UPTON. Thank you, Madam Chair.

And again, Dr. Elmendorf, we appreciate your participating today. And I just want to take us back to a question from earlier days, and that is, as this committee works to try and get an agreement, a solution, what is the real date that you want us to give you the information that your worker bees can turn out a reasonable number for us?

Dr. ELMENDORF. So, as you know, Congressman, our legions of skilled analysts are working very hard for this committee already.

Representative UPTON. Have they had time off until now?

Dr. ELMENDORF. No, Congressman, I am afraid not. We have a terrifically hard-working group, as you know.

As I said the last time I was here, if you have a set of proposals that would make changes across a range of mandatory spending programs, then that would require us some weeks to work with legislative counsel and the staff of this committee in refining the legislative language to accomplish the objectives that you are setting out to accomplish and then for us to produce a cost estimate.

And backing up from Thanksgiving, that left us looking at the beginning of November, which we are very aware, as you are, Congressman, is not very far away.

Representative UPTON. Thank you.

What is the deficit as a share of GDP today?

Dr. ELMENDORF. The deficit in fiscal year 2011 just completed was about 8.5 percent of GDP.

Representative UPTON. And if this committee fails and we end up with a sequester, and we do the numbers that you suggested here in your testimony for both defense and nondefense. So that defense we would end up with a sequester of, in essence, of $882 billion in savings over the 10 years and a number of almost the same, $794 billion, in nondefense over that same 10 years, and nothing on the entitlement side or nothing on the mandatory side—just those two—where would we go in terms of the debt as a percentage of GDP 10 years down the road?

Dr. ELMENDORF. So, Congressman, let me be clear. These numbers at the bottom of these tables are a comparison of the sequestered cap path to the inflated——

Representative UPTON. Right. Right.

Dr. ELMENDORF [continuing]. Extrapolation. It is not the amount of the sequester or the enforced budget portion itself. Remind you, our baseline projections for August incorporated the $1.2 trillion

that is under current law to be achieved either through the actions of this committee or through these enforcement procedures.

So whether the committee hits $1.2 trillion or hits the last—the remainder is filled in to the enforcement, as long as you don't save more than $1.2 trillion, you are putting yourself back to our baseline projection from the summer. Under that projection, allowing for the expiring provisions of the tax code to expire and Medicare payments to doctors to be cut very sharply and the other features of current law, deficits, by the end of the decade, are 1.5 percent or so of GDP, and debt is actually declining relative to GDP.

But that hinges absolutely critically on revenues rising above their historical average share of GDP, as it would under current law, and discretionary spending falling well below its average share of GDP in order, essentially, to make room for the great increase in Social Security and the major healthcare programs.

Representative UPTON. I didn't know if you saw the GAO report that was released earlier this week as related to if this committee fails that—or I want to say that $1 trillion in savings is not sufficient, is the words that they used, for stability, and they predicted, in essence, I believe, a credit downgrade. Have you had a chance to look at that report?

Dr. ELMENDORF. I have glanced at it, Congressman.

Representative UPTON. Do you have any comments? I know it just came out this week.

Dr. ELMENDORF. One technical point, which is that they offer two scenarios. One of which is close to our alternative scenario based on current policy. The other of which they view as closer to current law.

Nonetheless, what they do in that scenario is to limit the increase in tax revenue as a share of GDP that would actually happen under current law. Our extended baseline scenario incorporates the rising revenues relative to the GDP that would persist and go on beyond this next decade.

So both of their scenarios look worse than our better scenario. It is just a difference in policy assumption about tax revenue—tax policy. But we certainly agree very much with the underlying point of the analysis that under current policies, the U.S. Government is on an unsustainable fiscal path and that the magnitude of changes that will be needed from current policies is very large.

As I said the last time I testified here, if one wanted to consider extending the expiring tax provisions and limiting the reach of the alternative minimum tax and adjusting Medicare's payments to doctors, the deficit over the coming decade becomes $8.5 trillion rather than the $3.5 trillion under current law. And debt would be rising relative to GDP to levels that we have almost never seen in this country.

Representative UPTON. Thank you.

Chairman MURRAY. Representative Clyburn?

Representative CLYBURN. Thank you very much, Madam Chair.

And Dr. Elmendorf, thank you very much for being here again today.

You may recall that at the first hearing I discussed a little bit of the growing wealth gap that exists. I did that with some references to unemployment numbers.

Now your recent report indicates that over the last 28 years—in my estimation, that is a generation. Over the last generation, we have seen an increase in income of upper 1 percent households in America of 275 percent. During that same time, we have seen an increase in the top 20 percent of 65 percent. But of the bottom 20 percent, only 18 percent.

Now over that same period of time, for the 60 percent of the middle, we have seen income has grown only 40 percent. That indicates to me that the middle income is shrinking relative to the rest of the country.

Now if we were to extrapolate that out, as you talked about, I would assume that we are where we are because of—well, let me put it this way. To the extent that Government policy has allowed this gap to exist, if we continue current policy, then it is fair to say that we are going to experience that kind of continued widening of the wealth gap in America, in the United States.

Dr. ELMENDORF. So, Congressman, one of the issues that we wrestle with in our projections is the evolution of the income distribution. The study that we did, as you know, ends with data from 2007.

Representative CLYBURN. Right.

Dr. ELMENDORF. What has happened during the past few years of the recession and financial crisis is not clear. Although if you look in our study, some past recessions have shown some narrowing of the income gap, particularly because higher income people collect a relatively larger share of their income from capital income, which tends to be more cyclical.

So just where things precisely stand today, I am not sure. Our projections do incorporate some ongoing widening of the income distribution, but whether is it is on the—whether the events of the last 30 or so years will continue at that pace, we don't know, and I don't think our projection calls for a continued widening to that extent.

But neither do we see forces at hand that would cause that to be reversed in coming years.

Representative CLYBURN. So we don't see anything that could possibly shrink that either?

Dr. ELMENDORF. No, again, except for the effects of this recession, which we don't have data for. But looking from here on, we don't see those underlying factors reversing.

Representative CLYBURN. I would assume then that this—I have seen a whole lot in the media in recent days about who is, in fact, paying the taxes in the country. I am assuming, as my dad used to tell me, "Don't argue about taxes, son, because if you really owe them, that means you made something."

So I am assuming that these people are not paying because they don't owe anything. They don't owe anything because they have not made anything. So that is just an assumption on my part.

But let me look at this economic ladder that we talk about a lot. If we are going to see a shrinkage in that gap, it would seem to me that we need to start looking at how do you prepare people to assume tax-paying responsibilities in our society? And we do that by investing in their education, to the extent that things like Pell grant, Head Start, Title I for disadvantaged people, all of these

things are designed to prepare people to earn income and, therefore, pay taxes and not be on the Government dole, as we like to say down South.

Am I to believe that if we dramatically reduce that investment, then we will dramatically reduce people's abilities to assume these responsibilities and to become taxpayers?

Dr. ELMENDORF. You are raising important, but difficult questions, Congressman. People's ability to earn income comes, as you know, from a whole variety of forces on their lives. Federal Government policy is one of those forces. And if Federal policy were changed in a way that provided significantly less support for people in obtaining educations or getting skills, that could well affect their income in the future.

But I don't have a way of quantifying that. It depends very much on the specific programs. There is very large research literature and a lot of experimentation in the world about training programs, for example. And some seem to work well, and some seem to work badly. And the ones that work well are difficult sometimes to expand to a larger scale.

So just what role particular Government programs play, again, is a much-studied question, and we do some work in that area. But there isn't a very good general answer to how important that is as a factor relative to other factors influencing people's ability to earn income, as you say, and then, through that, to pay taxes.

Representative CLYBURN. Well, thank you very much, Dr. Elmendorf. This time goes real fast here.

Dr. ELMENDORF. Thank you, Congressman.

Representative CLYBURN. My time has expired.

Chairman MURRAY. Senator Portman?

Senator PORTMAN. Thank you, Co-Chair.

And thank you, Director Elmendorf, for being with us again and for all the hard work that you and your team are doing in responding to our many inquiries. Because I said that, I expect mine to be prioritized. Kidding, guys. [Laughter.]

Dr. ELMENDORF. We prioritize everybody first, Senator.

Senator PORTMAN. Thank you, yes. Especially the committee, I hope, because we do have a short period of time here, and we have a lot of work yet to do.

You talked a little about jobs and the economy earlier, and my colleague Congressman Clyburn just raised this issue, the importance of jobs, which is, after all, one way you get people paying taxes is to be sure they have the opportunity to earn enough money to pay those taxes. And you had said that you believe that demand was the key issue, and the source of that lack of demand was the tough question.

And I would just ask you if you could comment on the unsustainable fiscal path that you have outlined repeatedly, including again today, and the fact that, as you said, we are increasing the debt by anywhere from $3.5 trillion to $9 trillion over the coming decade, depending on whether you use the current law or current policy baseline. Reminding us that our commitment here is to reach $1.5 trillion and $1.2 trillion to avoid sequester. That, of course, isn't even close to the increase we are likely to see from the current $14.5 trillion debt.

What impact does that have? I am sure you have looked at the Rogoff and Reinhart study and others who have commented on the impact of this unsustainable fiscal situation on our current economy.

Dr. ELMENDORF. So I think the unsustainable path matters in the short run in various ways. Partly, the borrowing the Government has done and anticipation of Government borrowing can crowd out private investment to some extent. At the moment, with private investment weak anyway, the magnitude of that crowding out is less clear. In fact, we see Treasury interest rates, as you know, being very low at the moment.

But there can be crowding out of investment. I think beyond that, the uncertainty about fiscal policy is probably weighing on households and businesses. They can recognize that there will have to be, as a matter of arithmetic, changes in taxes and/or spending relative to current policy, but they don't know what those changes will be. And I think that sort of uncertainty is naturally an inhibiting factor in decisions, particularly commitments of money over time to invest in factories and equipment, to invest by hiring people, for households to invest in housing and durable goods.

That uncertainty is a piece, I think, of broader uncertainty about Government policies. There are a lot of different policies that are, I think, up in the air in a way. And that policy uncertainty, of course, is a piece of a much broader uncertainty about the state of the economy and the income that households think they will have in the future and the demand for the goods and services that businesses think they will have in the future.

Senator PORTMAN. Well, I appreciate that. And as an economist, I appreciate your giving us really a sense of the importance of our task because it is not just about cutting spending, is it? It is about the economy and jobs. And although we are not called the jobs committee, what we do will affect that sense of certainty and predictability going forward.

Dr. ELMENDORF. Yes.

Senator PORTMAN. And again, not in the substantial ways that we would hope, all of us, but it will make a difference and take us in the right direction. The alternative, of course, has been talked about today as well, which is if we don't do our work, what impact that could have, even make our prospects for economic growth more negative.

Let me use some figures here that you may not trust because they are from the Office of Management and Budget. And you said earlier that you trusted the CBO figures, but I think they are consistent with yours. And let me start by saying I totally agree with what you said earlier. Mandatory spending dominates the Federal—or mandatory spending dominates the Federal spending. That was your quote a few minutes ago.

Co-Chairs Murray and Hensarling have also made that same point in various ways from a little different perspective, and I totally agree with that. I think if this committee doesn't get at the issue, which is the biggest part of our budget, over 50 percent of the budget—60 percent, if you include interest on the debt—and the fastest-growing part of our budget has gone from roughly 25 percent of our budget in the 1960s to over 50 percent today.

If we don't get at that, the largest part and the fastest-growing part of the budget, we will, of course, not have accomplished our goal. But having said that, let me give you some statistics on the discretionary side, since that is the topic of our hearing today. I will give you some numbers from 1990 until today.

Nondefense discretionary has risen during that time by 95 percent, which, by the way, is nearly double the 52 percent growth in defense spending. So if you took 52 percent growth in defense spending from 1990 until today, 95 percent on nondefense. Now admittedly, the defense spending is not as high because the increases we have seen have been more recent, from 2001, which reflected an increase from the cuts in the 1990s on defense. So if you use just the last decade, defense would be higher.

But let us look then at 2001 to 2011 on the nondefense side. Outlays on the education side, discretionary spending up 116 percent in the last 10 years. International spending up 102 percent. Veterans spending up 100 percent. Community and regional development spending up 71 percent. Health research and regulation spending up 56 percent, and so on.

So I just think we need to keep both of these things in mind. One, that if we don't deal with the spending issues, it is tough to get this economy going. And second, we have seen some substantial increases in the discretionary spending, understanding that the BCA has now put those spending levels under more constraints. Do you agree with those numbers?

Dr. ELMENDORF. I don't know those—have this back of the hand, Senator. But I would not argue with your numbers.

Senator PORTMAN. Well, again, thank you for all your help to help us achieve the goal we have all talked about today, and we look forward to working with you going forward.

Dr. ELMENDORF. Thank you, Senator.

Chairman MURRAY. Senator Kerry?

Senator KERRY. Dr. Elmendorf, thank you very much for being here. Thank you for the terrific work you and your team are doing. We appreciate it.

It is my understanding that CBO keeps regular estimates on the number of jobs that have been created by the American Recovery and Reinvestment Act. Is that correct?

Dr. ELMENDORF. Yes, Senator. We are required to publish estimates once a quarter.

Senator KERRY. Right. And so, just quickly, because I don't want to spend much on time, is it not correct that without the policies of the American Recovery and Reinvestment Act that GDP would be lower and unemployment would be higher?

Dr. ELMENDORF. Yes, Senator.

Senator KERRY. So it has had a positive impact on GDP and on reducing unemployment?

Dr. ELMENDORF. Those are our estimates, Senator. Yes.

Senator KERRY. Now, with respect to our work here in the committee, I talked to you last time you were here about "going big," about a $4 trillion total target if you include the money already cut, $3 trillion if you don't. It is my understanding that you already have in your baseline an accounting for $1.2 trillion in deficit reduction by this committee. Is that accurate?

Dr. ELMENDORF. Yes.

Senator KERRY. So if all we do in this committee is $1.2 trillion, we, in effect, are not reducing the deficit below the current levels or rates?

Dr. ELMENDORF. That is right. That is because of these automatic enforcement procedures. If you don't take explicit action, there is a backup plan, which is the further cuts in spending that I have outlined here.

Senator KERRY. Now with respect to the bigger deal, so to speak, would you tell the committee or share with the committee your perception of assuming you had a $3 trillion reduction, which included something along the ratios we have all heard about either in Rivlin-Domenici or in Simpson-Bowles or Gang of Six, somewhere in the vicinity of 3-to-1 or 2-to-1 of cuts to revenue, and assuming that the revenue were to come exclusively from the highest-end people, that 275 percent increase in income, can you make a judgment as to what the impact would be on the marketplace and perceptions of deficit reduction or job growth that come from the $3 trillion versus just achieving the $1.2 trillion goal?

Dr. ELMENDORF. So just looking at the aggregate deficit reduction, I think it is clear that larger reductions coming from the work of this committee would have a positive effect on current spending and on current output and employment. And conversely, that a failure of this committee to reach agreement or for Congress to enact an agreement reached by the committee would have a negative effect on confidence and, thus, on spending.

Senator KERRY. And if we do simply $1.2 trillion or $1.5 trillion, which is the target goal, and that is all we do, isn't it a fact that we are going to be back here in about a year or 2 or 3, at maximum, dealing with the very same issues that are on the plate now about the unsustainability of our budget?

Dr. ELMENDORF. Yes, Senator. And I think that is certainly right.

Senator KERRY. So in terms of the duty that Co-Chair Hensarling has talked about to provide language to significantly reduce, the most important message to the marketplace, I am told, comes if you achieve a $4 trillion total, which is the only way to begin to stabilize the debt. Is that not accurate?

Dr. ELMENDORF. Yes, the amount that is needed depends, very importantly, on how you view the expiring tax provisions and some other provisions of current law that would take us away from current policies to which people have become accustomed. If one extends all or a large share of the expiring tax provisions over the next few years, then the gap between spending and revenues over the coming decade becomes much larger, and much more other action is needed in order to achieve any given objective for the path of debt relative to the size of the——

Senator KERRY. Well, can you share with the committee what would have a greater negative impact on growth—the failure of the committee to come up with more than $1.2 trillion or $1.5 trillion and the marketplace signals that would send about the continued fiscal plight of the country, or an ability to come up with a $3 trillion or $4 trillion level that had that 3-to-1, 2-to-1 ratio that I talked about with any revenue coming either from closing tax loop-

holes or exclusively from that high-end 275 percent increase income earner?

Which would have the greater negative impact on our economy—finding some revenue from those folks and getting a deal, or having no deal and not having that revenue?

Dr. ELMENDORF. I am afraid, Senator, I can't analyze the sort of policy proposals you are describing in my head.

Senator KERRY. Well, can you analyze——

Dr. ELMENDORF. And we have not done an analysis of any of the packages you have described.

Senator KERRY. But you can analyze—I mean, you have told us that if we fail to come up with anything that deals with the unsustainability, we are sending a bad message to the marketplace, aren't we?

Dr. ELMENDORF. Yes. Again, I think in terms of the amount of deficit reduction, the more that this committee can achieve over some period of time, the better that would be for current confidence. But I can't weigh that off against the effects of sort of a hypothetical combination of specific spending and tax changes.

Senator KERRY. Well, leave the hypothetical out. Can you tell us what, for instance, the expiration of the top end of the Bush tax cut, if it went from 35 to 39.6 and it was part of a $4 trillion deal, would that have a negative impact on growth in our economy?

Dr. ELMENDORF. So we actually did last fall, for the Senate Budget Committee, provide estimates of the effects on the economy of different ways of extending the expiring tax provisions, and extending them had the negative effect of reducing deficits, the positive effect of keeping marginal tax rates lower and, thus, encouraging work and saving.

In our estimates, the negative effects of the extra debt was larger than the positive effects of lowering marginal tax rates for those particular policies we looked, again, over the medium and longer term. But that is why the answer really depends on the specifics of the policies.

Senator KERRY. Thank you very much. I appreciate it.

Chairman MURRAY. Representative Camp?

Representative CAMP. Well, thank you, Co-Chair.

Mr. Elmendorf, is there anything in the Budget Control Act that would prevent the Congress from changing how the sequester would affect defense spending?

Dr. ELMENDORF. I mean, the Congress could enact a change in law that could override the Budget Control Act.

Representative CAMP. So there is nothing in the Budget Control Act that would prevent that?

Dr. ELMENDORF. No. I mean, in general, as you know, any Congress can reverse the actions of a previous Congress.

Representative CAMP. I appreciate your response to a question by Senator Murray that you believe that your projections on GDP growth are too generous and that you believe actually they would be lower, which would mean actually our deficit is worse than you have projected in the past. But under your projections, you are assuming a 30 percent cut to physicians in Medicare, are you not?

Dr. ELMENDORF. Yes.

Representative CAMP. And you are assuming that taxes go up $3.8 trillion, that everybody's taxes go up, certainly would have a detrimental effect on the economy. And you are assuming that there is a cut in discretionary spending.

So, as you project that and in answer to Mr. Upton's question that deficits are going to decline as a percentage of our GDP, it is based on all of these assumptions, which, frankly, would impact that number particularly in one way. I would just have to say——

Dr. ELMENDORF. As you know, Congressman, it is not our assumptions. We are following current law in that way.

Representative CAMP. But these are assumptions you baked into your proposals, into your testimony today. I am just trying to point that out.

And under either of your long-term fiscal projections, spending on entitlements or mandatory health programs, Social Security, et cetera, will increase between 15 and 17 percent of GDP, of our gross domestic product. And net interest costs will increase to between 4 and 9 percent. And under either of those scenarios, that crowds out discretionary spending, even if assuming the highest levels of revenue this country has even seen.

So I guess my question is under even the best of assumptions, the rosiest of assumptions, total discretionary spending under that sort of long-term scenario was about 1 percent of GDP versus the 9.3 percent it is today. And I guess I would say to you, your response to that suggestion or those calculations, do they sound correct to you?

Dr. ELMENDORF. So, again, I don't have our long-term numbers at hand. We extrapolate—for our projections over the long term also, we extrapolate discretionary spending according to some simple rule of thumb. What the Congress ultimately did when it reached an unsustainable point, we can't predict.

Representative CAMP. Well, presuming my question then that if, under the rosiest of assumptions, given those long-term CBO projections that discretionary spending is just 1 percent of GDP, has that ever occurred in recent history?

Dr. ELMENDORF. Well, I mean, I don't know about the 18th century. But, no, it has not occurred in recent history.

Representative CAMP. In recent history. Relatively recent history.

Dr. ELMENDORF. No.

Representative CAMP. So we have never been at that level?

Dr. ELMENDORF. No.

Representative CAMP. And I think the question is could we operate a functioning Government at just 1 percent of discretionary spending of GDP?

Dr. ELMENDORF. Nothing like the Government that we are now accustomed to in either defense or nondefense programs.

Representative CAMP. And again, with your testimony that mandatory spending, as you said, dominates the Government budget I think was your quote. You also said it is a growing share of spending. It is growing rapidly. Doesn't this illustrate that as part of what we are trying to do, the need to rein in mandatory spending is obviously one of the priorities that we need to address?

Dr. ELMENDORF. Again, it is up to the committee to choose what changes in policy it wants, but certainly, a growth in mandatory

spending, particularly for healthcare and also in Social Security, is the feature of the budget that makes the past unrepeatable. It is the change under current policies because of the aging of the population and the rising costs of healthcare that push up that spending in such a substantial way that require us as a country and you as our elected leaders to make choices to make the future different in some way from the past.

And whether that is through changes in those programs or changes in tax revenues or changes in other Government programs is up to you, as you know.

Representative CAMP. Thank you.

I yield back, Madam Chair.

[Disturbance in hearing room.]

Chairman MURRAY. The committee will be in order, please. The chair wishes to remind all of our guests that——

[Disturbance in hearing room.]

Chairman MURRAY. I would request that the Capitol Police restore order.

The committee shall recess until we are in order. [Recess.]

Chairman MURRAY. Thank you very much.

Representative, you can continue.

Representative CAMP. No, I had yielded back, Madam Chair.

Chairman MURRAY. All right. We will turn to Representative Van Hollen.

Representative VAN HOLLEN. Thank you, Madam Chairman.

Thank you, Dr. Elmendorf, for your testimony.

Just to be clear, if the Congress was to take action to repeal the defense portion of the sequester, all things being equal, that would make the deficit worse. Correct?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. Thank you.

Let me just go back to I think sort of an overall theme here, which is that as a share of GDP, under current law, nondefense discretionary spending is shrinking dramatically over the next 10 years. Is that not the case?

Dr. ELMENDORF. Yes, that is right, Congressman.

Representative VAN HOLLEN. And in fact, it goes to below 3 percent in your chart, Figure 6, which as a percent of the economy is about the lowest level since the Eisenhower administration.

Now there have been many questions that relate to the level of nondefense discretionary spending during the 2007–2008 period, which was a component of the Recovery Act. Just to be clear, in your response to Senator Kerry's question, I think you indicated very clearly that that spending as part of the overall Affordable Care Act actually helped prevent the economy from getting worse. Correct?

Dr. ELMENDORF. I think you mean the Recovery Act—

Representative VAN HOLLEN. Correct.

Dr. ELMENDORF [continuing]. In 2009 and 2010 and this year.

Representative VAN HOLLEN. That is right.

Dr. ELMENDORF. And we believe that cuts in taxes and increases in Government spending through that act increased output and employment relative to what would have occurred otherwise.

Representative VAN HOLLEN. That is right. And as we look forward in this committee, and I received a letter from you. I think the calculation of the Congressional Budget Office is that about a little over one-third of the current deficit that we face is a result of the fact that the economy is not at full employment. Is that right?

Dr. ELMENDORF. That sounds right. Yes, Congressman.

Representative VAN HOLLEN. So even though we have prevented things from getting a lot worse more quickly, clearly, we have a long way to go, and I wanted to follow up on a remark you made with respect to infrastructure spending where you said, "Many analysts think that the country should spend more in the area of infrastructure."

CBO, I know, has looked at infrastructure investments. Do you believe that that is an effective way to try and boost job growth, especially given the fact that we have over 14 percent unemployment in the construction sector?

Dr. ELMENDORF. Yes, Congressman. We think a variety of Government spending programs, if increased, or Government tax revenues, if reduced, would spur economic activity in the next few years.

Representative VAN HOLLEN. And I know CBO has also analyzed different forms of investment to see which would be more effective. There a lot of folks out there who are unemployed through no fault of their own and who are continuing to look for work. As I looked at your analyses, one of the most effective ways to boost consumer demand, which, of course, is a big soft spot, would be to extend support for people who are out of work through no fault of their own. Is that right?

Dr. ELMENDORF. Yes, Congressman.

Representative VAN HOLLEN. Thank you.

And another issue that is looming on the horizon is as of the beginning of next year, the current payroll tax holiday, which is in effect for all working Americans, will lapse unless the Congress takes action. And if that were to lapse and that would mean that working people had less disposable income, especially at this point in time, that would also dampen demand in the economy, would it not?

Dr. ELMENDORF. Yes, Congressman.

Representative VAN HOLLEN. And all that dampening of demand would mean less economic growth and fewer jobs, would it not?

Dr. ELMENDORF. Yes.

Representative VAN HOLLEN. Thank you.

A lot of ground has, obviously, been covered here. I would just want to pick up on the question, comment really that our Congressman Upton made, and I think we are all very aware of the fact that the clock is ticking here. And in my view, we have to accomplish an awful lot in a very short period of time, especially given your constraints.

And I really hope that this committee is able to complete its mission and come up with a package that serves two purposes. One is to try and get the economy moving again and put people back to work, and you have described some ways that that could be done in response to questions. And as you have also indicated, that can

also help reduce the deficit over a period of time because the sooner you get people back to work, the more the economy gets back into gear, the more revenue that will come in.

Secondly, we need to act to put in place a long-term, credible, deficit reduction plan that does that in a steady way without harming current jobs and economic growth, and we need to do it, I believe, in a balanced way, like every other bipartisan group that has looked at this challenge recently. And so, I hope we can complete that mission.

As you have indicated in your testimony today and before, in that long-term picture, there are two big components. One is there is no doubt we have to get a grip on the increasing costs, as a result of the baby boom retirement, rising healthcare, no doubt about it. And there are smart ways to do it, and then there are ways that I think would impose a lot of unnecessary pain on Americans.

But we need to reform the healthcare system so that we focus more on the value of care than the volume of care, more on quality than on quantity, and then we have to deal with the revenue issue. And we all know that in the past decade when folks at the very top were paying a little more, the economy performed just fine. Twenty million jobs were created. The economy was booming. And so, it seems to me that this is a time for shared responsibility to address our country's needs, and I think your testimony made that very clear.

So thank you, Dr. Elmendorf.

Thank you. Thank you, Madam Chairman and Mr. Chairman.

Dr. ELMENDORF. Thank you, Congressman.

Chairman MURRAY. Senator Toomey?

Senator TOOMEY. Thank you, Madam chairman.

And thank you, Dr. Elmendorf.

A couple of quick follow-ups here. First, I know it is your view that the recent huge increase in spending and the corresponding big deficits have generated more economic growth and more job creation than we would have had in the absence of those things. But surely you would agree that that essentially asks for a comparison to a counterfactual, and as such, it is completely impossible to prove?

Dr. ELMENDORF. Yes. That is right, Senator.

Senator TOOMEY. Okay. I would just urge us to consider that there is another theory here, which is that Government can't really create demand on balance. It can substitute public demand for private demand, but that it is illusory to think that the Government can simply step in and make up for what is perceived to be a shortfall of private sector demand.

And by the way, I would suggest that there are governments, such as Greece and Italy and Portugal and Spain, who have created a lot of demand domestically through their excessive spending, and it is not working out so well for them.

I wanted to follow up on something. I might have misunderstood this, but I thought I heard someone suggest that nondefense discretionary spending has been essentially flat for about the last decade. And I think we have touched on this in various ways, but I just want to be very clear. In fact, by any reasonable measure, non-

defense discretionary spending has grown dramatically, I would say.

The numbers I have are in 2000, we spent about $284 billion in nondefense discretionary spending. In 2010, we spent $550 billion. We have had a slight reduction in 2011. But this is growing, obviously, in nominal terms. It is growing in inflation-adjusted terms. It is growing faster than inflation plus population growth. It is growing faster than GDP, in fact. Isn't that true?

Dr. ELMENDORF. I think that is correct about outlays, Senator, and I do show that in one of the figures. The issue, though, worth pointing to is that funding, meaning the new budget authority the Congress is providing for nondefense discretionary purposes, is actually now back down already in fiscal year 2011 as a share of GDP to roughly what it was over the preceding few decades. And you can see that in Figure 6 of the testimony.

Now you are right as in terms of nominal dollars or in terms of real inflation-adjusted dollars, it is certainly up.

Senator TOOMEY. Right.

Dr. ELMENDORF. And as a share of GDP, though, there is a sharp distinction between the level of outlays in 2011, which depended on previous year's funding, and the level of funding in 2011, which is the jumping off point for future discussions of appropriations.

Senator TOOMEY. My point is over this 10-year period, we have seen huge growth in nondefense discretionary spending.

The last point I would just like to ask is I think it is your view, but I would like to ask, is it your view that if we were to pursue revenue-neutral tax reform that would have the effect of broadening the base on which taxes are applied and lowering marginal rates, that it is true both with respect to such corporate reform or individual reform that that would have a pro-growth effect on the economy, which, of course, in turn generates more income for the Government?

Dr. ELMENDORF. Yes, that is right. Again, the amount would depend on the specifics of the proposal.

Senator TOOMEY. Absolutely. But to the extent that we pursued that, we would be generating economic growth, therefore jobs and revenue for the Treasury?

Dr. ELMENDORF. Yes, Senator.

Senator TOOMEY. Great. Thanks very much.

Chairman MURRAY. Dr. Elmendorf, thank you very much for coming today and testifying.

And I want to thank all of our members for being short and concise. We have a lot of work to do and a shrinking amount of time to finish it with.

Dr. Elmendorf, thank you to you and your entire team for the tremendous amount of work that we are putting forward to you, and appreciate all of that.

I do want Members to know that they have 3 business days to submit questions for the record, and I hope the witnesses can respond very quickly to that. So Members should submit their questions by the close of business on Friday, October 28th.

Chairman MURRAY. I would also like to inform everyone that we are going to have another hearing on November 1st. The topic will be "An Overview of Previous Debt Proposals." We will be hearing

from former Senator Simpson, Erskine Bowles, Alice Rivlin, and former Senator Pete Domenici.

Without objection, this joint committee stands adjourned.

Dr. ELMENDORF. Thank you, Senator.

[Whereupon, at 11:45 a.m., the committee was adjourned.]

OVERVIEW OF PREVIOUS DEBT PROPOSALS

TUESDAY, NOVEMBER 1, 2011

UNITED STATES CONGRESS,
JOINT SELECT COMMITTEE
ON DEFICIT REDUCTION,
Washington, DC.

The committee met, pursuant to call, at 1:37 p.m., in Room 1100, Longworth House Office Building, Hon. Jeb Hensarling [co-chairman of the joint committee] presiding.

Present: Representatives Hensarling, Becerra, Camp, Clyburn, Upton, and Van Hollen.

Senators Murray, Baucus, Kerry, Kyl, Portman, and Toomey.

Chairman HENSARLING. The committee will come to order.

Before I recognize myself for an opening statement, I wish to make a few preliminary remarks.

Number one, I wish to remind all of our guests that the manifestation of approval or disapproval, including the use of signs or placards, is a violation of the rules which govern this committee. The chair wishes to thank our guests in advance for their cooperation in maintaining order and decorum.

This is the fourth hearing of the Joint Select Committee on Deficit Reduction, entitled "Overview of Previous Debt Proposals."

I want to thank our witnesses. First, I wish to thank them for their service to their country, all long-time, storied public officials.

Senator Alan Simpson, who served as a Senator from Wyoming for 18 years, served as chairman of the Veterans Committee, a member of the Finance, Judiciary, and Aging Committee, and obviously the co-chair of President Obama's National Commission on Fiscal Responsibility and Reform.

Additionally, Erskine Bowles, who served as chief of staff to President Bill Clinton and was appointed by President Obama to also co-chair the National Commission on Fiscal Responsibility and Reform.

Senator Pete Domenici, the longest-serving Senator in New Mexico's history, although New Mexico is still a fairly young State; a storied career as chairman of the Budget Committee; serves as a senior fellow at the Bipartisan Policy Center.

Finally, Dr. Alice Rivlin, who was a vice chairman of the Federal Reserve, director of the OMB in the first Clinton administration, and the founding director of the Congressional Budget Office, and served with Senator Domenici on the Bipartisan Policy Center's Task Force for Debt Reduction.

Again, I want to thank each of our witnesses for their work. There are many other fine organizations and think-tanks that have

added value to the process. This particular committee chose to hear from these four individuals and these two bodies.

With that, the chair will now yield to himself for an opening statement.

OPENING STATEMENT OF HON. JEB HENSARLING, A U.S. REPRESENTATIVE FROM TEXAS, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Chairman HENSARLING. What I do believe we will hear from each of our witnesses is that America at least does indeed face a legitimate debt crisis. Not only are we operating on borrowed money, we are operating on borrowed time as well.

In that vein, I never tire of reminding not only myself but the public and my colleagues that although we have a statutory goal to reduce the growth of the deficit over 10 years by $1.5 trillion, backed up by a $1.2 trillion sequester should we fail, more importantly we have a statutory duty to proffer legislation that would significantly improve the Nation's long-term fiscal imbalance.

What could not be clearer is that unless we offer fundamental and structural reforms to our Nation's entitlement programs, especially health care, we will not only end up failing in our duty, we may fail our Nation as well.

Health-care costs, measured by GDP, roughly have doubled since the time of my birth until I entered the workforce and have risen about two-thirds since then and are growing at what all acknowledge to be an unsustainable rate. Every agency and think-tank that I am aware of, every academic study shows that Medicare will go broke in 9 to 13 years. The President himself has said, "The major driver of our long-term liabilities—everybody here knows it—is Medicare and Medicaid and our health-care spending. Nothing comes close." I continue to agree with the President.

Unfortunately, Social Security faces its problems as well. My children will likely put more money into Social Security than they take out—at best, generational unfairness; at worst, a form of generational theft.

We have previously heard from the Congressional Budget Office that tax revenues, upon the recovery of this economy, will once again produce roughly 18.5 percent of GDP. We also know that there are many tax increases that are already built into current law. But spending, principally driven by our health-care and retirement programs, is due to roughly double in size, to 40 percent of GDP, over the course of a generation from where it was just a few short years ago.

Certainly, we cannot tax our way out of this crisis. We cannot solve it by simply tinkering around the edges of our entitlement programs. For the sake of our economy, our jobs, our National security, and our children's future, many people say it is time to, "go big." I agree, but going big is not merely measured by slowing the rate of growth of the deficit over the next 10 years. Going big must be measured in solving the problem—in other words, fundamental and structural reforms of our entitlement programs, giving every American the opportunity for quality health care and quality retirement security at a cost that does not harm our jobs and diminish our children's future.

[The prepared statement of Chairman Hensarling appears in the appendix.]

With that, I will now yield for an opening statement to my co-chair, Senator Murray of Washington.

OPENING STATEMENT OF HON. PATTY MURRAY, A U.S. SENATOR FROM WASHINGTON, CO-CHAIRMAN, JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

Co-Chair MURRAY. Thank you very much, Co-Chair Hensarling.

And I want to thank all of our colleagues and especially our witnesses who have all come today. We really appreciate your being in front of this committee today. And I want to thank all the members of the public who are joining us, as well.

We have all been working very hard over the past 2 months, but with 23 days left to go until our deadline and with even less time before we need to have a plan ready to be voted on, we are now entering the critical final phase of this process. And, as we all know, the consequences of failure are unacceptable. The triggers that have been put in place would be devastating for our National defense and for middle-class families and the most vulnerable Americans that depend on this country for things like education and housing and even nutrition assistance for women and infants.

Markets, rating agencies, and businesses across the country are watching closely to see if Congress can solve this problem. And the American people are looking to us to break out of the gridlock and partisan rancor that has dominated D.C. recently and to deliver the kinds of results that they expect and they deserve.

That is why members of this committee have been clear: We need to find a way to come together around a bipartisan deal. So I believe it is very appropriate that we are having this hearing with these witnesses as we move into these final few weeks.

Before us we have Democrats and Republicans who were able to come together around big and balanced proposals that tackle some of the most difficult challenges facing our Nation. The two groups went about it in slightly different ways, and I don't agree with each piece of each plan, but they provide serious models for big and balanced bipartisan proposals.

And as I know we will hear more about it today, these proposals achieved bipartisan support and came together only because they were balanced, they included concessions from all sides, and they required all Americans to share in the sacrifices that this endeavor calls for. Neither of these bipartisan proposals included only spending cuts, and they didn't simply address entitlements or only raise revenues. They put everything on the table. They made tough decisions, and because of that, they were able to put together balanced packages that garnered bipartisan support.

So, as this committee moves into the home stretch, hearing more about the importance of a balanced approach is going to be very helpful. As our witnesses today can address, a bipartisan deal isn't possible if Members refuse to come out of their partisan or ideological corners. It is not enough for either side to simply say they want to reduce the deficit. Now is the time when everyone needs to be putting some real skin in the game and offering serious compromises.

Democrats have made clear that we are prepared to do that. We have said we are very open to painful concessions and compromises if Republicans are, as well. And we have put forward serious ideas to reflect that. But these concessions will only be made and only considered in the context of a balanced deal that doesn't just fall on the middle class and most vulnerable Americans. But that requires big corporations and the wealthiest among us to share in the sacrifice.

The American people realize that. They overwhelmingly support a balanced approach, which is why this is the kind of deal every bipartisan group that has successfully tackled this issue has made. It is the kind of solution I am looking forward to hearing more about from our witnesses today, and it is the kind of deal I hope that every member of this committee is prepared to make.

So, again, I want to thank our witnesses for being here with us to have this critical conversation. The bipartisan, balanced plans that you have put forward provide a strong foundation for this committee, and we look forward to hearing your testimony and having a chance to ask our questions. So, again, thank you to all of you for being here today.

[The prepared statement of Co-Chair Murray appears in the appendix.]

Chairman HENSARLING. Thank you, Senator Murray.

And now we will hear from our panel. I have no idea why you are seated in this order, but we are going to start with you, Mr. Bowles.

Each witness will be recognized for 5 minutes, at which time members will have 10 minutes for questions.

Mr. Bowles, we are now prepared to receive your testimony.

STATEMENT OF ERSKINE BOWLES, CO-CHAIR, NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

Mr. BOWLES. Thank you, Mr. Chairman. I am delighted to be here. I am delighted to be in the company of these three great Americans. And I want to thank you for inviting me to come.

Both Alan and I thought long and hard about what we wanted to say today. We have submitted something in writing to you, but, instead, I would like to just speak to you from a few notes I have made.

I know most of you. I have worked closely with almost all of you on both sides of the aisle. I have great respect for each of you individually, but, collectively, I am worried you are going to fail—fail the country.

When Alan and I first got into this, we thought we were doing it for our 15 grandkids. I have nine, and he has six. But the closer we got to the numbers, the more we realized we weren't doing it for our grandkids, we weren't even doing it for our kids; we were doing it for us. That is how dire the situation is today.

I think that we face the most predictable economic crisis in history. I know that the fiscal path we are on here in Washington is not sustainable. And I know that each of you know it and you see it, because it is as clear as day.

When Alan and I travel around the country and we talk to people and we ask them, why do you think we have these deficits, they

tell us, oh, it's got to be waste, fraud, and abuse, it's got to be foreign aid, oil company subsidies. And, yes, all of those are a small part of the problem. But the big problem really comes from four sources, and you know it.

The first is health care. We spend twice as much as any developed country in the world on health care. And, unfortunately, if you look at the outcomes, our outcomes don't match the outlays. We rank somewhere between 25th and 50th in things like infant mortality, life expectancy, preventable death. And so the rapid growth of health care and the unsustainable growth of health care is our number-one problem.

The second biggest problem today, I believe, is that we spend in this country more than the next 14 largest countries combined on defense. Admiral Mullen, Chairman of the Joint Chiefs of Staff, who just stepped down, recently said that our biggest national security problem is these deficits and this debt because it will consume every dollar of resource we have. We believe that we have to make reasonable cuts in defense.

Third, I believe that we have the most ineffective, inefficient, anticompetitive tax system that man could dream up. What we believe you need to do is broaden the base, simplify the Code, eliminate or at least greatly reduce this backdoor spending that is in the Tax Code, and use that money to bring down rates and reduce the deficit.

And the fourth cause of the deficit is simply interest on the debt. And if there is one thing I am familiar with, it is the power of compound interest. And when interest rates go back to normal, this country is going to experience the power of compound interest.

This is a problem we can't grow our way out of. We could have double-digit growth for decades and not solve this problem. And, as the chairman said, it is not a problem we can solely tax our way out of. Raising taxes doesn't do a darn thing to change the demographics of a country or change the fact that health care is growing at a faster rate than GDP. And it is also not a problem that we can solely cut our way out of. I think you all have proven that over the last year.

That is why our commission came up with a balanced plan of $4 trillion of deficit reduction over the next decade. We didn't make the $4 trillion number up because the No. 4 bus rode down the street. Four trillion is not the maximum amount we need to reduce the deficit, it is not the ideal amount, it is the minimum amount we need to reduce the deficit in order to stabilize the debt and get it on a downward path as a percent of GDP.

We based this proposal on six basic principles. Those principles are that we shouldn't do anything to disrupt a very fragile economic recovery, so we made very light cuts in 2011 and 2012 and did not get spending back to pre-crisis levels in 2013, when we did get it back to pre-crisis levels in real terms.

Secondly, we didn't want to do anything that hurt the truly disadvantaged, so we didn't make any big cuts or any cuts in things like food stamps or SSI or workers' comp. And we actually did some things to improve Social Security, while making it sustainably solvent.

Third, we do want to make sure this country is safe and secure, but we have to realize, as Admiral Mullen said, that our biggest national security problem is these deficits.

Fourth, we thought the President was right, or at least half-right, in his State of the Union when he said America must invest in education, infrastructure, and high-value-added research if we are going to be competitive in a knowledge-based global economy. What he left out is we have to do it in a fiscally responsible manner. We live in a world of limited resources; that means choices and priorities.

Fifth, as I said earlier, we believe we have to revise the Tax Code, simplify the Tax Code to broaden the base, to reduce the tax expenditures, and use the proceeds to reduce rates and to reduce the deficit.

And, lastly, we have to be serious about spending cuts. We have to cut spending wherever it is, whether it is in the Tax Code, the defense budget, the nondefense budget, discretionary budget, or the entitlement budget.

I believe if you all go big, if you are bold, and if you do it in a smart manner, that the American people will support you if you make these big, bold, smart decisions. I hope for the country's sake you will.

Thank you very much.

Chairman HENSARLING. Thank you, Mr. Bowles.

Senator Simpson, you are now recognized.

STATEMENT OF ALAN SIMPSON, CO-CHAIR, NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

Mr. SIMPSON. Senator Murray and Representative Hensarling, it is a pleasure to be here.

I look at this panel, and I, too, know many of you. But at this stage of life, I have been around the track a while in this game. Never worked with finer people than Erskine and Alice and Pete, and have been working through years.

We don't need charts when we go out. We don't use PowerPoints. We just say, if you spend more than you earn, you lose your butt. And if you spend a buck and borrow 42 cents of it, you got to be stupid. Now, people do hear that. It is a rather wretched thing to say. And then you say, today your country is borrowing $4.6 billion and will borrow that tomorrow and the next day and the next day. If that has any common sense to the American people, it certainly has escaped us.

Now, my dad was a Governor and U.S. Senator. I know the game of inside baseball, and I know many of you well. As we wandered through this place a year ago, people came up and said, "Save us from ourselves." That is not a very smart thing to say in the duties you have to perform. So this is the toughest thing you have ever been in or ever will be in, without question, what you are doing. You have my deepest admiration and respect, all of you.

And you all know what you have to do. In your gut, you know what you have to do.

So some will say, well, you and Erskine have nothing to lose; you are not in the game. Well, that is true. But Dick Durbin and Tom Coburn had a lot to lose—a couple of diverse ideological allies.

They had something to lose, and they stepped right up to the plate and did it. They voted for our report. There were five Democrats, five Republicans, and one independent.

I used to take these people on when I was in the Congress. I did not do this suddenly. I am the only living person that had a hearing on the AARP. They went goofy, absolutely ballistic. "Why would you have a hearing on us? We do great things." Well, that is enough of that.

So anyway, I have dealt with professional veterans, I have dealt with extremists of the senior citizens, I have dealt with emotion, guilt, fear, racism, I did immigration, Social Security. I have done it all. And I never lost an election.

I dealt with Peter Rodino, a great Democrat, and Ron Mazzoli. We did things. I took on the professional veterans. I never heard anything out of Lloyd Bentsen and Bob Dole and Dan Inouye when did we veterans stuff. It was always from some guy that had never done anything, never even been in the military.

And in immigration I was called a bigot and a racist, and yet that bill brought 3 million people out of the dark. I was very proud of that. But it never got very far because the right and the left said, this is a national ID card, heh, heh, heh. That came from the right and the left.

People admire guts and courage. They may fight you, they may vilify you, but they will admire you. I have been the toast of the town one day and toast the next. I have been on the A list and the Z list in this town when I was here. It is a funny place. You are on the cover of Time one month, and 6 months later you are doing it.

And just a quick note about Grover Norquist. If Grover Norquist is now the most powerful man in America, he should run for President. There is no question about his power. And let me tell you, he has people in thrall. That is a terrible phrase. Lincoln used it. It means your mind has been captured; you are in bondage with the soul.

So here he is. I asked him, he said, my hero is Ronald Reagan. I said, "Well, he raised taxes 11 times in his 8 years." He says, "I don't know, I didn't like that at all." I said, "Well, he did it. Why do you suppose?" He said, "I don't know. Very disappointing." I said, "Probably did it to make the country run." Another sick idea.

And let's just look at the AARP. Just this morning, I saw that ad. That is the most disgusting—the most disgusting—ad I have ever seen. I don't know what the people got paid, especially the actors, but I can tell you this, they are well paid. They said, "We are 50 million. We are watching you. We remember, and we vote." I tell you, that is a really ugly thing.

But let me tell you about the AARP. Let's remember what they will be when they do nothing. We asked them what they would do to help, and they had said, we have two things we will tell you. They never did. But let me tell you what will happen with their view of the world, which is to do nothing to restore the solvency of Social Security. In the year 2036, you are going to waddle up to the window and get a check for 23 percent less. And then I hope that they will remember the AARP. I certainly will, and a lot of young people will too.

So anyway, it is a tough job, and you are going to have to do it. People are out there who are going to say, I have helped you forever, and now I never ask you for a thing, but here we are. And that is going to put a lot of heat. Well, the market will call the shots from now on. Won't need anything but that. Interest rates will go up, inflation will go up by the failure. And guess who gets hurt? The little guy. The vulnerable guy that everybody babbles about day and night will be the one hit with the hammer on the schnozz.

So remember the definition of "politics." In politics there are no right answers, only a continuous flow of compromises among groups resulting in a changing, cloudy, and ambiguous series of public decisions where appetite and ambition compete openly with knowledge and wisdom.

Thank you very much.

[The prepared joint statement of Mr. Bowles and Mr. Simpson appears in the appendix.]

Chairman HENSARLING. Thank you, Senator.

Dr. Rivlin, you are now recognized.

Dr. RIVLIN. I am going to defer to my colleague, Senator Domenici, if that is all right, to go first.

Chairman HENSARLING. Absolutely.

In that case, Senator Domenici, you are recognized. If you could pull the microphone a little closer to you, Senator.

STATEMENT OF HON. PETE DOMENICI, CO-CHAIR, DEBT REDUCTION TASK FORCE, BIPARTISAN POLICY CENTER

Mr. DOMENICI. Thank you, Mr. Chairman. I just wanted to say, the reason she asked for that privilege is we have our discussion with you planned in that order. And so we thank you very much.

First of all, let me say to the two co-chairs and the members of the committee, thank you for the opportunity to discuss with you today both the economic and fiscal challenges our Nation faces and our comprehensive plan to stabilize the national debt.

More than 18 months ago, Dr. Alice Rivlin and I decided that we should continue our decades-long work for a rational Federal fiscal policy. Our only stipulation was that everything is on the table. She and I agreed. We then invited 17 other members to join us in what became the Bipartisan Policy Center's Debt Reduction Task Force.

I tell you all of this because I think the history of the men and women that worked on this is very important to show you what kind of Americans we have out there who are worried about the future and will step up to the table and do what is necessary. The condition of their membership, those that joined us, was that they, too, would agree that everything was on the table.

Our task force ranged from Mayor Marc Morial of New Orleans to former Oklahoma Governor Frank Keating. Imagine the difference in the two. Some of you know. Yet they agreed. They agreed that we were in trouble, and they agreed that we had to solve the problem. We had liberals, conservatives, think-tank budget policymakers, former members of Presidential cabinets, people with business and labor experience. Our task force was as diverse

a group of serious American citizens as you could get to address what we all believed is a looming crisis for our Nation.

Last November, we issued our report. It has been much discussed, and you and your staffs have seen it. Our recommendations, after many days, were unanimous. And they were controversial, as they should be, because they were also serious. Individually, each of us might have preferred a different mix of solutions, but each compromised to find a set of policies that we could all support.

Since then, we have seen unemployment continue to exceed 9 percent, our economy continue to stagnate. At the same time, we have endured a damaging fight over the debt-ceiling increase. We have seen another series of the melodramas on annual appropriations. And we have seen another year of deficits exceeding $1 trillion and a debt that had ballooned to over $10 trillion—that is, the debt held by the public.

With spending projected to grow faster than revenues, we will be forced to borrow more and more every year if we do not change our policies. This fiscal projection is clearly unsustainable. Now, everybody has to learn that word because that is probably the best word to explain where we are. We are an America with an unsustainable economic policy, and it will ruin us sooner or later.

This unsustainable nature has been so attested to by the Federal Reserve Chairman, Ben Bernanke; the head of the International Monetary Commission; President Obama; and almost all fiscal experts have used that word, "unsustainable." You are there trying to fix the unsustainable and make it sustainable.

Righting our fiscal house will take three things: renewed economic growth; cutting Federal spending, especially entitlements, driven in large part by Medicare and Medicaid; and pro-growth fundamental tax reform that yields significant net new revenues.

The Medicare proposal that Alice and I present to you today is the only reasonable bipartisan plan to fundamentally reform that program, make it more efficient, and preserve it for future generations.

We also present to you a comprehensive pro-growth tax reform that clears out all the special interests that are in the Code. We, like our friends who chaired the President's commission—and I listened carefully to their recommendations today—they recommended a fairer and simpler tax system. We have one similar to it, but I would think that, if you look carefully at it, it better solves the problem that we have today.

Now, let me be blunt. A plan that does not fundamentally restructure Medicare and other health entitlements will fail to adequately address the debt crisis that we face. Both sides, those who are against any fundamental health entitlement reform and those who oppose any revenue increases, will be equally complicit in bringing the Nation closer to the fiscal brink.

I hope you heard that. I said it, and it is not like me. I don't usually say that about things. But I did say, if we don't do this, those who are for fixing health care and those who are for tax increases, and they say, "We will do not one without the other; we will do only one," then they are both complicit in letting America destroy

itself, letting this great democracy destroy itself, because we don't want to make tough decisions.

Additionally, while not currently the largest driver of our deficits, Social Security finances are unstable, and we must soon take action to implement some small fixes that will keep the system on solid ground for generations to come. And that can be done. That is not so difficult. Citizens will understand that.

What will happen if we continue to try to wriggle around these facts? When the debt-ceiling-increase battle caused short-term disturbances in the markets, when that happened, I had hopes that the fiscal reality would push the President and the Congress to real, fundamental action. Then, because of the turmoil in North Africa and the European debt problems of the highest order, investors rushed into quality, seen as the American sovereign debt. So instead of seeing higher interest rates for American debt, we have seen much lower interest rates. Instead of the stock market collapse, Dow Jones has been rising and going down steadily and on the upside during the last month. That is not normal for the situation we are in, but I just told you why it was.

So, are those of us who predict serious, perhaps calamitous, consequences for our fiscal policies, are we wrong? I think not. Right now, to borrow a phrase, American debt is the best house in a truly terrible neighborhood. Yes, we have rats, holes in the roof, and grass growing window-high, but other houses for global investors to store their money are even worse. And that accounts for us having lower interest rates.

However, it won't always be so. The neighbors might fix their houses or the whole neighborhood might burn. Either way, we will pay for our neglect with slower future growth. And that is the death knell for those in middle America who have been part of America's prosperity. Future growth and a less prosperous country, far less able to play a leading role in the world, is what we will present to the world if we don't fix this problem.

I am told that the Joint Select Committee doesn't have the time to truly do comprehensive reform. I believe it can create time through a fast-track mechanism using section 404 of your enabling legislation, and which we expand upon in the appendix documents in your folder. And I can say to you, those in your folder from us today, the five or six, make real sense and give you answers to almost every problem that you have before you.

I am told that the wise exchange of short-term political pain for long-term fiscal gain won't happen. I hope that is not true. Without substantial new revenues and structural entitlement reform, our fiscal ship is destined to capsize.

I am told that we need to put these kind of tax and entitlement changes off until 2013, an odd-numbered, nonelection year. Well, 2011 is an odd-numbered nonelection year. And although I am not making a prediction, we might not get to the next one unscathed. I am saying we might have the calamity before that event.

I know that the JSC has enormous power. What I don't know is whether or not they will use that power. Now, I have left one remark that was very important—I left it out here, and I want to find it so we can be sure that you understand—that those who say they will not support tax revenues unless we have entitlements,

that is a good position if, in fact, you are saying, I will do it if we get both. But both are complicit. If they fail to act because each blames the other, they will both be complicit if they don't both cooperate in participating in this deficit reduction. Not one, not the tax raisers, not the entitlement cutters, but both will be complicit and will have caused America to suffer what we have described here today.

I thank you very much.

Chairman HENSARLING. Thank you, Senator Domenici.

Now we will turn to Dr. Rivlin. You are recognized.

STATEMENT OF DR. ALICE RIVLIN, CO-CHAIR, DEBT REDUCTION TASK FORCE, BIPARTISAN POLICY CENTER

Dr. RIVLIN. Thank you, Co-Chairs Murray and Hensarling and members of the committee.

I share Senator Domenici's views and those of Mr. Bowles and Senator Simpson that this committee can change the course of economic history for the better.

The United States faces two huge challenges at once: accelerating growth in job creation and reducing future deficits to stabilize the debt. There is no choice between jobs and fiscal responsibility. Both are essential, and they reinforce each other. This committee, with its extraordinary powers, has the opportunity and the obligation to address both challenges.

To achieve success, the committee will have to go well beyond the minimum charge of $1.2 trillion in savings over the next 10 years, because even savings of this magnitude would leave the debt rising faster than the economy can grow. We believe you should craft a grand bargain involving structural entitlement and tax reform that would save at least $4 trillion over 10 years. To do so, the committee should take full advantage of the authority given to you in section 404 of the act and write instructions to authorizing committees to produce tax and entitlement reforms to be considered on a fast track.

A grand bargain would reduce the chances of a devastating double-dip recession that could lead to a stagnant lost decade. It would also reassure citizens and markets that our political process is functioning in the public interest, not stuck in partisan gridlock or overwhelmed by special interests.

I was privileged to serve on both the Simpson-Bowles Commission and the Domenici-Rivlin Task Force. Both groups worked hard to find a combination of policy changes that would enhance growth and put the budget on a sustainable path. The arithmetic of the problem, far more than political considerations, drove them to similar proposals. Both concluded that two major course changes were essential: structural reform in health programs, especially Medicare, and comprehensive reform of the individual and corporate income taxes that would raise more revenue from a more pro-growth tax system. Both also advocated freezes in domestic and defense discretionary spending to encourage weeding out low-priority activities in favor of more important ones.

The Budget Control Act capped discretionary spending. We believe that further reductions in discretionary spending would risk harming essential government functions. For the same reason, we

urge you to avoid the sequester. Instead, this committee should focus on reducing the growth of health-care spending and reforming the Tax Code. Our report offers solid bipartisan proposals to do this.

Our proposal for Medicare reform, which we call "defined support," would preserve traditional Medicare for all seniors who prefer a fee-for-service system. It would also offer an array of comprehensive health plans competing with traditional Medicare to deliver the same benefits. Plans could not refuse any Medicare beneficiary and would be compensated on a risk-adjusted basis. The Federal contribution would be determined by competitive bidding on a regional exchange.

We believe that the competition on a well-regulated exchange would lead providers and plans to deliver care more cost-effectively and reduce spending growth. As a fail-safe, the Federal contribution would be capped at GDP growth plus 1 percent. Excess costs, if any, would result in an increased premium, but low- and moderate-income beneficiaries would be protected from these increased payments. This bipartisan proposal would preserve Medicare for our rapidly rising population of seniors.

On tax reform, while growth in spending must be controlled, we do not believe that the projected tsunami of retirees can be absorbed by Federal programs without increasing revenues. Stabilizing the debt by spending cuts alone would cripple essential government functions and responses to human needs.

Moreover, as our colleagues have stressed, our current Tax Code is riddled with exclusions, exemptions, deductions, and other special provisions that distort economic activity, narrow the tax base so much that rates are unnecessarily high. Our proposed Tax Code would have only two individual rates, 15 and 28 percent, and one corporate rate, 28 percent. Most special treatment of income or spending would be eliminated or phased out. Capital gains, dividends, and so-called carried interest would be taxed at ordinary rates. Credits would be allowed for earned income, children, charitable contributions, mortgage interest on primary residences up to a limit, and retirement contributions. The exclusion of employer-paid health care from taxable income would be phased out, which we regard as both a tax and a health-care reform.

We believe, like our colleagues, that this simpler Tax Code would be both fairer and more conducive to economic growth. It would raise more revenue than current policy, but less than current law, and do it in a more progressive fashion.

We fully appreciate the difficulty of the choices facing this committee and hope you have the courage to restore fiscal responsibility and avoid the truly dire consequences of partisan gridlock.

Thank you very much.

[The prepared joint statement of Mr. Domenici and Dr. Rivlin appears in the appendix.]

Chairman HENSARLING. I thank you, Dr. Rivlin.

Thank you for the entire panel.

The chair will now yield to himself for 10 minutes.

I believe one of the things I have heard from all of the panelists—and I have certainly heard the revenue message, and we will go back to that—but I think I heard particularly you, Senator

Domenici, say that the number-one challenge that we have with respect to our debt is health care. Is that correct?

And I think, Mr. Bowles, I heard you say something similar.

Is there a consensus among the panel that the number-one challenge we face in our structural debt crisis is health care? No one is diverting from that?

Dr. Rivlin, I have a question, then, for you.

Mr. DOMENICI. Mr. Chairman, I want——

Chairman HENSARLING. Yes, Senator Domenici.

Mr. DOMENICI. I just wanted to ask if they would put up the chart that is very explicit on this. You cannot miss it.

Chairman HENSARLING. If you have a number for me, I would be glad to have the staff put it up.

Mr. DOMENICI. We don't use this, so I don't know—somebody said they would put it——

Chairman HENSARLING. I bet you somebody enterprising will be able to find that.

Mr. DOMENICI. They showed me just before we met.

Chairman HENSARLING. "Wake up, folks, it's health care." That appears to be how you entitled your slide. If the staff can pull that one up, please.

Mr. DOMENICI. I would ask them if they could put it back.

Dr. RIVLIN. There it is.

Chairman HENSARLING. Well, that is one of them.

Dr. RIVLIN. That is it.

Chairman HENSARLING. That is it?

Mr. DOMENICI. That is these various governmental functions versus GDP. And look which one, that blue line up there, that is health care. Look at the lines underneath. Those are big-ticket items that people think—but look at what is happening to health care.

I am going to give you a word. If we do not produce a plan that would permit CBO to say that the line has been bent—the line has been bent—if that isn't in the plan, then you have not caused in a major way a reform of health care. Because if that line keeps going that way, you have solved nothing. So it must start to bend someplace.

Chairman HENSARLING. So you are not speaking of simply slowing the rate of growth; you are talking about a plan that actually bends the cost curve.

Mr. DOMENICI. That is correct. And that is what we do.

Chairman HENSARLING. Dr. Rivlin, having the honor and, actually, pleasure of serving with you and Senator Simpson and Mr. Bowles on President Obama's Fiscal Responsibility Commission, I was somewhat familiar with your plan, with House Budget Committee Chairman Paul Ryan, on a Medicare premium support system. And you now have what I believe you have called a defined support system. And as I was listening to your testimony, it includes an aspect of maintaining some facet of the current fee-for-service aspect of Medicare.

But could you tell me why this form of defined support is critical to saving us from the national debt crisis? And how does it differ from your earlier premium support plan with Chairman Ryan?

Dr. RIVLIN. I think it differs in several respects. The most important one is the one you noted, that it preserves traditional Medicare for anyone who wants it. And I think that is important. It is important to seniors, and it is important to have—you should forgive the expression—a public option.

But in addition to traditional Medicare, it sets up Medicare exchanges, where seniors would choose among an array of plans that provided at least the same benefits as Medicare and competed with each other and with traditional Medicare to produce them in the most cost-effective way. We believe that that would control the costs, that the costs would go up much less rapidly. And that would be part of bending the curve, as the Senator says.

We have, however, a fail-safe mechanism in there. If the competition does not result in bending the curve enough, we would say the defined support, the Federal contribution, would not go up faster than the GDP grows plus 1 percent. And if it did, there would be additional premiums for those choosing the more expensive plan, but those premiums would not apply to low-income people.

That is the plan in a nutshell.

Chairman HENSARLING. Thank you.

A question for you, Mr. Bowles and Senator Simpson. And, again, it was both an honor and a pleasure to serve on your commission. I again want to say that I think you have contributed mightily to the Nation's consciousness. And I hope that whatever success that this Joint Select Committee achieves, part of it will certainly be on your shoulders and your previous good work.

Let me ask this question, having served alongside you all. And there was much great work that was done on the Commission. One of my personal reservations was that the Commission did not adopt the Rivlin-Ryan premium support plan. I thought the work particularly in Social Security—and if I have time, I want to go back to what you do on the 75-year solvency.

But on Medicare, which is really a larger, long-term challenge, we seemed on the Commission to apply much smaller, short-term reforms. You did put the 1-percent-plus-GDP cap, if I recall right, on total health-care spending, with a trigger of expedited procedures, if I recall right, to go to both bodies to fix the problem, but it wasn't a hard trigger.

So, two questions. Do you believe in the defined support system policy that was just articulated by Senator Domenici and Dr. Rivlin? And if you do, why didn't we adopt something like that in Simpson-Bowles? I assume either, one, you didn't agree with the policy or, two, you didn't have the votes. Or maybe there is a third option.

Mr. BOWLES. Probably both.

What we tried to do was to look at it on a realistic basis. If you look at the cost of Medicare and Medicaid alone today, it is about 6 percent of GDP, and it is growing like a weed. And that excludes what it takes to do—the $267 billion to do the doc fix, over $76 billion to repeal the CLASS Act. So it really is a big portion of our cost. It is, as, again, was said earlier, it is also, I believe, our biggest challenge from a fiscal viewpoint.

As we looked at the Affordable Health Care Act which was recently passed, it was the contention of the Democrats on our com-

mission that the cuts that were made to Medicare in the Affordable Health Care Act, along with the pilot programs that were set up, would reduce the rate of growth of health care to GDP plus 1.

Chairman HENSARLING. If I could interrupt, most of those cuts on the provider side, if I recall.

Mr. BOWLES. That is correct. That is correct.

We didn't think that would happen; we didn't think those cuts were enough. So we did about $500 billion of additional cuts over and above that, with the hope that those cuts would slow the rate of growth of health care to GDP plus 1.

But assuming that that didn't happen, you know, to us, there was no choice but to get the rate of growth to health care to that level, and we said there were certain options that would have to be considered at that point in time. And those options did include a premium support plan, it did include a robust public option, it did include even a single- or an all-payer plan.

Chairman HENSARLING. I see my time is about to run out here. Let me quickly cover two other subjects.

With respect to both of your plans on raising revenue, I do note that, as part of that, marginal rates are brought down in both plans. Is that correct? The witnesses are saying "yes."

I have less than a minute remaining in my time. Also, I was looking for certain common elements of your plans, one of which is global chained CPI throughout the entirety of government programs. And in the very short time that we have left, maybe I could get a 30-second answer out of each of you, why you thought that was a critical part of the solution.

Senator Domenici—okay, well, Dr. Rivlin, a brief answer on chained CPI?

Dr. RIVLIN. Yes, it is a technical change that economists have, for quite a while, decided was a better way, a more accurate way of measuring the cost of living for this purpose. And it would affect all government programs, including the Tax Code.

Chairman HENSARLING. So the COLA would still be there; it simply would rise at a different rate.

Dr. RIVLIN. Oh, absolutely. It is just a technical change in how you calculate the COLA and the index that is used for other programs with COLAs, including the Tax Code, which indexes the brackets.

Chairman HENSARLING. Senator Simpson, I am technically out of time, but could I get a quick answer on chained CPI?

Mr. SIMPSON. Everything we looked at, people had looked at it. It is better. Although there are suggestions for something else, CPI–I, but that is experimental. This one looks like everyone would adopt it. And if we could do it government-wide, it saves billions.

Chairman HENSARLING. I thank you, Senator.

The co-chair will now yield to his co-chair, Senator Murray, for 10 minutes.

Co-Chair MURRAY. Thank you very much.

And, again, thank you to all of you for your wise counsel on a very serious challenge.

Let me just start, it seems both of your prospective proposals would achieve deficit reduction of at least $4 trillion over the next

10 years through the use of a balanced-approach framework that includes reductions in spending and increases in revenue.

So let me just ask all of you, maybe by show of hands, do all of you believe that to get a balanced program that addresses the fiscal crisis, do we need both spending cuts, including entitlement reform, and revenue increases? Show of hands?

Mr. SIMPSON. No question, yes.

Co-Chair MURRAY. Okay. Well, let me start, then, with Senator Simpson and Ms. Rivlin. Maybe both of you can answer for your sides. Tell us why a balanced approach that includes both reductions in spending and increases in revenue was proposed by your committees.

Mr. SIMPSON. Well, we know you can't cut-spending your way out of this, you can't tax your way out of it. If you get into some of the rates that would happen if you are doing taxes or whatever it is, it can't be.

And we tire of the phrase "tax increase" when we are digging around in a $1.1 trillion stack of stuff called tax expenditures, which really affect about 5 percent of the American people. The little guy has never heard of half of them. And we said, let's take those, let's take those. And when you take one of those out, to call that a tax increase is a terminological inexactitude. It would be called a lie, in other words. And that is where that is. This is a fake, to say that you get rid of a tax expenditure and it is a tax increase.

So we said we are not going to get into that business of tax increase so that Grover won't have a stroke over in his shop; we are just going to go around Grover and let Grover rant. Because I will tell you one thing, if he and the AARP—if we are in thrall to those two groups, we haven't got a prayer, and neither have you.

Co-Chair MURRAY. Dr. Rivlin?

Dr. RIVLIN. I agree, we were attacking expenditures in the Tax Code, and they are almost identical with expenditures that are called spending.

There is another reason, however, why you need a balanced approach, and that, I think, is the demographics. This government is going to have to absorb a doubling of the number of people over 65 in the next couple of decades. That is an awful lot of people. That isn't changing the role of government; that is absorbing a lot more people, which we can't do unless we have some more revenue.

We must bend the curve on health care. We must fix Social Security. But we can't do it in such a drastic way that we can absorb all of those people without some more revenue.

Co-Chair MURRAY. Okay.

Mr. DOMENICI. Madam Chairman?

Co-Chair MURRAY. Yes, Senator Domenici?

Mr. DOMENICI. Might I just say, I think you all know, at least you, Madam Chairman, and a couple of other Senators there know me and have known me for a long time. And I didn't come on this committee trying to get anything—I didn't have any preconceived percentages that we used to work on. I said, let's start over.

And the truth of the matter is, even when you fix Medicare in any reasonable way and bend the curve so that over 20 years you really get some savings, the deficit is still too big unless you decide

to fill that gap with something. In other words, you don't have a viable budget versus the economy situation. So you have to look to the only thing that is left, because you have done the others. And we did it that way.

Co-Chair MURRAY. I very much appreciate that response.

And, Mr. Bowles, let me ask you, in the guiding principles and values that were established by your commission to guide in the development of your recommendations, you state that "growth is essential to restoring fiscal strength and balance, and deficit reduction must not disrupt the fragile economic recovery."

CBO and many economists agree that the rate of economic growth in the recovery projected for the remainder of this year and through 2012 was considerably stronger when your commission put out its recommendation than it is today.

So I wanted to ask you if you believe, first of all, that the Commission was successful in adhering to those economic principles, but also whether, given the weaker projections for today, whether we should be doing more now for economic growth and reducing unemployment.

Mr. BOWLES. First of all, our commission, it was the number one founding principle in our commission that we didn't want to do anything that we considered to be overtly stupid, and we felt it would be overtly stupid to do anything to disrupt what is clearly a very fragile economy and in fact a very fragile economic recovery.

Therefore, if you look at the cuts that we made in 2011 and 2012, you will see that those cuts are quite small. However, we thought it was very important for us to get spending down, and so we did make significant cuts in spending in 2013, and those spending cuts do get us back to 2008 levels or pre-crisis levels of spending.

When we came forward with that provision, lots of people thought, you know, that we were being too conservative. They said the recovery is real, that if you look at things like back in December, as you asked about, there was an increase in factory production, existing home sales were going up, retail sales were going up, it looked like banks were starting to lend to small businesses, unemployment was starting to come down, and investor sentiment was strong, and therefore people said at that point in time the recovery is real.

We, on the other hand, felt while the recovery may be real, it was very, very fragile, and the reason we thought it was fragile, and I think that has been proven to be right over time, is that we were very concerned about demand. Demand comes from three basic sources. You know, the consumer is still two-thirds of GDP, and in our cases we looked at consumer debt or household debt, it was still about 120 percent of household income, it was about $13 trillion outstanding. Over half of it was at floating rates. And if you think that a rise in food prices and gas prices took a bite out of consumer demand, you wait until interest rates go up. So we didn't see the consumer who had suffered a decline in their home value and a loss of income driving the economic recovery.

Second leg of growth would come from business. It is a fact small businesses can't grow and can't create jobs without capital, and banks simply weren't lending to small businesses, and so we didn't see that the small business community would be able to lead us out

of the recovery, and with big businesses who had plenty of capital, their capital was basically on strike because they didn't have confidence in the direction the country was going or didn't know which direction the country was going in, and lastly, it is hard to see business really lead us out of a recovery when the construction industry is really on its backside.

The third level of economic growth would come from government. We didn't foresee an additional big stimulus package coming out of Washington to add growth to the economy, and if you look at what State and local governments were doing, they were actually cutting spending and laying people off, trying to balance their budgets. So we didn't see where the growth would come to drive the economic recovery.

Myself, I believe we are in a structural contraction which will lead to a prolonged period of relatively slow growth and relatively high unemployment.

Co-Chair MURRAY. Dr. Rivlin, your plan also addressed the concern of accelerating the recovery and phasing in some kind of deficit reduction, and I think you also were worried about the demand. Can you talk to us about what you did in your proposal?

Dr. RIVLIN. Yes, we were very worried about inadequate demand, and so we not only phased in the deficit reduction slowly, but we called for a 1-year, both sides, employer and employee, payroll tax holiday on the grounds that that was needed to stimulate demand upfront before we could safely phase into the deficit reduction that we were calling for. That was at a time when the economy was somewhat stronger; it seems to us even more necessary now.

Co-Chair MURRAY. Did you have anything besides the payroll tax to stimulate jobs in your plan?

Dr. RIVLIN. No. We put that in as a kind of symbol of how concerned we were, a full year payroll tax holiday for employer and employee is, I think, $650 billion. That is a lot. Now, you could do it different ways. But we put it in to symbolize the fact that we were really worried about inadequate demand.

Mr. DOMENICI. Madam Chairman, I might comment on that. Frankly, I was very surprised in looking at the group of people that were on this debt reduction group, when it came to this issue, they were as worried as on any issue I had seen because they were really fearful that the economy was not going to recover. Frankly, we don't know what will make it recover, but Alice has appropriately told you what came about, how we came about what we did, and it is a lot of money. I guess some of us said that it might have been a much better thing to have done 2 years ago than whatever we tried to bring jobs. This might be a better way than anything we did, so we said let's suggest it.

Co-Chair MURRAY. Okay, appreciate that very much. My time has expired, so thank you very much.

Chairman HENSARLING. The co-chair now recognizes Senator Kyl from Arizona.

Senator KYL. Thank you. First to Senator Domenici and Senator Simpson, it is great to see you both again, and to all four panelists, thank you for the, what, thousands of hours that you have put in on these subjects, and it has been helpful to everyone. Senator

Simpson, you never disappoint. This is a serious subject but a little levity sometimes can help, and I appreciate that.

You talked about eliminating so-called tax expenditures, and I just have one quick question for you, a comment on taxes, and then I would like to talk about entitlement reform. If you eliminated the so-called tax expenditures, the biggest four of which on the personal side are deductions for medical expenses, charitable contributions, mortgage interest payments, and payments of State and local taxes, and you don't reduce marginal tax rates commensurately, the roughly one-third of Americans who itemize would have a higher effective tax burden, would they not? In other words, they would pay more in income taxes?

Mr. SIMPSON. Well, we, in getting rid of the 1 trillion 100 billion suggested that the $100 billion would go toward reduction of the debt and the rest of it would come out, and we would give the people of America what they have been asking for, broaden the base, lower the rates, get spending out of the code, and we said we will give three rates: 0 to 70 grand you pay 8 percent, 70 grand to 210 you pay 14, and everything over 210 you pay 23, and take the corporate rate to 26 from 36. But if you want to put something back, go ahead. The issue being if you want it, pay for it. So then you could go to rates of 12 and 18 or whatever you want to do. We said give—on home mortgage interest deduction, give them a 12½ percent nonrefundable tax credit, that helps the little guy. If you want to do charitable contributions, give them a 12½ percent nonrefundable tax credit. We realize those things, municipal bonds. But at some point you just say, look, you were told to bring home the bacon, the lobbyists got you what you wanted, and now it is over, the fun and games is over.

Senator KYL. So do I understand of the $1.1 trillion, $1 trillion of that would go for rate reduction?

Mr. SIMPSON. That is correct.

Senator KYL. And only $100 billion for debt reduction?

Mr. SIMPSON. That is correct, Jon, and it is good to see you, we served together, but let me just say, if you want to put something back, and they are wonderful things, earned income tax credit, you can get the violin out if you want to talk about what you are doing.

Senator KYL. Let me not take the time to do all that.

Mr. SIMPSON. No, I don't want to do that.

Senator KYL. Let me just make one observation, and then I do want to get to the entitlement spending. Both the Fiscal Commission and the Bipartisan Policy Center have suggested that one of the options here is to tax capital gains and dividends at ordinary income tax rates.

Now, you started the testimony by noting that you wouldn't want to do anything to disrupt a fragile economic recovery, sort of along the line of first do no harm, and my own observation is I think you could do great harm by effectively doubling the capital gains and dividends taxes because those represent areas of capital formation and investment in our economy.

Let me just make a quick observation here. The government receives capital gains revenues when taxpayers sell appreciated assets. The technical terms are called realizations. Now, Congress tried taxing capital gains at the same rate as ordinary income be-

fore—this was back in 1986—and the resulting capital gains revenues were dismal. In fact, they shrunk and remained depressed for a decade until Congress lowered the capital gains rate in 1997. Higher capital gains taxes mean fewer realizations, a higher cost of capital, less activity in the capital markets, and less economic growth.

The health care bill that was passed last year already increases capital gains and dividends rates by another 3.8 percent, and that means that the very lowest capital gains rate under your suggestion would be 26.8 percent, the highest would be 32.8. In other words, more than double the existing rate, and even the Joint Committee on Taxation would say that a rate that high will actually lose, not gain, revenue, and that doesn't even account for the negative impact on economic growth.

Other economists, ones who testified before our Finance Committee, said letting the top capital gains and dividends rate drift up to 20 percent will erase the theoretical revenue gain from increasing the tax rate and will lower both economic growth and wages. If the rate is pushed even higher, more revenue and GDP will be lost, and wages will be even lower.

So I would just ask you all, as we continue to visit about these things, to think about this. Your views are important to the committee, but in this one respect I think it could be very counterproductive by lowering economic growth, not really raising revenues, and it would make our deficit problem worse.

Now, let me turn to entitlements here because, Dr. Rivlin, I think you said something very important in response to Representative Hensarling's questions, and I want to make sure that I have this right. First of all, I think it would be useful for you to explain the benefits of a defined support or a premium support such as you recommend. If you could do that generally. But also correct me if I am wrong, but I understood you to describe the plan laid out in your submitted testimony, which is a little different than the original Domenici-Rivlin in that at least there are two attributes. First of all, you would actually—do you actually set the contribution, the Federal contribution level first by the second lowest bid, which would include fee for service but have the fail-safe, as you described it, that in no event would it go up more than GDP plus 1 with a sort of means tested premium support in the event that it did so? If that is not accurate, please tell me how I am wrong.

Dr. RIVLIN. Senator, you have it exactly right. We have improved this plan, I think, over our original one. It is now more like the bipartisan plan in the Breaux-Thomas proposal of the late 1990s, and one of the complaints that we got about the way we did it originally was it didn't reflect the actual costs of health care. When you do it by a bidding process, then it does reflect the actual cost.

Senator KYL. And also, as you are describing the benefits of this, talk about how you select the second lowest bid because I think that is a very clever way to do this.

Dr. RIVLIN. Well, that is arguable. There are different ways of doing it, but we thought——

Senator KYL. I thought it was.

Dr. RIVLIN [continuing]. Selecting the second lowest bid gave—it wasn't the lowest, which might well be flukishly low for some

reason, but people then who wanted to go to the even lower bid, the one that wasn't selected could do so and could get some money back.

Senator KYL. They would pocket the difference between the second bid and the one——

Dr. RIVLIN. Right.

Senator KYL. And if they wanted to be no dollar out of pocket, they would take the second lowest bid plans.

Dr. RIVLIN. Right.

Senator KYL. And of course anybody could offer plans at that level, and if somebody offered a plan that was more expensive, perhaps it had a different set of benefits or whatever, then they could pay for it, but the Federal premium support would only be at that second lowest bid.

Dr. RIVLIN. That is right. So it gives you a way of making the competition real, and we believe that would bring the costs down.

Senator KYL. I agree with that. Now let me go back to my first question there. Discuss the benefits of that premium support concept generally because I think it is not necessarily well understood. And then the final question I will ask is, that is not all that you would recommend. You also recommend—and this is really a question for all of you, but additional changes to the existing system that we have in order to potentially reduce expenditures, things like combining the part A and part B, increasing premiums under certain circumstances. I have forgotten whether you get into the co-pay issue or not. But could you also discuss whether some of those things are useful to do even if we do the premium support, but in any event, certainly if we don't do it.

Dr. RIVLIN. Yes, and I think also the things that Erskine Bowles mentioned, that the pilot programs and attempts to find better ways of delivering care and government support and private support for innovations and testing those things and putting them out in the public domain, that is all a very good thing to do, and we think it will pay off in the end, and it is not incompatible with our defined support plan because once you have those innovations out there in the public domain, the private sector is going to pick them up, Medicare will use them, things will get better.

Senator KYL. Hopefully reduce costs.

Mr. DOMENICI. Mr. Chairman, Madam Chairman, might I just follow up with Senator Kyl with one observation? On this one that you are speaking of on Medicare, the first thing that we did was to note the objection to a new system, and it was generally right upfront that you are abolishing Medicare, and so this new plan starts with the premise, we will have both programs, and you can choose, and that put us on a completely different path with our members than before, and it is very different than anything you all have considered, excuse me, you all in the House have considered heretofore when you took this subject up.

Senator KYL. An important observation. Thank you.

Mr. BOWLES. Actually, I didn't say it, Senator, but in our plan we did try to address this issue. Our belief was the current benefits structure encourages overuse, and there are currently a hodgepodge of different co-pays and deductibles and premiums. We wanted more cost sharing in our plan, we wanted people to have some

skin in the game, we wanted to get rid of first dollar coverage for that reason. So we went to one deductible on part A and part B of $550. We had a 20 percent payment up to $5,500, and then a 5 percent co-pay up to $75,000 and capped out at that level. We also on Medigap, we had no Medigap would be available for the first 500 and then 50/50 up to $5,000.

Senator KYL. All of those I think are very useful suggestions, and I appreciate them all. Thank you.

Chairman HENSARLING. The time of the gentleman has expired. The co-chair now recognizes the gentleman from California, Congressman Becerra.

Representative BECERRA. Thank you, Mr. Chairman. To all of you, thank you very much for your service to this country and for the work you have done to give us some templates that we can use to try to resolve this issue for not just the Congress but for our country.

I enjoy always hearing from the four of you because you have shown us that you can be big, you can be bold, and you can be balanced and still try to move the country forward, so I thank you for that, and as I said to both Alan and Erskine on many occasions, I thank you so much for attacking those sacred cows that too often get in the way of Congress being able to deal with those things that are most important. I honestly think, and I served on that Commission with you, as I said before, I thought you put all the elements in place. I would have put the mixture of those elements differently, but I compliment you today, as I did back then, and I applaud you for what you did in putting together the template of what could be a solution for the country.

I think I heard you all say this, but I want to make sure about this. While we are still suffering through these difficult economic times and back when we were going through this with the Commission, and Director Rivlin, I know that you and Senator Domenici were also going through this as well when you were coming up with your plan, times were tough. Well, they are still tough, and I suspect all of us back when we were going through the work of these two Commissions thought that the country, the economy was doing far better.

Is it still your premise that we should really concentrate on getting the economy back on track, getting Americans back to work before we go too heavily into trying to find these savings by making cuts in some of these important investments that we have? And I will open it up to anyone to answer. Director?

Dr. RIVLIN. It is a timing question, Mr. Becerra. We believe that drastic cuts in spending right now would be damaging to the economy, as would tax increases right now. We need to let the recovery happen and indeed stimulate it with proposals that we have been talking about. But that doesn't mean putting off the deficit reduction. One of the best things we could do for the growth of the economy right now is for this committee to legislate long-run reduction in the deficit on the entitlement and tax side right now. We can't wait until after 2013 or some other time to do that. The markets and the public have got to see that it is going to happen, that we are serious, and that it is in law. Then it doesn't have to take effect right away, but it has got to be in the law.

Representative BECERRA. So let it play itself through, get it done, let it play itself out, you have time for it to take effect long term as you see the economy begin to recover?

Dr. RIVLIN. Right. But don't wait to legislate it.

Representative BECERRA. Got it, got it.

May I ask a question regarding revenues? You all tackled the issue of revenues, you did it in somewhat different ways, but for the most part you did something that I thought was very important. You tried to also show the public that while we would increase real revenues, we would ultimately try to reduce the rates and give people a fair taxation system, and so that while we were still able to generate revenues, which we need, you are able also to tell the public that they are going to have a system that works better for them, and so that they could understand the simplicity and the fairness of it.

In both plans I believe, and we have had a little discussion on this, you equalized the taxation for capital gains and dividends to ordinary income or, in layman's terms, an asset, an investment in stocks or bonds would now be taxed at the same rate that the income earned by a hard working American would be taxed at, so they would be treated equally. You also found ways to reduce the rates overall for all income groups, and you went after what I know in the Bowles-Simpson Commission became known as tax earmarks, those tax expenditures which I believe, Senator Simpson, you mentioned totaled over a trillion dollars. And so you came up with a mix. Again, you tackled some sacred cows, and you came up with a mix.

Is it still your sense that that type of a mix can work for this committee? Open it up to anyone.

Mr. DOMENICI. Sir, I will say absolutely, and I would say to my friend Senator Kyl when he talks about capital gains, if you look at my record, I have voted in favor of capital gains for my 36 years in the Senate, but I didn't have a chance to lower the rates like we are lowering them at the same time that you were looking at capital gains. In this case that is what happened. We lowered the rates.

Now, I heard from the best experts this country could put before me when I was chairing that the best way to effect growth in this country is to lower the rates on all people. That was the best instrument of growth. They didn't say except for capital gains. They said it is the best instrument for growth, and we lowered it all substantially, so we put back into the code the instruments of growth which is the lowering of the rates on middle America and all Americans, which we did in ours and they did in theirs. Theirs is a little stronger in terms of, as Al explained it, they have come down lower so you can put back some things.

I would tell you, we also included in this, so you don't forget, we put in the medical expenses, which is the largest tax expenditure. It is bigger than homeowner interest rates. We phased that out over a long term. That is a very difficult one, but we did it in ours, and you all should know that is part of the reason we got the rates we got.

Representative BECERRA. And, Erskine, I think you called the tax expenditures backdoor spending through the Tax Code?

Mr. BOWLES. It is, Congressman. It is just spending by another name. I was flabbergasted, I was appalled to see that, you know, having listened to all the talk about earmarks all these years which are in the appropriations bills, there are about $16 billion worth of annual earmarks a year. There are $1.1 trillion worth of annual earmarks in the Tax Code. And it is just spending by another name. It is somebody's social policy. And if you were to eliminate them and use 92 percent of the proceeds to reduce rates and only 8 percent of the proceeds to reduce the deficit, you could reduce the deficit by about $100 billion a year, so a total over a 10-year window of about a trillion dollars, and you could take rates to 8 percent up to $70,000, 14 percent up to $210,000, and have a maximum rate of 23 percent. You could take the corporate rate to 26 percent, and you could pay for a territorial system so that $1 trillion that is captured overseas could be brought back to this country to create jobs over here. I believe that would create dynamic growth in this country and produce revenues far beyond what we have forecast. So I am very excited about broadening the base and simplifying the code. I think it makes a lot of difference.

Representative BECERRA. And I would love to focus on a couple more areas of spending. I know that when we talk about spending you also were willing to tackle this issue of the discretionary side of the budget, the kind of spending we typically talk about, but most people don't recognize that 65 percent of all the spending increases that occurred over the 10 years, the last 10 years came out of just one department, the Department of Defense, mostly because of the war, but because of the growth in some of our military projects and contracts and so forth. I know that you tried to tackle that some and I appreciate the work that you did there.

With the limited amount of time that I have, I would like to touch on health care, and I appreciate what each of the Commissions tried to do on health care, but let me just pose one question. Perhaps you can help us with this. We could do any number of things to try to reduce the cost of Medicare and Medicaid for the American public, but at the end of the day if we do nothing to try to help lower the cost of health care overall, not just within the public sector, within Medicare/Medicaid, we will simply have shifted the expense of health care in Medicare/Medicaid to those who use health care through Medicare/Medicaid, to our seniors and our disabled because the reality is that today the cost of health care under Medicare is growing slower than the cost of health care in the private insurance market. We went through that in the Bowles-Simpson Commission, how it is really strange, we are talking about the crisis in health care. The reality is if you were to get rid of Medicare and send seniors over to the private sector insurance market, they would actually end up paying more because the cost of private insurance is growing at a faster clip than is Medicare/Medicaid. So the issue is, how do we corral the cost of health care which it could hit Medicare/Medicaid, so that way we don't end up just shifting costs from the people, the taxpayers, to the actual beneficiaries, in this case our seniors who are now retired.

So if you can give that some thought, that would be very instructive. I know that the health reform of last year meant to do that, to try to help corral the cost in the private sector, but if we don't

do something about overall health care costs, simply telling seniors that they will end up paying more in Medicare doesn't help with our health care costs.

Thank you for your service to this country and your time.

Chairman HENSARLING. The time of the gentleman has expired. The co-chair now recognizes Congressman Upton of Michigan.

Mr. UPTON. Well, thank you, Mr. Chairman, and I certainly want to agree with each of you that these deficits are unsustainable. I appreciate your candor, your service, your hard work. Believe me, we know a little bit about your work because we together have spent hundreds of hours as well over the last number of weeks, and you underscore my respect for each of you as truly great Americans.

As you may know, my home State of Michigan, Dave Camp's as well, we have had 34 consecutive months of double digit unemployment, and as I talk to people back home, as I was again this past weekend, people know we are in a rut. Senator Simpson, they know exactly what you are talking about. And they, in fact, are relying on us to try and get our car out of the ditch and back in first gear.

I put a chart, I can't see it very well up here, but I think you have a chart I think in front of you that scores the President's health care plan from 2014 to 2023, and that 10-year outlay plan shows that spending, the effects on the Federal deficit will be almost $2 trillion in additional spending over the next 10 years.

[The chart appears in the appendix on p. 512.]

Representative UPTON. And each of you noted in your various proposals that the Federal budget is on this unsustainable path, and you identified health care as one of the most important items that this committee and the Nation should be focusing on.

So as you see from this chart, that the exchange subsidies are certainly the primary driver of this dramatic expansion of Medicaid. CMS actually certified that because of the President's proposal, nearly 25 million more Americans will be on Medicaid after 2014 because of that expansion, which means that more than one in four Americans will be, in fact, a Medicaid beneficiary.

So based on that and the statements that you have made about the budget crisis, do you believe that we should revisit the expansion of the Medicaid program in the President's proposal? Erskine? Sorry that you start on that end.

Mr. BOWLES. No, no, I am very happy to answer any question that you ask. You won't smell any fear on us out here.

Mr. SIMPSON. Go right ahead.

Mr. BOWLES. We had great questions that if the affordable health care plan could actually slow the rate of growth of health care to GDP plus 1. Because we had those questions, we did believe it would solve the problem of providing more people health care, but we didn't think it solved the problem of how to control the cost of health care, and therefore we made the $500 billion worth of additional cuts to both Medicare and Medicaid and certain other Federal health care programs in order to—and hoping that that would slow the rate of growth. If it didn't slow the rate of growth, then what we said is there has got to be an overall cap on all of these areas of spending, of Federal health care spending, and you are

going to have to look at some options like a premium support plan, like the robust public option, like a single payer plan.

Representative UPTON. Alice? Or, I am sorry, Alan.

Mr. SIMPSON. We just knew that whatever you call it, if you want to use the negatives or call it ObamaCare or any kind of care you want to, it won't work. It can't work because all you have to do is use common sense. You have this imploding of people, you have diabetes, you have one person in America weighs more than the other two, you have got guys who choose to do tobacco, who choose to do booze, who choose to do designer drugs, and all of them will be taken care of. You have got preexisting conditions in 3-year-olds. What happens through their 60 years or 50 years of life? All you have to do is forget the charts and know that if you torture statistics long enough, they will eventually confess, and know that this country cannot exist on any kind of situation where a guy who could buy this building gets a $150,000 heart operation and doesn't even get a bill. Now, that is nuts, and that is where we are in America. There is no affluence testing, you have got to raise copays, you have got to knock down providers, you have got to deal with physicians, you have got to have hospitals keep one set of books instead of two. That would be a start.

Representative UPTON. Alan, what did you do about Medicaid? Because originally you all had, as I understand it, you were going to convert it into a block grant for the States, and it is my understanding that you dropped that proposal; is that right?

Mr. BOWLES. We were never going to convert it into a block grant for the States. One of the things that—we felt that was too big of a shift, too unproven of a theory. What we did advocate is testing it in 10 States. It is on the theory that one size doesn't fit all, that Governors can cover more people with less cost if they have control of the funds. So we said let's test it in 10 States. If it does prove to be something that does lower the cost of health care and still provides coverage to people who need it, then we could support it, but you ought to test it first. I think that is what you would do in the business world, I think that is what you would do in most places.

It is now being tested in Rhode Island. It is working very well. I understand Washington State is actually asking if they can test it. So I do think it is one of the things that will prove out over time.

Representative UPTON. So beyond those tests did you ask for any other reforms on the Medicaid side?

Mr. BOWLES. Yes, we did.

Representative UPTON. And they were?

Mr. BOWLES. As an example, having run the public hospital in North Carolina for the last 5 years, you know, you can see the gaming that goes on in the Medicaid program by the payments, since it is a shared cost program, that is approximately 50/50 between the States and the Federal Government, you know, the docs would up the amount they would charge in order to cover higher fees charged by the State. They would both come out even, but the taxpayers would end up with about a $50 billion bill for that. So we cut out that kind of gaming in the State Medicaid programs.

Representative UPTON. Now, Alice, one of the proposals that you all recognized on the Medicaid side was this program called the per capita cap, which for those in the audience would actually, each State would receive an allotment determined by the number of folks in the specific categories for Medicaid based on the State population number for those numbers, and then that would be increased each year by GDP plus 1 beginning, I want to say, in 2014, 2015. Do you—are you a part of that proposal? I know way back when. Are you still supporting that idea?

Dr. RIVLIN. We looked at a number of ways to reduce the rate of growth of costs in Medicaid. One was splitting the responsibility between the Federal Government and the States. Medicaid is really two programs. It is acute care, which is largely for children and their mothers, and it is long-term care, and one of the things we looked at was split the responsibility for those two between the Federal Government and the States. We thought that would help make it clearer who is responsible for what, and not have the matching program that results in a certain amount of gaming. We also wanted to get rid of the kind of gaming that goes on in Medicaid, as Mr. Bowles has suggested, and one thing we were very clear about was the dual eligibles, those who were eligible for both Medicaid and Medicare. There is some impediments to their getting into managed care and management of their usually multiple diseases, and we wanted to fix that.

Representative UPTON. And what did you do in terms of added State flexibility to allow the States to be able to have greater control over what services were eligible?

Dr. RIVLIN. That is certainly a possibility. We did not, frankly, come down very clearly. We offered a menu of options on what to do about Medicaid. I think it is the hardest problem, much harder than Medicare, and we thought we had a good plan for Medicare. We offered a menu for Medicaid.

Representative UPTON. On Medicare, both Ways and Means and Energy and Commerce have jurisdiction over this issue, and I know that as many of us have looked at this, we have felt that it is the toughest entitlement to try and curb the cost curve downwards. We have heard a little bit about A and B, putting them together, the deductibles, the co-pay. It is my understanding that both of your groups also increased the age, is that right, for eligibility?

Dr. RIVLIN. No, we did not. We didn't even do it for Social Security. But we certainly did not for Medicare.

Mr. BOWLES. We have it as one of the options out in the 10-year window. It is not in the first 10-year window.

Representative UPTON. And when you looked at all the options that you considered, what was the one that was the first—what was the priority order that you came up with in terms of where you thought we—what we ought to do to reform Medicare?

Mr. BOWLES. We did not prioritize outside of a 10-year window. We said that drastic steps are going to be taken, those drastic steps must include looking at things like Alice and Paul's premium support plan, it has to look at a robust public option, it has to look at things like block granting Medicaid to the States, it has to look at things like a single payer plan, it has got to look at things like raising the eligibility age for Medicare. That is what we—those are

the options we saw that would have to be considered if, in fact, you can't slow the rate of growth to GDP plus 1.

Chairman HENSARLING. Before yielding to the next panel member, Senator Simpson, I think I have been informed that you have to depart in 20 minutes, if that is——

Mr. SIMPSON. Mr. Co-Chairman, I could wait a few minutes after that. I have to get to Dulles to catch a 5:30 flight to Denver so I can get out of town before they find out I have been here.

Chairman HENSARLING. Well, certainly Senator, we sincerely appreciate your participation today, and you will be excused from the panel whenever you need to depart.

Mr. SIMPSON. Let me share with the co-chairs that Erskine Bowles has a remarkable thing to present to you, and if I do have to leave early, I would have given him my time. It is very important that you hear what I think is a solution for you that only he, in his brightness, can propose. You can do anything you want with it, but I think it will get you somewhere where we think you want to get, and Erskine, as I say, if I leave, whatever time you would have allowed to me, but I want to hear from my colleague who came to the Senate when I did, Max, and I will stick around to about 25 or 20 of. Thank you so much.

Chairman HENSARLING. Thank you, Senator, and the co-chair notes that Mr. Bowles now has your proxy.

Mr. SIMPSON. Yes, he does.

Chairman HENSARLING. And the co-chair will yield to the gentleman from Montana, Senator Baucus.

Senator BAUCUS. Thank you, Congressman Hensarling. Everyone wants to reform the Tax Code. I don't know anyone who doesn't. But it is in the eyes of the beholder, what is reform to one might not be reform to the other. You have mentioned the $1.1 trillion in tax expenditures. I think it is important for everyone to know that only about $200 billion of those are itemized deductions. The rest are other tax expenditures, which include the employer-provided health insurance, for example, the retirement income provisions, R&D tax credit, there is a whole host of others in addition to itemized deductions. So if the proposal is to repeal them all in return for lower rates and deficit reduction, people have to realize what that means. A lot of people have relied on those provisions, employees have because that is in-kind income that is not taxed generally, as well as the R&D tax credit to make America strong, and retirement provisions so people can save for the future.

Now, the question that comes to my mind is how quickly do you recommend we tackle all of that? We have a November 23rd deadline, and I think one of you suggested, I think it was Mr. Bowles, you suggested that this be delegated to maybe the tax writing committees so that we do tax reform with some kind of a kicker at the end, penalty if the committees in the Congress don't act, et cetera. I would like you to comment on that. I am also waiting for the Bowles solution at the end of this presentation. I hope it includes something that addresses what I am talking about.

Address revenue. When you gave your presentation, Mr. Bowles, I might say we are all big fans of all four of you. You have worked so hard. When each of the four of you were speaking, you could hear a pin drop. You spent so much time on this subject and so

conscientiously, so thoughtfully, people know that. But when you, Mr. Bowles, mentioned one of your four principles, as I recall, one of them was tax reform, but you didn't say much about revenue, how you raise revenue.

My understanding is that the Commission suggested something in the neighborhood, I have forgotten exactly what it was, maybe a trillion dollars in new revenue to be offset with the spending cuts, and is that true? It is my understanding that you need to make permanent middle income tax cuts but not the upper income. You, in effect, propose raising revenue on the current policy basis of about $1 trillion. Does that sound about right?

Mr. BOWLES. Well, you know, you were on our commission and you attended a few of our meetings, so I think you probably know exactly what we did. What we did was, we did in the baseline extend the Bush tax cuts for everyone except the top 2 percent.

Senator BAUCUS. Right.

Mr. BOWLES. And then we reformed the Tax Code by broadening the base and simplifying the code and by eliminating the tax expenditures in our zero option plan, and in the zero option plan all of the tax expenditures did disappear, and 92 percent of the money went to reduce rates and 8 percent went to reduce the deficit. None of it went to additional spending.

Senator BAUCUS. Right. So I think the answer to Senator Kyl's question would be about $100 billion for deficit reduction; is that correct?

Mr. BOWLES. That is about $100 billion a year approximately.

Senator BAUCUS. How can that be enough revenue when there is such spending cuts recommended in your plan? I think you have a two-to-one ratio of revenue raised to spending cuts.

Mr. BOWLES. I think it was even more than that, Senator. I think it was, depending on how you counted, we had about a trillion dollars worth of additional revenue coming in, and we had about $3 billion worth of spending cuts, and we were working——

Senator BAUCUS. $3 trillion.

Mr. BOWLES. Excuse me?

Senator BAUCUS. Trillion.

Mr. BOWLES. Trillion, excuse me. And we were working towards that number. We were trying to get it to be no more than one-third revenue and two-thirds spending cuts, and we tried to get it to be one-quarter and three-quarters.

Senator BAUCUS. Going back to my first question, do you recommend that we here try to enact all those, cut all those tax expenditures and set rates or delegate it to the tax writing committees?

Mr. BOWLES. Well, we do recommend that you delegate it to the tax writing committees and set up a framework in this Commission. I don't think you can possibly rewrite the tax law between now and November 23rd and get it scored nor do I think you can rewrite the entitlement legislation and get it scored by November 23rd, but you can provide instructions to the appropriate committees.

Senator BAUCUS. To raise how much revenue?

Mr. BOWLES. To raise about a trillion dollars worth of revenues.

Senator BAUCUS. Which is included in the reform with broadening the base and lowering the rates?

Mr. BOWLES. Yes.

Mr. DOMENICI. I wonder if you would yield to me for one minute?

Mr. BOWLES. Sure.

Mr. DOMENICI. Mr. Chairman, could I just offer a suggestion?

Senator BAUCUS. Certainly.

Mr. DOMENICI. We felt ourselves extremely confronted by the problem of shortness of time for such a big job of reforming the Tax Code. Some of us were here when Bob Packwood was the chairman in the Senate and that effort took place. It took much longer than you need, but it took 2 or 3 years, 2½, 3 years or more. What we did in our testimony and what we have sent to you in a packet is we have taken Section 404 of the law that created you, which is a section that we think intentionally gave you an extreme amount of authority and more flexibility than we have been talking about, and that flexibility we think permits you to set up a direction with specific things you asked the tax writing committee to do, and that they have to do it by a date certain, which could be 3 months from now, 4 months.

Senator BAUCUS. I appreciate that.

Mr. DOMENICI. You would go to the committees. It is not reconciliation. It is an instruction.

Senator BAUCUS. We want tax reform in the worst way, all of us do. We are trying to figure out the best process and the best way to do it.

Second, I would like to ask about defense spending. It is my understanding that the Fiscal Commission recommended roughly $800 billion in defense cuts. When I compare that with the sequestration, which is about $800 billion, a little bit more, not much, the Budget Control Act in August cut about 350, referring to some accounting. Does that mean that you suggest another $450 billion in defense cuts?

Mr. BOWLES. We recommended about $1.7 trillion worth of discretionary cuts in outlays. It was about $2 trillion in budget authority from the President's proposed discretionary budget. I think he proposed, Senator Baucus, $11.7 trillion in discretionary spending. We proposed to cut it to $9.7 trillion, and the cost of the way the budget authority plays out slower in the form of outlays, it worked out to about $1.7 trillion. We said that should be split proportionally between security and non-security spending. We also recommended that there be a firewall between security and non-security spending over a period of time so that the future Congresses wouldn't come back and load it all up on the nondefense side and not on the defense side.

Senator BAUCUS. Right, right. In the same vein I think the Commission recommended a cap on something called Overseas Contingent Operations.

Mr. BOWLES. Yes, we did.

Senator BAUCUS. There is currently not a cap; is that right?

Mr. BOWLES. [Witness nods.]

Senator BAUCUS. Isn't it true—you may not know this; you probably do—that the Appropriations Committee transferred $9 billion over to Overseas Contingent Operations to escape the limitation?

Mr. BOWLES. I don't know about that.

Senator BAUCUS. That is going on. So you therefore would suggest a cap to help minimize that? I think your cap is $50 billion?

Mr. BOWLES. We were trying to keep the OCO from being a slush fund.

Senator BAUCUS. Thank you. That is what I am getting at.

Yes, Alan?

Mr. SIMPSON. May I say that whatever you do, and that will be so appropriate, just do a plan. You don't have to worry about, you know, who is doing this or the timetable and so on because let me tell you why the rating agencies don't mess with Germany or France or Great Britain, because each of those countries have a plan. All these people are waiting for is a plan. You can decide how many teeth you want to put in the jaw, but just do a plan, and you will see dramatic effects around the world with the rating agencies.

Senator BAUCUS. I agree with you very much. One question on the premium support, we don't have much time here. A concern some have is this, that with the election, to put it in rough terms, it would be a death spiral. That is that people currently on, the insurance companies will package sales of policies to the most healthy, so the most healthy people will buy these new policies, leaving the less healthy in Medicare, and the more that happens, the more the sicker people are in Medicare, so Medicare, the more it happens, Medicare costs just go up, up, up because the sickest are there. I am sure it is something you gave a lot of thought to. But some have raised this question. I am curious.

Dr. RIVLIN. Some have raised it, but we don't think it is true of our plan. We think we have avoided that possibility by the rules that we put in, any plan on the exchange would have to accept anybody, and they would be compensated on a risk-adjusted basis. I mean, they got more for people who are older and sicker, therefore they have no incentive to not serve those people.

Senator BAUCUS. Again, I just want to thank you all very much. You have offered a tremendous contribution to this country, all of you. Thank you.

Chairman HENSARLING. The time of the gentleman has expired. The co-chair now recognizes the gentleman from Ohio, Senator Portman.

Senator PORTMAN. Thank you, Mr. Chairman, and thank you to the four patriots who are sitting before us, trying to avoid what Erskine Bowles talked about today and in the Budget Committee testimony as the most predictable economic crisis our country has ever faced, and I appreciate the discussion today. We talked about a lot of the same issues that this group of 12 has been grappling with, revenues, of course, but also spending.

I would like to focus, if I could, on some of the issues that we have talked about, but maybe with a little different angle. If you wouldn't mind putting up that Bipartisan Policy Center chart, again, whoever is in charge of the charts, that is the one that Senator Domenici asked to be put up earlier. This is the chart that shows that health care spending as a percent of our GDP is set to just about double in the next 25 years. So just take my word for it, you don't need to see it; no, if you guys can put that chart up, I would appreciate it because it is the backdrop to this question.

Erskine Bowles said current benefits encourage overutilization. He talked about some of the things that could be done, including higher co-pays, higher premiums, talked about part A and part B being combined, having a single deductible that is a little higher. He also said that in the Simpson-Bowles proposal that you all recommended reducing—there it is—reducing health care spending over a 10-year period by $500 billion, and I assume to Senator Simpson and Mr. Bowles that that refers to the GDP plus 1, that is what that would mean, $500 billion, given this enormous growth or, to use your words, unsustainable growth in health care expenses.

And let me ask you about a couple of ways to get there that we haven't talked about yet. One is means testing. It seems to me this is one where Republicans and Democrats alike ought to be able to come together. I could give you some interesting statistics, a two-earner couple retiring today will pay about $119,000 in lifetime Medicare taxes and receive about $357,000 in lifetime Medicare benefits. That is 119 in taxes for 357 in benefits, which goes to the advertisement that you talked about, Al. So that is about three bucks in benefits for every dollar in taxes. If you multiply this by the 77 million retiring baby boomers, it is not hard to see why we have an unsustainable program.

Now, we can talk about this in terms of being sure, as Dr. Rivlin just said, that those at the lower end of the income scale are taken care of, but at the same time I think it is difficult to justify giving upper income seniors benefits that so far exceed what they paid into the system. Can you all just comment on that? We haven't talked about that specifically. How do you feel about means testing, particularly on the part B and part D premiums?

Mr. SIMPSON. Well, you have to, you follow the nomenclature here, you never want to use the word "mean" in anything especially. You call it affluence testing, and then you get juice, and that is what you should do. You are going to have to start affluence testing some of these benefits. There is no possibility of people who, as I say, literally, and you know them in your own community, who use these systems and pay nothing.

Senator PORTMAN. How about co-pays?

Mr. SIMPSON. Co-pays have to go up, and you have to affluence test in that. These are my personal views.

Senator PORTMAN. Could we see a show of hands from the panel because the photographers love this, how many are for affluence testing?

Mr. SIMPSON. It would be when they ask the Republicans for nine bucks worth of spending and one buck worth of revenue, and all hands shot up like robots. You don't want to get into that.

Senator PORTMAN. But this worked.

Mr. SIMPSON. I do favor that affluence testing, I think I always talked about it, Bob Kerry and I have talked about it, Max remembers Bob Kerry and I and Danforth and Bradley were all involved in that years ago when we were here. You have to start, and it will be called un-American, cruel, evil, breaking the contract, I can hear the music and the violins in the back already, and it won't work anymore.

Senator PORTMAN. Okay. Let me go to a tougher one. I don't know if we have——

Dr. RIVLIN. Can I chime in on that? We already do have in the part B premiums some——

Senator PORTMAN. And in part D now.

Dr. RIVLIN. And part D, and we are certainly in favor of increasing that.

Senator PORTMAN. Okay. Erskine, you talked a little bit about, again, some other ideas, and I am going to put you on the spot here, my friend, because one was raising the age. How do you feel about raising the eligibility age, given the statistics on longevity? Eligibility age on Medicare I am talking about.

Mr. BOWLES. We actually did not have that in our plan. As I have thought about it since that time, you know, under the Affordable Health Care Act, we provide subsidies for people who have really chronic illnesses and for people who have limited incomes to get so that they can afford health care insurance in the private sector, and that didn't exist before the Affordable Health Care Act, and that means that people 65, 66, 67 would still be able to get health care insurance.

So as I think about it, I could support raising the eligibility age for Medicare since we have other coverage available through the Affordable Health Care Act.

Senator PORTMAN. Let's go to tax reform for a second if I could. All of you are talking about broadening the base, and Chairman Baucus, and I am sure Chairman Camp is going to address this, too, something they are very interested in, simplifying the code, being able to do so by reducing marginal rates and getting rid of some of the underbrush. One thing we haven't talked about is corporate reform. As you all know, we have the second highest corporate tax rate among our trading partners. Japan is slightly higher, and they are intending to take theirs down. The average of all the developed countries, the OECD countries, is 26 percent, we are at 35 percent, but in fact we are not because you have to add State taxes on to that, and the average is about 6 percent, which happens to be Ohio's rate, so you are talking about 41 percent, and we do not have a territorial system, we have a worldwide system, which also puts us at a disadvantage, we are told, by all of our companies.

Could I see a show of hands on this, do you all support getting the corporate rate down to a competitive level? I would define that as 25, 26 percent and territoriality, does everybody agree with that?

Senator PORTMAN. Oh, Alice. I almost got Alice.

Dr. RIVLIN. Well, if you are pinning us down to a rate, I mean, we did take the rate down to 28 in ours.

And, actually, we didn't do territoriality. And the reason was interesting. Simpson-Bowles had strong representation from big, multinational corporations on it. They spoke very eloquently for territoriality. Our business representation was more small business. They were not enthusiastic about territoriality. So we left it out.

Mr. BOWLES. Yeah, we did. We took the corporate rate to 26 percent, and we went to a territorial system to pay for it.

Senator PORTMAN. Pete?

Mr. DOMENICI. I support ours, the one we have been describing. We didn't come down as far as them, but 28 is ours.

I think the problem we have with the public on that is it is discussed in isolation by the commentators. They just say we are lowering taxes on fat cats, corporations. But when it is part of an overall plan, they got a big——

Senator PORTMAN. Yeah, I am talking about not lowering the tax, so it would be revenue-neutral, so there would be no reduction in the taxation. In fact, you would get growth from that, based on all the economic analysis that we have seen, which would add more revenue that was not revenue from increasing taxes but revenue from growth and other feedback effects.

Mr. DOMENICI. I don't disagree. I was just giving you an explanation that I have heard.

Senator PORTMAN. Yeah. I appreciate it.

With regard to balance, because that has come up here—the co-chair talked about balance, you all talked about ratios and balances—what is the right balance? I think, first, can—you talked about this earlier, in terms of where you all were headed and where you ended up. Could you or Senator Simpson give us a sense of what you believe is the right balance here between revenue that is generated, again, through tax reform, but new revenue, on the one hand, and, on the other hand, reductions in spending? What is the right balance?

Mr. BOWLES. We thought it was no less than two-thirds, and we worked toward three-quarters coming from spending, as opposed to one-quarter or one-third coming from revenue. If you look at the projections for 2020, it had spending, I think, at about 25 percent and revenue at 19 percent. And we didn't want to see revenue go above 21 percent. And, obviously, we wanted to see if we could drive spending down to where revenue was so we could balance the budget at some point in time.

Senator PORTMAN. Yeah. Well, that is interesting, because you are right, you know, we are now at about a historical average of about 18.4 percent on revenue. And we are lower now with the recession, but even under CBO's statistics showing that the tax cuts would all continue, we get back up to that 18 percent in the next several years.

One final—well, I see my time has expired. Listen, again, I want to thank you all for your help today and the help you have given us up to this point, all of you who have made contributions to our efforts, both individually and as part of your groups. And we are going to need your help going forward. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The co-chair now recognizes the gentleman from South Carolina, Congressman Clyburn.

Representative CLYBURN. Thank you very much, Mr. Chairman.

Let me add my voice of thank-yous to all four of our panelists here today, and thank them so much for their service.

I want to start with a statement. I have asked—and it has been put up—for a chart to be put up here, looking at a bar graph that I suspect a lot of us have seen in the last week or so and we talked about when Dr. Elmendorf was before this committee. It shows the

widening wealth gap that is existing within our country today, and it covers basically the last 30 years.

Now, we have 3,143 counties in the United States. Of those 3,143 counties, 474 of them, 15 percent of those counties, more than 20 percent of their citizens have been living beneath the poverty level for the last 30 years.

And it is kind of interesting because I didn't think about this through the weekend because, about several months ago, I joined with Congresswoman Emerson on trying to focus on these counties and trying to direct resources to these counties. Back when we did the American Recovery and Reinvestment Act, the stimulus bill, in the rural development section of that bill we were successful in getting that bill to focus on these counties by directing the expenditure of at least 10 percent of those funds into those counties where 20 percent or more have been beneath the poverty level for the last 30 years. So when this report came out from CBO a couple weeks ago, it focused my attention once again to those communities.

Now, when I first came on this panel, I said that I wanted to focus on the human side of this deficit. So what I would like to ask today is whether or not it is feasible to do $1.5 trillion reduction in deficit by cuts only. What will that do to that bottom 20 percent that has seen only 18 percent growth in their income over the last 30 years and those communities where 20 percent or more of their population have been beneath the poverty level for the last 30 years? What would it do to those communities and those people if we were to reduce this deficit only by cuts that have been proposed?

I would like to hear from all four of you on that.

Mr. BOWLES. Yeah, I am delighted to go first on that.

As you know, Mr. Clyburn, if you go east of I–90 and you are in North Carolina, we have more counties that fall into that category than any other place in the Union. If that part of the North Carolina was a State by itself, it would be the poorest state in the Union. So, as you know, I had many of our universities, from Fayetteville State to Elizabeth City State, that operated and served the people in those communities.

I think if you think about what you have already done, if you look at the continuing resolution, you took about $400 billion of cuts through the continuing resolution. And then if you think about—I always think about what you all are working on now with the Budget Control Act in two parts, and the first part was $900 billion in cuts. So you had another $900 billion in cuts that have already been done.

So you have done about $1.3 trillion worth of cuts already before you guys start on what you are doing.

Representative CLYBURN. Right.

Mr. BOWLES. I have always thought it has to be some combination of revenue and cuts in order to get to the $4 trillion number that we focused on. I do think it is important for all of you to think about the fact that these deficits are just eating the budget alive. And they don't leave any money left over to do the kind of economic development work in these poor counties that you want to see done if these deficits continue to grow and interest on the deficits continue to occur.

What we tried do was to make sure in the analysis, in the plan that we put forward that we didn't make any cuts in the income support programs like SSI and food stamps and workers' compensation. In addition, we tried to make sure that on things like Social Security that we actually upped the minimum payment to 125 percent of poverty to help those people who really needed it. And we gave people a 1 percent bump-up per year between 81 and 86, because that is when every Democrat and Republican economist that came to see us said that is when people need it the most.

So we tried to be sensitive to those people that were most disadvantaged while we did make the kind of cuts we had to make in order to put our fiscal house in order.

Mr. SIMPSON. We have enjoyed our time with you during our work. And you have been very cordial and listened to us, and I appreciate that deeply.

Representative CLYBURN. Thank you.

Mr. SIMPSON. The irony to me is that if we don't get there and the strike comes, the tipping point—Dick Durbin always asks, where is the tipping point? I don't know where it was, but I do know that it will come swiftly. And it will come by the ratings and the markets. It won't come by anything that any chart has ever disclosed before.

And, at that point in time, interest rates will go up and inflation will go up. And the very people who will be hurt the very worst in that procedure are the very people you speak of with such passion. This is a tremendous irony to me. By doing little or nothing and the tipping point comes, the little guy is going to get hammered worse than ever he is or she is now. That is the irony—the strange, hideous irony.

Representative CLYBURN. That is true, Senator. But wouldn't you say that, if we were do it, let's do a $1.5 trillion deficit reduction and let's do it on the backs of those same people, then what happens to that chart in the next 30 years, where we have a 275 percent increase in income for those people who are in the upper 1 percent and if you are in the upper quintile you saw an increase of around 56 percent and the lower quintile only 18 percent?

So let's just say, let's do it. Let's cut the deficit by $1.5 trillion. Let's do it by cutting Medicare, Medicaid, cutting Pell Grants, cutting education, cutting health care. And we will have saved the markets, but what will we have done to these 474 communities? That is my question.

Dr. RIVLIN. I think that is not a question that we should answer, because you shouldn't do that.

And there are two points. And I think we are all making the same two points. One is, we need to cut the deficits, but not by hurting vulnerable people. You should avoid doing that. And, secondly, that the importance of avoiding a double-dip recession and a lost decade of growth is extreme and will hurt those people most if you don't avoid it.

Mr. DOMENICI. I am the last here, and you have heard almost anything humankind can think of, but I would suggest to you that the answers that were given are really relevant and important.

And one of the reasons that our group did not get as big of reductions in appropriated accounts as other plans was because we came

upon the idea that we were going to have to come up with some revenue and we ought to have a budget that was understanding in this area, or it would, quite properly, be attacked with equal vigor to destroy it as we were trying to create a country that was strong again. And so we did take care of the problem you talk about.

But I would tell you from my own experience as I leave the scene, one time I asked a very wise man, "What do we do to help poverty?" And the person said, "I can tell you in one word." And I thought, you must have direct ties with the Holy Spirit. And he said, "Educate." He said, "Would you like it again? Educate."

Representative CLYBURN. Absolutely.

Mr. DOMENICI. And that is what he said, is that people must get educated. Well, that won't solve the bread on the table, but any plan you have in mind should obviously look at whether the poor people are getting educated or not.

Representative CLYBURN. I appreciate that.

Mr. DOMENICI. And that is the first step out, has got to be that.

And, secondly, the country has to grow or there is nothing to split, there is nothing to give to our people. So whatever programs you are talking about have to have growth in them. That is why all our tax plans are growth tax plans. Theirs is; ours is. We call it that. And we asked experts, and they say, your tax plan will cause far better growth than the plan we are under now.

That is why we cut corporate taxes. And people shouldn't immediately say, what do you cut the fat cats for? They aren't making as much here to give to our people in wages because they are going elsewhere because our taxes are too high. So it is not what people say. The reality is competition. We can't force them to stay in America if our taxes are too high.

So I think education and a fair tax for corporations belongs on this litany, maybe not first but somewhere.

Chairman HENSARLING. The time of the gentleman has expired.

Representative CLYBURN. Thank you.

Chairman HENSARLING. The co-chair now will recognize the gentleman from Michigan, Congressman Camp. And before I do, I just wish to thank him for arranging for the Joint Select Committee to use the Ways and Means Committee room. And your chair is very comfortable. Thank you.

Representative CAMP. Thank you.

Well, I also want to thank our witnesses for being here and for all of your hard work and your testimony today.

I do have a question. Mr. Bowles, in the Simpson-Bowles plan, you recommended that the United States move to a territorial tax system. And I agree with that recommendation because I think our current system is one that really means that our companies and workers aren't competitive. Do you share that view, and is that why you recommended moving to that system?

Mr. BOWLES. Yes. I have read your—I guess it is what this committee put out, the Ways and Means Committee put out, and I was very much in favor of what you put out.

Representative CAMP. Do you believe that—in our proposal or draft discussion we have out there, there are ways to move to a territorial system that does not create incentives for companies and employers to move jobs to other parts of the world, or their invest-

ment or their R&D. But, also, I think it is possible to craft a plan that could get that policy wrong.

In the Commission's meetings, our discussions, you were focused on moving to a territorial plan that did not make our companies less competitive. And do you think that can be done in the context of a revenue-neutral territorial plan?

Mr. BOWLES. Yeah, I do. And I think, you know, if you encourage—if you stay on a worldwide system and you almost force companies to leave those dollars overseas, then, naturally, if they are going to have to pay a big tax on those dollars to bring them back, I think the likelihood is more probable that they are going to create the jobs somewhere else rather than here.

And that is one of the principal reasons I support a territorial system, in addition to the fact that everybody else in the world has gone to it with the exception of us.

Representative CAMP. You also really recommended a complete overhaul of our Tax Code. And I appreciate the model that you set up, where you tried to lower rates in exchange for doing away with various provisions or exceptions in the Code. And I think that really has shifted the debate on what tax reform might mean.

Your reform proposal would raise revenue compared to the current policy baseline, but you didn't do it by raising taxes. A lot of people get those two things confused. And why did you choose that route of raising revenue really through reform rather than imposing new taxes?

Mr. BOWLES. Because I felt like, based on my experience in the business world and the economists that I talked to, that it would create dynamic growth in this country and create jobs and opportunities for people. And I felt it just made sense to get the spending out of the Tax Code and to use that money more efficiently, more effectively by lowering rates and reducing the deficit.

Representative CAMP. All right. Thank you.

Dr. Rivlin and Senator Domenici, in your plan, you have had the government's share of our GDP around 21 percent, I believe. Is that correct?

Dr. RIVLIN. Yes.

Representative CAMP. And that is basically $1 out of every $5 of our economy would come to Washington, D.C. And that is more than the highest levels of revenue we have seen in the history of the Nation. And I think there has been only one time where the government's take has really gotten anywhere close to that level, and that was during the Internet bubble because there were enormous capital-gains revenues associated with that.

Did you perform an analysis of the impact on the economy and on job creation of having government's revenue of GDP reach that level?

Dr. RIVLIN. No, not ourselves. We examined other people's research on this. I don't read the record as having much evidence at all, of a connection between the exact proportion of the Federal Government's revenue and economic growth.

The reason ours went up was, as I have stated earlier in the hearing, we didn't see how, in this very new situation of a much older population and the tsunami of the baby boom, we didn't see how we could fulfill our obligations to those people, and perform

the other services of government without having the government in that range.

It has been there before; it is not a disaster. This is not taking on new government responsibilities. It is just saying, we have a lot more older people and we have to take care of them. And that is going to mean slightly higher government spending than we had in the days when the population was a lot younger.

Representative CAMP. Senator?

Mr. DOMENICI. Yes. Let me just say, I, too, in my past life, have used percentages like that. I have learned that on many of them there is no reality attached to the number. Nobody can tell you that 20 percent, 19 percent is better than 19.5 or 20.6. If you have the rest of the policies right, things will—in our kind of economy, we will get growth.

The problem we have in this country has been expressed over and over here today, and that is that the population is growing older, the population has less workers per retiree, and so you have a—when we looked at the 19 or 18.5 that was used as the historically significant number, we didn't have these demographics, we didn't have this kind of problem.

So we solved it by trying our best to use the Tax Code to generate some extra revenue in the manner we have suggested here. And, at the same time, we have taken on the responsibility of some of the programs that are going to sink us if we sit by and say, we have to have 18.5 percent, and that is all on the revenue side, and then what are we going to do about the exploding costs of the programs? And I think we have solved it in a pretty reasonable manner. If you want to just say, let that one go out there, we will fix it someday, we can't fix Medicare to match the 21, much less the 18.5 that was historically right.

So that is my answer. I think there is no absolutely positive evidence that any of these numbers are absolutely right. They are right, they are in the range, but if you do the other policies correct, we will survive with 21 percent, I am sure.

Representative CAMP. You also had two new tax structures in your proposal. One was what you described as a debt-reduction sales tax, or what most people would consider to be the value-added tax. The other was the tax on sugared drinks, or beverages.

Did you do an analysis about the cost of those two new tax structures, the implementation of two new tax structures on our economy and what that might mean?

Dr. RIVLIN. Well, you are right that we did have the debt-reduction sales tax. We didn't call it a VAT, but you are right, it is analogous to that. I think that the Senator and I and the members of the group all believed that it would be sensible for the United States to move part of its tax burden off the income tax and onto a broad-based consumption tax. But this is not the moment to do that. And we realized that and eventually took it out, though we still believe in it, and revamped our income tax proposals to make up part of the lost revenue.

The sugared drinks, you know, that is not going to change the economy. Whether it, at the margin, discourages people from drinking too much soda, I don't know. But we had some sentiment for doing it.

Mr. DOMENICI. I would say, on the last one, sir, we didn't look at the economic significance of it. You have been chairman of a committee, and I understand you are now of a very significant—sometimes you are just outvoted and you have to do things that aren't necessarily the greatest.

Representative CAMP. Yeah, I get that part.

Mr. DOMENICI. You got that.

Representative CAMP. All right. Thank you. Thank you very much.

I yield back.

Chairman HENSARLING. The gentleman yields back.

The co-chair now recognizes the gentleman from Massachusetts, Senator Kerry.

Senator KERRY. Thank you very much, Mr. Co-Chair.

First of all, I want to thank each of you for your extraordinary service, not just in this effort, which is important, but over the years. And we are particularly appreciative to this contribution to the dialogue. And I hope it will be a contribution to more than a dialogue, but to a result from this committee.

I just want to spend a few moments on some of the context that brings us here.

Administrator Bowles, you opened up with a comment that caught my attention—two comments. One, you said, this is the most predictable economic crisis in history that we are looking at coming at us, even as you pegged the minimum figure of $4 trillion, which is what you think we ought to do. But then you said you are worried that you are going to fail. And I want you to speak to that for a moment.

Mr. BOWLES. You all have done a great job of stopping the leaks coming out of your committee for an extended period of time, but over recent days I have been able to put together some of the proposals that you all are considering. And I have also listened to some of the back-and-forth that has been in the press.

And I have heard people talk about simply settling for $1.2 trillion worth of deficit reduction, maybe $1.5 trillion, but more of the talk is at $1.2 trillion; doing it across the board, which is never the smart way to make any kind of—to control any of your budgets in any way, shape, form, or fashion. And I have even heard talk that if you end up doing $600 billion out of defense and $600 billion out of nondefense, that the day after the sequester takes place that you will have people in the House and the Senate be working to get around the sequester.

I think that would be disastrous. I think people would look at this country and say, you guys can't govern. I think people would look at it and say, you know what, they are really not going to stand up to their long-term fiscal problems, and this is not going to be a powerful country in the future. And they would think that we were well on our way to becoming a second-rate power. I think it would be a disaster.

Senator KERRY. So I want to sort of build on that a little bit. We all know that the figure we should hit in order to stabilize the debt, which is the mission and ought to be the mission of the Congress, is $4 trillion.

What is the impact in the marketplace, what would the impact be on a discounting of our debt, a write-down, if we hit $1.2 trillion or $1.5 trillion? Aren't we going to just be back here almost immediately with the very same issues sitting on the table?

Mr. BOWLES. You could lose the $1.2 trillion to $1.5 trillion by an increase in interest rates back to the normal rate very quickly. You wouldn't be accomplishing very much if you did that.

And plus, you know, the effect it would have on how people would look at this country would really be devastating. I can tell you, when we went through this whole debt default fiasco before August, I can tell you, globally, countries lost a lot of respect for America, and they lost confidence in us that we would really stand up and address our long-term problems.

Senator KERRY. Now, Pete, I am sorry that Al had to leave, but you and I had the great pleasure of working together on a number of different issues, and I trust your judgment. And while we are not wearing partisan hats, hopefully, here, you are a Republican. And I would like you to share with us, sort of, your perception as a long-time legislator.

When, in your memory, has a committee in Congress ever had the right to put together a proposal that would be voted on by expedited procedure in both Houses of Congress with a 51-vote majority without amendment?

Mr. DOMENICI. The answer is never.

But I would tell you, when we passed effectively in the Senate the bill that created the Budget Committee, it was an impoundment and budget act, as you recall. It was to deauthorize the authority of the President to impound and, at the same time, to create a Budget Committee. Senator Robert Byrd, the expert extraordinary on the Senate, spent weeks on end trying to figure out a way that you could assure the passage of bills that pertained to the budget and not destroy the filibuster rule. And, in the end, he quietly gave in.

And the Budget Act, if you go look at it, it is a big, thick bill, but, nonetheless, if you read it and do what I did, I decided that it meant that I could take a reconciliation bill to the floor of the Senate and it could not be filibustered. And I defeated Robert Byrd because his own writing said he had found a way, without changing the rules of the Senate, to get around filibuster and give authority to a committee.

So we gave the Budget Committee in the Senate the authority to act without filibuster. But nothing as powerful as this committee.

Senator KERRY. And what would be the implication—I would like to ask all three of you. You answered this, to some degree.

Director Rivlin, you have headed up the CBO, you have headed up the OMB, as well. What would be the implications, in your mind, of the United States of America not meeting what everybody understands is the financial challenge facing us, sort of, stabilizing the debt and beginning to get on a long-term fiscal path? How would the world view this, particularly given the fragility of Europe right now and their efforts on Greece, Italy, Spain, et cetera?

Dr. RIVLIN. I think it could be devastating. I agree with Erskine and would be even stronger. I think we could face a long period of

stagnant growth, another recession, which would be worse than the one we are slowly climbing out of.

It is very hard to predict when this might happen or what the course might be. But, certainly, in the last few months, we have seen dramatically in Europe that sovereign debt of quite solid-seeming countries can go down very fast. And that could happen to us. And we could just lose the confidence of our trading partners and ourselves.

I think the problem is, if we are seen by our own citizens as not being able to face up to problems and solve them, we are in deep trouble.

Senator KERRY. And, importantly—I think it has been put on the table here clearly today, and I am sort of trying to reiterate this because I think it is important—it is possible to put revenue on the table to the tune of $1 trillion-plus, whatever, with tax reform, is it not? You do not have to raise the tax rates. In fact, you could do the tax reform with specific instructions to the tax committees to hold the rates down, lower the rates, get a lower range, broaden the base, correct?

Dr. RIVLIN. Right.

Mr. DOMENICI. We actually went out of our way to get some experts together, the best experts in this town—and I think we know who they are—and asked them, does that section 404 give the kind of authority that you just alluded to, to direct to the committees that they perform the following and report it back? And that bill would carry with it in the Senate the same prerogatives that the original bill carried when you were created.

Senator KERRY. Now, Pete, you and I met, and we talked about your concept with respect to health reform. And I appreciate the contribution of it, and I have been trying to work through how we might be able to do some of those things. There are some issues, I think, about how you guarantee the coordination of the lowest health-care plan and still get coverage in certain areas, but I don't want to get stuck on that for the moment. What I want to do is, sort of, deal with the bigger issue here.

I assume all of you would agree that you can do structural reform in Medicare, in the entitlements, that is not necessarily just the premium support approach. Is that accurate?

Mr. DOMENICI. That is accurate.

Senator KERRY. Director Rivlin?

Dr. RIVLIN. Oh, certainly. There are several approaches. We like that one.

Senator KERRY. And, for instance, the age thing that Senator Portman asked about, that is structural reform, isn't it?

Dr. RIVLIN. I actually wouldn't think of raising the age as structural reform.

Senator KERRY. What would you think of? Give us some thoughts about structural reform that you think would conceivably alter it, whether it is dual-eligible, Part A, Part B. Are there other components? Or, how about this, that you begin to move the entire system off of fee-for-service where possible, where it works you would leave it, but you move into a value-based payment system?

Dr. RIVLIN. Yes. And that is roughly what we are proposing.

Mr. BOWLES. Senator Kerry, I have a lot of opinions about health care. I think the current system doesn't make any sense, to pay twice as much as any other developed country for health care and have our results rank somewhere between 25th and 50th. You know, we have 50 million, roughly, people who don't have health-care insurance. You know, I just ran the public health-care system in North Carolina; it reports to the president of the university. And if you don't think those 50 million people get health care, you are crazy. They get health care, they just get it in the emergency room at five to seven times the cost it would be in the doctor's office. And that cost doesn't disappear; it just gets cost-shifted to those of us who have health-care insurance and in the form of higher taxes.

You know, we have got to have real structural reform in health care. I believe all people ought to have health care, but I don't think anybody should get, on the government's checkbook or the taxpayers' checkbook, a Cadillac plan. I don't think anybody ought to get first-dollar coverage, because I think we ought to make sure that people have skin in the game.

And if you are going to have everybody have coverage, then you have to have everybody have a medical home. And if everybody is going to have to have a medical home, then you darn well got to make sure that education institutions like mine are producing more primary-care doctors and more nurse practitioners and more physician's assistants and not so many specialists.

I think if you want everybody to have prescription drugs, then I don't know why in the world you wouldn't have Medicare negotiate with the drug companies for prescription drugs if the taxpayers are going to pay for them. And I don't know why anybody who was getting drugs from the taxpayers ought not to have generic drugs.

If you don't think that hospitals and doctors practice defensive medicine, you are absolutely crazy. They do. So we have to have some kind of real tort reform.

And you are absolutely right, we have to go to paying for quality, not quantity.

And at the end of the day, you know, nobody likes this, but without talking about death panels and that kind of crazy stuff, you are going to have to do something about the end-of-life scenario.

Those kinds of things have to be done if you are really going to address health care.

Senator KERRY. Well, I thank you all.

And I apologize to the chairman——

Chairman HENSARLING. The time of the gentleman has expired.

The co-chair now recognizes the gentleman from Pennsylvania, Senator Toomey.

Senator TOOMEY. Thank you very much, Mr. Co-Chair.

And I also want to add my voice in thanks to the folks who have come here today for the work you have done. It has been enormously helpful.

Let me touch on a couple of the issues and develop a few a little bit further, if I could.

One, obviously, we all know, as a given, that the Federal revenue is ultimately a function of our economy. But I think it is worth noting, and I think you will all agree, that the growth in Federal rev-

enue is related to the growth of the economy, but, in fact, Federal revenue will grow faster, as long as the economy is growing, than the growth of the economy.

And since Dr. Rivlin is the professional economist on the panel, I wonder if you would just confirm that, as a general rule, if we have strong economic growth, we will have even faster Federal revenue growth.

Dr. RIVLIN. That used to be true, Senator, before we indexed the tax system. It is much less true now. If you have strong growth, Federal revenue will go up a little faster than the economy, not much. We gave away that tool, actually, with the indexing.

Senator TOOMEY. All right. So we could have a discussion about how much that magnitude is, but, even now, there is some additional growth faster than GDP growth.

One of the things that came out from our discussion with CBO about this is that one-tenth of 1 percent of additional GDP growth, on average, over 10 years they estimate results in about $300 billion of additional revenue to the government. Now, this is not perfectly linear, and I understand that, but, very roughly, if that were to be roughly true, less than half a percent of average greater economic growth would result in, coincidentally, about $1.2 trillion, which is the statutory goal here. I am not suggesting that that is an alternative to our doing the work that we do, but I think it underscores how important it is that whatever we do attempts to create an environment to maximize growth.

My own view from the beginning has been that the most constructive thing we can do to maximize economic growth is major reform of both the corporate and the individual tax codes. I don't think there is any dispute about that. But I wanted to drill down a little bit.

For instance, if we—there are many approaches one could take. Let's look at the individual side for a moment. And for the sake of argument, if we were to reduce the value of all the deductions that are currently available to individuals and we had an equivalent reduction in rates, for sake of argument, everybody agrees that would be very pro-growth. Is that right? There is a consensus on that?

My understanding, from both Mr. Bowles and Senator Simpson, was that when you folks looked at this exercise of reducing deductions and credits and write-offs, lowering rates, you did it with roughly a 10-to-1 ratio. For every dollar that was dedicated to lowering rates, there was a dollar dedicated to deficit. I think you had suggested that it was, like, 92 to 8?

Mr. BOWLES. Yeah, that is correct. Yeah.

Senator TOOMEY. So 10 to 1, 11 to 1, that was about the ratio. Do you recommend that we take an approach like that, where we would, on the individual side, do that kind of simplification, lowering of rates, and have a ratio comparable to that?

Mr. BOWLES. I think you will run into some of the problems that Senator Baucus brought up. That is why we presented two options. If you go with the zero plan and get rid of all of the tax expenditures, then you do create enough resources that you can use only 8 percent of the resources and still generate a trillion dollars' worth of additional revenue that could go to reduce the deficit.

However, if you are going to go back and not get rid of all of these tax expenditures but you are going to keep some of them—like, some of the Democrats will want to keep the Earned Income Tax Credit, they will want to keep the child tax credit, some of you may want to go to a credit for mortgage—to help people with their mortgage debt, some people might want to go to a credit for charitable contributions.

So anything you keep gives you a smaller pie to work with. So if you are still going to come up with a trillion dollars of deficit reduction, then that 1-to-10 ratio won't work anymore.

Senator TOOMEY. Okay.

Does everybody on the panel agree that if any package were to include net tax revenue it ought to come in the context of reform that actually lowers marginal rates?

Dr. RIVLIN. Yes.

Mr. DOMENICI. Yes.

Mr. BOWLES. Yes.

Senator TOOMEY. Okay.

Let me move over to health care for just a second. I am glad, I think, again, that there was a consensus, I think it was unanimous, that it is our health-care costs that is driving the deficit and debt crisis that we have.

It has been my view, and I wonder if anyone disputes this, that, in fact, it is our Medicare plan that essentially drives the entire health-care sector. And while there is, obviously, a significant private-sector component, to a large degree it is a reaction to, and it acts in the context of, what Medicare does. And so Medicare is the real driver of the entire health-care picture.

Do you agree with that?

Mr. DOMENICI. Yes.

Dr. RIVLIN. Yes. And there are instances in which Medicare has actually done significant reforms and the private sector has followed.

Senator TOOMEY. Right.

Mr. BOWLES. And I only agree with part of it. You said that Medicare was the only—I am not sure you said "only," but Medicare is one of the drivers of our deficit problem. It is not the only driver. I think it is the number-one problem——

Senator TOOMEY. What I said was that health care is, and I meant to say is the primary driver.

Mr. BOWLES. Yeah.

Senator TOOMEY. Senator Kerry talked about structural reform. It seems, in my view, meaningful structural reform means getting away from fee-for-service. To me, that is the heart of Medicare, that is the heart of the design. And because we use this terminology and assume that everyone knows it, I will take a crack at describing what I think of as fee-for-service, and tell me if I have characterized it right.

But, essentially, what we have is a committee here in Washington that specifies the price it will pay for every conceivable medical procedure, the circumstances under which it will pay it, the people who are permitted to perform it, where they are allowed to perform it, in which venue. And it is a completely, you know, government-controlled mechanism, which also, by the way, doesn't ac-

count for whether the outcome is successful or not and whether the procedure needs to be repeated.

Is that a fair characterization of fee-for-service?

Mr. BOWLES. I think what I said earlier in answer to Senator Kerry was that I think we are going to have to move from paying for quantity to paying for quality. And I think you are saying something very similar.

Senator TOOMEY. Well, I am. I think, at the heart of this, this necessarily creates all kinds of inefficiencies, misallocations, perverse incentives. And the solution has to be to get away from this.

I guess my last question for everybody, are all of you confident that——

Mr. DOMENICI. Before you proceed——

Senator TOOMEY. Senator?

Mr. DOMENICI [continuing]. I did want to make an observation, that we recognized that Medicare had some very significant problems of the type you are alluding to, and that is why we are here suggesting that it be changed.

Senator TOOMEY. Right.

Mr. DOMENICI. At the same time, we have explained why we said, as we move——

Senator TOOMEY. Right.

Mr. DOMENICI [continuing]. We don't move so quickly with getting rid of one and establishing the other that we lose both or lose all reform.

Senator TOOMEY. One of the things that concerns me is that, as long as we leave a significant fee-for-service component in place, I worry about whether the reforms are capable of defeating the mechanism and the misallocations and the, sort of, perverse effects of that fee-for-service.

So I would ask this. Do you think it is possible to devise a plan that would transition completely away from fee-for-service, some kind of premium support model that is defined to ensure that the most vulnerable people have the coverage that they need?

Mr. DOMENICI. Well, I will say, for the time being and for the foreseeable future, it seems to me you cannot do that. You have to go with some transition. You wouldn't get the other done.

That was the question, whether you can get it done. I am not an expert. I didn't sign on for this job to be an expert on Medicare. That is why I don't answer some of your questions. But I am saying, practically, I don't think it could be done now under this circumstance. We have to do something——

Senator TOOMEY. Well, I am not suggesting that so much, but I appreciate the response.

Dr. Rivlin?

Dr. RIVLIN. Well, I agree with the Senator. I think that the idea—we believe that, actually, competition on a well-designed exchange between comprehensive health plans, particularly capitated plans, they would win out in a fair competition.

There are parts of the country, especially rural parts of the country, where it probably isn't feasible right now to do that. And that is why we think there ought to be a transition, and that it is much less scary for seniors to say, "If you like what you have, you can

stay with it, but you are going to be offered something which is likely better."

Mr. BOWLES. Yeah. And I would say, if you look at some of the pilot projects in the Affordable Health Care Act, they have some good examples in there of experiments that are going on today to do just what you are talking about.

Senator TOOMEY. All right. Thank you all very much.

Chairman HENSARLING. The gentleman yields back.

The co-chair now recognizes the gentleman from Maryland, Congressman Van Hollen.

Representative VAN HOLLEN. Thank you, Mr. Chairman.

And I want to join my colleagues in thanking all of you for your terrific service to our country in many different capacities.

Mr. Bowles, thank you for recognizing that actions the Congress has already taken to date, including passage of the Budget Control Act, has already achieved projected savings of close to a trillion dollars in discretionary funds, which isn't far from the targets that all of you set in your work, the major difference being you actually had a higher part of that coming from defense cuts. Is that not the case?

Mr. BOWLES. We actually divided ours between security and nonsecurity.

Representative VAN HOLLEN. Right. And so you were at about $1.2 trillion in discretionary. Half of that is $600 billion. I think the figures will show that your proposals took more than has been taken to date from the defense side of the equation.

But I want to—I think many of us view your general approaches here as balanced approaches, balanced frameworks. So I want to put the discretionary piece to the side for a minute because we have come close to achieving, in some cases overachieving, your targets.

In Simpson-Bowles, as you mentioned, Mr. Bowles, you had about $500 billion gross cuts in Medicare and Medicaid. You actually took some savings out of that. Net, it was around $400 billion.

But on the revenue, I just want people to understand, because what you had in both your plans was genuine—what us budget geeks call genuine CBO-, Joint Tax Committee-scorable revenue. And, as you mentioned, Mr. Bowles, your baseline assumed as part of your deficit projections that we would have about $800 billion, which is equivalent to about the amount of money that would be generated from allowing the rates for the folks at the very top to lapse, correct?

Mr. BOWLES. That is absolutely correct.

Representative VAN HOLLEN. That is right. And then on top of that you had proposals, through tax reform and the other things you have talked about, to generate another about $1.2 trillion. Isn't that right?

Mr. BOWLES. Right. We—that is exactly right.

Representative VAN HOLLEN. All right. And so, again, on the Budget Committee, when we are comparing that to what we call the current policy baselines, compared to CBO that is about a $2.1 trillion, $2.2 trillion tax cut compared to current law. Of course it is a—excuse me, revenue increase. Compared to current law, it is a tax break.

And looking at your testimony, Dr. Rivlin and Senator Domenici, you come in about the same place, $2.2 trillion on a current law baseline, correct?

Mr. DOMENICI. Right.

Dr. RIVLIN. Right.

Representative VAN HOLLEN. All right. So let me just ask one other question with respect to tax reform. I take it, from looking at both your reports, that you would want tax reform to be done in a way that maintains at least the current progressivity of the Tax Code. Is that correct?

Mr. BOWLES. Yes.

Mr. DOMENICI. We worked very hard to do that in ours.

Representative VAN HOLLEN. Thank you.

Dr. RIVLIN. Ours is actually slightly more progressive than the current.

Representative VAN HOLLEN. Right. So at least the current progressivity of the Tax Code.

Now, you have both, in your written testimony, suggested we may want do two-step processes, downpayment and then something else. Dr. Rivlin, Senator Domenici, you specifically say, as part of that downpayment, you would include about $450 billion of what you call tax expenditure savings.

I assume, therefore, that you see that as something you could do for deficit-reduction purposes, not necessarily at the same time as tax reform. And I think, if I look at the ones you have picked out, you think that they could be what we call rifle shots. Is that right?

Dr. RIVLIN. Right. But it should be consistent with—our notion is you have a tax reform idea.

Representative VAN HOLLEN. Yes.

Dr. RIVLIN. You move some of it forward.

Representative VAN HOLLEN. That is right. And, again, on net, your tax reform ideas would generate $2.2 trillion on the current policy baseline, correct?

Dr. RIVLIN. Right.

Representative VAN HOLLEN. Okay.

Let me talk a minute about jobs and the economy, because the Congressional Budget Office has said that about a little over one-third of our current deficit today is as a result of the fact that we have a very weak economy, we are not operating at full potential. So I think all of us agree that we need to get the economy moving again.

Dr. Rivlin, you pointed out that your plan with Senator Domenici had about $680 billion in payroll-tax relief. And I think you said the other day on one of the Sunday shows you would, "go bigger" than the President's job plan.

Do you believe that something like that is necessary at this time?

Dr. RIVLIN. Yes. I think we are in danger of slipping into stagnation, and we should do something about it.

Representative VAN HOLLEN. Mr. Bowles, would you agree that it would be a bad idea this coming year to have every working American see an increase in their payroll tax relative to last year?

Mr. BOWLES. Yeah, on the payroll tax that was in the President's proposal, I think it was about $240 billion out of a $447 billion?

Representative VAN HOLLEN. That is right.

Mr. BOWLES. And it is hard for me, as a fiscal conservative, to say this, but I could support a continuation of the payroll-tax deduction for, you know, another year for employees.

It is very hard for me to understand how an approximately $600 deduction for the employer on a temporary basis is going to be enough to get them to hire a full-time, permanent $30,000-a-year employee. So I don't think I would support the payroll-tax deduction for the employer. I could see supporting it for the employee if we could pay for it.

Representative VAN HOLLEN. Okay. Thank you.

Just——

Mr. DOMENICI. Could I say——

Representative VAN HOLLEN. Yes?

Mr. DOMENICI [continuing]. On our end, I am for what we told you we are for, but I wouldn't argue if you followed his suggestion. As I see it, it is still alive. And what he is talking about is certainly better than nothing.

Representative VAN HOLLEN. Got it. Thank you. Thank you, Senator Domenici.

On health care—and, Dr. Rivlin, you have testified many times in front of the Budget Committee and stated that you thought that the Affordable Care Act introduced a number of very important innovations. I agree with you that we need to do more in terms of modernizing the Medicare system to focus more on the value of care and the quality of care versus the quantity of care.

I do have a question with respect to your version of the premium support plan, the most recent one. And that is, if you are confident in the market forces driving down the prices and if your argument is that Medicare is driving those market forces, then why would you need a fail-safe mechanism? In other words, why would you need to say, if you don't achieve the goal we want in savings, you have to have GDP plus 1? And if it is not keeping track with the market, isn't that just a cost transfer to Medicare beneficiaries?

Dr. RIVLIN. Well, I am not absolutely certain how the markets will work. We have seen even in the limited market that is Medicare Advantage that in some places they work well and come in under the fee-for-service and in other places they don't. We think this is a much more robust plan than Medicare Advantage.

But the reason you want the fail-safe is so the Congress will absolutely know what they are going to spend going forward on Medicare. It is not going to grow faster than this. It is a defined contribution. And we think that is very useful.

And as for the cost-shifting, there might be some cost-shifting, but then you could arrange it so that it is not cost-shifting onto lower-income people—it is means-tested, as we were saying before—it is cost-shifting onto people who can better afford it.

Representative VAN HOLLEN. Right. Well, I think that, again, I mean, if we are confident that the market forces were going to work the way intended, then I don't think there would be a need for a backup. I do know that Members of Congress and folks who are on the Federal Employees Health Benefit plan, for example, they bid, different plans bid, and there is a defined-support mechanism that is set in law, 72 percent-28 percent. So I am not sure

why we would be proposing something different for Medicare beneficiaries.

Let me just close, Mr. Chairman, by saying we asked, actually, CBO to take a look at some of these ideas, including one where we just had competition among the managed-care plans and another one where we threw in the wrinkle of premium support. It wasn't the second-lowest bidder. It was more along the lines of what some other plans did, which was just marketplaces. And just having competition among the managed-care plans they said came out a score of about $9 billion between 2014–2021. Adding in this other mechanism achieved about—it took you up to a total of about $25 billion.

So it is pretty clear, at least from these numbers—and we can take a look at them—that we are going to need to do other things, that this is not a panacea, at least according to CBO's numbers, for dealing with the Medicare challenge, that we need to look at a lot of these other innovative ideas that are out there, including some of the things that have been talked about today.

Thank you, Mr. Chairman.

Chairman HENSARLING. Thank you.

The gentleman yields back.

All time for Member questions has concluded.

However, I would note, prior to Senator Simpson's departure, he did mention, Mr. Bowles, that you had something you might want to present. Without objection, I would certainly yield you a couple of minutes if I understand you have something else you wish to present to this committee.

Mr. BOWLES. I can do it very quickly. I tried to think, if I were sitting in your shoes or I was the go-between as I was in the what became the Simpson-Bowles plan, if it was possible for you all to get to the $3.9 trillion deficit reduction, given where your positions are today, and I think it is, I think you can get this done, and I will just go through briefly the arithmetic. And, again, you have got to flesh out the policies, but if you look at where I understand the two sides now stand, and this is from just listening, which is what you have got to do if you are the guy in the middle, you know, the proposals for discretionary spending, and these are all above what the $900 billion and the 400 that was in the continuing resolution, so this is in addition to the $1.3 trillion worth of spending cuts that have already been done, but you all are between $250 and $400 billion of additional cuts on discretionary, so I assumed that we could reach a compromise of an additional $300 billion on discretionary spending cuts.

On health care you are somewhere between $500 and $750 billion of additional health care cuts. I assumed that we could get to $600, and I got there by increases in the eligibility age for Medicare that I discussed with Senator Kerry when he was talking to me. That is about $100 billion. That would take you from the 500 where the Democrats are to $600 billion, and it happens to come not on the provider side, which I think would kind of balance that out.

On other mandatory cuts, you are somewhere between 250 and 400, so I settled on 300 there, and we had enough cuts in our plan to get you to 300 on the other mandatory. Interest will obviously

just fall out at approximately 400 billion, the savings there. You agreed actually on CPI in your two plans of approximately $200 billion. The total of that is $1.8 billion. That left me a little short.

That gets me to revenue. And on revenue I took the number that the Speaker of the House, I had read had actually agreed to, and I was able to generate $800 billion through revenue from the Speaker's recommendation, and if you did that without dynamic scoring, but you did it, and, you know, on dynamic scoring I am kind of on the Reagan plan, trust and verify, which we talked about earlier. If it actually comes, great, you will use it to reduce rates or you will use it to reduce the deficit. But if you add the $800 billion there and you do that slightly on a more, make it so the code is slightly more progressive after you have done it than before, then I think you have really got something that you might be able to work with the Democrats on.

That would give you an additional total of $2.6 trillion added to the 1.3 you have already done. That is $3.9 trillion in deficit reduction, and I think that would create a lot of excitement with people in the country, and I think it would go a long ways toward building up confidence that we really could stand up to our problems.

Chairman HENSARLING. Thank you, Mr. Bowles. You certainly created some excitement with the press, I think. I would say, don't necessarily believe everything you read and hear about the proceedings of this committee.

I do want to thank every single member of the panel on behalf of the Joint Select Committee for Deficit Reduction, not just for your presence here today away from your businesses and your families, but, frankly, more important, the entirety of what you have lent to the body of work to try to really address a very real crisis that we face. I do thank you for that. Your testimony was certainly sobering and helpful, and not the least of which was timely.

I do want to remind all members that they have 3 business days to submit questions for the record, and I would ask our witnesses to respond promptly to the questions. Members should submit their questions by the close of business on Thursday, November 3rd.

With no other business before the committee, without objection, the joint committee stands adjourned.

[Whereupon, at 4:35 p.m., the joint committee was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

September 13, 2011

The History and Drivers of Our Nation's Debt and Its Threats

Senator Max Baucus

Founding Father Patrick Henry once said, "I know no way of judging the future but by the past."

Today, we examine the past for lessons to improve our economic future to reduce the deficit, to create jobs that put Americans back to work and to regain the certainty our country needs to thrive in the global economy.

The world is closely watching what we do here and the next steps we take as a country to confront our deficits. We can do this. We've already begun the process by cutting $900 billion. We've already taken the first step.

And while the road ahead will not be easy, we have a duty to think even bigger and aim even higher to ensure our country is on sound fiscal footing for the long term. We have a duty to ensure that we approach these cuts in a balanced manner that creates jobs here at home.

I was back home in Montana again this weekend, and folks kept repeating the same thing: "Let's get it done." They want to see results. They want us to work together and find a balanced approach to cut our debt and create jobs, and I bet my colleagues hear the same thing when they go home as well. It's time to listen to these folks and work together to get our economy moving again.

Today we review the sources of the problem. A number of factors created our current deficit: the cost of two wars; long-term health care costs, which we began to tackle in health reform; a stagnant economy which increased spending; and reduced federal revenues, which are at historic lows.

Today, federal revenues make up only 15 percent of GDP, compared, for example, to 17 to 19 percent during the Reagan Administration. A combination of factors created the deficit; and it will take balance to solve it. There is no silver bullet to fix this problem.

So let us listen to the wisdom of the folks back home who want us to work together to craft a balanced solution, let us look to the past for lessons -- not blame -- and let us focus on creating jobs and improving our economy for the future.

Representative Xavier Becerra

Opening Statement

"I thank the two co-chairs and thank Dr. Elmendorf for being with us.

The creation of this joint select committee on deficit reduction is the direct result of legislative policies and economic recessions that have hit us over the last ten years and that have caused the Congressional Budget Office's (CBO) $5.6 trillion surplus in 2001 to turn into a more than $6 trillion deficit that we see today.

So to know where to go with the work that we have to do, you have to know from where we came. Today we will hear about how we lost our way.

What we will hear is that a select few in this country enjoyed the additional government spending that occurred in those ten years while the rest of Americans are being confronted with paying the tab.

In January 2001 CBO's assessment in its yearly budget and economic outlook report was this: 'the outlook for the federal budget over the next decade continues to be bright. Assuming that current tax and spending policies are maintained, the CBO projects that the mounting revenues will continue to produce growing budget surpluses for the next ten years.' But as we all know, current tax and spending policies were not maintained.

Dr. Elmendorf, it is exactly these policies that induce the federal deficit which I want to explore in my questioning with you today. Decisions were made to extinguish a $5.6 trillion surplus.

The individuals and groups who received the most benefits should be willing and ready to ante up to meet their patriotic duty, to contribute revenue and necessary spending decisions to heal this country's long-term fiscal situation.

We need to ask ourselves: was it the senior citizen, the student, or the Wall Street banker who received the benefit of this spending binge?

When we have our answer we should ask the appropriate person or group to pay their fair share to right the wrong of running up the government's debt.

I look forward to working with my colleagues to take the responsibility of improving job creation in this country and fixing the long term deficits that we face to ensure that those responsible for our deficits pay their fair share."

Representative James Clyburn

Opening Statement

WASHINGTON, DC—Assistant Democratic Leader James E. Clyburn today released the following statement on the Joint Select Committee on Deficit Reduction's hearing with Dr. Douglas Elmendorf, Director of the Congressional Budget Office. Below is Clyburn's statement as prepared for delivery:

"Thank you, Madam Chairwoman and Mr. Chairman, and Dr. Elmendorf, thank you for taking the time to talk with us today.

"I think it is appropriate that today's hearing is entitled 'The History and Drivers of our Nation's Debt and Its Threats.' If we want to solve the related problems of debt and joblessness, we need to know how these problems arose.

"In 2000, we had a $236 billion surplus and had begun paying down our national debt. The economy was booming for all Americans, unemployment was at 4 percent, and the poverty rate dipped to its lowest level since 1979. Instead of building on the policies that had served us so well, we embarked upon two wars, one of which was dubious at best. Using credit cards, we instituted two tax cuts totaling $1.8 trillion which were tilted in favor of millionaires and billionaires, we created a new prescription drug benefit program which CBO estimates will cost $967 billion over the next ten years, and we allowed mortgage lenders to gamble away the economic prosperity of millions of Americans. And then it was declared that 'deficits don't matter.' This special committee was created because deficits and debt do matter.

"Now we find ourselves with painfully slow growth, unacceptably high unemployment, deficits as far as the eye can see, and a mounting long term debt burden.

"As we work together to achieve significant deficit reduction, it is important to remember how we got here. Many factors got us into this situation, and many factors are needed to get us out. We must balance the budget with a balanced approach that includes job creation, revenue increases, and smart spending cuts. Shared sacrifice will be required. We cannot solve the problem on the backs of the most vulnerable in our society, who have had nothing to do with causing it.

"I am willing to make tough compromises. I have said that if the distance between an opponent and me is five steps, I am willing to take three as long as the other side takes the other two.

"Dr. Elmendorf, thank you again for being here, and I look forward to discussing these issues with you in the question and answer period."

Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

Confronting the Nation's Fiscal Policy Challenges

before the
Joint Select Committee on Deficit Reduction
U.S. Congress

September 13, 2011

This document is embargoed until it is delivered at 10:30 a.m. (EDT) on Tuesday, September 13, 2011. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Senator Murray, Congressman Hensarling, and Members of the Committee, thank you for the invitation to testify about the outlook for the economy and the budget and about the Congressional Budget Office's (CBO's) analysis of the fiscal policy choices facing this Committee and the Congress.

Summary

The federal government is confronting significant and fundamental budgetary challenges. If current policies are continued in coming years, the aging of the population and the rising cost of health care will boost federal spending, as a share of the economy, well above the amount of revenues that the federal government has collected in the past. As a result, putting the federal budget on a sustainable path will require significant changes in spending policies, tax policies, or both. The task of addressing those formidable challenges is complicated by the weakness of the economy and the large numbers of unemployed workers, empty houses, and underused factories and offices. Changes that might be made to federal spending or tax policies could have a substantial impact on the pace of economic recovery during the next few years as well as on the nation's output and people's income over the longer term.

The Economic Outlook

The financial crisis and recession have cast a long shadow on the U.S. economy. Although output began to expand again two years ago, the pace of the recovery has been slow, and the economy remains in a severe slump. CBO expects that the economic recovery will continue but that output will stay well below the economy's potential output—an amount that corresponds to a high rate of use of labor and capital—for several years. CBO published its most recent economic forecast in August; that forecast was initially completed in early July and was updated in August only to reflect the policy changes enacted in the Budget Control Act. Incoming data and other developments since early July, as well as the latest *Blue Chip* consensus forecast, suggest that economic growth for the remainder of this year and next is likely to be weaker than the agency anticipated—with growth in the vicinity of 1½ percent this year and around 2½ percent next year.[1]

With output growing at that modest rate, CBO expects employment to expand vety slowly during the rest of this year and next year, leaving the unemployment rate close to 9 percent through the end of 2012. Weakness in the demand for goods and services is the principal restraint on hiring, but structural impediments in the labor market—such as a mismatch between the requirements of existing job openings and the characteristics of job seekers—appear to be hindering hiring as well.

If economic growth occurs at the slow pace that CBO anticipates, a large portion of the economic and human costs of the recession and slow recovery remains ahead. In

1. The *Blue Chip* consensus is the average of about 50 forecasts by private-sector economists.

mid-2011, according to the agency's estimates, the economy was only about halfway through the cumulative shortfall in output relative to its potential level that will result from the recession and the weak recovery. Between late 2007 and mid-2011, the cumulative difference between gross domestic product (GDP) and estimated potential GDP amounted to roughly $2½ trillion; by the time the nation's output rises back to its potential level, probably several years from now, the cumulative shortfall is expected to equal about $5 trillion. Not only are the costs associated with the output gap immense, but they are also borne unevenly, falling disproportionately on people who lose their jobs, who are displaced from their homes, or who own businesses that fail.

The economic outlook remains highly uncertain, however. The recent recession was unusual compared with previous ones in terms of its causes, depth, and duration. As a result, the recovery has had unusual features that have been hard to predict, and the path of the economy in coming years is also likely to be surprising in various ways. Many developments, such as changes in the degree to which households want to further reduce their debt burdens or the adoption of fiscal policies that differ from current law, could cause economic outcomes to differ substantially, in one direction or the other, from those CBO has projected.

The Budget Outlook

If the recovery continues as CBO expects, and if tax and spending policies unfold as specified in current law, deficits will drop markedly as a share of GDP over the next few years. Under CBO's baseline projections, which generally reflect the assumption that current law will not change, deficits fall to 6.2 percent of GDP in 2012 and to 3.2 percent in 2013, and then fluctuate within a range of 1.0 percent to 1.6 percent of GDP from 2014 through 2021. In that scenario, cumulative deficits over the coming decade will total $3.5 trillion, and by 2021, debt held by the public will equal 61 percent of GDP—well above the annual average of 37 percent recorded between 1971 and 2010. (The weaker economy that CBO now anticipates for the remainder of this year and next would imply, all else being equal, a slightly larger federal deficit during that period.)

CBO's baseline projections incorpotate the assumption that current law remains in place so they can serve as a benchmark for policymakers to use in considering possible changes to the law. But those baseline projections understate the budgetary challenges facing the federal government because changes in policy that will take effect under current law will produce a federal tax system and spending for some federal programs that differ noticeably from what people have become accustomed to. Specifically, CBO's baseline projections include the following policies specified in current law:

- Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312, referred to in this testimony as the 2010 tax act) that reduced the payroll tax for one year and limited the reach of the

alternative minimum tax (AMT) for two years are set to expire on December 31, 2011.

- Several other key provisions of the 2010 tax act—including the extension of lower tax rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act (ARRA, P.L. 111-5)—are set to expire on December 31, 2012.

- Medicare's payments for physicians' services are scheduled to be reduced by nearly 30 percent after December 31, 2011.

- Discretionary appropriations between 2012 and 2021 will be subject to statutory caps set in the Budget Control Act of 2011 (P.L. 112-25) that will reduce discretionary spending in real (inflation-adjusted) terms over time.

- Additional budgetary savings of more than $1 trillion required by the Budget Control Act will occur as a result of legislation produced by this Committee or, if lawmakers fail to enact such legislation, by means of automatic cuts in spending that will then be triggered.

Changing provisions of current law so as to maintain major policies that are in effect now would produce markedly different budgetary outcomes. For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then cumulative deficits over the coming decade would total $8.5 trillion, and debt held by the public would reach 82 percent of GDP by the end of 2021, higher than in any year since 1948.

Beyond the coming decade, the fiscal outlook worsens, as the aging of the population and the rising costs of health care exert significant and increasing pressure on the budget under current law. When CBO issued its most recent long-term projections in June 2011, debt held by the public was projected to reach 84 percent of GDP in 2035 under an extension of current law. In those projections, rising federal spending relative to GDP kept debt high even though federal revenues reached significantly larger percentages of GDP than ever seen before in the United States. The agency also examined an alternative scenario in which the tax provisions enacted since 2001 that were extended most recently in 2010 were assumed to be extended, the reach of the AMT was assumed to be restrained to stay close to its historical extent, and tax law was assumed to evolve over the long term so that revenues remained near their historical average of 18 percent of GDP. CBO projected in June that, under that alternative scenario, revenues would increase much more slowly than spending, and debt held by the public would balloon to nearly 190 percent of GDP by 2035.

Although new long-term projections reflecting the latest 10-year projections would differ, the amounts of federal borrowing that would be required under those policy

assumptions clearly would be unsustainable. Interest payments on that debt would rise dramatically relative to the size of the tax base that would be available for generating revenues to cover those payments, consuming an ever-growing share of the federal budget. Even before the interest burden became unsupportable, a fiscal crisis could arise if participants in financial markets lost confidence in the government's ability to manage its budget and became unwilling to lend to the government at affordable rates. Thus, under current policies, the federal budget is quickly heading into territory that is unfamiliar to the United States and to most other developed countries as well.

Fiscal Policy Choices

The budgetary and economic challenges facing the nation present policymakers with difficult choices about fiscal policy. As this Committee considers its charge to recommend policies that would reduce future budget deficits, its key choices fall into three broad categories:

- How much deficit reduction should be accomplished?
- How quickly should deficit reduction be implemented?
- What forms should deficit reduction take?

The Magnitude of Deficit Reduction. There is no commonly agreed upon level of federal debt that is sustainable or optimal. Under CBO's current-law baseline, which incorporates $1.2 trillion in expected deficit reduction related to this Committee's work, as well as significant increases in tax revenues relative to GDP, debt held by the public is projected to fall from 67 percent of GDP at the end of 2011 to 61 percent by 2021. However, stabilizing the debt at that level would leave it larger than in any year between 1953 and 2009.

Lawmakers might determine that debt should be reduced to amounts lower than those shown in CBO's baseline—in order to reduce the burden of debt on the economy, relieve some of the long-term pressures on the budget, diminish the risk of a fiscal crisis, and enhance the government's flexibility to respond to unanticipated developments. Accomplishing that objective would require larger amounts of deficit reduction. If, for example, this Committee chose to make recommendations that would lower debt held by the public in 2021 to 50 percent of GDP, roughly the level recorded in the mid-1990s, it would need to propose changes in policies—relative to those embodied in current law, which underlie CBO's baseline projections—that reduced deficits by a total of about $3.8 trillion over the coming decade.

Furthermore, lawmakers might decide that some of the current policies that are scheduled to expire under current law should be continued. In that case, achieving a particular level of debt could require much larger amounts of deficit reduction through other changes in policy. For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then reducing debt held by the

public in 2021 to the 61 percent of GDP projected under current law would require other changes in policy to reduce deficits over the next 10 years by a total of $6.2 trillion, rather than the $1.2 trillion in deficit reduction that this Committee would have to accomplish to avoid the automatic budget cuts required by the Budget Control Act.

The Timing of Deficit Reduction. Policymakers face difficult trade-offs in decisions about how quickly to implement policies to reduce budget deficits. On the one hand, cutting spending or increasing taxes slowly would lead to a greater accumulation of government debt and might raise doubts about whether the longer-term deficit reductions would ultimately take effect. On the other hand, implementing spending cuts or tax increases abruptly would give families, businesses, and state and local governments little time to plan and adjust. In addition, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion.

However, credible steps to narrow budget deficits over the longer term would tend to boost output and employment in the next few years by holding down interest rates and by reducing uncertainty and enhancing business and consumer confidence. Therefore, the near-term economic effects of deficit reduction would depend on the balance between changes in spending and taxes that take effect quickly and those that take effect gradually. According to CBO's analysis, credible policy changes that would substantially reduce deficits later in the coming decade and over the long term—without immediate cuts in spending or increases in taxes—would both support the economic expansion in the nexr few years and strengthen the economy over the longer term.

There is no inherent contradiction between using fiscal policy to support the economy today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential. If policymakers wanted to achieve both a short-term economic boost and medium-term and long-term fiscal sustainability, a combination of policies would be required: changes in taxes and spending that would widen the deficit now but reduce it later in the decade. Such an approach would work best if the future policy changes were sufficiently specific and widely supported so that households, businesses, state and local governments, and participants in the financial markets believed that the future fiscal restraint would truly take effect.

The Composition of Deficit Reduction. As policymakers consider the composition of policy changes to be used to reduce budget deficits, many factors may play a role. The amount and composition of federal spending and revenues affect the total amount and types of output that are produced and consumed in the country, the distribution of those material resources among various segments of society, and people's well-being in a variety of ways.

In considering the challenge of putting fiscal policy on a sustainable path, many observers have wondered whether it is possible to return to policies regarding federal spending and revenues that, in earlier years, usually generated deficits that were small relative to GDP and kept the amount of debt held by the public to between about one-quarter and one-half of GDP. Unfortunately, however, the past combination of policies cannot be repeated when it comes to the federal budget: The aging of the population and rising costs for health care have changed the backdrop for federal budget policy in a fundamental way.

Under current law, spending on Social Security and the major health care programs—Medicare, Medicaid, the Children's Health Insurance Program, and insurance subsidies to be provided through exchanges in coming years—is projected to be much higher than has historically been the case, reaching 12.2 percent of GDP in 2021, compared with 10.4 percent of GDP in 2011 and an average of 7.2 percent of GDP during the past 40 years. Most of that spending goes to benefits for people over age 65, with smaller shares for blind and disabled people and for nonelderly able-bodied people.

In contrast, under current law, all spending apart from that for Social Security, the major health care programs, and interest payments on the debt is projected to decline noticeably as a share of the economy. That broad collection of programs includes defense (the largest single piece), the Supplemental Nutrition Assistance Program (formerly known as Food Stamps), unemployment compensation, other income-security programs, veterans' benefits, federal civilian and military retirement benefits, transportation, health research, education and training, and other programs. Such spending has averaged 11.5 percent of GDP during the past 40 years and totals 12.0 percent in 2011. Expected improvement in the economy and the caps on discretionary spending instituted in the Budget Control Act are projected to reduce such spending to 7.7 percent of GDP in 2021, the lowest level as a share of GDP in the past 40 years.

Thus, according to CBO's projections under current law, even with the new constraints on discretionary spending, federal spending excluding net interest will grow to 19.9 percent of GDP in 2021—compared with the 40-year average of 18.6 percent. And the composition of that spending will be noticeably different from what the nation has experienced in recent decades: Spending for Social Security and the major health care programs will be much higher, and spending for all other federal programs and activities, except for net interest payments, will be much lower. Alternatively, if the laws governing Social Security and the major health care programs were unchanged, and all other programs were operated in line with their average relationship to the size of the economy during the past 40 years, total federal spending excluding net interest would be much higher in 2021—nearly 24 percent of GDP. That amount exceeds the 40-year average for revenues as a share of GDP by nearly 6 percentage points—even before interest payments on the debt have been included.

At the same time, the sharp increase in federal debt and a return to more-normal interest rates will boost the government's net interest costs. They are projected to reach 2.8 percent of GDP in 2021, compared with only 1.5 percent of GDP in 2011 and an average of 2.2 percent of GDP during the past 40 years.

What do those numbers imply about the choices that policymakers—and citizens—confront about future policies? Given the aging of the population and the rising costs for health care, attaining a sustainable budget for the federal government will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

- Raise federal revenues significantly above their average share of GDP;
- Make major changes to the sorts of benefits provided for Americans when they become older; or
- Substantially reduce the role of the rest of the federal government relative to the size of the economy.

The nation cannot continue to sustain the spending programs and policies of the past with the tax revenues it has been accustomed to paying. Citizens will either have to pay more for their government, accept less in government services and benefits, or both.

The Economic Outlook

The financial crisis and recession have cast a long shadow on the U.S. economy. Although total output began to expand again two years ago, the pace of the recovery in output and employment has been slow, and the economy remains in a severe slump. Some of the factors that appear to have contributed to economic weakness in the first half of this year—such as a reduction in consumers' purchasing power because of a rise in the price of crude oil—are projected to fade. Nevertheless, CBO expects that the economic recovery will continue to be slow and that real GDP will stay below the economy's potential—a level that corresponds to a high rate of use of labor and capital—for several years (see Figure 1).

CBO published its most recent economic forecast in August.[2] The agency initially completed that forecast in early July, and it updated its projections in August to reflect the policy changes enacted in the Budget Control Act of 2011 but no other developments. The news since CBO completed that work suggests that economic growth for the remainder of this year and next is likely to be weaker than the agency anticipated—with growth in the vicinity of 1½ percent this calendar year (as measured by the change between the fourth quarter of 2010 and the fourth quarter of 2011) and around 2½ percent next year.[3] (The latest *Blue Chip* consensus forecast for growth in

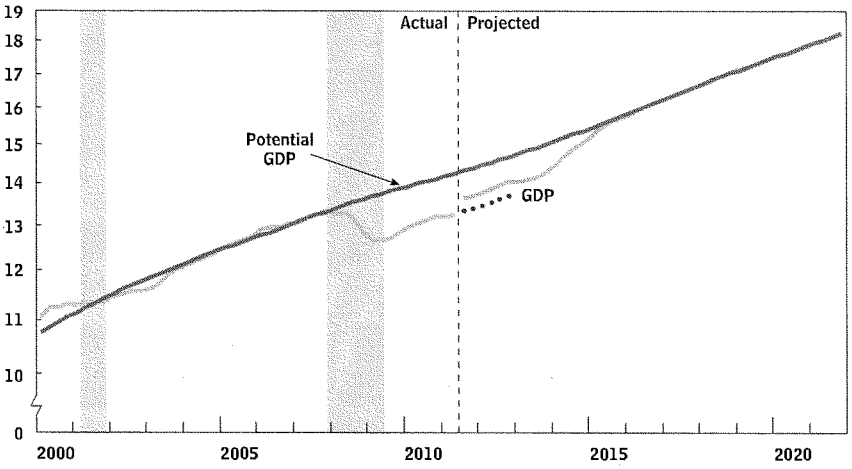
2. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).

3. Although real GDP grew at an average annual rate of 0.7 percent in the first half of this year, CBO anticipates it will grow at about 2.0 percent in the second half.

Figure 1.

Real Gross Domestic Product

(Trillions of 2005 dollars, logarithmic scale)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: Real gross domestic product (GDP) is the output of the economy adjusted to remove the effects of inflation. Potential GDP is CBO's estimate of the output that the economy would produce with a high rate of use of its labor and capital resources.

Data are quarterly. Actual data for GDP, which are plotted through the second quarter of 2011, incorporate the July 2011 revisions of the national income and product accounts. The projections of GDP indicated by the solid line are taken from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011). They are plotted through the fourth quarter of 2021 and are based on data issued before the revisions. The projections of GDP indicated by the dotted line incorporate the effects of the revisions and the news since early July, when the previous forecast was completed; they are plotted through the fourth quarter of 2012.

real GDP is 1.3 percent for 2011 and 2.5 percent for 2012.) Those estimates reflectCBO's expectation of continued strong growth in investment by businesses, modest increases in spending by consumers, gains in net exports (exports minus imports), and the beginning of a recovery in new-home construction. With weak economic growth anticipated for the next few years, CBO expects employment to expand very slowly, leaving the unemployment rate close to 9 percent through the end of 2012.

The economic outlook remains highly uncertain. The recent recession was unusual compared with previous ones in terms of its causes, depth, and duration. As a result, the recovery has had unusual features that have been hard to predict, and the path of

the economy in coming years is also likely to be surprising in various ways. Many developments, such as changes in the degree to which households want to further

reduce their debt burdens or the adoption of fiscal policies that differ from current law, could cause economic outcomes to differ substantially, in one direction or the other, from those CBO has projected.

Recent Developments

The period since early July has seen significant financial and economic news that has led many forecasters to lower their projections of near-term growth. In the *Blue Chip* consensus forecast, the probability of a recession by the end of next year now stands at about one-third. Stock prices, as measured by the value of the Standard & Poor's 500 index, fell by more than 12 percent between early July and early September, returning to their level of late 2010. Interest rates on 10-year Treasury notes have dropped by almost a full percentage point since early July from already low levels—mainly because participants in financial markets have sought safer investments because of their concerns about a weaker U.S. economy and potential losses on the sovereign debt of some major euro-zone countries and because the Federal Reserve has signaled its intention to keep short-term interest rates low for an even longer period than many market participants may have expected.

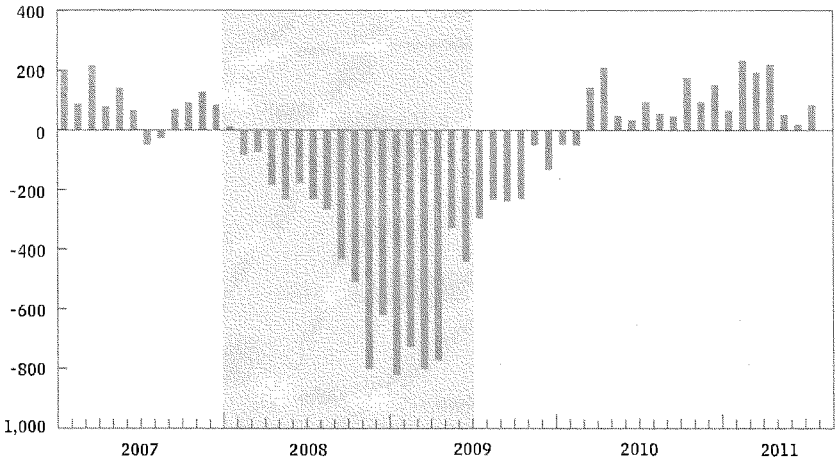
Moreover, employment growth has slowed in the past few months. The total number of jobs increased at an average monthly rate of about 180,000 in the first four months of this year, more than double its average pace in 2010 (see Figure 2). However, employment growth has ebbed again, averaging only 40,000 jobs per month from May through August. Likewise, the unemployment rate fell from 9.8 percent in November 2010 to 8.8 percent in March 2011, but in August, it was back up to 9.1 percent (see Figure 3). Probably reflecting the weak job market and developments such as the declines in stock prices, consumer confidence plunged recently; according to a survey by the University of Michigan, for example, it fell in August to levels last seen during the depths of the recession.

The annual revisions to the national income and product accounts (NIPAs) and the first estimate of GDP for the second quarter of 2011, issued by the Commerce Department in late July, showed that the economy was weaker from 2008 through the first half of 2011 than was previously thought. Real GDP grew at an average annual rate of 0.7 percent in the first half of this year—well below the previous estimate of 1.9 percent that CBO used in constructing its economic forecast in early July. In addition, the revisions indicated that the recession was considerably deeper than previously thought: The total decline in real GDP from its peak in the fourth quarter of 2007 to its trough in the second quarter of 2009 was revised downward from -4.1 percent to -5.1 percent. The figure for subsequent growth of real GDP from the trough of the recession in the second quarter of 2009 through the first quarter of 2011 was also revised downward slightly. With the revisions, real GDP for the first quarter of this year was 1.6 percent lower than previously estimated.

Figure 2.

Net Job Growth per Month

(Thousands of jobs)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: Data are monthly and are plotted through August 2011; in that most recent month, net job growth was zero. The data exclude temporary jobs associated with the 2010 census.

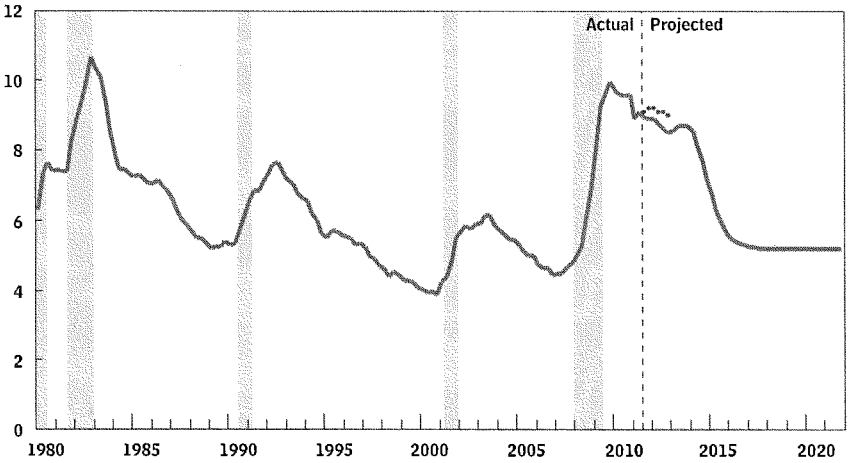
Prospects for world economic growth have also deteriorated since early July, which suggests a weaker outlook for U.S. exports. Recent data reveal that growth slowed in major foreign economies during the second quarter of 2011. The annualized growth of real GDP in the euro zone slowed to 0.6 percent in the second quarter from 3.4 percent in the previous quarter, as economic growth in Germany fell sharply. The outlook for growth in China is still bright, but prospects for other Asian economies that rely heavily on exports are softening, and Japan's economy contracted in the second quarter. In addition, the European sovereign debt crisis spread to Spain and Italy, increasing uncertainty and generating volatility in financial markets.

The news since early July has not been uniformly negative, though. Oil prices dropped in July and August from their recent highs. In the nonfinancial sector, the data released since early July point to stabilization in both homebuilding and house prices and to a recovery in vehicle sales and production after supply disruptions earlier in the year. In addition, consumer spending appears to have held up, at least through July. Moreover, the revisions to the NIPAs revealed that real gross domestic income, which some consider to be a more accurate indicator of current economic activity than real GDP, grew at a relatively healthy 2.2 percent pace during the first half of

Figure 3.

Unemployment Rate

(Percent)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Notes: The unemployment rate is a measure of the number of jobless people who are available for work and are actively seeking jobs, expressed as a percentage of the labor force.

Data are quarterly. Actual data are plotted through the second quarter of 2011. The projections indicated by the solid line are taken from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011) and are plotted through the fourth quarter of 2021. The projections indicated by the dotted line incorporate the effects of the news since early July when the previous forecast was completed; they are plotted through the fourth quarter of 2012.

2011, well above the 0.7 percent growth in real GDP.[4]

The Economic Outlook for 2011 and 2012

CBO expects the pace of economic recovery to pick up a little in the second half of this year but to remain modest for the next few years. Growth slowed and inflation increased in the first half of 2011, in part because of developments that are likely to be temporary, including jumps in energy and food prices and disruptions to the global supply chain caused by the earthquake and nuclear accident in Japan. As the effects of those developments fade, growth in the U.S. economy is likely to rebound a little, driven by continued strength in business investment, modest increases in consumer spending, and expansions in net exports and residential investment. Nevertheless, the pace of growth will probably be restrained for several more years by the lingering

4. For a review of evidence suggesting that real gross domestic income is a more accurate indicator of current economic activity than real GDP, see Jeremy J. Nalewaik, "The Income- and Expenditure-Side Estimates of U.S. Output Growth," *Brookings Papers on Economic Activity* (Spring 2010), pp. 71–106.

effects of the financial crisis and the recession—particularly their impact on households' net worth and indebtedness, on access to credit for riskier borrowers, on the number of vacant homes, and on consumer and business confidence.

The growth in GDP that CBO now anticipates—about 1½ percent this year (as measured by the change between the fourth quarter of 2010 and the fourth quarter of 2011) and around 2½ percent next year—would be weaker than what CBO forecast in August, when it projected real GDP growth of 2.3 percent in 2011 and 2.7 percent in 2012. Other forecasters have also modified their expectations. For example, between early July and early September, the *Blue Chip* consensus forecast for real GDP growth in 2011 was marked down from 2.6 percent to 1.3 percent. For 2012, the *Blue Chip* forecast was lowered from 3.0 percent to 2.5 percent.

With modest growth in output, CBO expects employment to expand very slowly during the rest of this year and next year. Weakness in the demand for goods and services is the principal restraint on hiring, but structural impediments in the labor market—such as a mismatch between the requirements of existing job openings and the characteristics of job seekers (including their skills and geographic location)—appear to be hindering hiring as well. As a result, the unemployment rate is likely to be around 9.0 percent through the fourth quarter of next year. (In CBO's August forecast, the unemployment rate fell to 8.5 percent by the fourth quarter of 2012.) Between early July and early September, the *Blue Chip* consensus similarly raised its forecast for the unemployment rate in the fourth quarter of 2012—from 8.1 percent to 8.7 percent.

Inflation increased markedly in the first half of 2011, spurred in large part by a sharp rise in oil prices, but CBO projects that it will diminish in the second half of the year and be low in 2012 (see Figure 4). The increase in oil prices since mid-2010 has been partly reversed, and trading in financial markets points to fairly stable prices for oil and other commodities in the next few years. In addition, the large amount of unused or underemployed resources in the economy will continue to hold down the growth of wages and prices.

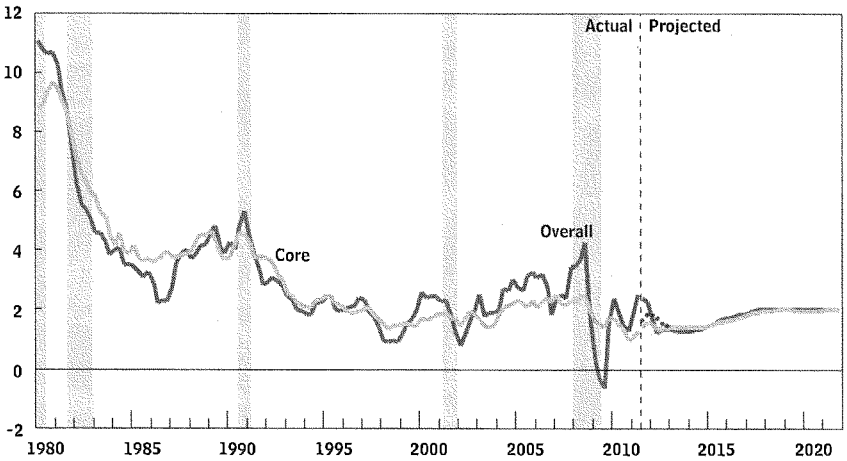
CBO now projects that the price index for personal consumption expenditures (PCE) will increase by about 2½ percent this year and by about 1½ percent next year (as measured by the change from the fourth quarter of the previous year). The "core" version of the PCE price index, which excludes prices for food and energy, is projected to rise by about 1¾ percent in 2011 and by about 1½ percent in 2012. The consumer price index for all urban consumers and its core version are expected to increase more rapidly than their PCE counterparts, especially in 2011. CBO now expects inflation in 2011, as measured by both the PCE price index and the consumer price index, to be higher than it forecast in August because gasoline prices have remained high and inflation in housing rents has been higher than projected; expected higher inflation in rents accounts for CBO's higher inflation forecast in 2012.

With modest inflation and slow economic growth, interest rates are likely to remain quite low for the rest of 2011 and 2012. The interest rate on 3-month Treasury bills is likely to remain barely above zero, and as indicated by the financial markets, the rate on 10-year Treasury notes will probably average less than 3.0 percent.

Figure 4.

Inflation

(Percentage change in prices from previous year)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: The overall inflation rate is based on the price index for personal consumption expenditures; the core rate excludes prices for food and energy.

Data are quarterly. Actual data, which are plotted through the second quarter of 2011, incorporate the July 2011 revisions of the national income and product accounts. The projections indicated by the solid lines are taken from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011). They are plotted through the fourth quarter of 2021 and are based on data issued before the revisions. The projections indicated by the dotted line are for core inflation and incorporate the effects of the revisions and the news since early July, when the previous forecast was completed; they are plotted through the fourth quarter of 2012.

The Output Gap and Its Costs

Economic growth at the rates CBO anticipates would leave a very large and persistent gap between actual output and the agency's estimate of potential output—that is, a large amount of labor and capital resources would be unused for some time. In CBO's August baseline projections, the output gap is about 5 percent of potential GDP at the end of 2011 and does not close fully until the second half of the 2011–2021 projection period.[5]

As a result, a large portion of the economic and human costs of the recession and slow recovery remains ahead. In mid-2011, according to CBO's estimates, the economy was only about halfway through the cumulative shortfall in output relative to its

5. CBO has not prepared new estimates of the paths for potential GDP and the output gap since it published its previous estimates in August.

potential level that will result from the recession and the weak recovery. Between late 2007 and mid-2011, the cumulative difference between GDP and estimated potential GDP amounted to roughly $2½ trillion; by the time the nation's output rises back to its potential level, the cumulative shortfall is expected to equal about $5 trillion.

Not only are the costs associated with the output gap immense, but they are also borne unevenly. Those costs fall disproportionately on people who lose their jobs, who are displaced from their homes, or who own businesses that fail. In the first quarter of 2011, for example, the recession and weak recovery led to a shortfall of about 10 million jobs relative to the number that would have existed had the recession not occurred and had job growth matched the average rate in the previous business cycle. And the unemployment rate is projected to remain well above CBO's estimate of the natural rate of unemployment for several years.[6] Even among workers who find a new job, experience suggests that many will end up with lower earnings, not only in the short term but for many years to come.[7]

Uncertainty in the Economic Outlook

Economic forecasts are always subject to a considerable degree of uncertainty, but the uncertainty surrounding the economic outlook is especially great because the present business cycle has been unusual in a variety of ways. CBO constructs its economic forecasts to lie in the middle of the distribution of possible future outcomes for the economy under an assumption that current law remains unchanged. Actual outcomes will undoubtedly differ from what CBO has projected in at least some respects. Key areas of uncertainty in the economic outlook include the following factors:

- The degree to which households want to further reduce their debt burdens,
- The pace at which firms hire and invest,
- The timing and magnitude of a recovery in house prices,
- The evolution in people's confidence about their future economic gains,
- Changes in stock prices and long-term interest rates,
- The resolution of concerns that some European governments may default on their debts, and
- The path of U.S. fiscal policy.

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6. The natural rate of unemployment is the rate arising from all sources except cyclical fluctuations in the economywide demand for goods and services.

7. For an analysis of the cost of losing a job in an economic downturn, see Congressional Budget Office, *Losing a Job During a Recession*, Issue Brief (April 2010). For a discussion of other measures of weakness in the labor market, including the number of people who have recently been employed part time but want full-time work, see Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011), pp. 47–48.

Different outcomes for those factors could combine to have quite divergent effects: from boosting the growth of the U.S. economy significantly to causing a new recession, or producing some result in between.

On the upside, the economy could grow considerably faster than CBO anticipates if the forces that have restrained the recovery fade more rapidly than the agency anticipates. The most important of those forces are the ones holding down consumer spending, including weak growth in employment and income as well as the loss of wealth from declines in house and stock prices. If wages and salaries grew faster than CBO projects—because of a shift in national income toward employee compensation and away from profits, for example—then they could support stronger consumer spending. If that faster growth in compensation was matched by gains in house prices and further easing of constraints on lending, then consumer spending could be buttressed by increased net worth and faster growth in consumer credit. Those conditions could in turn speed up the growth of employment and boost businesses' spending on facilities and equipment, potentially leading to a self-reinforcing cycle of increased spending, hiring, and income.

That favorable chain of events could be bolstered by renewed stability in financial markets or declines in the prices of oil and other commodities. In addition, foreign demand for U.S. goods and services could be greater than CBO expects if fears of negative financial repercussions from default on European sovereign debt proved to be exaggerated and if economic expansion in India, China, and other parts of the developing world ended up being stronger than expected.

However, outcomes that are considerably worse than CBO projects are also possible. The slowing of growth in U.S. output during the first half of 2011 might portend the onset of another recession. Although current economic indicators are not pointing to the kinds of imbalances that have preceded previous recessions, one possible path to a new recession would be a self-reinforcing downward spiral in which reduced hiring led to weaker growth of household income and diminished consumer and business confidence, which in turn led to lower spending by households and businesses and thus less need for workers and less hiring. Stock prices could continue to fall, reducing households' wealth and confidence. In addition, problems in housing and mortgage markets could persist longer than anticipated, which could push down house prices further, prolong problems in the financial system, and further restrain consumer spending and residential construction. Under those conditions, the income and confidence of businesses and households would decline further, and such a cycle of self-reinforcing adjustments could drive the economy into recession again.

Another possible catalyst for a recession is a worsening of the sovereign debt crisis in Europe, leading to more turmoil in international financial markets, potentially spilling over to U.S. financial markets, which have been fragile recently. If that occurred while policymakers in some developing countries were already slowing their economies to counteract inflationary pressures, economic activity worldwide could contract. The problems for the U.S. economy would be compounded if oil prices spiked because of further political unrest or military conflict in oil-producing states that threatened to disrupt the supply of oil. The problems would also be amplified if

concerns about large federal deficits and the high current level of federal debt restricted policymakers' ability to use fiscal policy to address the effects of an economic crisis.

The Budget Outlook

In part because of the weak economy and actions the government has taken in response, the budget deficit in fiscal year 2011 will total nearly $1.3 trillion, CBO estimates.[8] At 8.5 percent of GDP, this year's deficit will be the third-largest shortfall in the past 65 years, exceeded only by those in 2009 (at 10.0 percent) and 2010 (at 8.9 percent). As a result, at the end of the current fiscal year (September 30, 2011), debt held by the public will stand at an estimated 67 percent of GDP—the highest level since 1950 and up from 40 percent at the end of fiscal year 2008.

CBO's Budget Projections for 2012 to 2021

During the next several years and over the longer term, the nation faces profound challenges regarding the federal budget. The future paths of federal deficits and debt will depend crucially both on the strength of the economic recovery and on the tax and spending policies pursued by the federal government. In CBO's baseline estimates, which generally reflect the assumption that current law will not change, deficits drop markedly as a share of GDP over the next few years.[9] Under current law, CBO projects, the deficit will fall to 6.2 percent of GDP in 2012 and to 3.2 percent in 2013, and then will fluctuate within a range of 1.0 percent to 1.6 percent of GDP from 2014 through 2021 (see Table 1). (The weaker economy that CBO now anticipates for the remainder of this year and next would imply, all else being equal, a slightly larger federal deficit during that period.) In that scenario, deficits will total $3.5 trillion between 2012 and 2021, and by 2021, debt held by the public will equal 61 percent of GDP—well above the annual average of 37 percent recorded between 1971 and 2010.

However, the budgetary challenges facing the federal government are not fully reflected in CBO's baseline projections because current law provides for substantial changes to tax and spending policies in coming years. If those changes did not occur and current policies were continued instead, much larger deficits and much

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8. Budget estimates are provided for fiscal years, which span the period of October 1 through September 30, while the economic outlook discussion presents information on a calendar year basis.

9. The budget projections discussed here are those that CBO reported in August 2011 and are based on the economic forecast that the agency issued at that time. For a more detailed discussion of those projections, see Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011).

Table 1.

CBO's Baseline Budget Outlook

	Actual, 2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
							In Billions of Dollars							
Projection Excluding Effects of Provisions Related to the Joint Select Committee on Deficit Reduction														
Revenues	2,163	2,314	2,635	3,069	3,423	3,665	3,847	4,087	4,286	4,508	4,731	4,969	16,640	39,221
Outlays	3,456	3,597	3,609	3,692	3,803	3,988	4,249	4,449	4,635	4,913	5,161	5,409	19,340	43,908
Deficit	-1,294	-1,284	-973	-623	-380	-322	-402	-362	-349	-405	-430	-440	-2,701	-4,687
Effects of Provisions Related to the Joint Select Committee on Deficit Reduction[a]	0	0	0	113	115	118	124	132	139	146	154	161	469	1,200
Total Deficit	**-1,294**	**-1,284**	**-973**	**-510**	**-265**	**-205**	**-278**	**-231**	**-211**	**-259**	**-277**	**-279**	**-2,232**	**-3,487**
Debt Held by the Public at the End of the Year	9,019	10,164	11,153	11,773	12,148	12,463	12,840	13,169	13,473	13,820	14,181	14,541	n.a.	n.a.
							As a Percentage of Gross Domestic Product							
Projection Excluding Effects of Provisions Related to the Joint Select Committee on Deficit Reduction														
Revenues	14.9	15.3	16.8	19.0	20.2	20.2	20.1	20.4	20.5	20.6	20.7	20.9	19.3	20.0
Outlays	23.8	23.8	23.0	22.8	22.4	22.0	22.2	22.2	22.1	22.4	22.6	22.7	22.5	22.4
Deficit	-8.9	-8.5	-6.2	-3.9	-2.2	-1.8	-2.1	-1.8	-1.7	-1.8	-1.9	-1.8	-3.1	-2.4
Effects of Provisions Related to the Joint Select Committee on Deficit Reduction[a]	0	0	0	0.7	0.7	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.5	0.6
Total Deficit	**-8.9**	**-8.5**	**-6.2**	**-3.2**	**-1.6**	**-1.1**	**-1.5**	**-1.2**	**-1.0**	**-1.2**	**-1.2**	**-1.2**	**-2.6**	**-1.8**
Debt Held by the Public at the End of the Year	62.1	67.3	71.2	72.8	71.6	68.7	67.2	65.8	64.3	63.1	62.0	61.0	n.a.	n.a.

Source: Congressional Budget Office.

Notes: The Budget Control Act of 2011 (Public Law 112-25) created the Joint Select Committee on Deficit Reduction to propose further deficit reduction totaling at least $1.5 trillion over 10 years. The act also specified automatic procedures for reducing spending by as much as $1.2 trillion if legislation originating with the new deficit reduction committee does not achieve savings of at least $1.2 trillion. CBO has incorporated that amount of deficit reduction (which includes savings in debt-service costs) in its baseline but has no basis for allocating that amount between revenues and outlays. Policy changes were allocated evenly across the 2013–2021 period; the incremental increase in the annual effects results from the compounding of debt-service savings.

n.a. = not applicable.

a. Includes effects on debt service.

greater debt would result (see Figure 5). Specifically, current law includes the following features whose modification or elimination could significantly increase future deficits and debt:

- Provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that reduced the payroll tax for one year and limited the reach of the alternative minimum tax for two years are set to expire on December 31, 2011.

- Several other key provisions of the 2010 tax act—including the extension of lower tax rates and expanded credits and deductions originally enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the American Recovery and Reinvestment Act are set to expire on December 31, 2012.

- Medicare's payments for physicians' services are scheduled to be reduced by nearly 30 percent after December 31, 2011.

- Discretionary appropriations between 2012 and 2021 will be subject to statutory caps set in the Budget Control Act of 2011. If adhered to, those caps will reduce discretionary outlays by about 5 percent in real terms over the 2012–2021 period relative to spending in 2011, CBO estimates.[10]

- Additional budgetary savings of more than $1 trillion required by the Budget Control Act will occur as a result of legislation produced by this Committee or, if lawmakers fail to enact such legislation, by means of automatic cuts in spending that will then be triggered.

Under an assumption that those provisions of current law all remain in place, CBO projects that revenues will rise sharply—from 15.3 percent of GDP in 2011 to 20.2 percent in 2014 and to 20.9 percent by 2021. Outlays, by contrast, are projected to decrease as a percentage of GDP over the next few years, falling from 23.8 percent of GDP in 2011 to a low of 22.0 percent of GDP in 2015, before increasing again to 22.7 percent by 2021. (Those projections of revenues and outlays exclude the effects of changes that might occur as a result of provisions of the Budget Control Act related to the deficit reduction committee because CBO cannot predict what those changes might be.) By comparison, during the past 40 years, revenues have represented 18.0 percent of GDP, on average, and outlays have represented 20.8 percent.

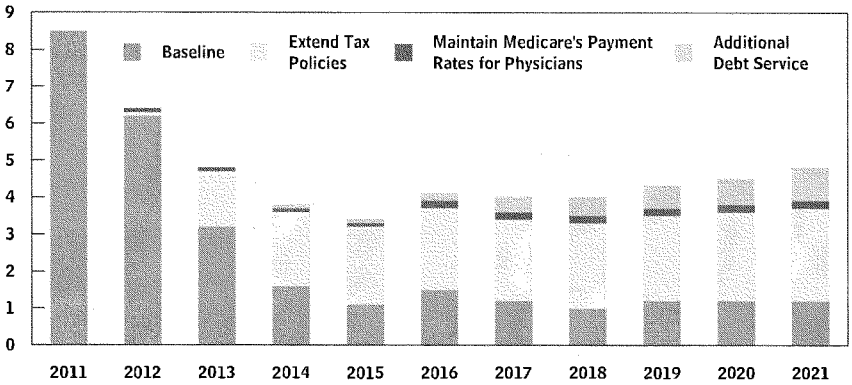
Changing provisions of current law so as to maintain major policies that are in effect now would produce markedly different budgetary outcomes. For example, if most of the provisions in the 2010 tax act were extended (rather than allowed to expire on

10. Outlays refer to spending to pay a federal obligation.

Figure 5.

Deficits in CBO's Baseline and Assuming a Continuation of Certain Policies

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: "Extend Tax Policies" reflects the following policy assumptions: Most of the provisions in the 2010 tax act that were originally enacted in 2001, 2003, 2009, and 2010 are extended (instead of being allowed to expire on December 31, 2012, as scheduled), and the alternative minimum tax is indexed for inflation. "Maintain Medicare's Payment Rates for Physicians" involves preventing the nearly 30 percent reduction in Medicare's payment rates for physicians' services that is scheduled to take effect at the end of 2011. "Additional Debt Service" is the amount of interest payments on the additional debt issued to the public that would result from the continuation of the specified policies.

December 31, 2012) and if the AMT was indexed for inflation, CBO projects that annual revenues would average 18 percent of GDP from 2012 through 2021, rather than the 20 percent shown in the baseline projections.[11] If Medicare's payment rates for physicians' services also were held constant, then deficits from 2012 through 2021 would average 4.3 petcent of GDP, compared with the 1.8 percent in the baseline. With cumulative deficits during that decade of nearly $8.5 trillion under such policies, debt held by the public would reach 82 percent of GDP by the end of 2021, higher than in any year since 1948 (see Figure 6).

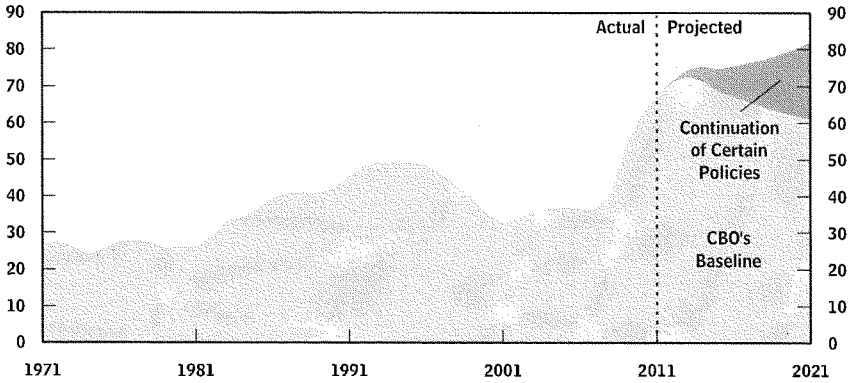
The projected deficits reflect the fact that, during the coming decade and over the long term, the aging of the population and rising costs of health care will exert

11. That alternative is based on an assumption that the lower tax rates, expanded credits, and higher deductions enacted in 2001, 2003, and 2009 and then extended through 2012 by the 2010 tax act are made permanent. It also reflects an assumption that the estate and gift tax rules for 2011 and 2012 (as established by the 2010 tax act) continue permanently beyond their currently scheduled expiration in 2012. Furthermore, it incorporates an assumption that the higher AMT exemption contained in the 2010 tax act does not expire at the end of 2011 and is indexed to inflation thereafter. Finally, it does not incorporate any changes in revenues that may result from the work of the deficit reduction committee.

Figure 6.

Federal Debt Held by the Public

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: The projected debt with the continuation of certain policies is based on several assumptions: first, that most of the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312) that originally were enacted in 2001, 2003, 2009, and 2010 do not expire on December 31, 2012, but instead continue; second, that the alternative minimum tax is indexed for inflation after 2011; and third, that Medicare's payment rates for physicians are held constant at their 2011 level.

significant and increasing pressure on the budget. The number of people age 65 or older will increase by roughly one-third between 2011 and 2021, causing that segment of the U.S. population to climb from 13 percent to 17 percent of the total; beyond 2021, that share will rise further. In addition, the major health care legislation enacted in 2010 will increase the number of beneficiaries of federal health care programs, and CBO projects that the costs of those programs per beneficiary will continue rising (albeit at different rates because of differences in the laws that govern them). All told, outlays for Social Security, Medicare, and Medicaid—which will account for 44 percent of all federal noninterest spending in 2011—will continue to rise relative to GDP and to consume a growing share of the federal budget.

The Budget Control Act of 2011

CBO's current baseline projections show smaller deficits than the agency estimated earlier this year primarily because of the enactment of the Budget Control Act of 2011.[12] Provisions in that act:

12. Those earlier projections are shown in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012* (April 2011). For an analysis of the Budget Control Act of 2011, see Congressional Budget Office, letter to the Honorable John A. Boehner and the Honorable Harry Reid estimating the impact on the deficit of the Budget Control Act of 2011 (August 1, 2011). The estimates discussed here do not include the effect of initiatives in the Budget Control Act to enhance "program integrity," which depend on future appropriations and will be incorporated into CBO's baseline if they are implemented in the future.

- Establish caps on discretionary funding through 2021;
- Allow certain amounts of additional spending for "program integrity" initiatives aimed at curtailing improper benefit payments;
- Change the Pell Grant and student loan programs;
- Require the House of Representatives and the Senate to vote on a joint resolution proposing a balanced budget amendment to the Constitution;
- Establish a procedure for increasing the debt limit by $400 billion initially and procedures to raise the limit again in two additional steps, for a cumulative increase of between $2.1 trillion and $2.4 trillion;
- Reinstate and modify certain budget process rules;
- Create the Congressional Joint Select Committee on Deficit Reduction to propose further reductions that will amount to at least $1.5 trillion in budgetary savings over 10 years; and
- Establish automatic procedures for reducing spending if legislation originating with the new deficit reduction committee does not achieve savings estimated to total at least $1.2 trillion.

Discretionary Caps. The Budget Control Act imposes caps on appropriations of new discretionary budget authority that start at $1,043 billion in 2012 and reach $1,234 billion in 2021. For 2012 and 2013, separate caps for "security" and "nonsecurity" budget authority will be in effect; from 2014 through 2021, only one cap will apply to total discretionary funding unless automatic spending reductions are triggered (as described below under "Enforcement procedures").[13]

The law allows for adjustments to the discretionary caps when appropriations are provided for certain purposes. Funding for the wars in Afghanistan and Iraq or similar activities (sometimes called overseas contingency operations) would lead to an increase in the caps, as would other funding designated as an emergency requirement. Furthermore, the law allows for an increase in the caps if additional budget authority is provided for program integrity initiatives aimed at reducing improper benefit payments in the Disability Insurance and Supplemental Security Income programs, Medicare, Medicaid, and the Children's Health Insurance Program. Finally, the caps would be increased if appropriations were provided for disaster relief, but the adjustments would be limited on the basis of historical averages for such funding.

13. Budget authority (or "funding") refers to the authority provided by law to incur financial obligations, which eventually result in outlays. For the purpose of enforcing the discretionary caps, the security category comprises discretionary appropriations for the Department of Defense, the Department of Homeland Security, the Department of Veterans Affairs, the National Nuclear Security Administration, the intelligence community management account (95-0401-0-1-054), and discretionary accounts in budget function 150 (international affairs). The nonsecurity category comprises all discretionary appropriations not included in the security category.

According to CBO's estimates, if appropriations in the next 10 years are equal to the caps on discretionary spending, implementing those caps will reduce budget deficits by $756 billion between 2012 and 2021 (not counting the savings in interest payments that will result from lower outlays), compared with what would occur if discretionary budget authority was allowed to grow at the rate of inflation.

Overall Budgetary Impact of the Act. The law also made changes to education programs that will reduce mandatory outlays over the 2012–2021 period by $5 billion. The savings in interest on the public debt because of the lower deficits resulting from those changes and the discretionary caps will come to $134 billion, CBO estimates.[14] In addition, CBO's estimate of the budgetary impact of the law, as well as the agency's August baseline projections, include further deficit reduction totaling $1.2 trillion over the 10-year period stemming from legislation originating with the deficit reduction committee or the automatic reductions in spending that will occur in the absence of such legislation. (As discussed on the following page, CBO estimates that enforcement of the act, in the absence of any enacted legislation stemming from the committee's recommendations, would result in net savings of about $1.1 trillion over the coming decade.) The composition of that additional deficit reduction over time and across budget categories will depend on the specific provisions of any legislation stemming from the committee's proposals and the extent of any automatic reductions that would be triggered. Overall, CBO's baseline projections incorporate $2.1 trillion in deficit reduction over the 2012–2021 period stemming from the act.

Enforcement Procedures. If legislation originating from this Committee and estimated to produce at least $1.2 trillion in deficit reduction (including an allowance for interest savings) is not enacted by January 15, 2012, automatic procedures for cutting both discretionary and mandatory spending would take effect.[15] The magnitude of those cuts would depend on any shortfall in the estimated effects of such legislation relative to the $1.2 trillion amount.

The automatic reductions—if triggeted—would take the form of equal cuts (in dollar terms) in defense and nondefense spending starting in 2013. Those cuts would be achieved by lowering the caps on discretionary budget authority specified in the Budget Control Act and by automatically cancelling budgetary resources (a process known as sequestration) for some programs and activities financed by mandatory spending.[16] The law exempts a significant portion of mandatory spending from sequestration,

14. That reduction in interest on the public debt is projected using CBO's August 2011 forecast for interest rates. Those rates are lower than ones forecast earlier in the year and used in Congressional Budget Office, letter to the Honorable John A. Boehner and the Honorable Harry Reid estimating the impact on the deficit of the Budget Control Act of 2011.

15. Discretionary spending refers to outlays from budget authority that is provided and controlled by appropriation acts. Mandatory spending refers to outlays from budget authority provided by laws other than appropriation acts.

16. Budgetary resources consist of all sources of authority provided to federal agencies that permit them to incur financial obligations, including new budget authority, unobligated balances, direct spending authority, and obligation limitations.

however. The total savings attributed to the automatic procedures would include lower debt-service costs resulting from those cuts.

CBO has estimated the changes in discretionary and mandatory spending that would occur if the automatic enforcement mechanisms were triggered because no new deficit reduction legislation was enacted. CBO's analysis can only approximate the ultimate results; the Administration's Office of Management and Budget would be responsible for implementing any such automatic reductions on the basis of its own estimates. CBO estimates that, if no legislation originating from this Committee was enacted, the automatic enforcement process specified in the Budget Control Act would produce the following results between 2013 and 2021:

- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in the caps on new discretionary appropriations for defense programs, yielding total outlay savings of $454 billion.

- Reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in the caps on new discretionary appropriations for nondefense programs, resulting in outlay savings of $294 billion.

- Reductions ranging from 10.0 percent (in 2013) to 8.5 percent (in 2021) in mandatory budgetary resources for nonexempt defense programs, generating savings of about $0.1 billion.

- Reductions of 2.0 percent each year in most Medicare spending because of the application of a special rule thar applies to that program, producing savings of $123 billion, and reductions ranging from 7.8 percent (in 2013) to 5.5 percent (in 2021) in mandatory budgetary resources for other nonexempt nondefense programs and activities, yielding savings of $47 billion. Thus, savings in nondefense mandatory spending would total $170 billion.

- About $31 billion in outlays stemming from reductions in premiums for Part B of Medicare and other changes in spending that would result from the sequestration actions.

- An estimated reduction of $169 billion in debt-service costs.

In all, those automatic cuts would produce net budgetary savings of about $1.1 trillion over the 2013–2021 period, CBO estimates. That amount is lower than the $1.2 trillion figure for deficit reduction in the Budget Control Act for three reasons. First, because of the lag in timing between appropriations and subsequent expenditures, part of the savings from the automatic cuts in budgetary resources would occur after 2021. Second, CBO expects that some reductions—particularly those related to Medicare—would have other effects that would boost net spending (by the $31 billion mentioned above). Third, CBO estimates that the reduction in debt-service costs

would be lower than the amount of such savings stipulated in the Budget Control Act.[17]

The majority of the savings from the automatic spending reductions would stem from further cuts in discretionary spending (beyond those embodied in the new law's caps on discretionary budget authority). CBO expects that about 71 percent of the net savings from the automatic procedures would come from lowering the caps on discretionary appropriations, 13 percent would come from a net reduction in mandatory spending, and 16 percent would result from lower debt-service costs.

Of course, the Budget Control Act could produce outcomes that are very different from the figures outlined above. The Congress could enact legislation originating from this Committee that would produce $1.2 trillion in savings through changes that differ significantly from the automatic reductions that would be required in the absence of such legislation. Or such legislation could yield some savings, but less than $1.2 trillion, so the automatic procedures would have a smaller impact than CBO has estimated here. Alternatively, this Committee could recommend, and the Congress could enact, legislation saving significantly more than $1.2 trillion. (The Budget Control Act states that the Committee's goal is to achieve at least $1.5 trillion in savings over the 2012–2021 period.)[18]

The Long-Term Budget Outlook

Beyond the coming decade, the fiscal outlook worsens. When CBO issued its most recent long-term projections in June 2011, debt held by the public was projected to reach 76 percent of GDP in 2021 under current law.[19] Beyond 2021, under an extension of current law that CBO labeled the "extended-baseline scenario," debt was projected to rise to 84 percent of GDP in 2035. Because CBO's projections based on current law now show that debt held by the public will be declining relative to GDP after 2013 (to 61 percent in 2021), the long-term outlook under current law is a little brighter than it was earlier in the year. Even under the latest projections, however, debt would still be larger relative to GDP in 2021 than in any year between 1953 and 2009. Moreover, although long-term budget projections are highly uncertain, the aging of the population and rising costs for health care would almost certainly push federal spending up sharply relative to GDP after 2021 if current law remained in effect. Federal revenues also would continue to increase relative to GDP after 2021 under current law, reaching significantly higher percentages of GDP than ever seen before in the United States. CBO has not updated its long-term projections to reflect

17. The Budget Control Act specifies that 18 percent of the $1.2 trillion goal for deficit reduction be assumed to result from debt-service savings; that amount comes to $216 billion. However, CBO estimates that the automatic spending reductions would produce debt-service savings of $169 billion through 2021.

18. For further details, see Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act* (September 2011).

19. See Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (June 2011).

its new 10-year baseline, and the net effect that those trends in outlays and revenues would have on budget deficits beyond 2021 is not clear.

Under certain policy assumptions other than those underlying CBO's baseline, the budget outlook is much bleaker—both for the next 10 years and over the longer term. In CBO's long-term projections issued in June, the agency also examined an "alternative fiscal scenario," which incorporated several changes to current law that are widely expected to occur or that would modify some provisions of law that might be difficult to sustain for a long period. Specifically, the tax provisions enacted since 2001 that were extended most recently in 2010 were assumed to be extended, the reach of the AMT was assumed to be restrained to stay close to its historical extent, and tax law was assumed to evolve over the long term so that revenues remained near their historical average of 18 percent of GDP. CBO projected in June that, under the alternative fiscal scenario, revenues would increase much more slowly than spending, and debt held by the public would balloon to nearly 190 percent of GDP by 2035.

Although new long-term projections reflecting the latest 10-year projections would differ, the amounts of federal borrowing that would be required under those policy assumptions clearly would be unsustainable. Moreover, the projections of federal debt that CBO highlighted in June for the alternative fiscal scenario do not include the harmful effects of rising debt on economic growth and interest rates. If those effects were taken into account, projected debt would increase even more rapidly. Thus, under current policies, the federal budget is quickly heading into territory that is unfamiliar to the United States and to most other developed countries as well.

Fiscal Policy Choices

The budgetary and economic challenges facing the nation present policymakers with difficult choices about fiscal policy. As this Committee considers its charge to recommend policies that would reduce future budget deficits, its key choices fall into three broad categories:

- How much deficit reduction should be accomplished?
- How quickly should deficit reduction be implemented?
- What forms should deficit reduction take?

The Magnitude of Deficit Reduction

There is no commonly agreed upon level of federal debt that is sustainable or optimal. At a minimum, federal debt cannot continually increase as a share of the economy because the interest payments on that debt would then continually grow relative to the size of the tax base that would be available for generating revenues to cover those payments and all of the other activities of the government. Even before the interest burden became unsupportable, a fiscal crisis could arise if participants in financial

markets lost confidence in the government's ability to manage its budget and became unwilling to lend to the government at affordable rates.[20]

Under CBO's current-law baseline, which incorporates $1.2 trillion in expected deficit reduction related to this Committee's work, debt held by the public falls from 67 percent of GDP at the end of 2011 to 61 percent by 2021. However, stabilizing the debt at that level relative to GDP would leave it larger than in any year from 1953 through 2009. Moreover, an aging population and rising health care costs will exert significant and increasing pressure on the budget in the years beyond 2021.

Lawmakers might determine that debt should be reduced to amounts lower than those shown in CBO's baseline—in order to reduce the burden of debt on the economy, relieve some of the long-term pressures on the budget, diminish the risk of a fiscal crisis, and enhance the government's flexibility to respond to unanticipated developments. Accomplishing that objective would require larger amounts of deficit reduction. For example, to lower debt held by the public in 2021 to 50 percent of GDP, roughly the same level recorded in the mid-1990s, budget deficits during the next decade would need to be about $2.6 trillion lower than in CBO's baseline. If this Committee aimed to achieve that goal through its own recommendations, it would need to propose changes in policies that would reduce deficits by a total of about $3.8 trillion (including interest savings) over the coming decade.

Furthermore, the current laws that underlie CBO's baseline projections provide for significant changes to tax and spending policies in coming years. Lawmakers might decide that some of those current policies should be continued. In that case, achieving a particular level of debt could require much larger amounts of deficit reduction through other changes in policy.

For example, if most of the provisions in the 2010 tax act were extended, if the AMT was indexed for inflation, and if Medicare's payment rates for physicians' services were held constant, then in the absence of other policy changes, deficits over the next 10 years would total $8.5 trillion—compared with $3.5 trillion in the baseline—and debt held by the public would reach 82 percent of GDP in 2021, well above both the current level and the projected level in 2021 under current law. If lawmakers decided to change the law in order to extend those policies, then reducing debt held by the public in 2021 to the 61 percent of GDP projected under current law would require other changes in policy that reduced deficits over the next 10 years by $5 trillion in addition to the $1.2 trillion in deficit reduction that this Committee would have to accomplish to avoid the automatic budget cuts required by the Budget Control Act. If this Committee aimed to achieve that goal through its own recommendations, it would need to propose changes in policies that reduced deficits (apart from the effects of extending those existing policies) by a total of about $6.2 trillion (including interest savings) over the coming decade. To lower debt held by the public to the 50 per-

20. See Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis*, Issue Brief (July 2010).

cent of GDP seen in the mid-1990s would require significantly larger reductions in deficits.

In 2021 alone, the gap between federal revenues and spending if those policies were continued and no other budgetary changes were made would be $1.1 trillion, or 4.7 percent of GDP, CBO projects (see Figure 7). Given CBO's forecast of economic growth and interest rates in that year, the deficit would need to be less than 2.2 percent of GDP to put debt on a downward trajectory relative to GDP. Relative to the benchmark of continuing those policies, reaching that objective would require a reduction in the deficit of roughly 2.5 percent of GDP, or about $600 billion in that year.

An additional consideration is that lawmakers might determine that current economic conditions call for new policies that would increase deficits in the next few years. If such policies were enacted, then reducing debt held by the public to a particular level in 2021 would require even greater deficit reduction in later years.

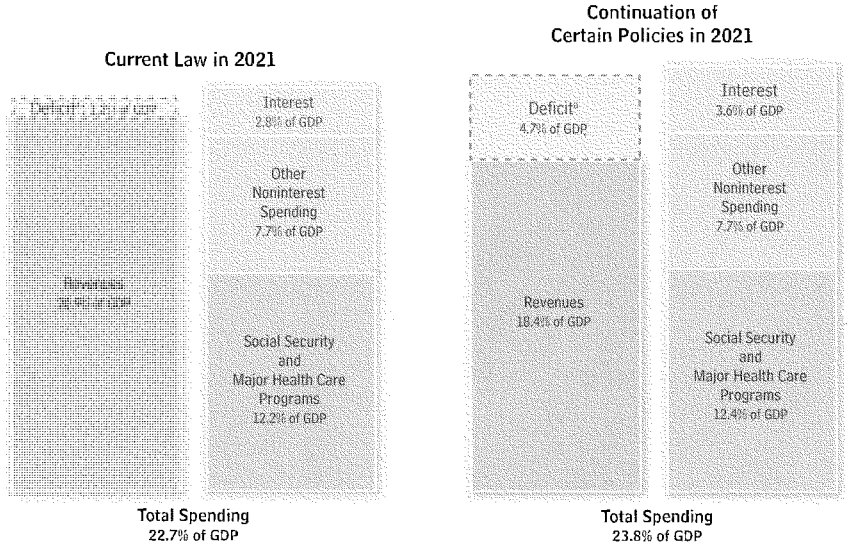
The Timing of Deficit Reduction

Policymakers face difficult trade-offs in decisions about how quickly to implement policies to reduce budget deficits, as the impacts on people and the economy depend crucially on the timing of the changes. In confronting those trade-offs, policymakers could consider the relative disadvantages of reducing deficits slowly or quickly, the economic effects of deficit reduction achieved on alternative time paths, and ways to reconcile near-term and longer-term economic objectives.

Although there are trade-offs in choosing the timing of policy changes to reduce future deficits, such trade-offs do not apply to the timing of decisions about the changes. Rather, there are important benefits and few apparent costs to deciding now what policy actions will be taken to resolve the longer-term budgetary imbalance. Enacting policy changes soon would allow for implementing them gradually while still limiting further increases in federal debt and the corresponding negative consequences. Moreover, the enactment of credible policy changes that reduce deficits in the future would probably increase economic activity in the near term by boosting confidence and holding down interest rates.

Figure 7.

Federal Revenues and Spending in 2021 Under CBO's Baseline or with a Continuation of Certain Policies



Source: Congressional Budget Office.

Notes: The projection with the continuation of certain policies is based on several assumptions: first, that most of the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that originally were enacted in 2001, 2003, 2009, and 2010 do not expire on December 31, 2012, but instead continue; second, that the alternative minimum tax is indexed for inflation after 2011; and third, that Medicare's payment rates for physicians are held constant at their 2011 level. Continuing the tax provisions would also increase outlays for refundable tax credits; however, the effect on outlays is shown in the revenue portion of the bar.

Major health care programs include Medicare, Medicaid, the Children's Health Insurance Program, and exchange subsidies and related spending.

GDP = gross domestic product.

a. In this figure, the deficit does not equal total spending minus revenues in 2021 because it has been reduced by incorporating effects of provisions related to the Joint Select Committee on Deficit Reduction. The Budget Control Act of 2011 (Public Law 112-25) created that committee to propose further deficit reduction totaling at least $1.5 trillion over 10 years. The act also specified automatic procedures for reducing spending by as much as $1.2 trillion if legislation originating with the new deficit reduction committee does not achieve savings of at least $1.2 trillion. CBO has incorporated that amount of deficit reduction in its baseline (including an amount equal to 0.7 percent of GDP in 2021, which includes savings in debt-service costs) but has no basis for allocating that amount between revenues and outlays. Accordingly, outlay and revenue projections included here exclude the effects of those provisions; the deficit projection, however, includes the effects.

Disadvantages of Reducing Deficits Slowly. On the one hand, reducing deficits slowly would have some negative consequences. First, implementing spending cuts or tax increases gradually, rather than abruptly, would lead to a greater accumulation of government debt, which would have a number of costs:

- Rising debt would cause a growing portion of people's savings to go to purchase government debt rather than to finance investments in productive capital such as factories and computers. Specifically, larger federal deficits imply, all else being equal, lower national saving; that lower saving reduces the capital stock owned by U.S. citizens over time through a decrease in domestic investment, an increase in net borrowing from abroad, or both. That crowding out of investment in productive capital would lead to lower output and incomes than would otherwise occur.[21]

- Higher levels of debt imply higher interest payments on that debt, which would eventually require either higher taxes or a reduction in government benefits and services.

- Rising debt would increasingly restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges, such as economic downturns, financial turmoil, or international crises. As a result, the effects of such developments on the economy and people's well-being could be worse.

- Growing debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates. Such a crisis would confront policymakers with extremely difficult choices. To restore investors' confidence, policymakers would probably need to enact spending cuts or tax increases more drastic and painful than those that would have been necessary had the adjustments come sooner.

Second, gradual spending cuts or tax increases might reduce the credibility of the intended deficit reduction. Households, businesses, state and local governments, and financial market participants might be skeptical that unpleasant policy changes that were announced but deferred well into the future would ever take effect. Instead,

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21. CBO estimated the magnitude of those effects for the paths of federal debt presented in *CBO's 2011 Long-Term Budget Outlook*. CBO estimated that under the extended-baseline scenario in that report, real gross national product (GNP) would be reduced slightly by 2025 and by as much as 2 percent by 2035, compared with what it would be under the stable economic environment underlying most of the projections in that report. In addition, CBO estimated that under the alternative fiscal scenario in that report, real GNP would be 2 percent to 6 percent lower in 2025, and 7 percent to 18 percent lower in 2035, than under a stable economic environment. (GNP differs from GDP primarily by including the capital income that residents earn from investments abroad and excluding the capital income that nonresidents earn from domestic investment. In the context of analyzing the impact of growing deficits and debt, GNP is a better measure because projected budget deficits would be partly financed by inflows of capital from other countries.)

those observers might expect that those changes would be altered before they occurred. Such expectations might be reinforced by recent experience, in which the expiration of provisions that restrain individual income tax revenues were extended, the expanding reach of the AMT under existing law was checked, and looming cuts in Medicare's payments to physicians under existing law were avoided. In each of those policy areas, lawmakers have acted to extend existing policies rather than to follow current law.

Lessening the credibility of future deficit reduction would diminish the favorable effects of such policy changes in the near term. If there is widespread belief that cuts in spending or increases in taxes were going to happen in the future, that expectation would help to hold down current medium-term and long-term interest rates. Those lower interest rates would tend to increase spending and investing by households and businesses, other things being equal. However, if people did not believe that promised changes in policy would actually take effect, those advantages would be diminished or lost. In order to increase the credibility of future deficit reduction, policymakers could enact specific policy changes into law and show that those changes had fairly widespread support.

Disadvantages of Reducing Deficits Quickly. On the other hand, reducing deficits quickly would have some negative consequences as well. First, implementing spending cuts or tax increases abruptly would give families, businesses, and state and local governments little time to plan and adjust. Deficit reduction inevitably involves some combination of scaling back government benefits, shrinking government contracts or payrolls, reducing grants to state and local governments, or raising tax collections. The households, businesses, and other levels of government that would be affected by such changes would need to adjust their own spending habits, work behavior, investment and hiring decisions, or tax policies—perhaps in significant ways. Therefore, they would benefit from advance notice so they would have some flexibility in how and when they can alter their behavior.

Older generations would have particular difficulty adapting to immediate spending cuts or tax increases because their opportunity to adjust their work or saving is more limited.[22] As a result, a common feature of proposals to change programs that affect older Americans—including Social Security, Medicare, and Medicaid—is to limit the impact of such changes on people who are currently over certain ages. (Of course, limiting the impact of policy changes on the current elderly would reduce the amount of savings that could be achieved in the near term and might, for a given amount of cumulative deficit reduction, increase the extent of the policy changes that would be imposed later on current young people.) Moreover, the ability of many households, firms, and state and local governments to adjust to cutbacks in federal spending or

22. See Congressional Budget Office, *Economic Impacts of Waiting to Resolve the Long-Term Budget Imbalance*, Issue Brief (December 2010).

increases in federal taxes may be more limited now than at other times because of the strained financial circumstances in which many find themselves.

Second, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion. When the economy has substantial unemployment, as well as unused factories, offices, and equipment, reductions in aggregate demand (the total purchases of a country's output of goods and services by consumers, businesses, governments, and foreigners) generally widen the gap between the economy's actual level of output and its potential (a level that corresponds to a high rate of use of labor and capital). Decreasing federal spending or increasing federal taxes now would tend to reduce aggregate demand and thereby lead to less output and employment in the next few years.

For example, cutting federal purchases of goods and services subtracts from the demand for goods and services directly, and reducing federal transfers to people (such as unemployment insurance payments or Social Security benefits) or to states and localities (such as support for secondary education) tends to decrease the amount of goods and services purchased by the recipients. Similarly, raising tax collections tends to decrease the spending of the people paying those taxes.

The extent to which deficit reduction lessens demand depends on the details of the policies enacted and on the economic situation.[23] For example, when the Federal Reserve's ability to lower short-term interest rates is constrained because those rates are already near zero, as they are currently, the short-run effects of changes in government spending and taxes on output tend to be larger than usual. Nevertheless, changes in government spending and taxes usually affect demand only temporarily: They raise or lower output relative to potential only for a while because, over time, stabilizing forces in the economy (such as the responses of prices and interest rates and actions by the Federal Reserve) tend to move output back toward its potential.

Quantifying the Economic Effects of Deficit Reduction. Although cuts in government spending or increases in taxes in the next few years would, by themselves, reduce output and employment during that period, credible steps to narrow budget deficits over the longer term would tend to boost output and employment in the next few years by holding down interest rates and by reducing uncertainty and enhancing business and consumer confidence. Therefore, the near-term economic effects of deficit reduction would depend on the balance between changes in spending and taxes that take effect quickly and those that take effect gradually. According to CBO's analysis, credible policy changes that would substantially reduce deficits later in the coming decade and over the long term—without immediate cuts in spending or increases in taxes—

23. See Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from March 2011 Through June 2011* (August 2011) and Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices* (September 28, 2010).

would both support the economic expansion in the next few years and strengthen the economy over the longer term.

A recent analysis by CBO provides a rough indication of the magnitude of the economic effects of reducing deficits along a hypothetical time path under current economic conditions.[24] In that analysis, the agency estimated the short-term and longer-term effects of reducing the primary deficit (the budget deficit excluding net interest) by $100 billion in 2012 and by amounts increasing gradually to $300 billion by 2021 (without any particular changes in spending or revenues specified). According to the agency's estimates, that illustrative plan would decrease real gross national product (GNP) in 2012, 2013, and 2014 by amounts ranging from roughly 0.1 percent to 0.6 percent depending on the year and the assumptions used.[25] However, the increases in national saving and investment that would result from smaller deficits were estimated to increase real GNP by roughly 0.4 percent to 1.4 percent from 2019 through 2021.[26]

A different policy that had the same amount of cumulative reduction in primary deficits but that reduced deficits more slowly than the policy analyzed would have more favorable macroeconomic effects in the next few years. However, that alternative policy would have less favorable effects later in the decade because the total budgetary impact of slower deficit reduction would be smaller?a result of the policy's smaller impact on interest and the slower reduction in debt relative to what would otherwise occur, causing the savings in interest costs to compound more slowly. Those differences in macroeconomic effects later in the decade could be offset by undertaking slightly more cumulative reduction in primary deficits.

The economic effects of policies that reduce budget deficits sharply given current economic conditions can be seen by comparing CBO's baseline economic projections under current law with economic projections under a different set of policies. Under current law, most of the provisions in the 2010 tax act expire at the end of 2011 or 2012, the reach of the AMT expands greatly at the end of 2011, and Medicare's payment rates for physicians' services fall sharply at the end of 2011; those policies help

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24. See Congressional Budget Office, *The Macroeconomic and Budgetary Effects of an Illustrative Policy for Reducing the Federal Budget Deficit* (July 2011).

25. CBO's analysis considered a range of possible short-term effects on output. The medium-sized response reflected the assumption that each one-dollar reduction in the deficit would cause economic output to decline by a dollar in the short term, excluding the effects from changes in interest rates. At one end of the range, each one-dollar cut in the deficit was assumed to cause cumulative economic output to decline by $0.60 over several quarters. At the opposite end of the range, each one-dollar cut in the deficit was assumed to cause economic output to decline by a cumulative $1.40. The dollar-for-dollar response lies within the ranges of estimated effects on economic output for many policies examined in CBO's analysis of the macroeconomic effects of ARRA.

26. To illustrate a range of possible effects, CBO assumed that each dollar of deficit reduction would increase domestic investment by 20, 36, or 50 cents (reflecting different assumptions about the effects of deficits on both national saving and net borrowing from abroad).

to reduce deficits sharply, but CBO also expects them to reduce economic growth in the near term. Suppose, instead, that most of the cuts in individual income taxes and estate and gift taxes now scheduled to expire in 2012 or 2013 are extended through 2021, limits to the reach of the AMT that are set to expire at the end of 2011 are also continued through 2021, and Medicare's payment rates for physicians are maintained at their 2011 levels. Under those alternative assumptions, CBO estimates that real GDP in 2013 would be between 0.6 percent and 2.3 percent more than projected under current law.[27] Higher real GDP would result in a lower unemployment rate and somewhat higher interest rates over the next few years than would occur with the smaller deficits projected in the baseline.

However, unless other policy changes were enacted, real GDP would be higher in CBO's baseline projections by later in the decade than under that set of alternative policies. The lower marginal tax rates under those policies would increase people's incentives to work and save, but the significantly larger budget deficits would crowd out private investment in productive capital. By the end of 2021, as the effect of larger budget deficits outweighed that of lower tax rates, real GDP would be between 0.3 percent and 1.9 percent smaller than it would be under current law, CBO estimates. Without other policy changes, the budget would be on an unsustainable path under those policies, and the negative effects on output and incomes would rise further after 2021.

Reconciling Near-Term and Longer-Term Objectives. Some policymakers and analysts have advocated near-term reductions in taxes or increases in federal spending to increase output and employment in the next few years. Such policies might or might not worsen the medium-term and long-term fiscal outlook depending on whether other changes in policy were enacted at the same time and on what those other changes were. However, there is no inherent contradiction between using fiscal policy to support the economy today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential.[28] What would such an approach mean in practice?

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27. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011), Table 2-2. To reflect the high degree of uncertainty that accompanies estimates of the economic impact of fiscal policy, CBO used a range of assumptions about the extent to which changes in taxes and government spending affect the demand for goods and services, budget deficits affect private investment, and changes in marginal tax rates on labor income affect the labor supply. For more information about CBO's assumptions, see Congressional Budget Office, *The Macroeconomic and Budgetary Effects of an Illustrative Policy for Reducing the Federal Budget Deficit.*

28. For further discussion, see Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011* (January 2010) and Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices.*

If taxes were cut permanently or government spending was increased permanently, and no other changes were made to fiscal policy, the economy would suffer in the medium term and long term. Indeed, if people believed that policy changes that increased near-term deficits presaged larger budget deficits in the medium term and long term, and thus that the federal budget outlook had become even bleaker, the economy could be hurt in the near term by a faltering of business and consumer confidence and an increase in interest rates. Moreover, even if tax cuts or spending increases were temporary, the additional debt accumulated during that temporary period would weigh on the budget and the economy over time.

Therefore, if policymakers wanted to achieve both a short-term economic boost and medium-term and long-term fiscal sustainability, a combination of policies would be required: changes in taxes and spending that would widen the deficit now but reduce it later in the decade. Such an approach would work best if the future policy changes were sufficiently specific and widely supported so that households, businesses, state and local governments, and participants in financial markets believed that the future fiscal restraint would truly take effect.

The Composition of Deficit Reduction

As policymakers consider the composition of policy changes to be used to reduce budget deficits, many factors may play a role. The most fundamental question is what role the government should play in the U.S. economy and society. The amount and composition of federal spending and revenues affect the total amount and types of output that are produced and consumed in the country, the distribution of those material resources among various segments of society, and people's well-being in a variety of ways.[29] In particular, policymakers may be influenced by the historical patterns of spending and revenues and by the economic impacts of alternative spending and tax policies.

Projected Spending and Revenues in Historical Context. In considering the challenge of putting fiscal policy on a sustainable path, many observers have wondered whether it is possible to return to policies regarding federal spending and revenues that, in earlier years, usually generated deficits that were small relative to GDP and kept the amount of debt held by the public to between about one-quarter and one-half of GDP.

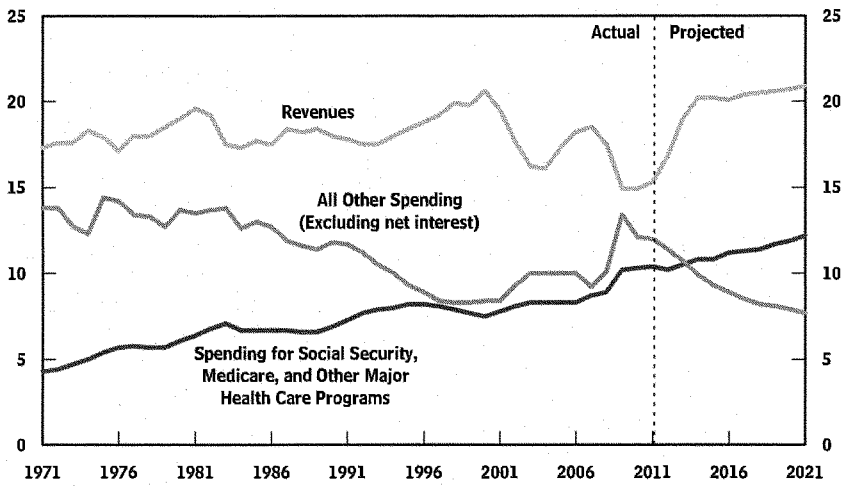
Looking for historical reference points is natural. However, the past combination of policies cannot be repeated when it comes to the federal budget: The aging of the population and rising costs for health care have changed the backdrop for federal

29. For numerous options for changing tax and spending policies, and estimates of their potential budgetary impacts, see Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011).

Figure 8.

Revenues and Spending, Excluding Interest

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: Other major health care programs include Medicaid, the Children's Health Insurance Program, and exchanges, subsidies, exchanges, and related spending.

budget policy in a fundamental way. To see this point most clearly, it is useful to consider the historical experience and CBO's projections for three broad categories of the budget: revenues; spending for Social Security, Medicare, and other major health care programs; and all other spending excluding interest payments.

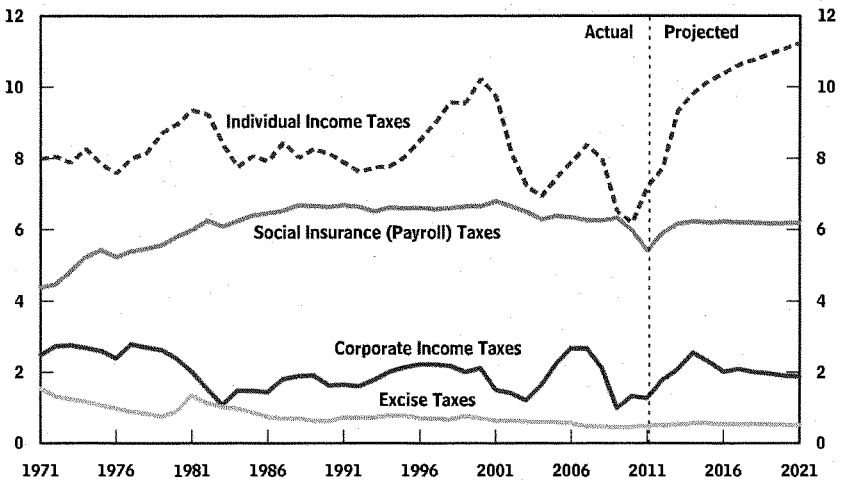
Federal Revenues. Revenues have averaged 18.0 percent of GDP during the past 40 years (see Figure 8). They have varied substantially around that level but show no clear trend. Under current law, revenues equal 15.3 percent of GDP in 2011 and will rise to about 21 percent of GDP in 2021; if, instead, all of the tax provisions that are scheduled to expire under current law were extended, revenues in 2021 would be close to their historical average of 18 percent.

Individual income tax receipts account for most of the projected increase in federal revenues over the coming decade, largely because of scheduled changes in tax law and features of the tax system that cause revenues to rise faster than income over time, as well as projected increases in receipts that reflect an expected rebound in taxable

Figure 9.

Revenues by Source

(Percentage of gross domestic product)



Source: Congressional Budget Office.

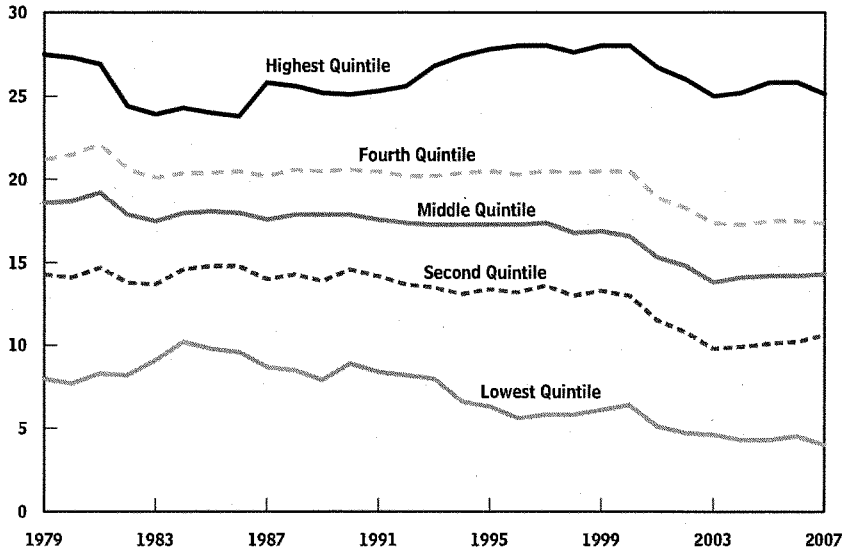
income and some other effects of the economic recovery (see Figure 9). As a result, individual income tax receipts increase steadily in CBO's baseline, from 7.2 percent of GDP in 2011 to 11.2 percent in 2021. By comparison, such receipts stood at 8.0 percent in 1971. Receipts from both social insurance and corporate income taxes are projected to increase modestly relative to GDP over the next 10 years, remaining in the vicinity of their 40-year averages, CBO projects.

Two additional perspectives on the evolution of the federal tax system during the past several decades are provided by changes in the burden of taxes on households at different points in the distribution of income and by changes in tax rates that affect the after-tax return to additional work or saving.[30] Households generally bear the economic cost, or burden, of the taxes that they pay directly, such as individual income taxes (including taxes paid on dividends, interest, and capital gains) and employees' share of payroll taxes. Households also bear the burden of the taxes paid by businesses; in particular, in CBO's judgment (and that of most economists), employers' share of payroll taxes is passed on to employees in the form of lower wages. One measure of the tax burden is the average tax rate—that is, the taxes paid as a share of income.

30. For additional information on these topics, see Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on Finance, *Trends in Federal Tax Revenues and Rates* (December 2, 2010); and Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2012.*

Figure 10.

Average Federal Tax Rates, by Income Quintile, 1979 to 2007



Source: Congressional Budget Office.

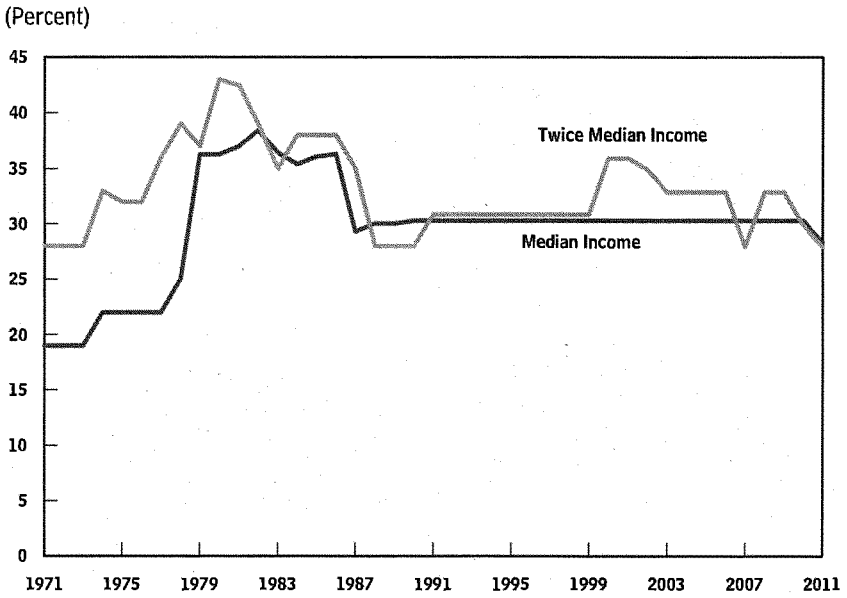
Note: For information on the calculation of average tax rates, the ranking of households, and the allocation of taxes, see Congressional Budget Office, *Average Federal Tax Rates in 2007* (June 2010).

Federal taxes are progressive: Average federal tax rates generally rise with income. In 2007 (the most recent year for which data are available), households in the bottom fifth, or quintile, of the income distribution (with average income of $18,400, under a broad definition of income) paid about 4 percent of their income in federal taxes, while the middle quintile, with average income of $64,500, paid 14 percent, and the highest quintile, with average income of $264,700, paid 25 percent (see Figure 10). Between 1979 and 2007, average tax rates declined, on balance, for households in each quintile of the income distribution.

One measure of the effect of taxes on the returns from working and saving is the marginal tax rate—the tax paid per dollar of extra earnings or dollar of extra income from savings. For a representative family of four with median income, the marginal tax rate on earnings (combining the rates for both federal income and payroll taxes) 40 years ago was around 20 percent (see Figure 11). That rate climbed over the next 10 years as a result of rising payroll tax rates and inflation-driven increases in nominal incomes, which pushed median-income families into higher tax brackets. Following a reduction in income tax rates in 1986, the marginal tax rate for a representative

Figure 11.

Marginal Tax Rates (Income and Payroll) on Earnings for a Family of Four with a Single Earner, 1971 to 2011



Sources: Department of the Treasury, Office of Tax Analysis, Congressional Budget Office.

median-income family has remained at about 30 percent (the rate is 2 percentage points lower in 2011 with the temporary reduction in the payroll tax rate). The marginal tax rate on income from savings has also fallen, on balance, over the past 40 years owing to reductions in statutory tax rates on overall taxable income as well as separate reductions in the tax rates that apply to income from capital gains and dividends.

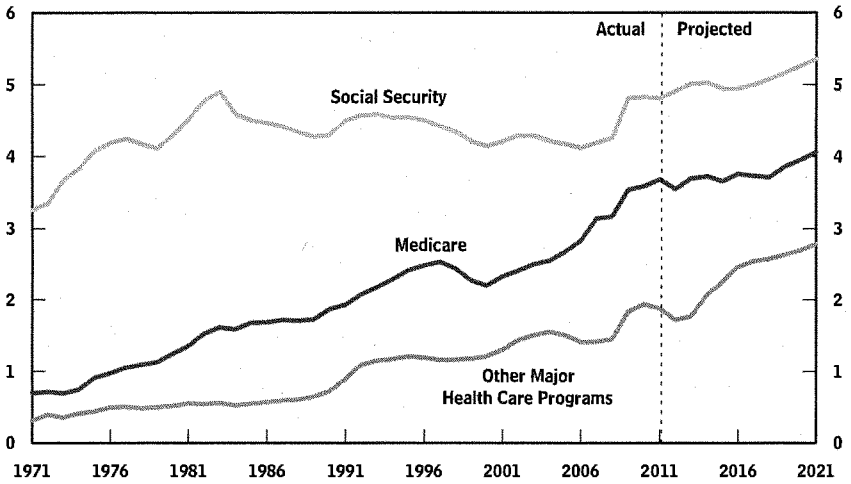
Social Security and Major Health Care Programs. Spending on Social Security and the major health care programs—Medicare, Medicaid, the Children's Health Insurance Program, and insurance subsidies to be provided through exchanges in coming years—will be 12.2 percent of GDP in 2021, according to CBO's projections based on current law. Such spending equals 10.4 percent of GDP in 2011 and represented an average of 7.2 percent of GDP during the past 40 years. The marked increases in such spending experienced during the past 40 years and projected for the next 10 years reflect the aging of the population, rising costs for health care, and changes in federal programs.

Spending for Social Security, which totaled 3.3 percent of GDP in 1971, will equal 4.8 percent in 2011 and is projected to continue growing over the next 10 years,

Figure 12.

Spending for Social Security, Medicare, and Other Major Health Care Programs

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: Other major health care programs include Medicaid, the Children's Health Insurance Program, and exchanges, subsidies, and related spending.

reaching 5.4 percent in 2021 (see Figure 12). Medicare spending (excluding offsetting receipts) is projected to grow even faster, relative to the overall economy, from 0.7 percent of GDP in 1971 to 3.7 percent in 2011 and 4.1 percent in 2021. CBO projects that spending for other major health care programs will rise from 1.7 percent of GDP in 2012 to 2.8 percent in 2021; by comparison, Medicaid spending represented 0.3 percent of GDP in 1971.

Most of the spending for Social Security and the major health care programs goes to benefits for people over age 65, with smaller shares for blind and disabled people and for nonelderly able-bodied people. Specifically, CBO estimates that more than four-fifths of Social Security spending in 2021 will go to benefits for retired workers and their dependents and survivors, with the remaining less than one-fifth going to benefits for disabled workers and their spouses and children. In addition, even with the significant expansion of federal support for health care for lower-income people enacted in last year's legislation, CBO projects that about half of spending for the major health care programs in 2021 will go to people over age 65, with another quarter going to the blind and disabled, and the remaining quarter going to able-bodied nonelderly people.

Other Federal Spending. All spending apart from that for Social Security, the major health care programs, and interest payments on the debt has averaged 11.5 percent of GDP during the past 40 years and equals 12.0 percent in 2011. That broad category includes some mandatory spending as well as all of defense and nondefense discretionary spending. That mandatory spending includes various income security programs, retirement benefits, and other outlays. Defense spending is by far the largest single piece of the broad category, and nondefense discretionary spending includes transportation, health research, education and training, and other programs. Given the assumptions that govern CBO's baseline projections, spending for all of these programs together is projected to equal 7.7 percent of GDP in 2021, the lowest as a share of GDP in the past 40 years.

The mandatory spending in that category is spending apart from that on Social Security and the major health care programs—specifically, outlays for the Supplemental Nutrition Assistance Program (formerly known as Food Stamps), unemployment compensation, some veterans' benefits, federal civilian and military retirement benefits, and other programs (including offsetting receipts). Such spending averaged 2.7 percent of GDP during the past 40 years and totals 3.0 percent in 2011 (see Figure 13). Expected improvement in the economy and other factors reduces that spending to 1.6 percent of GDP by 2021 in CBO's baseline projections.

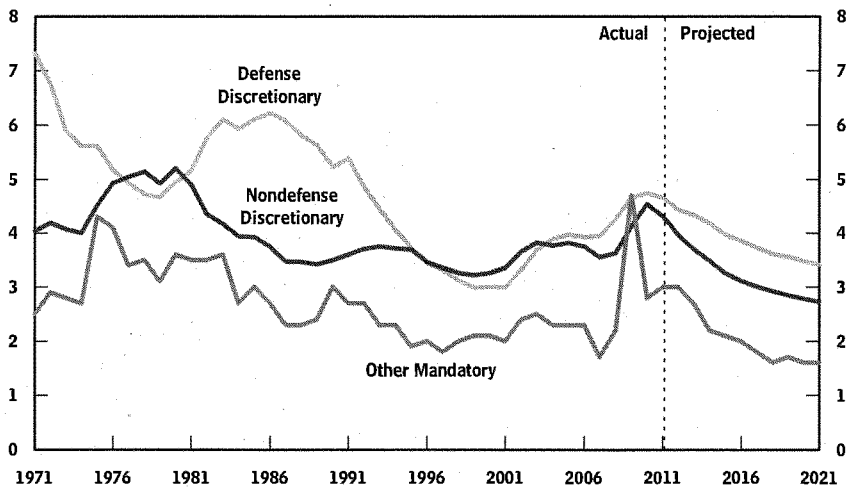
Discretionary spending, which stood at 11.3 percent of GDP in 1971, will total 9.0 percent in 2011. As a result of the caps put in place by the Budget Control Act (and apart from any further reduction in caps triggered by the enforcement provisions of the act), such spending will fall sharply relative to the size of the economy over the next 10 years, reaching 6.1 percent in 2021, CBO projects. That reduction in discretionary spending could be achieved by many different combinations of defense and nondefense appropriations. For example, if defense and nondefense appropriations (excluding war-related funding) were reduced proportionately, relative to the funding that would be necessary to keep pace with inflation, defense spending would total 3.4 percent of GDP in 2021 while nondefense spending would equal 2.7 percent, CBO estimates. By comparison, in 1971, defense and nondefense spending totaled 7.3 percent and 4.0 percent of GDP. Many other combinations of defense and nondefense funding are possible under the caps.

Implications for Future Budget Policy. Combining the various components of spending, total federal spending excluding net interest will represent 19.9 percent of GDP in 2021, according to CBO's projections under current law, a bit above the 40-year average of 18.6 percent (see Figure 14). And the composition of that spending will be noticeably different from what the nation has experienced in recent decades: Spending for Social Security and the major health care programs will be much higher, and spending for all other federal programs and activities, except for net interest payments, will be much lower. Alternatively, if the laws governing Social Security and the major health care programs were unchanged, and all other programs were operated in line with their average relationship to the size of the economy during the past

Figure 13.

Other Federal Spending, by Category

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: Other federal spending includes discretionary spending (both defense and nondefense) and mandatory spending besides that for Social Security and Medicare and other major health care programs (as shown in Figure 12) as well as interest payments on debt held by the public.

When constructing its baseline, CBO assumes that discretionary appropriations will adhere to the statutory caps recently enacted into law by the Budget Control Act of 2011 (Public Law 112-25). Because the caps do not constrain appropriations for military operations in Afghanistan and Iraq (or for similar activities), such outlays are assumed to equal $159 billion (the amount provided for 2011), adjusted in future years for inflation. In this figure, all other funding is assumed to be reduced proportionately, relative to the funding that would be necessary to keep pace with inflation, in order to keep total discretionary funding within the caps on appropriations other than those for war-related purposes.

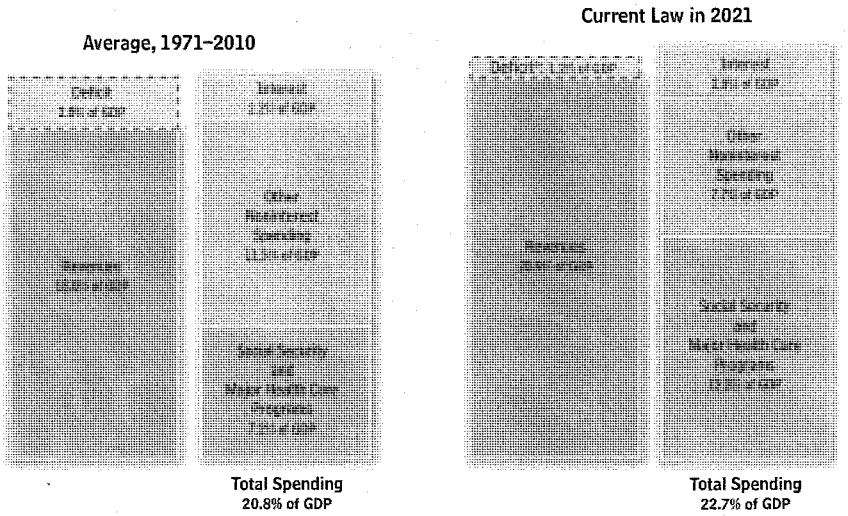
40 years, total federal spending would be projected to be much higher in 2021—nearly 24 percent of GDP. That amount exceeds the 40-year average for revenues as a share of GDP by nearly 6 percentage points—even before interest payments on the debt have been included.

At the same time, the sharp increase in federal debt and a return to more-normal interest rates will boost the government's net interest costs. They are projected to reach 2.8 percent of GDP in 2021, compared with only 1.5 percent of GDP in 2011 and an average of 2.2 percent of GDP during the past 40 years.

What do those numbers imply about the choices that policymakers—and citizens—confront about future policies? Given the aging of the population and the rising costs

Figure 14.

Federal Revenues and Spending Historically and in 2021 Under CBO's Baseline



Source: Congressional Budget Office.

Notes: Major health care programs include Medicare, Medicaid, the Children's Health Insurance Program, and exchange subsidies and related spending.

GDP = gross domestic product.

a. In this figure, the deficit does not equal total spending minus revenue in 2021 because it has been reduced by incorporating effects of provisions related to the Joint Select Committee on Deficit Reduction. The Budget Control Act of 2011 (Public Law 112-25) created that committee to propose further deficit reduction totaling at least $1.5 trillion over 10 years. The act also specified automatic procedures for reducing spending by as much as $1.2 trillion if legislation originating with the new deficit reduction committee does not achieve savings of at least $1.2 trillion. CBO has incorporated that amount of deficit reduction in its baseline (including an amount equal to 0.7 percent of GDP in 2021, which includes savings in debt-service costs) but has no basis for allocating that amount between revenues and outlays. Accordingly, outlay and revenue projections included here exclude the effects of those provisions; the deficit projection, however, includes the effects.

for health care, attaining a sustainable budget for the federal government will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

- Raise federal revenues significantly above their average share of GDP;
- Make major changes to the sorts of benefits provided for Americans when they become older; or

- Substantially reduce the role of the rest of the federal government—that is, defense, the Supplemental Nutrition Assistance Program, unemployment compensation, support for blind and disabled people, other income-security programs, health care programs for people under age 65, veterans' benefits, federal civilian and military retirement benefits, transportation, health research, education and training, and other programs—relative to the size of the economy.

Economic Effects of the Composition of Deficit Reduction. The effects of deficit reduction on the economy would depend not just on the timing of changes in federal spending and taxes, as discussed earlier, but also on the composition of those changes.

In the near term, with a large amount of unused resources in the U.S. economy and short-term interest rates near zero, the principal channel through which policy changes will affect output and employment is through their impact on the economy's overall demand for goods and services. Changes in different types of federal spending and different types of federal taxes could have very different impacts on demand, as CBO has estimated previously.[31] Policies that would generally reduce near-term output and employment the most per dollar of budgetary savings are those that are implemented relatively quickly; have the largest effect on people whose consumption tends to be restricted by their income; or withdraw a time-limited incentive for households, businesses, or state and local governments to increase their spending.

In the medium term and long term, the principal channel through which policy changes would affect output and employment is through their impact on the economy's potential output. Over the long run, the nation's potential to produce goods and services depends on the size and quality of its labor force, on the stock of productive capital (such as factories, vehicles, and computers), and on the efficiency with which labor and capital are used to produce goods and services. The nation's capital stock depends both on public saving (the surpluses, if any, of state and local governments and the federal government) and on private saving (by households and businesses). Efficiency depends on such factors such as production technology, the way businesses are organized, and the regulatory environment. Thus, the federal government's tax and spending policies affect potential output by altering the size and quality of the labor force, the amount of public and private saving, and the efficiency with which labor and capital are combined.

Smaller federal deficits owing to any combination of spending and tax policies imply greater public saving and, other effects aside, national saving. An overall increase in national saving expands the capital stock owned by U.S. citizens over time through an increase in domestic investment, a decrease in net borrowing from abroad, or both. However, changes in spending or tax policies can have other significant effects on potential output depending on the specific nature of those changes.

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31. See Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011* and Statement of Douglas W. Elmendorf, Director, Congressional Budget Office, before the Senate Committee on the Budget, *The Economic Outlook and Fiscal Policy Choices*.

The Economic Impact of Increases in Federal Tax Revenues. Changes in tax policy can affect the incentives for individuals and businesses to save and invest. Increasing effective marginal tax rates on capital income (income derived from wealth, such as stock dividends, realized capital gains, or the owner's profits from a business) would reduce the after-tax rate of return on saving and therefore affect the amount of saving that people chose to do.[32] Specifically, a reduction in the after-tax return on saving would influence private saving in two opposing ways: Lower after-tax returns would tend to decrease saving, but they also would reduce the value of existing assets, making households poorer and thus tending to encourage saving. On balance, the combined effect on saving of lower after-tax returns can be positive or negative, and researchers generally conclude that the effect is small. CBO, in its analyses, projects that increases in marginal tax rates on capital income reduce saving by a small amount.[33]

Changes in corporate tax rules can affect the effective marginal tax rates on investments in different forms of physical capital (equipment, software, and structures) and in research and development related to new types of goods and services and methods of production. They can also affect the organization of production: Because the corporate income tax does not apply to all businesses (for example, it exempts partnerships, sole proprietorships, and corporations with a limited number of shareholders), changes in corporate tax rules can affect how businesses are organized, which can affect the efficiency of the allocation of resources. In addition, corporate tax rules can affect multinational corporations' decisions about where to invest. A country with a relatively high corporate tax rate stands to lose investment to lower-tax countries, and less investment may reduce the amount of capital available to workers and thus reduce wages. Even if the location of investment does not change, the tax base of a country with a relatively high corporate tax rate may erode because businesses can reduce their taxes by recharacterizing where their income is earned to place relatively more of it in low-tax countries.

Changes in tax policy can also affect the incentives for individuals to work or for individuals and firms to invest in the education and skills of the workforce. Increasing effective marginal tax rates on labor income would reduce the after-tax return on work and therefore affect the amount of work that people chose to do. As with a reduction in the after-tax return on saving, a reduction in after-tax earnings would influence labor supply in two opposing ways: Lower after-tax earnings would tend to decrease working because workers would receive less for each extra hour of labor they supplied, but lower after-tax earnings also would reduce workers' earnings for any given amount of work, making it difficult to sustain a certain standard of living and thus tending to

32. The effective marginal tax rate on capital income is the rate that would apply to the return on additional investment. That rate is averaged across all the businesses, people, and institutions that would receive that investment income (and that could face different tax rates).

33. Reductions in saving can, in turn, affect labor supply. A smaller capital stock would lead to lower pretax wage rates, which would weaken people's incentives to work.

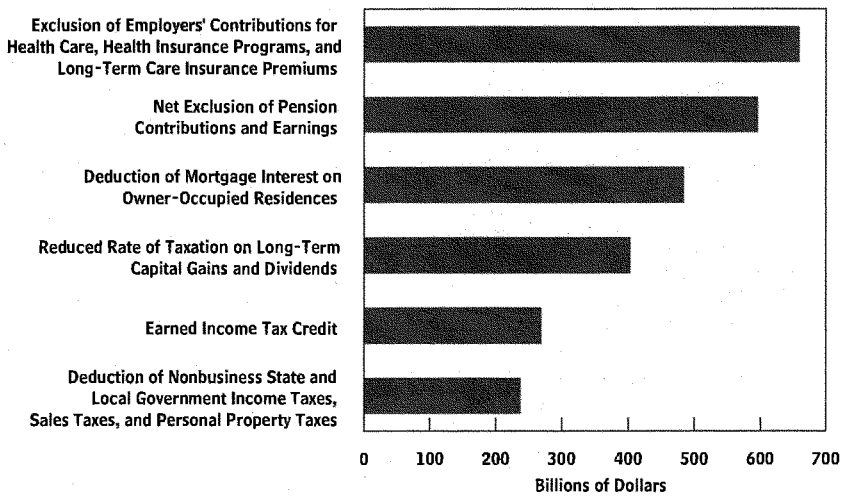
encourage additional work. For many people, the opposing incentives from increasing marginal tax rates largely offset each other, although most economists conclude that, on average, the negative effects of lower after-tax earnings for each additional hour worked slightly outweigh the positive effects of lower after-tax earnings from current working hours. Responses to changes in tax rates can also vary among family members, with secondary earners (for example, the spouse of a household's primary breadwinner) generally responding to a greater extent than primary earners. CBO, in its analyses, projects that increases in marginal tax rates on labor income decrease modestly the hours of labor that workers supply.

Rather than, or in addition to, changes to tax rates, changes in tax policy could involve revisions to other aspects of the tax code. A variety of exclusions, deductions, and exemptions in both the federal individual and corporate income taxes cause the individual and corporate income tax bases—the amount of income subject to taxation—to be significantly smaller than the income reported on tax returns. The most comprehensive measure of income reported on individual income tax returns is gross income—and even that measure omits certain types of personal income that taxpayers are allowed to exclude from reporting. Gross income totaled $8.4 trillion in 2008, but once the allowable deductions and exemptions were subtracted, total income subject to tax (taxable income) was $5.7 trillion—or 67 percent of gross income. In addition to the exclusions, deductions, and exemptions, both the individual and the corporate income tax allow for tax credits that reduce the final tax directly paid by households and businesses. All else being equal, those provisions of tax law reduce tax receipts by hundreds of billions of dollars each year; as a result, tax rates must be higher to collect the same amount of revenues that would be collected in the absence of those provisions.

Income tax exclusions, deductions, exemptions, and credits generally fall into three broad categories: those that modify taxable income to exclude the costs of earning that income, such as an employee's deduction for work-related expenses; those that subsidize or promote certain uses of income that are deemed worthy, such as the deduction for charitable contributions; and those that provide tax relief on the basis of certain income or demographic characteristics, such as the earned income tax credit for lower-income working families and the child tax credit for families with children. Some of those tax provisions are termed "tax expenditures" because they are similar in some ways to government spending. Like spending programs, tax expenditures provide financial assistance to particular activities, entities, or groups of people. They are more similar to entitlement programs than to discretionary spending because they are not subject to annual appropriations and any person or entity that meets the requirements can receive the benefits.

Figure 15.

Cumulative Budgetary Effect of Major Income Tax Expenditures, 2010 to 2014



Source: Joint Committee on Taxation.

Raising tax revenues by reducing tax expenditures would, for many existing expenditures, enhance the allocation of resources and therefore be good for the economy. According to estimates by the staff of the Joint Committee on Taxation, the three largest tax expenditures in the individual income tax law are those providing preferential treatment for employment-based health insurance, retirement savings, and home ownership (see Figure 15). Each of those tax expenditures may help achieve certain societal goals: a healthier population, adequate financial resources for retirement, and stable communities of homeowners. But uncapped tax expenditures may also encourage overconsumption of the favored good or subsidize activity that would have taken place without the tax incentives. For example, those three income tax expenditures may prompt people to consume more health services than are necessary, reallocate existing savings from accounts that are not tax-preferred to retirement accounts, and acquire mortgages and purchase homes beyond their needs.

The Economic Impact of Reductions in Federal Spending. Changes in government spending can affect potential output as well. Some types of spending, such as funding for improvements to roads and highways, may add to the economy's potential output in much the same way that private capital investment does. Other government programs, such as funding for grants to increase access to college education, may raise long-term productivity by enhancing people's skills. Reducing spending in those areas might reduce potential output.

Even among types of federal spending that contribute to potential output, the effects of different policies can vary greatly. For example, spending for basic research and education may affect output only after a number of years, but once those investments begin to boost output, they may pay off over more years than would the average investment in physical capital (in economic terms, they may have a low rate of depreciation). Moreover, even within a specific program, how those funds are allocated also matters a great deal. Although some specific government investments in a particular category may be as productive as private investment, other projects probably fall short of that benchmark.

On a more fundamental level, the government provides a crucial role in maintaining the legal and institutional framework within which the economy operates. Government spending on the justice system, for example, supports the smooth functioning of the economy by protecting private property rights and enforcing contracts. Cutbacks in such spending could diminish potential output.

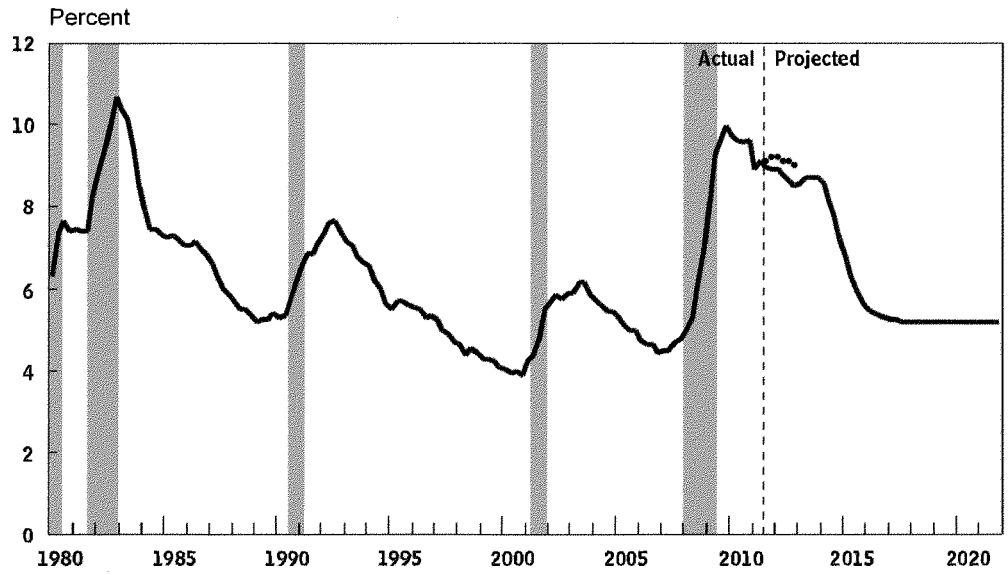
Congressional Budget Office

Confronting the Nation's Fiscal Policy Challenges

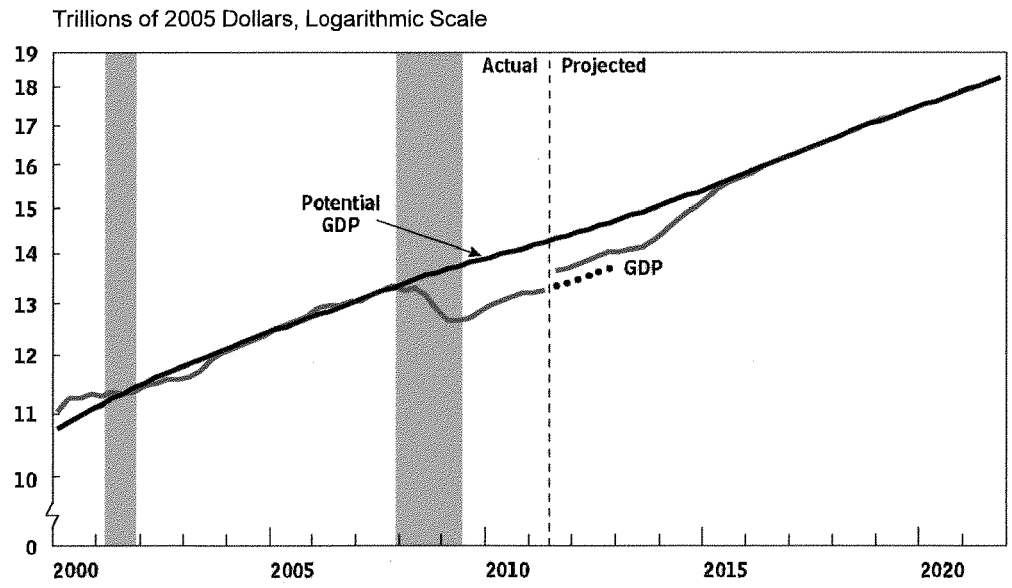
September 13, 2011

Douglas W. Elmendorf
Director

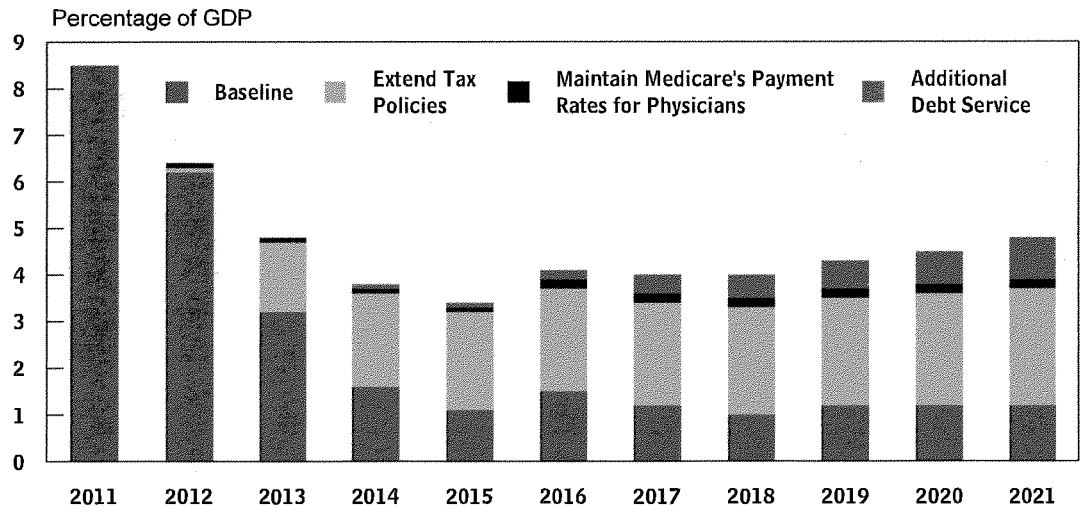
Unemployment Rate



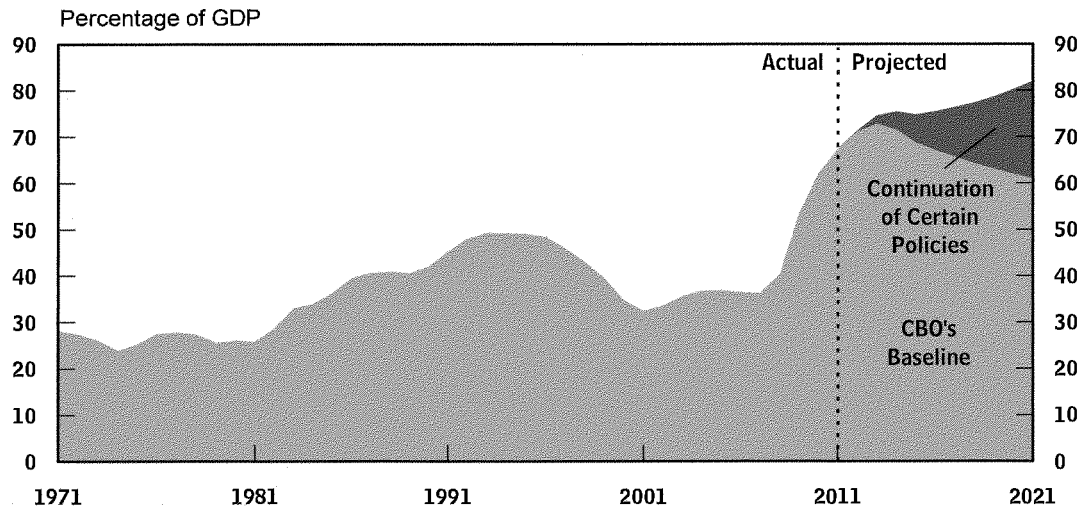
Real Gross Domestic Product



Deficits in CBO's Baseline and Assuming a Continuation of Certain Policies



Federal Debt Held by the Public



Enforcement Procedures of the Budget Control Act

If no legislation originating from this Committee was enacted, the following would occur over the coming decade:

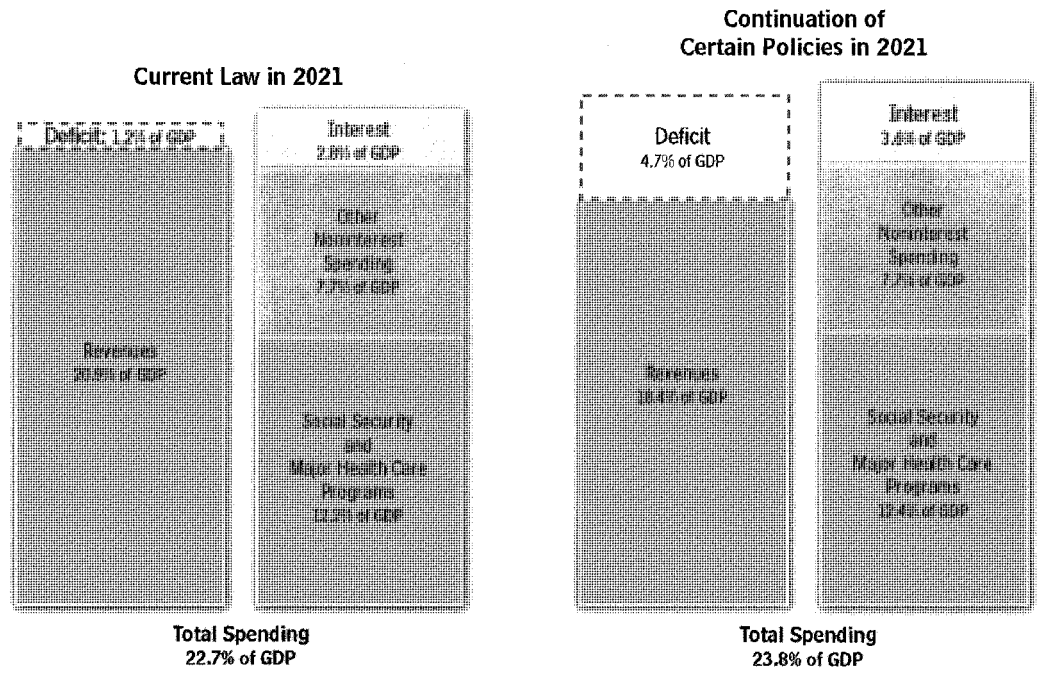
- Reductions in the caps on discretionary appropriations for defense would cut outlays by about $450 billion.
- Reductions in the caps on discretionary appropriations for nondefense purposes would cut outlays by about $300 billion.
- Reductions in mandatory spending would yield net savings of about $140 billion.
- Debt-service costs would decline by about $170 billion.

The total reduction in deficits would be about $1.1 trillion.

Fiscal Policy Choices

- How much deficit reduction should be accomplished?
- How quickly should deficit reduction be implemented?
- What forms should deficit reduction take?

Federal Revenues and Spending in 2021 Under CBO's Baseline or with a Continuation of Certain Policies



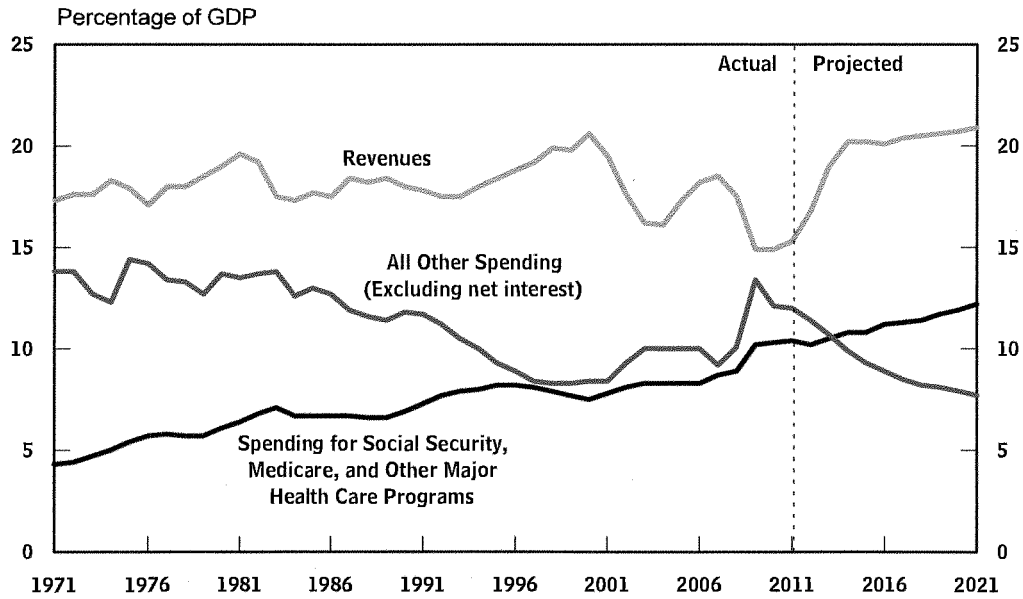
Trade-offs in the Timing of Deficit Reduction

- Cutting spending or increasing taxes slowly would lead to a greater accumulation of government debt and might raise doubts about whether the longer-term deficit reductions would ultimately take effect.
- Implementing spending cuts or tax increases abruptly would give little time to plan and adjust. In addition, and particularly important given the current state of the economy, immediate spending cuts or tax increases would represent an added drag on the weak economic expansion.

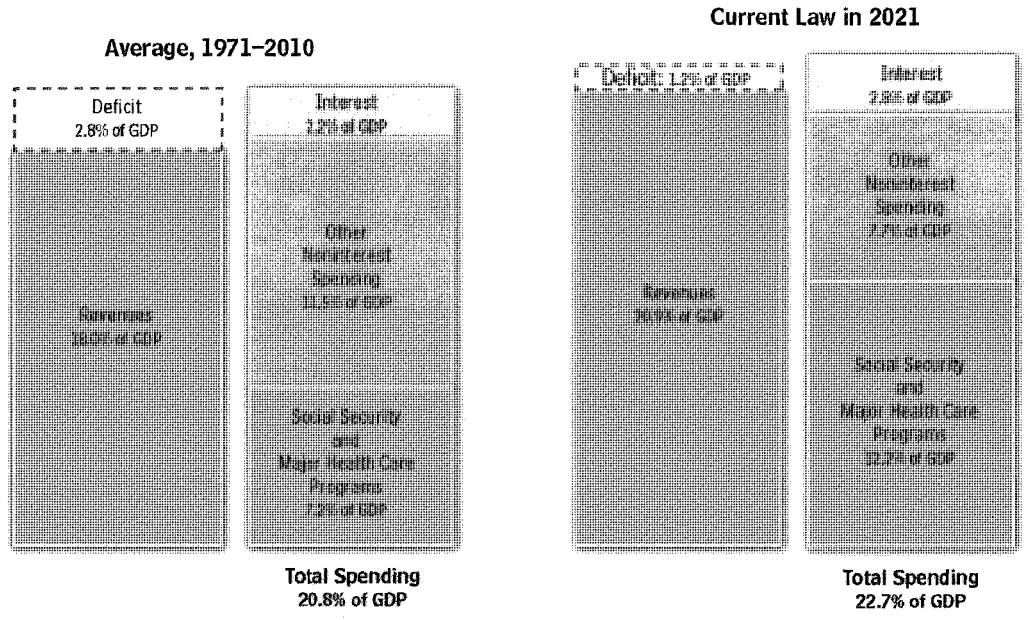
Near-Term Economic Effects of Deficit Reduction

- Credible policy changes that would substantially reduce deficits later in the coming decade and beyond—without immediate spending cuts or tax increases—would both support the economic expansion in the next few years and strengthen the economy over the longer term.
- There is no inherent contradiction between using fiscal policy to support the economy today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential.

Revenues and Spending, Excluding Interest



Federal Revenues and Spending Historically and in 2021 Under CBO's Baseline



Conclusion

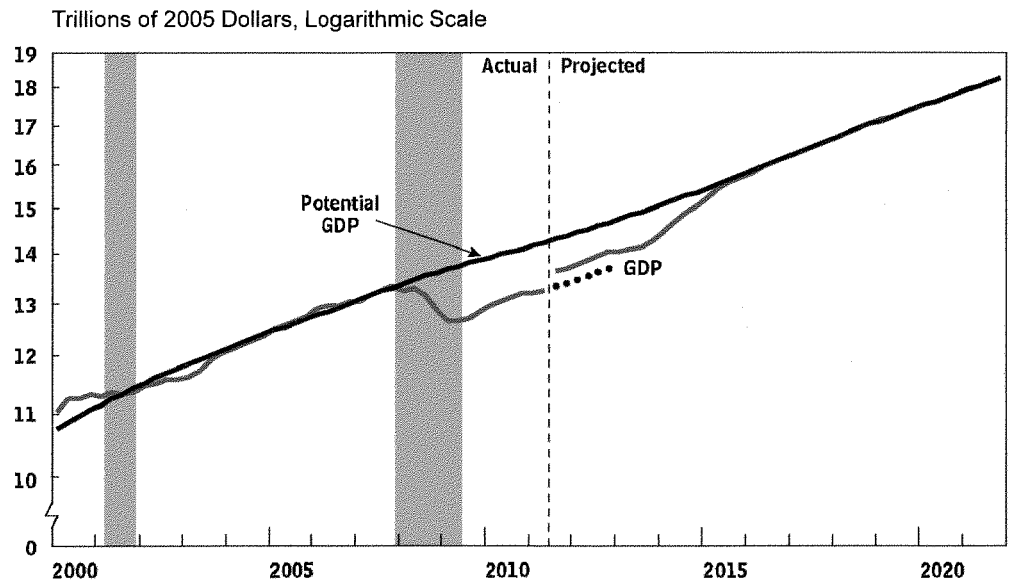
Given the aging of the population and rising costs for health care, attaining a sustainable federal budget will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

- Raise federal revenues significantly above their average share of GDP;
- Make major changes to the sorts of benefits provided for Americans when they become older; or
- Substantially reduce the role of the rest of the federal government relative to the size of the economy.

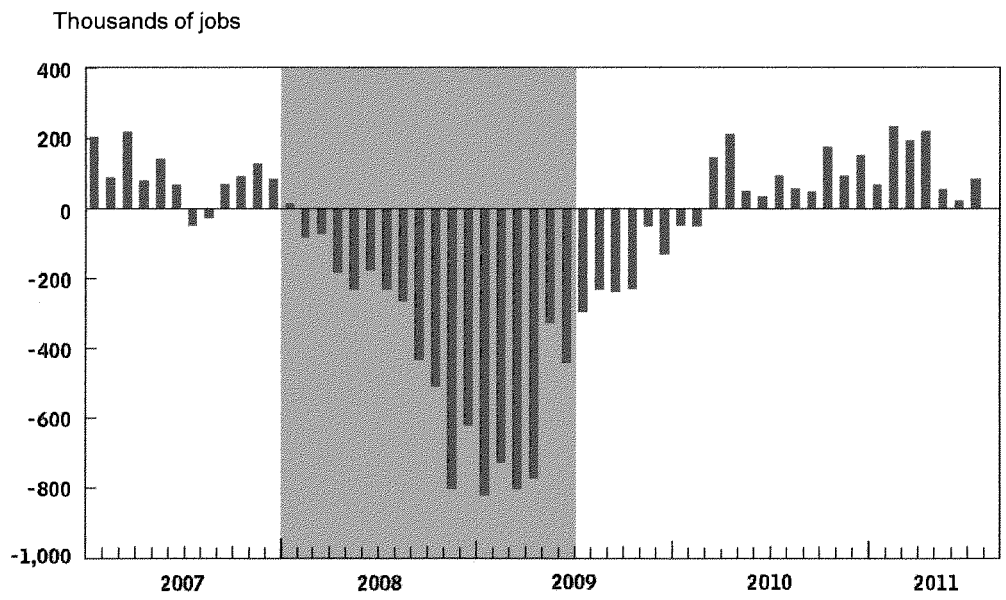
Congressional Budget Office

Full Set of Figures from the Written Testimony

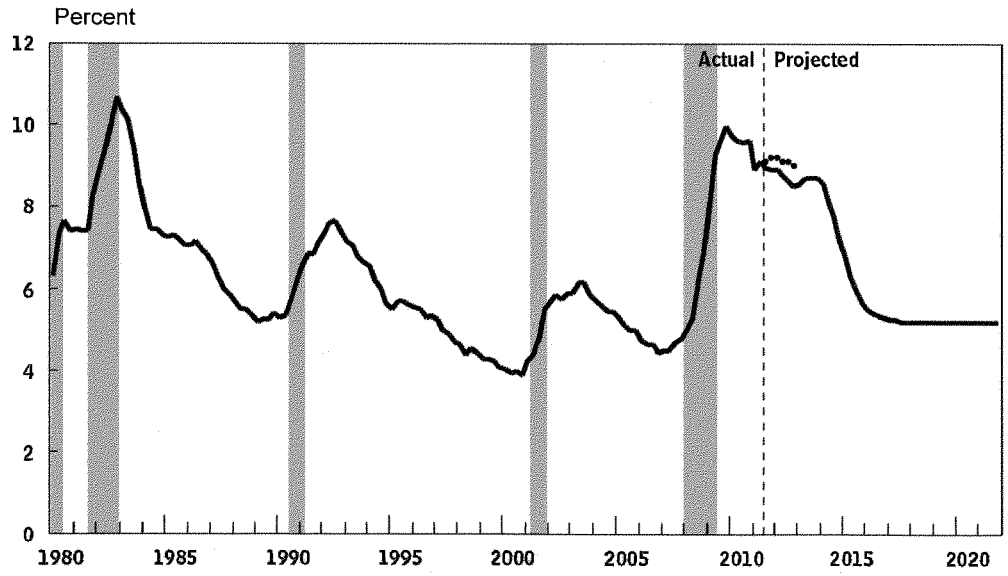
Real Gross Domestic Product



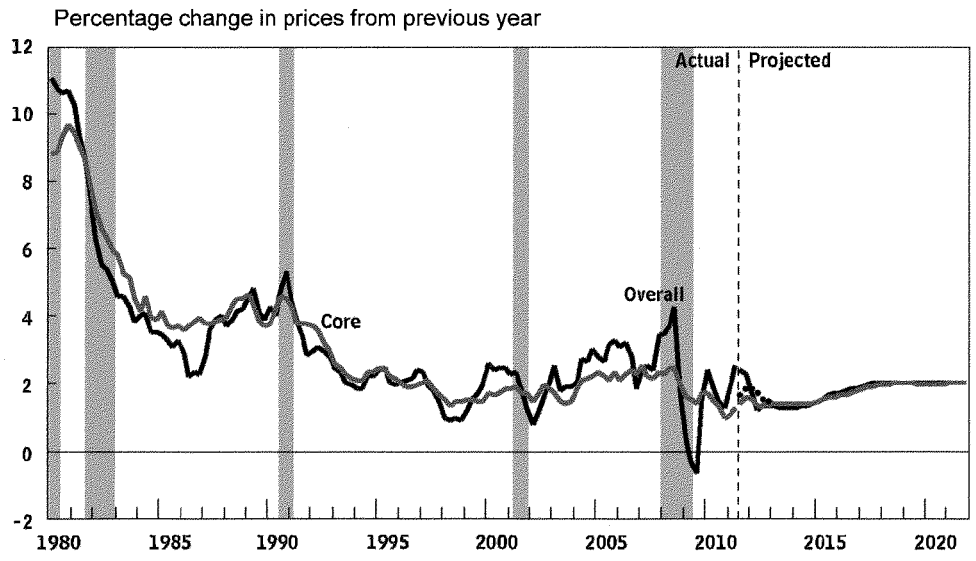
Net Job Growth per Month



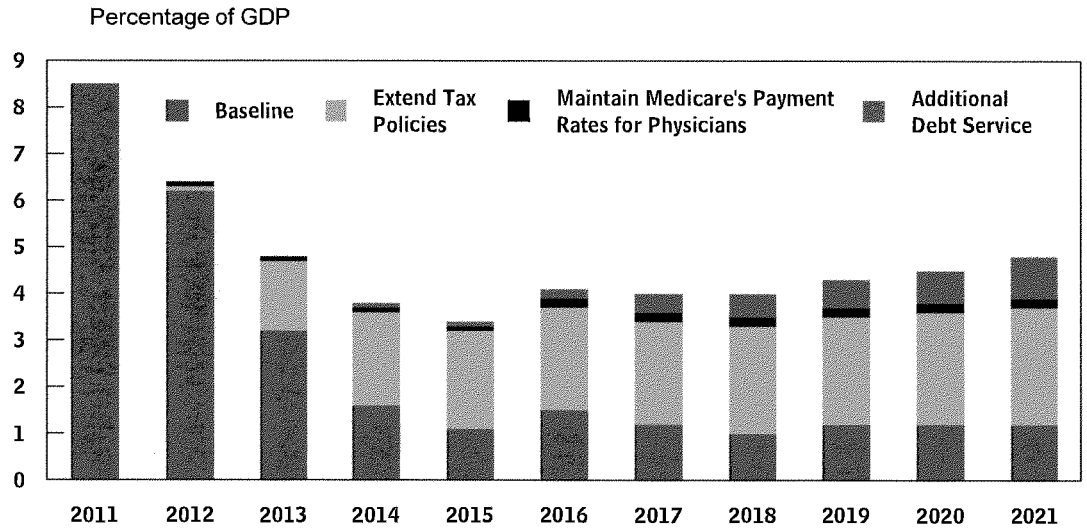
Unemployment Rate



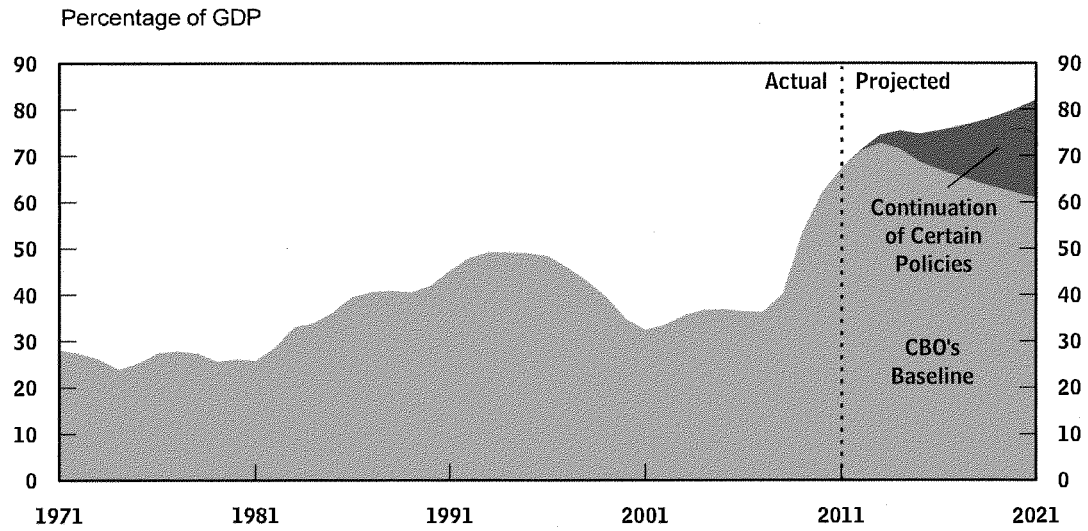
Inflation


Percentage change in prices from previous year
12
10
8
6
4
2
0
-2
1980
1985
1990
1995
2000
2005
2010
2015
2020
Actual
Projected
Overall
Core

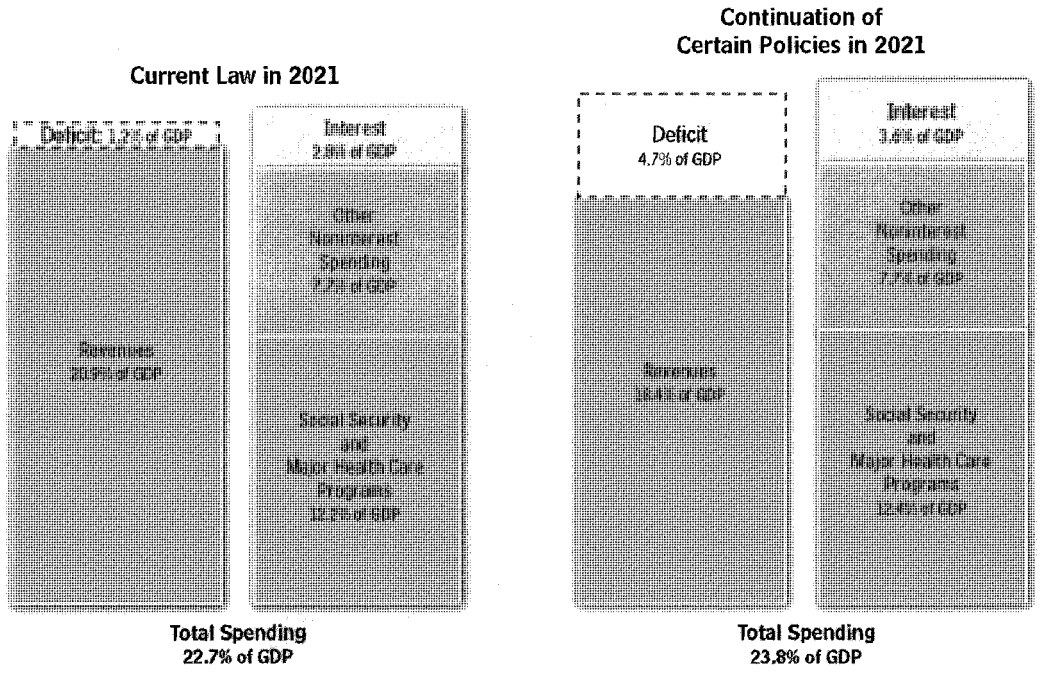
Deficits in CBO's Baseline and Assuming a Continuation of Certain Policies



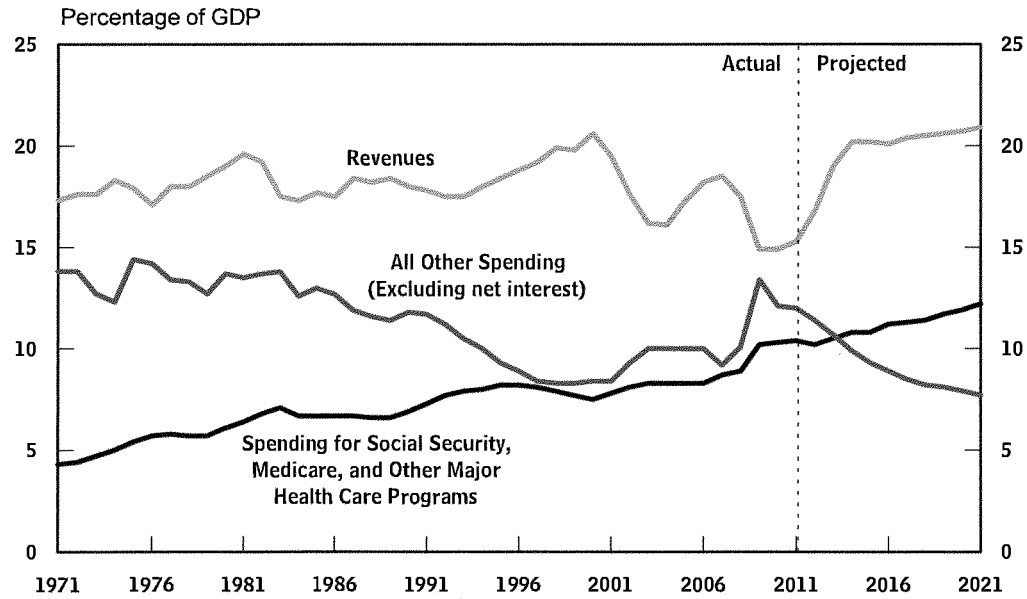
Federal Debt Held by the Public



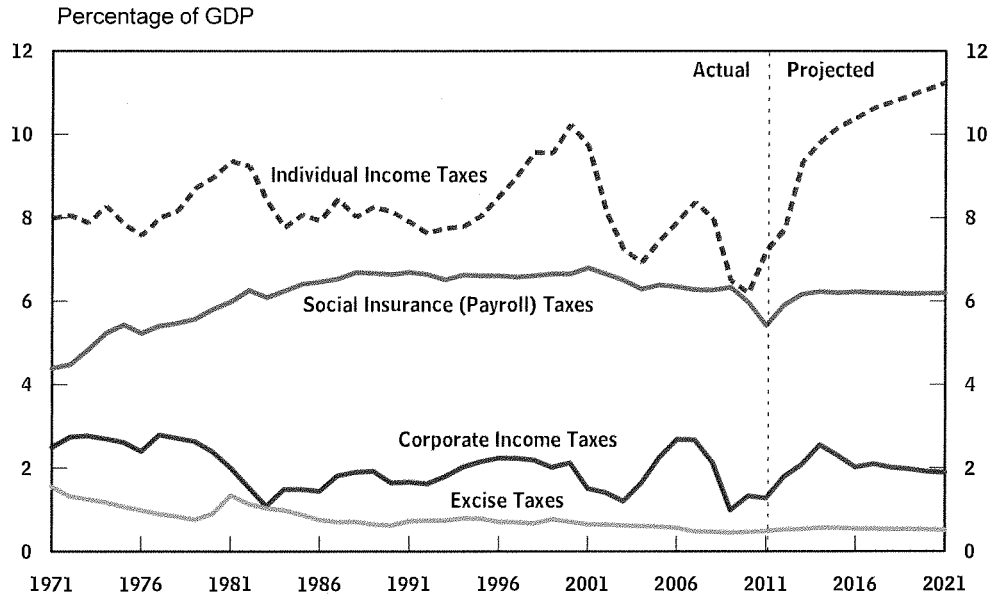
Federal Revenues and Spending in 2021 Under CBO's Baseline or with a Continuation of Certain Policies



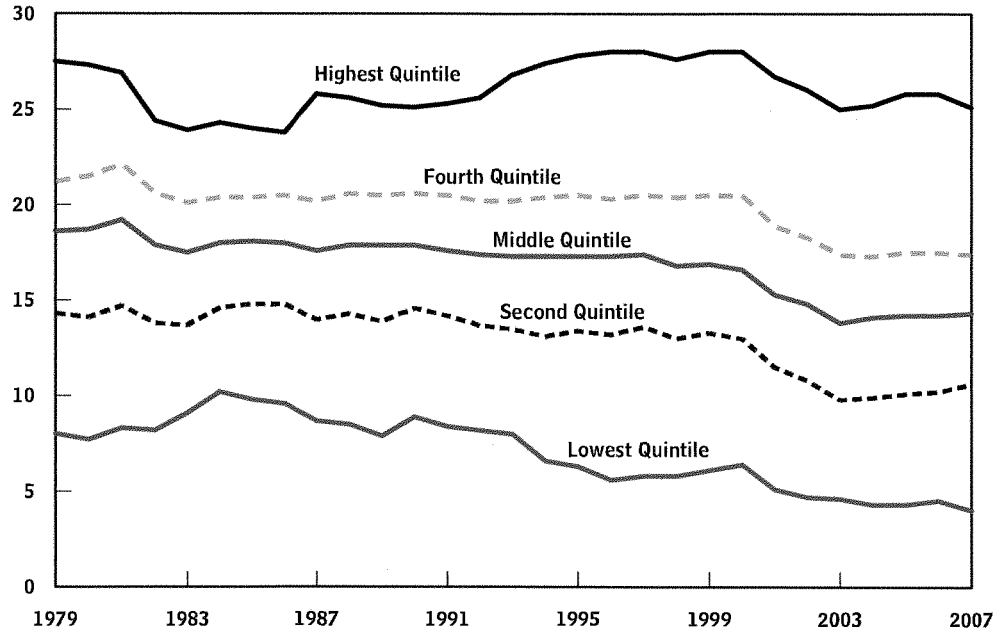
Revenues and Spending, Excluding Interest



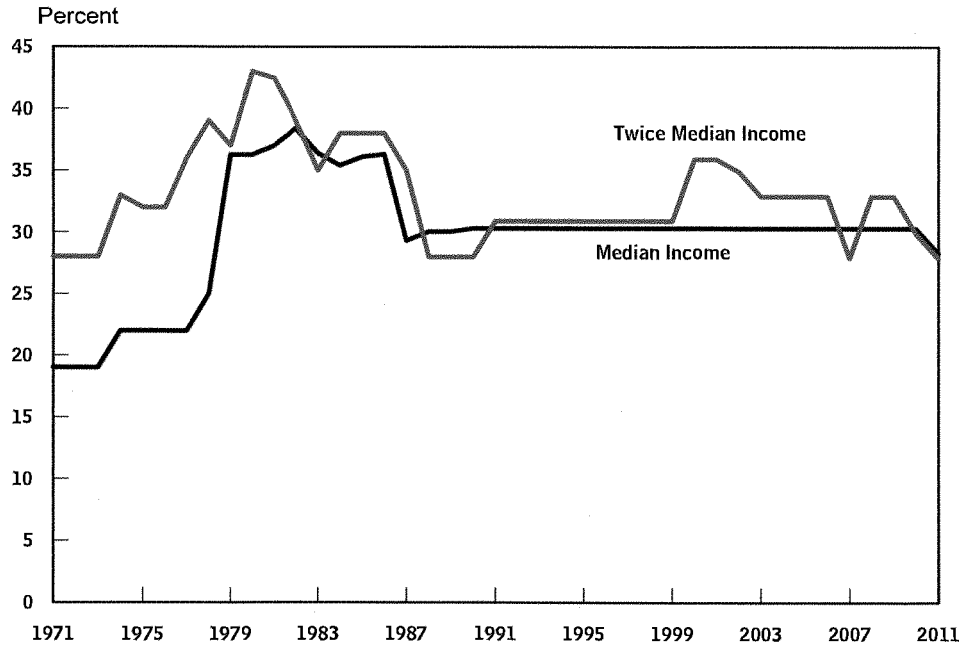
Revenues by Source



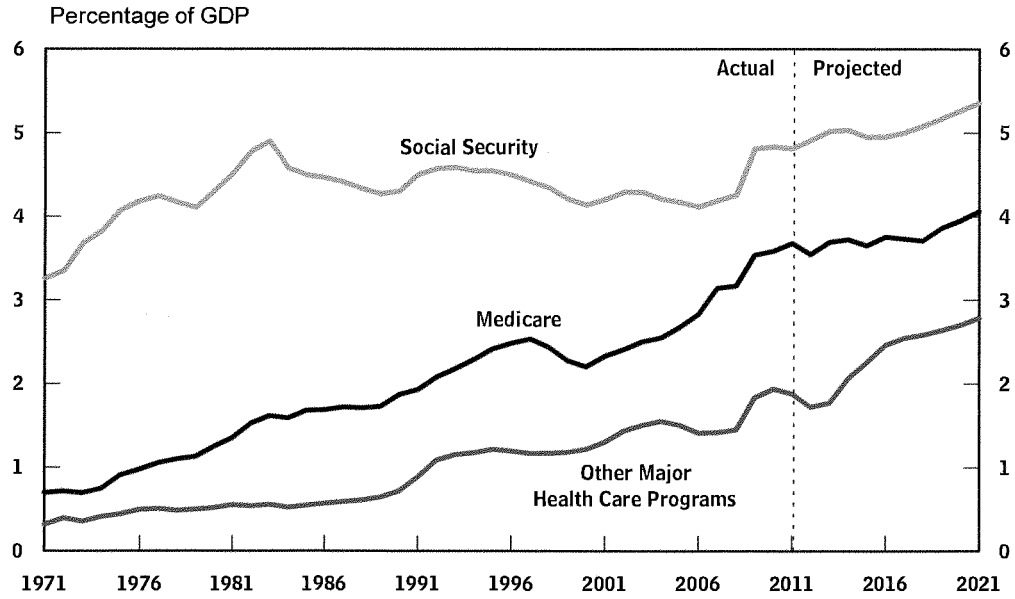
Average Federal Tax Rates, by Income Quintile,1979 to 2007



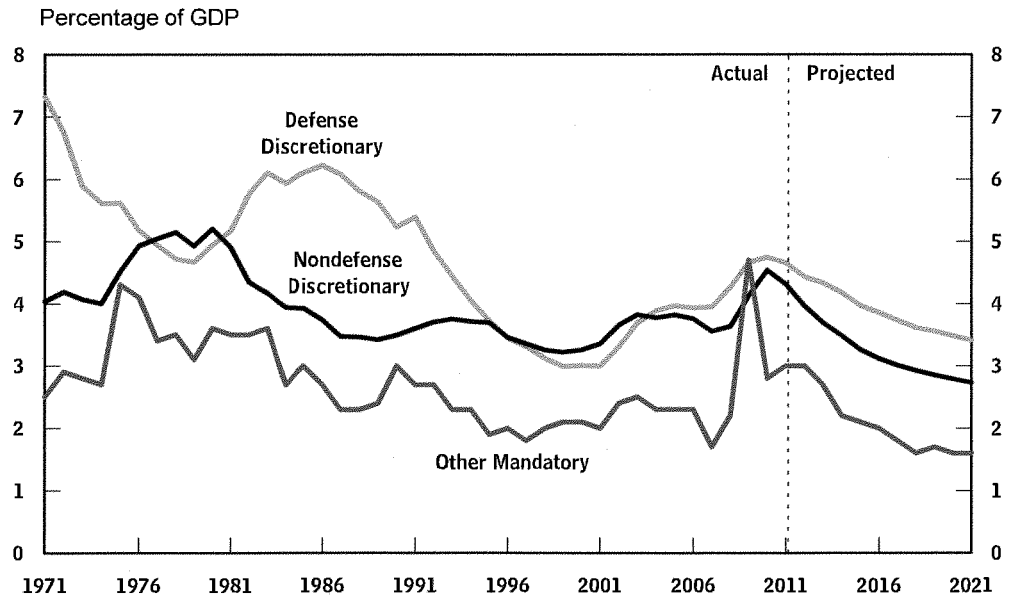
Marginal Tax Rates (Income and Payroll) on Earnings for a Family of Four with a Single Earner, 1971 to 2011



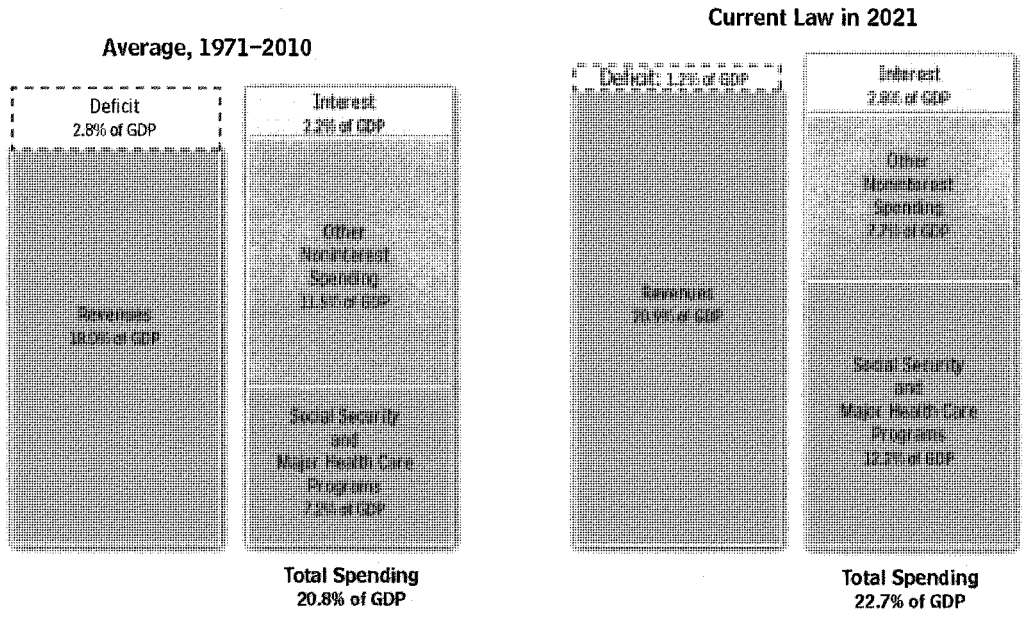
Spending for Social Security, Medicare, and Other Major Health Care Programs



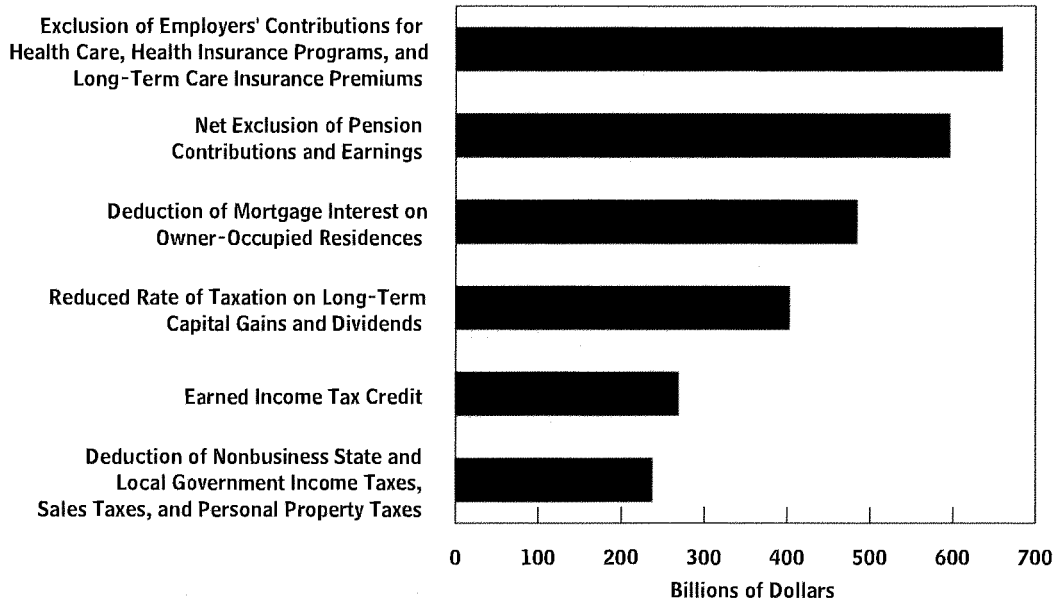
Other Federal Spending, by Category



Federal Revenues and Spending Historically and in 2021 Under CBO's Baseline



Cumulative Budgetary Effect of Major Income Tax Expenditures, 2010 to 2014



Questions for the Record
CONGRESSIONAL BUDGET OFFICE

Question from Senator Kerry:

As we discussed, the last five times there have been surpluses, revenues have ranged between 19.5 percent and 20.6 percent of GDP. All five of these surpluses occurred since 1969. The budget has been in surplus 12 times since 1940. Seven of the surpluses occurred between 1947 and 1960; in those surplus years, revenues ranged as a share of GDP from 14.5 percent to 17.8 percent. Those surpluses were achieved in years that pre-date the creation of Medicare and Medicaid. Does the historical data since 1969 more closely reflect the commitments of our modern government?

Answer:

The federal government is currently confronting significant and fundamental budgetary challenges that differ in nature and magnitude from those it has faced in previous periods: With our aging population and rising costs for health care, the combination of budget policies that has worked in the past cannot be maintained in the future.

It is certainly true that historical data since 1969 provide somewhat more-relevant information about current government spending commitments than data for much-earlier years, but even the past 40 years of history are not necessarily a good predictor of the future: It is clear that if current policies are continued in the coming years, the aging of the population and the rising costs of health care will boost federal spending, as a share of the economy, well above both the amounts spent in earlier years and the average revenues (as a share of the economy) that the federal government has collected in the past. For example, if the laws governing Social Security and the major health care programs were unchanged, and all other programs were operated in line with their average relationship to the size of the economy during the past 40 years, total federal spending would be projected to be much higher in 2021—nearly 24 percent of GDP—than it has been in recent decades. That amount exceeds the 40-year average for revenues as a share of GDP by nearly 6 percentage points—even before interest payments on the debt have been included.

Thus, the nation cannot continue to sustain the spending programs and policies of the past with the tax revenues it has been accustomed to paying. Given the aging of the population and rising costs for health care, attaining a sustainable federal budget will require the United States to deviate from the policies of the past 40 years in at least one of the following ways:

- Raise federal revenues significantly above their past average share of GDP;

- Make major changes to the sorts of benefits provided for Americans when they become older; or

- Substantially reduce the role of the rest of the federal government relative to the size of the economy.

Question from Senator Baucus:

Much of the hearing focused on historical levels of spending and revenue. But as you explained in your testimony, "The aging of the population and rising costs for health care have changed the backdrop for federal budget policy in a fundamental way." Given these fundamental changes, how would a return to historical levels of spending for Social Security and health programs translate to cuts in currently scheduled benefits in 2021?

Answer:

Social Security, Medicare, and Medicaid have been expanded and modified many times since their inception; as a result, comparisons with spending levels of the past would reflect such programmatic changes, as well as the aging of the population and changes in the cost of health care. In 2000, for example, spending for those three programs amounted to 7.5 percent of gross domestic product (GDP). In CBO's current-law baseline, spending for those three programs is projected to total nearly 12 percent of projected GDP in 2021. To get back down to the 2000 level (as a share of GDP) in 2021 would require reductions, relative to current law, of more than one-third.

The underlying demographic and economic trends, by themselves, would necessitate significant cuts just to return 2021 outlays for those programs to the share of GDP they were in 2011. Spending for Social Security, Medicare, and Medicaid, in total, amounted to a little more than 10 percent of GDP in that year. If policies were changed so that those three programs maintained their current level of spending relative to GDP, outlays in 2021 would be about 12.5 percent—about $350 billion—lower than projected in CBO's most recent current-law projections.

Question from Senator Baucus:

Can you describe where our current level of defense spending stands in historical terms? For instance, how does our current defense spending compare with spending during the Korean War, the Vietnam War, the Reagan Administration, and the Cold War average?

If the sequester were triggered, how would defense spending compare with spending during the Korean War, the Vietnam War, the Reagan Administration, and the Cold War average?

Answer:

There are a number of different ways to compare spending at different points in time. The following are comparisons of spending over time on the military activities of the Department of Defense (DoD) as a share of gross domestic product (GDP) and in constant 2011 dollars (that is, adjusted for inflation).

Spending by DoD as a Share of GDP
Spending by the Department of Defense on military activities amounted to about 4.5 percent of GDP in 2011, slightly lower than the 4.6 percent share in 2010. Although high by recent standards (that 4.6 percent share in 2010 was higher than in any year since 1992), that level of spending is not at all high by historical standards. Prior to the 1990s, DoD's spending in the post-World War II era ranged from a high of almost 12 percent of GDP in 1953 (during the Korean War) to a low of 4.6 percent in 1978. As a share of GDP, DoD's spending on military activities averaged:

- 9.6 percent during the Korean War (1950-1953);
- 7.3 percent during the Vietnam War (1965-1973);
- 5.8 percent during the Reagan Administration (1981-1989); and
- 6.7 percent during the Cold War (1946-1991; data begin in 1948)

If reductions in the annual caps on discretionary funding are triggered for the 2013-2021 period as specified in the Budget Control Act (specifically, if legislation emanating from the Joint Select Committee on Deficit Reduction to lower deficits over the 2012-2021 period is not enacted), CBO estimates that DoD's spending as a share of GDP would average 3.3 percent over that period and fall to a low of 3.0 percent by 2021. For this estimate, CBO assumed that funding each year for overseas contingency operations (OCO—such as the operations in Afghanistan) would equal the annualized level in the current continuing resolution for 2012 (that is, $119 billion) adjusted for inflation. Under that scenario, such spending would account for roughly 21 percent of DoD's spending, on average, over the 2013-2021 period, meaning that non-OCO spending by DoD would fall to about 2.4 percent of GDP by 2021 if defense spending is subject to such caps on new non-OCO funding.

Spending by DoD in Constant 2011 Dollars
DoD's spending for 2011 amounted to $678 billion, an all-time high. In constant 2011 dollars (calculated using the GDP chain-type price index), past peak levels of spending were about $300 billion during the Korean War, $400 billion during the Vietnam War,

and $480 billion in 1989 (a figure that was not reached again until 2004). In 2011 dollars, annual spending by DoD on military activities averaged about:

- $240 billion during the Korean War;
- $340 billion during the Vietnam War;
- $445 billion during the Reagan Administration; and
- $310 billion during the Cold War (data begin in 1948).

If reductions in the annual caps on discretionary funding specified in the Budget Control Act are triggered, CBO projects that DoD's outlays would average $590 billion, in 2011 dollars, over the 2013-2021 period—including an average of $121 billion of annual OCO spending (assuming that OCO funding in each year is equal to the annualized amount in the current continuing resolution for 2012, adjusted for inflation). Even without any OCO spending, those amounts would exceed average spending, in 2011 dollars, during the previous periods shown above.

(Note: DoD spending accounts for over 95 percent of total spending in the defense budget function. Most of the remaining 5 percent of spending in that budget function is for atomic energy activities carried out by the Department of Energy. CBO does not have long-term historical data for that part of defense spending.)

Representative Jeb Hensarling

Opening Statement

The purpose of today's hearing is to highlight the unsustainable nature of our nation's debt and I believe the term "unsustainable," frankly, is understated. I certainly want to welcome Dr. Doug Elmendorf, director of the CBO, who when I was a member of the budget committee, I had an opportunity to work with, truly a professional in this town. Sir, I look forward to your testimony.

In the last organization meeting we had, I mentioned the work by Professors Carmen Reinhart and Kenneth Rogoth, This Time is Different. Through their historical study of financial crises, they indicated that letting debt rise above 90% of GDP was frankly a recipe for bad things to happen to a nation. Well, this year our nation has raced past that tipping point. Our gross debt has now surpassed 100% of GDP. And I believe there are two crises facing our nation, not just a debt crisis, but a jobs crisis, and they are clearly connected. The explosive growth in our nation's debt hampers our job creation today.

Last week I quoted a small business person from the 5th District of Texas on the subject; today I want to quote from a few more—names you may be more familiar with.

Bernie Marcus, former chairman and CEO of Home Depot, which employs 255,000: "If we continue this kind of policy we are dead in the water. If we don't lower spending, if we don't deal with paying down the debt, we are going to have to raise taxes. Even brain-dead economists understand that when you raise taxes you cost jobs."

Mike Jackson, CEO AutoNation, 19,000 employees: "The best thing this town could do to help this economic recovery become sustainable is to deal with the deficit and to see tax reform."

Jay Fishman, Chairman and CEO of Traveler's insurance company: "What is really weighing on their minds is not knowing how the coming explosion in federal debt is going to affect their borrowing costs, liquidity, cost of doing business, and prices."

Finally, two or three months ago the U.S. Chamber came out with their small business survey; 83% of their respondents said that America's debt and deficit have a negative impact on their businesses.

So I would make the point, Madam Co-chair, that a path to credible deficit reduction is a jobs program, and we should not be deterred in that mission. We have a spending driven debt crisis. The deficit reduction will be a jobs plan, and I look forward again to hearing the comments of our colleagues as we go about this important work, and of the testimony of Dr. Elmendorf.

Senator John Kerry

Opening Statement - Hearing on "The History and Drivers of our National Debt"

"We all agree that we're facing an unsustainable financial future. Under CBO's alternative fiscal scenario, debt will reach 82 percent of GDP by 2021, higher than any year since 1948. We all agree we can't let that happen.

"But to avoid that dismal scenario, we have to be clear-eyed about the way we got here and the forces keeping us on that dangerous trajectory. This road began now more than a decade ago. Economic meltdown, two wars, rounds of the largest tax cuts in history, and efforts to forestall larger economic collapse contributed. Demographic challenges loom large in the out years. It is more than just a "spending problem" narrowly defined, and we do the dialogue a disservice by oversimplifying it: both because if it was a mere spending issue, it'd be a lot easier to solve – but also because many tax expenditures are a form of spending in disguise.

"But while there may be partisan interpretations of how we got here, there is bi-partisan consensus not just about the urgency of action to dig us out of this mess, but about the approach it requires. Three bipartisan groups looked at this problem in recent months – Rivlin/Domenci, Simpson/Bowles, and the so-called Gang of 6 – and they've all said that any real solution needs to be balanced with a mix of revenues and spending cuts and long term reforms.

"We benefit from their guideposts, and we also benefit from the cautionary lessons of other countries. That means not fixating on austerity measures alone, particularly in the short term.. We've seen the damage they've caused across Europe, and we can't put our own fragile economy in jeopardy by taking actions that will slow economic growth and decrease job creation. We need growth, not just revenue, and not just cuts. In a recent speech, IMF managing Director Lagarde warned Europe about "drastic upfront belt tightening" and recommended that the United States "strike the right balance between reducing public debt and sustaining the recovery—especially by making a serious dent in long-term unemployment" That's the path we need to take – because any economist will tell you, creating jobs today helps reduce the deficit tomorrow.

"Last week, the Committee for a Responsible Budget, a bipartisan organization which includes some of our country's leading experts on budget issues, including the co-chairs of the Fiscal Commission, recommended that this Committee "go big, go long, and go smart.

"Director Elmendorf's testimony today helps solidify the reality that we need to "go big" and reach savings of more than $1.5 trillion to address long-term deficits. We need to "go long" and address our long-term budget issues. And most importantly of all we need to "go smart" and address the budget without preconceived dogmas or political agendas. So I look forward to delving more deeply into these issues today, and helping us shape recommendations for this Committee and this Congress to adopt.

Thank you."

Senator Patty Murray

Opening Statement

This hearing of the Joint Select Committee on Deficit Reduction will now come to order.

"As my co-chair Representative Hensarling mentioned at our meeting on Thursday, we have agreed to alternate chairing these hearings, with him chairing those held on the House side, and me the ones here in the Senate.

"I want to recognize all of my fellow committee members, as well as our witness, Dr. Elmendorf, for joining us.

"And I want to thank the members of the public here today—we appreciate your presence, and ask that you help us maintain decorum by refraining from any displays of approval or disapproval during the hearing.

"Before I start, I want to announce that the Joint Select Committee's website is now up and running.

"Members of the public can go to deficitreduction.gov where they can provide input and ideas to the Committee, and where all public hearings will be streamed live starting today.

"Today we are going to start off with brief opening statements from committee members—fifteen minutes for the Democrats, and then fifteen minutes for the Republicans.

"We will then hear from Dr. Elmendorf, and following his testimony we will have some time for questions and answers.

"The topic of today's hearing is "The History and Drivers of Our Nation's Debt and Its Threats.

"I think this is a fitting opening for the difficult work this Committee has ahead of us.

"We are tasked with tackling a problem that wasn't created overnight. That didn't come about just in the last few years. Our debt and deficit problems have a lengthy and complex history.

"And we will not be able to truly address them without a deep and honest understanding of the policies and circumstances that have led to where we are today.

"The challenges we face are real, and our task will not be easy—but I am confident we can get it done, because we've done it before.

"Like a number of my fellow committee members, I was here back in the '90s when we were facing serious deficits and a mounting public debt.

"And I was proud to work with President Clinton and Republicans in Congress to balance the budget in a way that truly worked for the American people.

"A way that made the smart cuts to government spending that were desperately needed, included revenues, and continued to make the strong investments in health care, education, and infrastructure that helped lay down a strong foundation for economic growth.

"The balanced and bipartisan work we did not only balanced the budget, and it not only helped set our country up to create millions of new jobs, but it also put us on track to completely pay down our debt by 2012—which was truly a great accomplishment.

"As we all know, a lot has changed since then. For many reasons, our deficit and debt have exploded in the years since. Some of these reasons have to do with government policies here at home, some with decisions made regarding our policies overseas—and others due to the financial and economic crisis that has devastated families and businesses here over the last few years.

"I am looking forward to hearing more about the scope and drivers of our deficit and debt from Dr. Elmendorf today.

"And I am confident the members of this Committee can help bring our nation together once again around a balanced and bipartisan path to fiscal health and economic growth."

Senator Rob Portman

WASHINGTON, D.C. – U.S. Senator Rob Portman (R-Ohio) a member of the Joint Select Committee on Deficit Reduction, today made the following opening remarks, as delivered, during the Committee's hearing on "The History and Drivers of Our Nation's Debt and Its Threats."

Thank you, Madame Chair. And welcome Director Elmendorf. As you all know, this Committee is going to be relying heavily on your analysis and for your scoring. And to you and your colleagues behind you, I thank you in advance for the many hours you will put in. Our success or failure will depend in large measure on your good work, so we need you and look forward to your responses to our many requests.

I listened to my colleagues' comments this morning and I must say I'm delighted you're here today because we need to have a little objective analysis of how we got to where we are and I know you'll provide that. I hope you'll also talk a little about the appropriate baseline for us to use to look at our proposals. It's always going to be compared to what? Whether it's a spending issue or a revenue issue. And as you know, I have some concerns about the current law baseline because I don't think it's realistic. And I want you to address that today if you could. Is that closer to realistic or is the current policy baseline or is there another one like the long term extended baseline, alternative fiscal scenario – all these are going to matter greatly in our work.

We have a $1.5 trillion-dollar task over the next ten years. This of course is a huge challenge but I'd also like your analysis of how that compares to what you see as the real fiscal challenge over the next ten years and the real economic challenge we face. As many of the colleagues on the committee have mentioned this morning, obviously our economy is directly linked to what we do. And we hear about this today from you as we'll see how we got in the situation we're in, largely because of economic conditions. Just as in the late 90's because of the growing economy we were able to come to a unified balanced budget faster than anyone expected.

Using your data and the current policy baseline, as I look at $1.5 trillion I think it's about 4 percent of projected spending over the next 10 years. So in that sense it seems like it's something realistic. It's also as I look at it, based on again your data, and the current policies, less than 20 percent of the projected increase in the deficit over the next 10 years. So 1.5 seems to me to be something we should be doing at the very least. Again I look forward to your insights on that and what is the most realistic baseline.

I hope you and your colleagues will also help us better understand the impacts of policy choices over the coming decades. As I look at your projections, it seems to me that deficit and debt levels would be devastating to our economy over the second, third and fourth 10 years if we don't do something about the longer term impact. So while we could, within this budget window, find ways to 1.5, it will not be something that markets will react to well in my view unless we're also looking at long term impacts. And we'd love to have your view there.

The long-term budget estimates are so unsustainable, that your alternative budget scenario simply stops calculating the national debt after 2036, because it is so unsustainable. We will have crossed into totally unchartered territory.

Clearly, entitlement spending is driving these long-term deficits to impossible levels. I'm interested in hearing what reforms you think can protect those in need, which we must do while at the same time modernizing these programs and placing them on a sustainable path for future generations.

Again, thank you for being before us and more importantly, thank you for all the hard work you'll be doing with us over the next several weeks.

Representative Fred Upton

I'd like to begin by thanking Mr. Elmendorf for joining us today to examine the history and drivers of our nation's debt and the threat this debt poses to our long-term economic health and stability.

So why are we here? Why was this committee created? In my view, it is ultimately a question of jobs. We need jobs to get our economy growing. We need jobs to improve the fiscal outlook and bring in more revenues because more folks are working.

We hear from job creators all the time who tell us the long-term debt burden and uncertainty about spending and entitlements are keeping them from investing and growing. When I am home in Michigan, where families have faced double-digit unemployment for 32 straight months, people are crying out for an economy they can count on, and that begins by getting our fiscal house in order.

Our nation's fiscal future is on an unsustainable path. If job creators lack confidence in our *economic policy*, that means they lack confidence in our *economy*. And that lack of confidence means they're not hiring.

Deficit reduction is a pro-growth strategy. Reducing our deficit by cutting spending and reforming entitlements will help restore that confidence. And that is why we are here.

We need to look at the spending side of the ledger, and especially at the health care spending and entitlements that continue to grow at an unsustainable rate. I expect we will hear from Mr. Elmendorf this morning about the unique challenges when it comes to both containing health care spending and accurately estimating the impact of policy changes on such spending. The combination of an aging population and ever-rising health care costs means that health care is going to consume more and more of our budget each year.

Left unchecked, this would force us to choose among several unacceptable options. The massive tax increases that would be required to pay for these costs would send our economy into a permanent downward spiral, which would only worsen our long-term fiscal outlook. Dramatically reducing benefits becomes more likely as time passes without action. The only remaining choice would be to disinvest in other national priorities as health care consumes nearly every dollar we take in. None of these are welcome choices.

So what do we do about it?

That is the question the JSC was created to answer. And the solutions are not a mystery. We need to reform entitlements and begin to tackle the rising cost of health care. We need to shrink the size of government so we are living within our means. We need to enact policies that spur investment and economic growth.

With passage of the health care law, Congress dramatically expanded the entitlement state and made an already-unsustainable fiscal challenge significantly worse. I can point to three new entitlements in that law – premium/cost-sharing subsidies, an unprecedented expansion of Medicaid, and the unsustainable CLASS program – three programs that are not benefitting a single American today, yet they will cost trillions in the long-term.

President Obama promised Medicare and Medicaid reform in his address to Congress last week. While I am disappointed we have not yet received his entitlement reform or deficit reduction proposals, I am eager to see them so they can be viewed alongside his proposals for new spending. I'm also eager for Mr. Elmendorf to score the entirety of the president's plan, so we know what he is asking to spend and how he proposes to pay for this spending. But as we review the existing Medicare and Medicaid programs, we should also look to potential changes in the new entitlements when we weigh the difficult choices about what we can afford.

As the president said, we need entitlement reform – I have consistently argued we need to address the rising cost of health care if we want these programs to serve future generations and not simply bankrupt them. I look forward to hearing Mr. Elmendorf's thoughts on our fiscal picture as a whole, and particularly his views on the role of entitlement spending and where we are headed.

Representative Chris Van Hollen

"Yesterday there were two important developments that relate to our work.

"First, the President submitted to Congress a jobs plan that is fully paid-for over 10 years. Every day that Americans are out of work, the country is hurting and the deficit is growing. The fastest, most effective way to reduce the deficit is to put Americans back to work. We must address that reality in our work and include job creation as part of our effort.

"Second, the co-chairs of the bipartisan National Commission on Fiscal Responsibility and Reform, Alan Simpson and Erskine Bowles, called upon our Committee to 'go big' – urging us to use this unique opportunity to develop a plan to reduce the deficit by over $4 trillion over 10 years, including the almost $1 trillion in savings from the Budget Control Act. They are right. We should propose a plan of that size.

"The bipartisan Simpson-Bowles Commission and the bipartisan Rivlin-Domenici Commission, as well as the Gang of Six, have provided a framework for how to achieve that goal. What is clear in all of their work is that a balanced approach is required to reduce the deficit – one that contains savings achieved from modernizing certain programs as well as savings gained by simplifying and reforming the tax code in a way that generates revenue. Addressing a problem of this magnitude requires shared responsibility in order to grow the economy and reduce the deficit.

"The testimony we will hear today from Mr. Elmendorf demonstrates why such a balanced approach is necessary. It vividly illustrates that the policy choices driving our deficit are the significant cuts made to revenues combined with increasing retirement and health security costs due to the retirement of the baby bombers.

"Let's not duck those realities. Let's follow the advice of Simpson-Bowles, Rivlin-Domenici, and the Gang of Six: 'go big." I don't agree with every one of their proposals, but those bipartisan groups have provided this bipartisan group with a framework from which to start."

September 22, 2011
Overview: Revenue Options and Reforming the Tax Code

JOINT COMMITTEE ON TAXATION
September 22, 2011
JCX-49-11

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION

SEPTEMBER 22, 2011

My name is Thomas A. Barthold. I am the Chief of Staff of the Joint Committee on Taxation. It is my pleasure this morning to provide a brief overview of the Federal tax system. You asked if I could emphasize the income taxation of individuals and corporations. My written testimony provides additional details and includes an appendix with further information. Members have separately been provided with several charts and tables to which I will refer during my oral testimony.

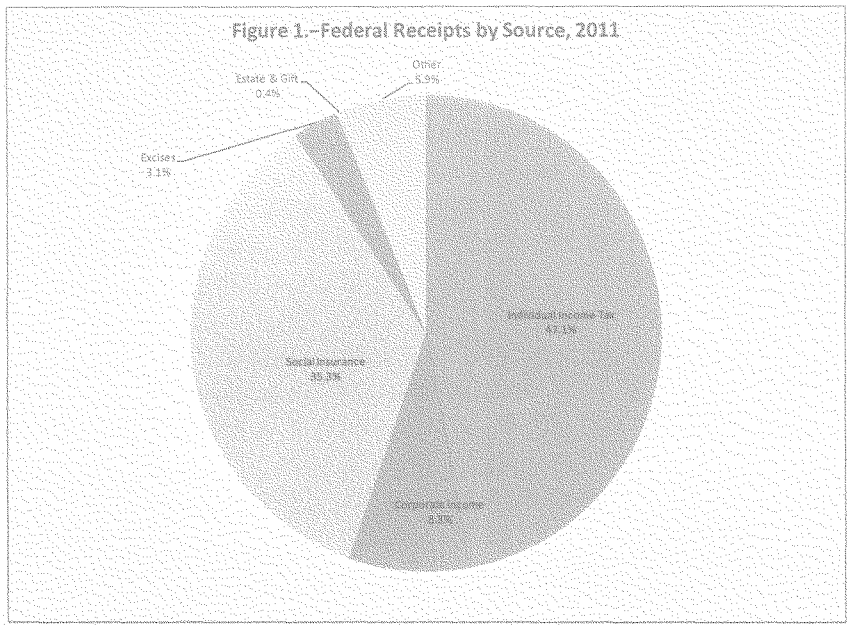
The staff of the Joint Committee on Taxation is nonpartisan and serves the entire Congress. The staff of the Joint Committee on Taxation includes experienced professional economists, attorneys, and accountants, who assist Members of the majority and minority parties in both houses of Congress on tax legislation.

I. OVERVIEW OF THE FEDERAL INCOME TAX SYSTEM

A. Historical Federal Receipts by Source

Figure 1 below shows aggregate Federal receipts by source for 2011. The individual income tax is the largest source of Federal revenue, comprising 47.1 percent of the total Federal revenues, while social insurance (employment) taxes[1] are the second largest source of revenue at just over 35.3 percent. No other single source constitutes more than ten percent of Federal revenue.

[1] The principal social insurance (employment) taxes are the Federal Insurance Contributions Act (FICA) and Self-Employment Contributions Act (SECA) taxes that fund the Social Security and Medicare systems.



Source: Congressional Budget Office, August 2011 baseline.

Figure 2 below shows Federal receipts by source as a percentage of all Federal receipts from 1950 to 2010. The individual income tax has always been the largest source of Federal revenue, oscillating around its average share of 44.8 percent over this period. The corporate and excise taxes have declined as a percentage of all revenues, and social insurance taxes have risen substantially from around 10 percent of the total in the early 1950s to levels generally varying between 35 and 40 percent in recent years.

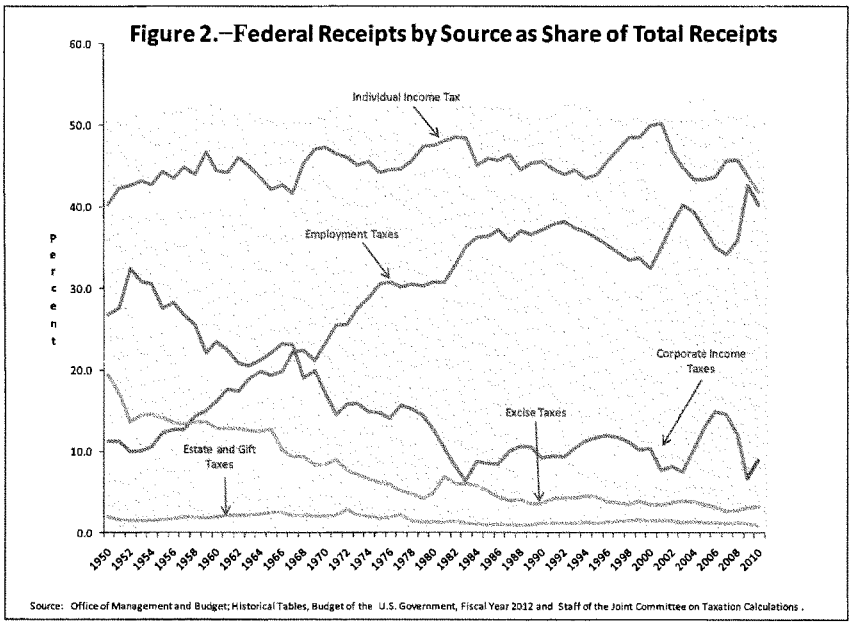
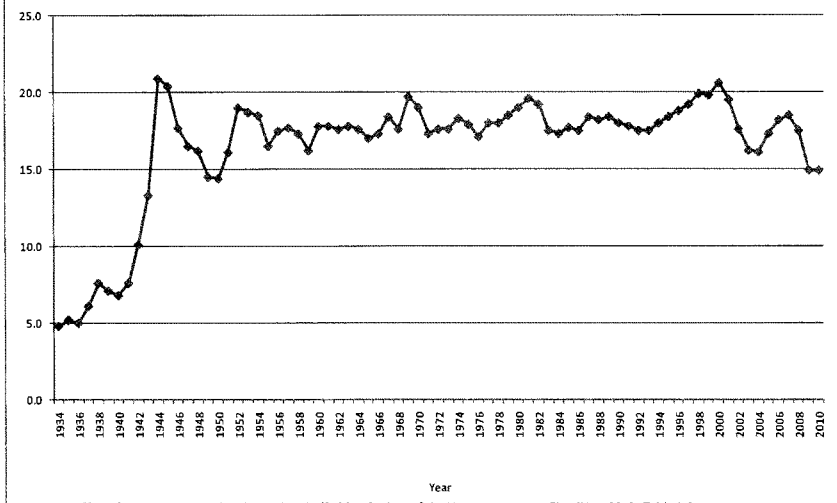


Figure 3 below shows receipts as a percentage of GDP from 1934 to the present. Since 1950, total Federal receipts have averaged 17.9 percent of GDP. The drop in receipts as a percent of GDP in 2009 and 2010 (to 14.9 percent) reflects the impact of both the economic recession and the legislated tax reductions of the American Recovery and Reinvestment Tax Act of 2009.[2] Receipts as a share of GDP have not been this low since 1950.

Figure 3.—Federal Receipts as a Percentage of GDP

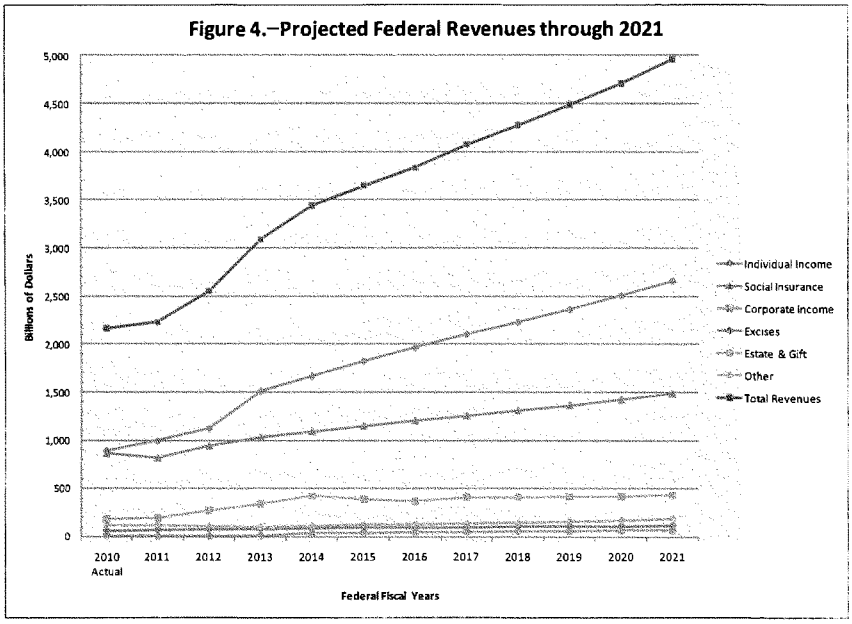


Sources: Office of Management and Budget, Historical Tables, Budget of the U.S. government, Fiscal Year 2012, Table 2.3.

[2] Pub. L. No. 111-5.

Figure 4 below shows total projected Federal revenues by source over the current budget period, through 2021.

The increase in social insurance receipts in 2012 reflects the expiration of the temporary (for 2011 only) reduction in employee social insurance taxes by 2 percentage points. The increase in individual receipts in 2013 reflects the expiration of numerous provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001,[3] the Jobs and Growth Tax Relief Reconciliation Act of 2003,[4] and the American Recovery and Reinvestment Tax Act of 2009.[5]



Source: Congressional Budget Office, January 2011 baseline.

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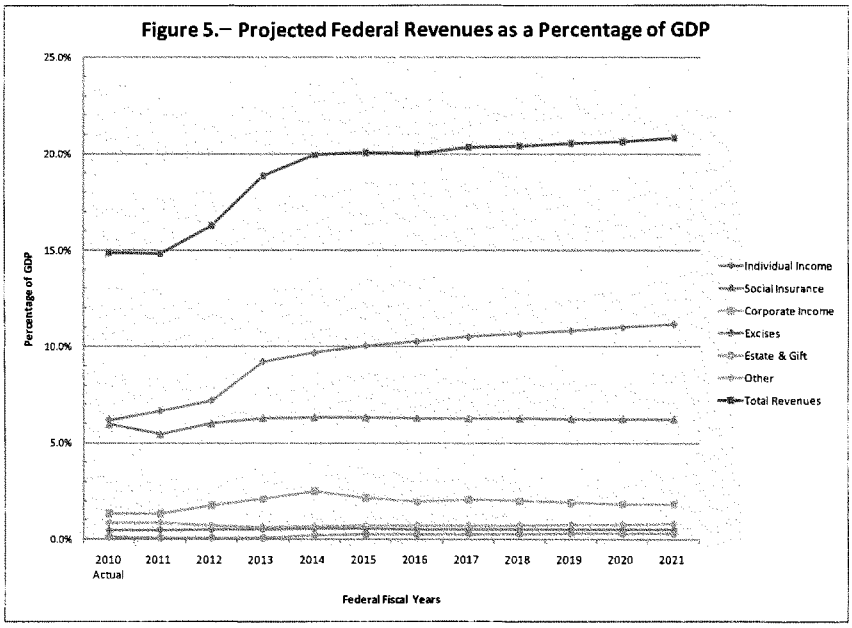
[3] Pub. L. No. 107-16.

[4] Pub. L. No. 108-27.

[5] Pub. L. No. 111-5.

Figure 5 below shows the same projections as Figure 4 above as a percentage of GDP. Total revenues are projected to rise from about 15 percent of GDP currently to about 20 percent of GDP by 2014, rising gradually to about 21 percent of GDP in 2021.



Source: Congressional Budget Office, January 2011 baseline.

B. Variety of Business Organizations

The preceding figures have showed the importance of the individual income tax and corporate income tax to the Federal tax system. However, it is important to recognize that not all businesses are organized as corporations and, consequently, the taxation of active business income occurs both for taxpayers that file Form 1120 (the corporate income tax return) and for taxpayer who file Form 1040 (the primary individual income tax return).

Businesses may be organized under a number of different legal forms. Owners of a business sometimes conduct their activities as sole proprietorships, which do not involve a legal entity separate from the owner. However, for a variety of business or other reasons, a business often is conducted through a separate legal entity. Common reasons to use a separate legal entity include the ability to pool the capital and other resources of multiple owners, the protection of limited liability accorded by State law to the owners of qualifying entities (but generally not to sole proprietors), and an improved ability to access capital markets for investment capital.

The tax consequences of using a separate entity depend on the type of entity through which the business is conducted. Partnerships, certain closely held corporations that elect to be taxed under subchapter S of the Code (referred to as "S corporations"),[6] and limited liability companies that are treated as partnerships are treated for Federal income tax purposes as passthrough entities whose owners take into account the income (whether or not distributed) or loss of the entity on their own tax returns.

In contrast, the income of a C corporation[7] is taxed directly at the corporate level. Shareholders are taxed on dividend distributions of the corporation's after-tax income. Shareholders are also taxed on any gain (including gain attributable to undistributed corporate income) on the disposition of their shares of stock of the corporation. Thus, the income of a C corporation may be subject to tax at both the corporate and shareholder levels.[8]

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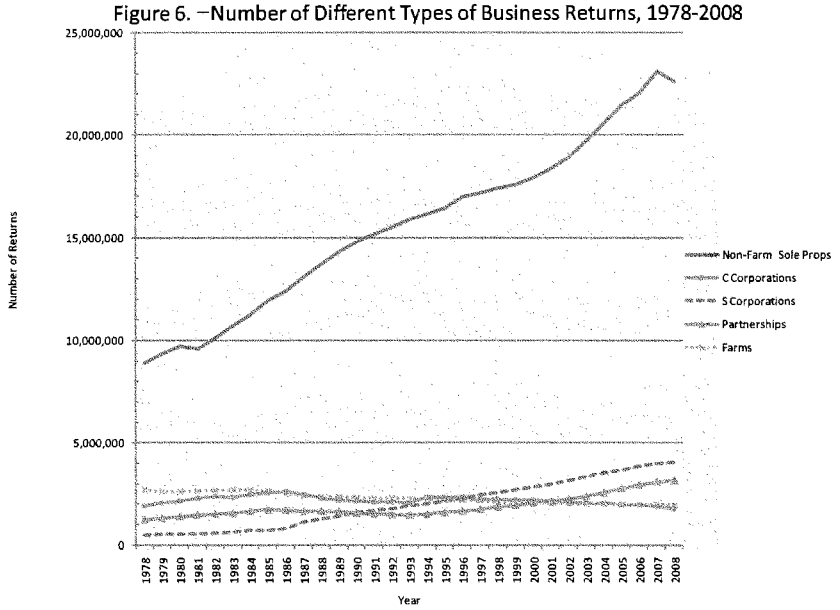
[6] To be eligible to make an election under subchapter S a corporation must generally (1) be an eligible domestic corporation; (2) not have more than 100 shareholders (taking into account applicable attribution rules); (3) have as shareholders only individuals (other than nonresident aliens), estates, certain trusts and certain tax-exempt organizations; and (4) have only one class of stock.

[7] A C corporation is a corporation that is subject to subchapter C of the Code, which provides rules for corporate and shareholder treatment of corporate distributions and adjustments. C corporations generally are subject to the corporate-level tax rate structure set forth in section 11 of the Code.

[8] Business entities also include specialized corporations which are not subject to entity level tax, or which are allowed a deduction for distributions to shareholders, under the Federal income tax rules. Federal tax rules applicable to these entities generally require that they distribute substantially all their income and require that they meet other specified limitations on activities, assets, and types of income, for example. These types of entities include regulated investment companies (RICs) (mutual funds in common parlance), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), and cooperatives. In addition, some business activities are conducted through tax-exempt entities, whether as activities subject to unrelated business income tax (UBIT), or as permitted under the Federal tax rules relating to tax-exempt organizations.

Figure 6 below shows the change in number of different types of business returns for the period 1978 through 2008.

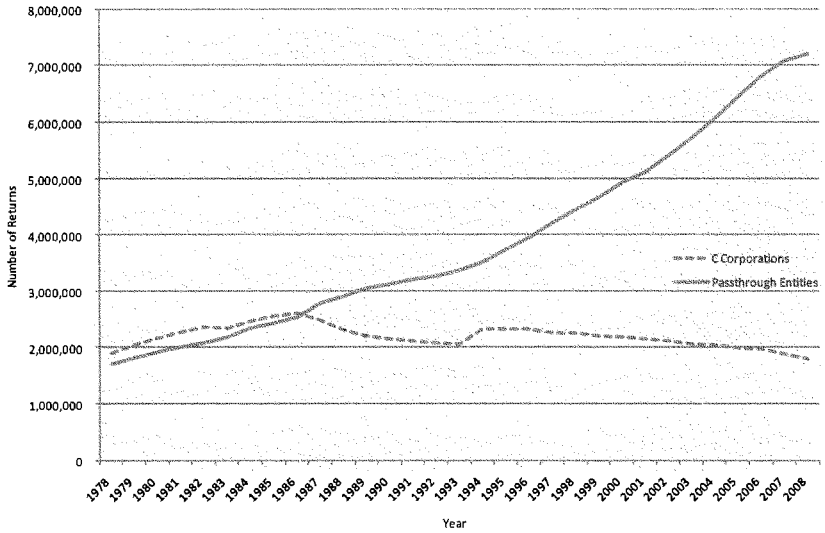
Figure 6. –Number of Different Types of Business Returns, 1978-2008



Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Figure 7 below compares the number of C corporation returns to the total number of passthrough entity returns (S corporations, partnerships and LLCs taxable as partnerships) over the same period.

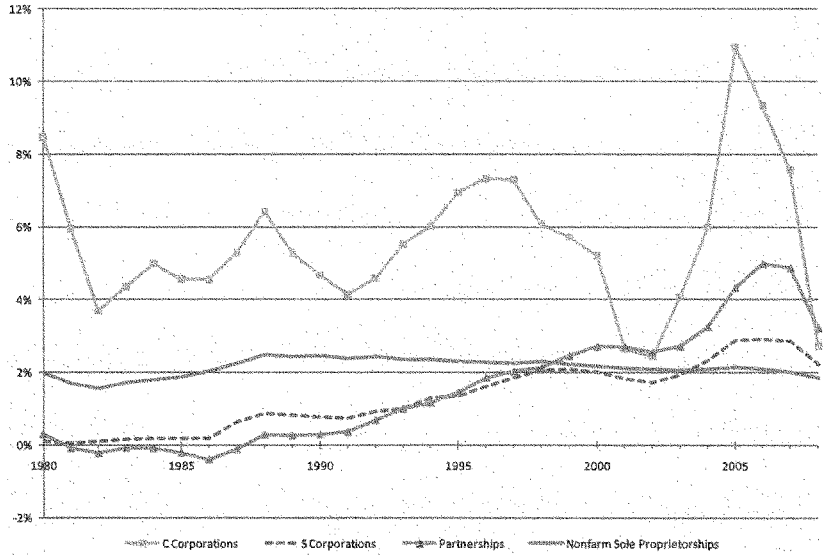
Figure 7. –Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2008



Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Figure 8 below shows the income of various business forms as a percentage of GDP over the period 1980 through 2008.

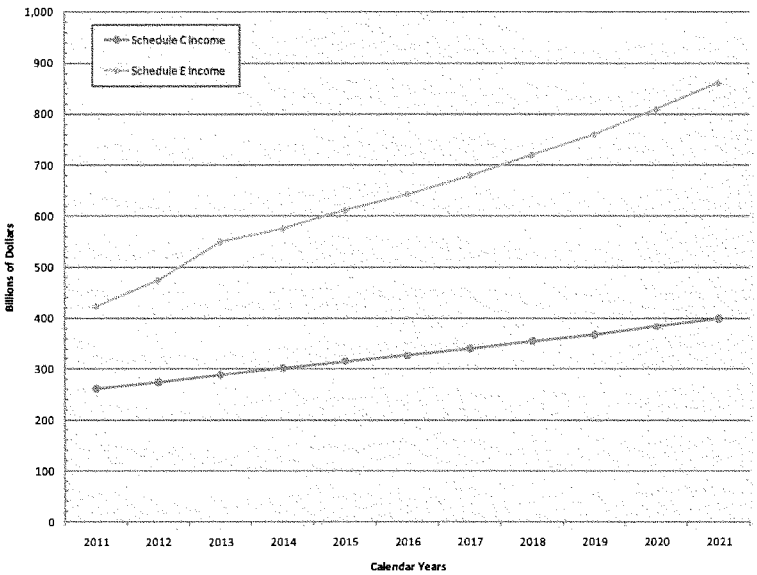
Figure 8.–Aggregate Net Income (less deficit) as a Percentage of GDP
1980 - 2008



Source: IRS Statistics on Income.

Figure 9 below shows projected business income earned by sole proprietorships, reported on Schedule C, and income reported on Schedule E, over the period 2011 - 2021. While total adjusted gross income is forecast to increase somewhat more than 70 percent over this period, passthrough income reported on individual returns (the sum of income reported on Schedules C and E) goes up by over 80 percent. Growth in this passthrough income is driven by growth in Schedule E income, which is projected to more than double.

Figure 9.—Projected Schedule C and Schedule E Income, 2011 - 2021



Source: Joint Committee on Taxation.

II. OVERVIEW OF THE INDIVIDUAL INCOME TAX

A. Structure of the Individual Income Tax

In general

An income tax is imposed on individual citizens and residents of the United States.[9] The tax is based on an individual's taxable income. An individual computes his or her taxable income by reducing gross income by the sum of (i) the deductions allowable in computing adjusted gross income, (ii) the standard deduction (or itemized deductions, at the election of the taxpayer), and (iii) the deduction for personal exemptions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her income tax liability. Lower rates apply to net capital gain and qualified dividend income. A taxpayer may also be subject to an alternative minimum tax. A taxpayer may reduce his or her income tax liability by certain tax credits. In the remainder of this section of the document, the broad structure of the individual income tax system is outlined, and certain parameters of the individual tax system are highlighted for selected years beginning with 1975.[10]

Gross income

Gross income means "income from whatever source derived" other than certain items specifically excluded from gross income. Sources of gross income generally include, among other things, compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,[11] and trusts or estates.[12] Exclusions from gross income include death benefits payable under a life insurance contract, interest on certain tax-exempt State and local bonds, employer-provided

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[9] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

[10] For more information regarding individual tax rates and the individual tax base, see Joint Committee on Taxation, *Federal Tax Treatment of Individuals* (JCS-43-11), September 12, 2011, and Joint Committee on Taxation, *Present Law and Historical Overview of the Federal Tax System* (JCS-1-11)), January 18, 2011.

[11] In general, partnerships and S corporations are treated as passthrough entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of these entities is passed through and taxed to the partners and shareholders, whether distributed or not.

[12] In general, estates and trusts (other than grantor trusts) pay an individual income tax on the taxable income of the estate or trust. Items of income which are distributed or required to be distributed under governing law or under the terms of the governing instrument generally are included in the income of the beneficiary and not the estate or trust. Estates and trusts determine their tax liability using a special tax rate schedule and may be subject to the alternative minimum tax. Certain trusts are treated as being owned by grantors in whole or in part for tax purposes; in such cases, the grantors are taxed on the income of the trust.

health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include, among other things, trade or business expenses, losses from the sale or exchange of property, deductions attributable to rents and royalties, contributions to pensions and other retirement plans, certain moving expenses, and alimony payments.

Taxable income

In order to determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Table 1 below summarizes the amount of personal exemptions for selected years between 1975 and 2011. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. Beginning in 1985, the amount of the personal exemption was indexed annually for inflation during the preceding year.

Table 1.–Personal Exemption and Standard Deduction, Selected Calendar Years 1975-2011

	1975	1985	1990	1995	2000	2005	2011
Personal Exemption	$750	$1,040	$2,050	$2,500	$2,800	$3,200	$3,700
Standard Deduction							
Single Individual	$1,600*	$2,390	$3,250	$3,900	$4,400	$5,000	$5,800
Head of Household	$1,600*	$2,390	$4,750	$5,750	$6,450	$7,300	$8,500
Married Couples Filing Jointly	$1,900*	$3,540	$5,450	$6,550	$7,350	$10,000	$11,600
Married Individual Filing Separately	$950*	$1,770	$2,725	$3,275	$3,675	$5,000	$5,800

* Shows minimum standard deduction.

A taxpayer may also reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. Also, an additional standard deduction is allowed with respect to any individual who is elderly or blind.[13]

[13] For 2011, the additional amount is $1,150 for married taxpayers (for each spouse meeting the applicable criteria) and surviving spouses. The additional amount for single individuals and heads of households is $1,450. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount of $2,300 or $2,900, as applicable.

In lieu of taking the applicable standard deduction, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI).

In recent decades there have been many changes to the individual income tax base. The increased availability of pre-tax contributions to Individual Retirement Arrangements[14] (commonly called "IRAs") followed by the subsequent curtailment of their availability[15] and the taxation of a portion of Social Security and Railroad Retirement Tier 1 benefits[16] are two items which affect the measurement of gross income for some taxpayers. The enactment of pre-tax elective contributions under tax-qualified employer-sponsored retirement plans and the enactment of "pre-tax elective benefits" designed to respond to increased health-care costs are examples of changes to adjusted gross income.[17] The calculation of taxable income has been affected by the numerous changes to itemized deductions. Examples of such changes include the creation of the two-percent floor on miscellaneous itemized deductions,[18] changes to the tax treatment of moving expenses,[19] and changes to the floor on the itemized deduction for medical expenses.[20] Another significant change to the individual income tax base was the enactment of a limitation on passive activity losses, which may affect an individual's tax liability on certain business investments.

Tax liability

In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax.

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[14] The Economic Recovery Tax Act of 1981 (Pub. L No. 97-34).

[15] The Tax Reform Act of 1986 (Pub. L. No. 99-514).

[16] The Social Security Amendments of 1983 (Pub. L. No. 98-21), as amended by the Railroad Retirement Solvency Act of 1983 (Pub. L. No. 98-76) and the Consolidated Budget Reconciliation Act of 1985 (Pub. L. No. 99-272). The Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66).

[17] The Revenue Act of 1978 (Pub. L. No. 95-600).

[18] The Tax Reform Act of 1986 (Pub. L. No. 99-514).

[19] The Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66).

[20] The Internal Revenue Act of 1954 (Pub. L. No. 83-59) set the floor at three percent, the 1982 Tax and Equity Fiscal Responsibility Act (Pub. L. No. 97-248) raised the floor to 5 percent, the Tax Reform Act of 1986 (Pub. L. No. 99-514) raised the floor to 7.5 percent, and the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) raised the floor to 10 percent (for taxable years beginning after December 31, 2012).

Regular tax liability

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases.

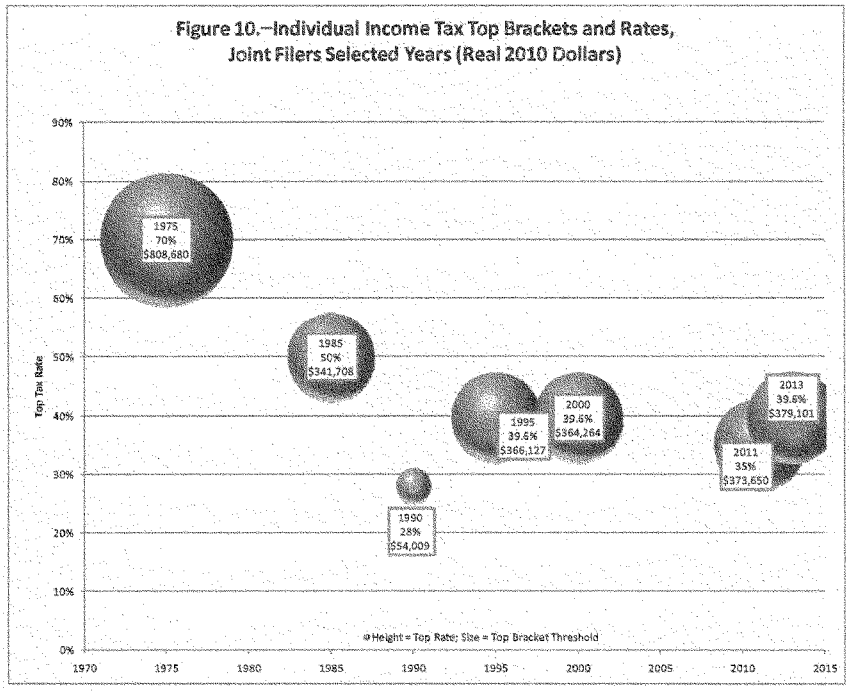
Separate rate schedules apply based on an individual's filing status. Table 2 shows the individual income tax rate schedule for 2011. It should be noted that these rates will change in 2013 when individual income tax rates will increase from the current rates of 10, 15, 25, 28, 33, and 35 percent to the rates of 15, 28, 31, 36, and 39.6 percent.

Table 2.–Federal Individual Income Tax Rates for 2011

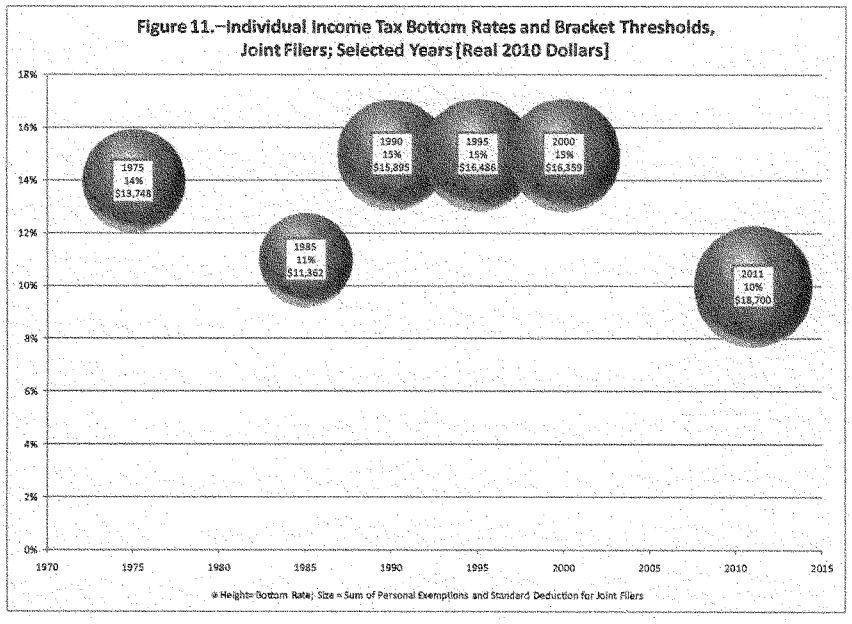
Single Individuals	
If taxable income is:	*Then income tax equals:*
Not over $8,500	10% of the taxable income
Over $8,500 but not over $34,500	$850 plus 15% of the excess over $8,500
Over $34,500 but not over $83,600	$4,750 plus 25% of the excess over $34,500
Over $83,600 but not over $174,400	$17,025 plus 28% of the excess over $83,600
Over $174,400 but not over $379,150	$42,449 plus 33% of the excess over $174,400
Over $379,150	$110,016.50 plus 35% of the excess over $379,150
Heads of Households	
Not over $12,150	10% of the taxable income
Over $12,150 but not over $46,250	$1,215 plus 15% of the excess over $12,150
Over $46,250 but not over $119,400	$6,330 plus 25% of the excess over $46,250
Over $119,400 but not over $193,350	$24,617.50 plus 28% of the excess over $119,400
Over $193,350 but not over $379,150	$45,323.50 plus 33% of the excess over $193,350
Over $379,150	$106,637.50 plus 35% of the excess over $379,150

Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,000	10% of the taxable income
Over $17,000 but not over $69,000	$1,700 plus 15% of the excess over $17,000
Over $69,000 but not over $139,350	$9,500 plus 25% of the excess over $69,000
Over $139,350 but not over $212,300	$27,087.50 plus 28% of the excess over $139,350
Over $212,300 but not over $379,150	$47,513.50 plus 33% of the excess over $212,300
Over $379,150	$102,574 plus 35% of the excess over $379,150
Married Individuals Filing Separate Returns	
Not over $8,500	10% of the taxable income
Over $8,500 but not over $34,500	$850 plus 15% of the excess over $8,500
Over $34,500 but not over $69,675	$4,750 plus 25% of the excess over $34,500
Over $69,675 but not over $106,150	$13,543.75 plus 28% of the excess over $69,675
Over $106,150 but not over $189,575	$23,756.75 plus 33% of the excess over $106,150
Over $189,575	$51,287 plus 35% of the excess over $189,575

Figure 10 below shows the top tax bracket rate and income level at which it begins to apply for married tax payers filing jointly for selected years. Figure 11 shows the bottom rate and the income level at which it would begin to apply for married taxpayers filing jointly, calculated as the sum of the standard deduction and two personal exemptions.



Note: For 1975 the maximum rate on earned income was 50 percent.



Capital gains

In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. However, any net capital gain of an individual generally is taxed at rates lower than rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S.

publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Tax credits

An individual may reduce his or her tax liability by any available tax credits.

Refundable tax credits

The two most widely used refundable credits are the earned income tax credit (the "EITC") and the child tax credit.

Earned income tax credit.–The EITC generally equals a specified percentage of wages up to a maximum credit amount. The maximum credit amount applies over a certain income range and then diminishes to zero over a certain income range. In 2011, the maximum EITC is $5,751 for taxpayers with more than two qualifying children, $5,112 for taxpayers with two qualifying children, $3,094 for taxpayers with one qualifying child, and $464 for taxpayers with no qualifying children.

The EITC is phased out along certain phase-out ranges. In 2011, the phase-out range is $7,590 to $13,660 for no qualifying children, $16,690 to $36,052 for one qualifying child, $16,690 to $40,964 for two qualifying children, and $16,690 to $43,998 for three or more qualifying children. Also for 2011, the phase-out threshold for married couples filing a joint return is increased by $5,080.

After 2012 the larger EITC for three or more qualifying children and the higher phase-out threshold for married couples filing a joint return are repealed. Additionally, certain of the rules of the credit return to pre-2001 law.

Progression of the EITC

Although the basic structure of the EITC is unchanged since its enactment in 1975, the maximum credit has been increased several times since enactment by expanding the applicable percentage of the credit and the base against which that percentage is applied (including adjusting the EITC for number of qualifying children). Also, the beginning point of the phase-out range has been raised as has the length of the phase-out range. Finally, the dollar amounts of the credit have been automatically adjusted for inflation. In all, these changes have had the effect of further expanding the availability of the EITC.

As originally enacted in 1975, the credit was 10 percent of the first $4,000 of earned income[21] (i.e., a maximum credit of $400). The credit began to be phased out for filing units with earned income (or AGI, if greater) above $4,000, and was entirely phased out for filing units with income of $8,000. The EITC was not adjusted for inflation in 1975.

Thus, an eligible EITC recipient in 1975 with $4,000 of income ($16,844 in today's dollars) received the maximum $400 ($1,684 in today's dollars). In 2011, a similarly situated taxpayer (i.e., one with $16,844 in income) would receive today's maximum amounts if married ($3,094, $5,112, or $5,751 with one, two, or more than two children, respectively). An unmarried filer would receive just shy of these maximum amounts as his income is just over the start of the phaseout threshold of $16,690. In 1975, a taxpayer without children was not eligible for the EITC. In 2011, a taxpayer with $16,844 in income but without a qualifying child would be phased out of the EITC.

A taxpayer earning $8,000 in 1975 would receive no EITC, while a similarly situated taxpayer (i.e., one with $33,688 in income today) would receive $378, $1,532, or $2,171 if an unmarried filer with one, two, or more than two children, respectively. If married, the taxpayers would receive $1,190, $2,602, or $3,241 depending on whether he had one, two, or more than two children, respectively. In 2011, a taxpayer with $33,688 in income but without a qualifying child would be phased out of the EITC.

Child tax credit.–For 2011, the child tax credit generally is $1,000 for each qualifying child.[22] The credit is allowable against the regular tax and, for taxable years beginning before January 1, 2012, is allowed against the AMT.

The child tax credit is phased out for individuals with income over certain thresholds. The phase out rate is $50 for each $1,000 of modified AGI[23] (or a fraction thereof) in excess of the threshold. For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These thresholds are not indexed for inflation.

To the extent the child tax credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of a threshold dollar amount (the "earned income" formula). For 2011, the

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[21] Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings.

[22] A qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendant of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer.

[23] For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively).

child tax credit is refundable up to the greater of: (1) 15 percent of the taxpayer's earned income in excess of $3,000; or (2) for families with three or more children, the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income.

After 2012, the maximum child tax credit is $500 for each qualifying child and is only refundable for families with three or more children if the taxpayer's social security taxes exceed the taxpayer's earned income. The maximum child tax credit after 2012 is equivalent to the credit as originally enacted in the Taxpayer Relief Act of 1997.[24] Before 1997, taxpayers could not claim tax credits based solely on the number of dependent children. Instead, they were generally able to claim a personal exemption for each of these dependents. The Taxpayer Relief Act of 1997 provided for a child tax credit of $500 ($400 for 1998) for taxable years beginning after December 31, 1997. The Economic Growth and Tax Relief Reconciliation Act of 2001 increased the maximum child tax credit from $500 to $1000 over a number of years and made other changes to the child tax credit. [25]

Nonrefundable tax credits

Nonrefundable personal credits include the foreign tax credit, child and dependent care credit, education credits, retirement savings contributions credit, child tax credit, residential energy efficient property credit, nonbusiness energy property credit, and expenses of elderly or disabled.

Alternative minimum tax liability

In general

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of: (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are also used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's "tax preference items" and adjusted by redetermining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2011 are: (1) $74,450 in the case of married individuals filing a joint return and surviving spouses; (2) $48,450 in the case of unmarried individuals other than surviving spouses; (3) $37,225 in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an

[24] Pub. L. No. 105-34.

[25] Pub. L. No. 107-16.

amount equal to 25 percent of the amount by which the individual's AMTI exceeds: (1) $150,000 in the case of married individuals filing a joint return and surviving spouses; (2) $112,500 in the case of other unmarried individuals; and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions items, are not allowed to reduce alternative minimum taxable income.

B. Largest Tax Expenditures for Individuals

The following Table 3 shows the ten largest tax expenditures for individuals estimated for the period 2010-2014. The Appendix includes the top ten tax expenditures for five-year periods beginning with 1975-1979. Several items have consistently been among the top ten largest individual tax expenditures. Four have made the top ten lists in all eight of the five-year periods. These four items are: (1) the exclusion of employer contributions for health care and health insurance premiums; (2) the net exclusion of pension contributions and earnings: employer plans;[26] (3) the deduction for mortgage interest on owner-occupied homes; and (4) the deduction for nonbusiness State and local taxes (other than State and local property taxes on owner-occupied homes). Two items have been on the top ten list seven out of eight times: (1) the exclusion of untaxed Social Security and railroad retirement benefits, and (2) the deduction for charitable contributions. Two items have been on the top ten list six out of eight times: (1) the deduction for State and local property taxes on owner-occupied homes, and (2) the reduced rate of tax on dividends and long-term capital gains.[27]

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[26] This item represents a combination of two items appearing on Table 3, (1) net exclusion of pension contributions and earnings: Defined benefit plans, and (2) net exclusion of pension contributions and earnings: Defined contribution plans, which are shown as a single combined item on the Tables for periods prior to 2010-2014 in the Appendix.

[27] Dividends have been included in this category for periods during which a reduced tax rate applies to them.

Table 3.–Largest Tax Expenditures, Individual 2010-2014

Tax Expenditure	Total Amount (2010-2014) (Billions of dollars)
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	659.4
Deduction for mortgage interest on owner-occupied homes	484.1
Reduced rates of tax on dividends and long-term capital gains	402.9
Net exclusion of pension contributions and earnings: Defined contribution plans	303.2
Earned income credit	268.8
Deduction of nonbusiness State and local government income, sales and personal property taxes	237.3
Net exclusion of pension contributions and earnings: Defined benefit plans	212.2
Exclusions of capital gains at death	194.0
Deductions for charitable contributions, other than for education and health	182.4
Exclusion of untaxed social security and railroad retirement benefits	173.0

III. OVERVIEW OF THE CORPORATE INCOME TAX

A. Structure of the Corporate Income Tax

Since its inception in 1909, the Federal income tax assessed on the earnings of corporations as entities separate and apart from their owners has undergone significant changes, both with respect to the corporate income tax rate structure and the tax base. The following very generally describes the corporate income tax as it exists today, an abbreviated history of the corporate income tax rates, and certain significant changes to the corporate income tax base.[28]

In general

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income.[29]

The taxable income of a corporation generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenses, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year typically may be carried back two years or carried forward 20 years and allowed as a deduction in another taxable year. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied). Moreover, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.

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[28] For a more information regarding corporate historic corporate tax rates and the corporate income tax base see the Appendix to this document, Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Income Provisions* (JCX-34-11), June 1, 2011, and Joint Committee on Taxation, *Present Law and Historical Overview of the Federal Tax System* (JCX-1-11), January 18, 2011.

[29] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States.

The Code also specifies certain expenses that typically may not be deducted, such as expenses associated with earning tax-exempt income,[30] certain entertainment expenses, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, and fines, penalties, bribes, kickbacks and illegal payments.

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. Thus, the maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses are listed in the Appendix, relating to the general business credit. Credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. For purposes of calculating tax liability, corporations filing a consolidated return generally are treated as divisions of a single corporation; thus, the losses (and credits) of one corporation generally can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Alternative minimum tax

A corporation is subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[31] Credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances

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[30] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

[31] The exemption amount is phased out for corporations with income above certain thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, net operating losses and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceeds its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

A corporation with average annual gross receipts of not more than $7.5 million is exempt from the alternative minimum tax.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings and profits, and such a distribution is not a deductible expense of the corporation.[32] Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder.[33] Although subject to a second tax when distributed, shareholders in a corporation may benefit from deferral of this tax on undistributed corporate income (e.g., corporate income reinvested in the business).

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

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[32] A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of common stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

[33] This double taxation is mitigated by a reduced maximum tax rate of 15 percent generally applicable to dividend income of individuals (prior to 2013). Note that amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) because the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

Tax treatment of foreign activities of U.S. corporations[34]

The United States employs a worldwide tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic parent corporation. Until that repatriation, the U.S. tax on the income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by its foreign corporate subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[35] and the passive foreign investment company rules.[36] A limited credit against U.S. tax is generally available for foreign tax imposed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[37]

Corporate income tax rates

A corporation's regular income tax liability generally is determined by applying the appropriate tax rate to its taxable income. Table 4 below provides a compilation of the marginal rates of tax imposed on corporate income in 2011.

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[34] For more information regarding the tax treatment of the foreign activities of U.S. corporations, see Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income* (JCX-33-11), May 20, 2011; *Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011; *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S Businesses* (JCX-22-06), June 21, 2006; and *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08), June 25, 2008.

[35] Secs. 951-964.

[36] Secs. 1291-1298.

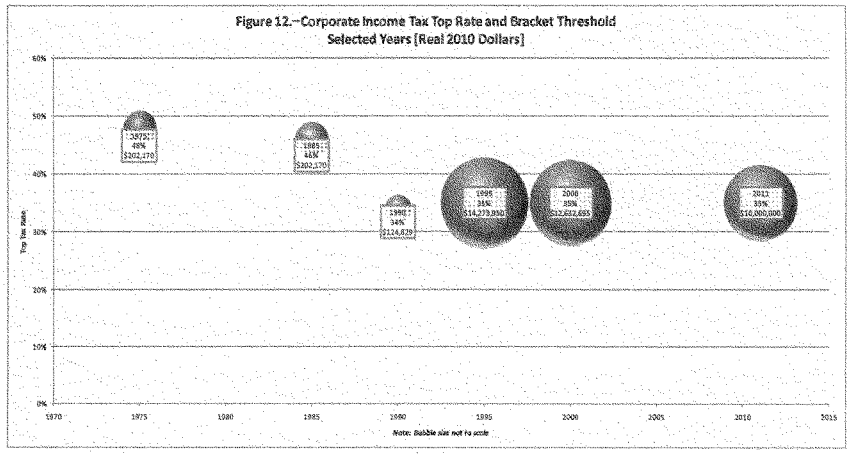
[37] Secs. 901, 902, 960, 1291(g).

Table 4.–Federal Corporate Income Tax Rate Structure in 2011

Corporate Taxable Income	Income Tax Rate (percent)
First $50,000	15
$50,001-$75,000	25
$75,001-$100,000	34
$100,001-$335,000	39*
$335,001-$10,000,000	34
$10,000,001-$15,000,000	35
$15,000,001-$18,333,333	38*
Over $18,333,333	35

* Rates higher than the top bracket rate reflect phaseouts of the benefit from the lower bracket rates and are not technically the top corporate statutory rate.

Figure 12 below shows the top statutory corporate income tax rate and income threshold at which the rate begins to apply for selected years.



Significant modifications to the corporate income tax base

The following discussion summarizes certain significant modifications to the corporate income tax base in the last few decades. In addition to affecting corporations, many of the Federal income tax provisions discussed below apply to all businesses.

Investment tax credit.–From 1962 through 1985 the Code from time to time allowed an investment tax credit. The investment tax credit was originally seven percent (three percent in the case of certain public utilities) of the cost of capital investments in new tangible personal property and certain depreciable real property. The investment tax credit was suspended during the years 1966 and from 1969-1971. The credit was revived in 1972 and then increased to a rate of ten percent in 1975. The Tax Reform Act of 1986 largely repealed the investment tax credit in an effort to equate effective tax rates with statutory tax rates and to rationalize the tax treatment of different assets.

Depreciation.–For Federal income tax purposes, a taxpayer is allowed to recover through annual depreciation deductions the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The MACRS depreciation categories generally are set out in the Code and Internal Revenue Service guidance.[38]

Generally, the depreciation deduction calculation is a function of the capital investment in depreciable property, the recovery period, and the cost recovery method. Recovery periods and rates of recovery have varied over time. For example, prior to 1981, the depreciation system was based on estimated useful lives determined either by using facts and circumstances or by using guideline lives in Treasury guidance.[39] The useful lives were generally applied to calculate depreciation deductions using a straight-line method. The Economic Recovery Tax Act of 1981[40] replaced the prior law depreciation system with the Accelerated Cost Recovery System ("ACRS") which significantly accelerated depreciation on tangible property.[41] The Tax Reform Act of 1986 created MACRS. At times, Congress has enacted temporary bonus depreciation rules.

Section 179 expensing.–In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. The rules of section 179 were originally enacted in 1958 and the amount allowed to be expensed has generally increased over time.[42] Under a temporary provision enacted in 2010, for taxable years beginning in 2011, the maximum amount that a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2 million. For taxable years beginning in 2012 and

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[38] Sec. 168; Rev. Proc. 87-56, 1987-2 C.B. 674.

[39] See Rev. Proc. 62-21, 1962-2 C.B. 418, for guideline useful lives.

[40] Pub. L. No. 97-34.

[41] Pub. L. No. 97-34, sec. 201.

[42] Pub. L. No. 85-866. sec. 204.

thereafter, the limitation amount is $125,000 and the phaseout threshold amount is $500,000, adjusted for inflation.

Amortization of goodwill and certain other intangible assets.–Prior to 1993, goodwill was not an amortizable asset and the amortization of other intangible assets was generally based on facts and circumstances. The Code was amended in 1993 to specify a 15-year amortization period for acquired goodwill and certain other intangible assets.[43]

Deduction for income attributable to domestic production activities.–The American Jobs Creation Act of 2004[44] created a deduction for income attributable to domestic production activities. The allowance of a deduction equal to a specified percentage of certain qualifying domestic production activities income has the effect of lowering the tax rate applicable to income from such activities. For taxable years beginning in 2005 or 2006, the deduction is three percent of the income from manufacturing, construction, and certain other activities specified in the Code. For taxable years beginning in 2007, 2008 and 2009, the deduction is equal to six percent. Beginning in 2010, the percentage is generally[45] nine percent.[46]

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[43] Pub. L. No. 103-66.

[44] Pub. L. No. 108-357.

[45] In the case of oil related qualified production activities income, for any taxable year beginning after 2009, the percentage is reduced by three percent of the least of: (1) oil related qualified production activities income of the taxpayer for the taxable year; (2) qualified production activities income of the taxpayer for the taxable year; or (3) taxable income (determined without regard to the deduction for income attributable to domestic manufacturing activities).

[46] At the fully phased-in nine percent deduction, a corporation is taxed at a rate of 35 percent on only 91 percent of qualifying income, resulting in an effective tax rate on qualifying income of 31.85 percent (0.91 x 0.35 = 0.3185). A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

B. Overview of Business Entities Other Than Corporations

Significant business activity is conducted through entities other than corporations. Such business entities include passthrough entities such as partnerships (including limited liability companies ("LLCs")) and S corporations. For Federal income tax purposes, these passthrough entities generally are not subject to tax at the entity level. Rather, the owners – that is, partners or S corporation shareholders – are subject to tax on their shares of the entity's income, gain, loss, deduction, and credit, whether or not distributed.[47] The tax treatment of passthrough entities differs from the generally applicable entity level tax on income of C corporations. In addition, noncorporate business income is generated by sole proprietorships and farms.[48]

Allowable deductions for businesses conducted in passthrough entity form are generally the same as allowable deductions for businesses conducted in corporate form. However, the calculation of these deductions is affected by the fact that they are taken into account for tax purposes by the partners or S corporation shareholders rather than by the partnership or S corporation at the entity level.

There are no limitations on the identity of a partner in a partnership under present law. Thus, a partner in a business conducted through a partnership (including an LLC taxable as a partnership) can generally be an individual, a corporation, or another partnership, for example. Permissible shareholders of S corporations are restricted to individuals (other than nonresident aliens), estates, certain trusts, and certain tax-exempt organizations, and may not exceed 100 in number (taking into account applicable attribution rules).

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[47] Partners and S corporation shareholders who are individuals generally report this income on Schedule E.

[48] This income is generally reported by individuals on Schedules C and F.

C. Largest Corporate Tax Expenditures

The following Table 5 shows the ten largest corporate tax expenditures estimated for the period 2010-2014. The Appendix includes top ten tax expenditures for five-year periods beginning with 1975-1979. Although the composition of the top ten lists has changed over time, two items have been in the list of top ten expenditures for the entire period: the exclusion of interest on general purpose State and local debt, and some form of accelerated depreciation.[49] Reduced rates for an initial amount of corporate income has been in the top ten since 1980-1985. A tax benefit for research expenses (either through a deduction or a tax credit) has been on the list for seven out of the eight periods.

Table 5.–Largest Tax Expenditures, Corporate 2010-2014

Tax Expenditure	Total Amount (2010-2014) (Billions of dollars)
Deferral of active income of controlled foreign corporations	70.6
Exclusion of interest on public purpose State and local government debt	45.3
Deduction for income attributable to domestic production activities	43.2
Inventory property sales source rule exception	38.0
Depreciation of equipment in excess of alternative depreciation system	37.1
Inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument	28.8
Tax credit for low-income housing	27.0
Expensing of research and experimental expenditures	25.6
Inventory methods and valuation: Last in first out	20.0
Reduced rates for first $10,000,000 of corporate taxable income	15.9

[49] The tax expenditure item relating to accelerated depreciation (a function of asset basis, recovery period, and depreciation method) is a measure of the depreciation allowed in excess of the amount allowed in a normative system, though the terminology describing it has changed in the tax law over the years.

IV. REFORMING TAX EXPENDITURES AND THE NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM

A. The National Commission's General Approach to Tax Reform

In their report, the National Commission on Fiscal Responsibility and Reform (the "Commission") concluded that "[t]ax reform should lower tax rates, reduce the deficit, simplify the tax code, reduce the tax gap, and make America the best place to start a business and create jobs."[50] The Commission proposed eliminating most income tax expenditures and using the revenue to lower marginal tax rates and to reduce projected deficits. The proposed approach is consistent with much commentary over the years that a tax system with a broad base and low rates generally promotes market efficiency and growth.

It is possible that part of the motivation of the Commission was the recognition of the growth in number and value of tax expenditures. Figure 13 below displays a simple count of provisions identified as tax expenditures with an estimated value in excess of $50 million as reported in the document published annually by the staff of the Joint Committee on Taxation.[51]

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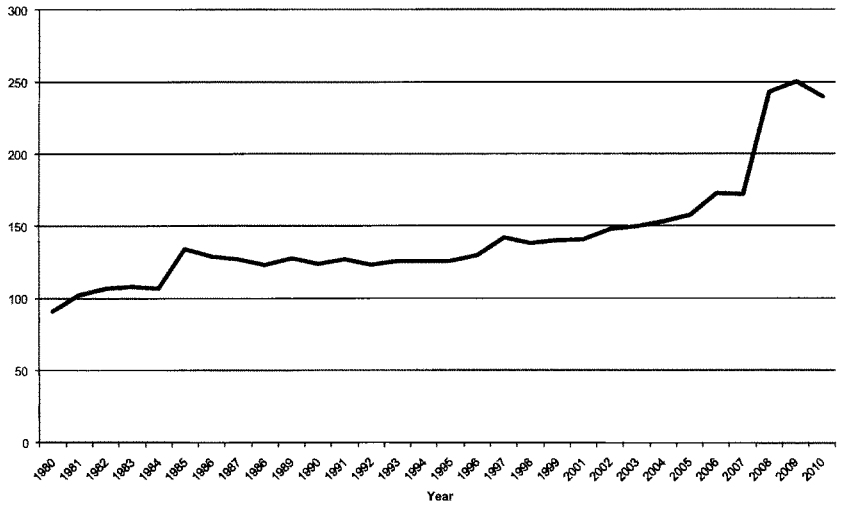
[50] The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010, p. 28.

[51] The annual publication also lists other tax expenditure provisions, identified as quantitatively *de minimis* tax expenditures, that do not meet a $50 million threshold. The Appendix to this testimony includes a list of tax expenditures that have been added to the Code since the passage of the Tax Reform Act of 1986.

Figure 13.–Joint Committee on Taxation Count of Tax Expenditures, 1980-2010



Source: Joint Committee on Taxation staff.

B. Considerations for Congress in Assessing the National Commission's Approach

Two concerns

The course proposed by the Commission appears clear. However, I think it is important to emphasize today that the Commission's proposed course is not simply achieved. I say this for two reasons.

- First, it is not clear as a matter of crafting legislation what it means to eliminate all tax expenditures and start from a clean slate.
- Second, the dollar value of tax expenditures, as calculated by the staff of the Joint Committee on Taxation, is not the same as the estimated revenue effect to the Federal Treasury from elimination or reform of any such provision.

What replaces a repealed tax expenditure?

The Congressional Budget and Impoundment Control Act of 1974 defines tax expenditures as "revenue losses attributable to provisions of the Federal tax law which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit,

a preferential rate of tax, or a deferral of tax liability."[52] Tax expenditures are defined relative to a more theoretically pure income tax. Thus, tax expenditures include any reductions in income tax liabilities that result from special tax provisions that provide tax benefits to particular taxpayers relative to this hypothetical income tax. Because the notion of a tax expenditure is measured against a hypothetical world, eliminating tax expenditures can involve many significant policy questions.

Example: home mortgage interest deduction

As noted above, one of the largest individual tax expenditure provisions is the deductibility of home mortgage interest expense by individuals. What does it mean to eliminate this tax expenditure? As of what date would mortgage interest no longer be deductible? Would the repeal apply to all existing mortgages or only to mortgages undertaken after the effective date? Either choice could be said to substantially eliminate the tax expenditure. These decisions will affect taxpayer's behavior regarding owning versus renting, the size of a home that they may choose to purchase, as well as the amount of debt they undertake and the choice of assets that they may retain in their portfolios. These decisions will affect the magnitude of revenues that redound to the Federal Treasury from the elimination of the tax expenditure and, as discussed below, these revenues will generally be less than the value of the estimated tax expenditure.

Example: employer de minimis fringe benefit--exercise room on site

Another example, while small in size, is employer de minimis fringe benefits. Currently, for example, the employer provision of an amenity like an exercise room on site is an allowable deductible expense for the business but is not included in the income of the employee. How would this tax expenditure be eliminated? Would the deduction be denied to the employer? Or would there be an attempt to value the benefit and require that it be included in the income of the employer?

Example: employer-provided pension benefits[53]

Another significant individual tax expenditure arises because pension benefits that accrue to individuals, either in defined contribution pension plans or in defined benefit pension plans, are not subject to the individual income tax. In the case of an employer's contribution to an individual's defined contribution pension plan, elimination of the tax expenditure could mean: counting the employer's specific dollar contribution as part of the individual's current taxable income. But the treatment of existing accounts is less clear. Would existing accounts still benefit from deferral of tax on earnings?

It is even less clear what elimination of this tax expenditure means in the context of a defined benefit accrual. Often the accrual value attributable to any specific individual depends upon economic outcomes that are not currently known to either the employer or the employee.

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[52] Congressional Budget and Impoundment Control Act of 1974 (Pub. L. No. 93-344), sec. 3(3).

[53] The Commission did not propose eliminating this tax expenditure.

Specifically, the accrual value often depends upon the number of years of service that the employee ultimately provides to the employer and to the employee's as yet unknown highest salary level. How policymakers might develop the rules to value and tax this current tax expenditure benefit is not obvious.

Summary

These three examples demonstrate that eliminating many tax expenditures is not an easy legislative task. It is a task that involves many important decisions for policymakers.

Tax expenditure estimates compared to estimates of changed Federal revenues

A tax expenditure calculation is not the same as a revenue estimate for the repeal of the tax expenditure provision for three reasons. First, unlike revenue estimates, tax expenditure calculations do not incorporate the effects of the behavioral changes of affected individuals or entities that are anticipated to occur in response to the repeal of a tax expenditure provision. Second, tax expenditure calculations are concerned with changes in the reported tax liabilities of taxpayers. Because tax expenditure analysis focuses on tax liabilities as opposed to Federal government tax receipts, there is no concern for the short-term timing of tax payments. Revenue estimates are concerned with changes in Federal tax receipts that are affected by the timing of all tax payments. Third, some of the tax provisions that provide an exclusion from income also apply to the FICA tax base, and the repeal of the income tax provision would automatically increase FICA tax revenues as well as income tax revenues. This FICA effect would be reflected in revenue estimates, but is not considered in tax expenditure calculations. There may also be interactions between income tax provisions and other Federal taxes such as excise taxes and the estate and gift taxes.

If a tax expenditure provision were repealed, it is likely that the repeal would be made effective for taxable years beginning after a certain date. Because most individual taxpayers have taxable years that coincide with the calendar year, the repeal of a provision affecting the individual income tax most likely would be effective for taxable years beginning after December 31 of a certain year. However, the Federal government's fiscal year begins October 1. Thus, the revenue estimate for repeal of a provision would show a smaller revenue gain in the first fiscal year than in subsequent fiscal years. This is due to the fact that the repeal would be effective after the start of the Federal government's fiscal year. The revenue estimate might also reflect some delay in the timing of the revenue gains as a result of the taxpayer tendency to postpone or forgo changes in tax withholding and estimated tax payments, and very often repeal or modification of a tax provision includes transition relief that would not be captured in a tax expenditure calculation.

APPENDIX

A. Overview of Other Federal Taxes

1. Social insurance (employment) taxes

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages and self-employment income. The Federal Insurance Contributions Act ("FICA") imposes a tax on employers based on the amount of wages paid to an employee during the year. The tax is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($106,800 in 2011); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. For calendar year 2011, the employee OASDI rate is reduced by two percentage points to 4.2 percent. The employee tax generally must be withheld and remitted to the Federal government by the employer.[54] Self-employed taxpayers are subject to payroll tax under the Self-Employment Contributions Act ("SECA").

The earnings base is indexed each year automatically according to a statutory formula. Any increase in the earnings base is based on the increase in average wages in the economy.[55]

As part of the Omnibus Budget Reconciliation Act of 1993,[56] the earnings base for the HI portion of the tax was removed, making all earnings taxable for HI purposes, effective starting in 1994.

The social insurance tax rate and taxable wage base have increased over time. Table A-1 below shows the evolution of the taxable wage base and rates of tax since 1975.

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[54] The OASDI and HI payroll tax is generally collected as a single tax with portions of it allocated by statute among three separate trust funds (OASI, DI and HI).

[55] The earnings base can only increase in a year in which there was an increase in benefits under the cost-of-living adjustment (COLA) formula. If there was no increase in benefits, the earnings base is prohibited from increasing. Sec. 230(a) of the Social Security Act. Since there was no increase in benefits from 2009 through 2011, the earnings base remained constant from 2009 through 2011 as well.

[56] Pub. L. No. 103-66.

Table A-1.–Social Insurance Taxable Wage Base and Rates of Tax

Year	Annual Maximum Taxable Wage Base	Contribution Rate for Both Employers and Employees (Percent of Covered Earnings)			Contribution Rate for Self-Employed Persons		
		Total	OASDI	HI	Total	OASDI	HI
1975	$14,100	5.85	4.95	0.9	7.9	7.0	0.9
1976	$15,300	5.85	4.95	0.9	7.9	7.0	0.9
1977	$16,500	5.85	4.95	0.9	7.9	7.0	0.9
1978	$17,700	6.05	5.05	1.00	8.1	7.1	1.0
1979	$22,900	6.13	5.08	1.05	8.1	7.05	1.05
1980	$25,900	6.13	5.08	1.05	8.1	7.05	1.05
1981	$29,700	6.65	5.35	1.3	9.3	8.0	1.3
1982	$32,400	6.7	5.4	1.3	9.35	8.05	1.3
1983	$35,700	6.7	5.4	1.3	9.35	8.05	1.3
1984[1]	$37,800	7.0	5.7	1.3	14.00	11.4	2.6
1985	$39,600	7.05	5.7	1.35	14.10	11.4	2.7
1986	$42,000	7.15	5.7	1.45	14.30	11.4	2.9
1987	$43,800	7.15	5.7	1.45	14.30	11.4	2.9
1988	$45,000	7.51	6.06	1.45	15.02	12.12	2.9
1989	$48,000	7.51	6.06	1.45	15.02	12.12	2.9
1990	$51,300	7.65	6.2	1.45	15.3	12.4	2.9
1991	$53,400	7.65	6.2	1.45	15.3	12.4	2.9
1992	$55,500	7.65	6.2	1.45	15.3	12.4	2.9
1993	$57,600	7.65	6.2	1.45	15.3	12.4	2.9
1994	$60,600	7.65	6.2	1.45	15.3	12.4	2.9
1995	$61,200	7.65	6.2	1.45	15.3	12.4	2.9
1996	$62,700	7.65	6.2	1.45	15.3	12.4	2.9
1997	$65,400	7.65	6.2	1.45	15.3	12.4	2.9
1998	$68,400	7.65	6.2	1.45	15.3	12.4	2.9
1999	$72,600	7.65	6.2	1.45	15.3	12.4	2.9
2000	$76,200	7.65	6.2	1.45	15.3	12.4	2.9
2001	$80,400	7.65	6.2	1.45	15.3	12.4	2.9
2002	$84,900	7.65	6.2	1.45	15.3	12.4	2.9
2003	$87,900	7.65	6.2	1.45	15.3	12.4	2.9
2004	$87,900	7.65	6.2	1.45	15.3	12.4	2.9
2005	$90,000	7.65	6.2	1.45	15.3	12.4	2.9
2006	$94,200	7.65	6.2	1.45	15.3	12.4	2.9
2007	$97,500	7.65	6.2	1.45	15.3	12.4	2.9
2008	$102,000	7.65	6.2	1.45	15.3	12.4	2.9
2009	$106,800	7.65	6.2	1.45	15.3	12.4	2.9
2010	$106,800	7.65	6.2	1.45	15.3	12.4	2.9
2011	$106,800	[2]	[2]	1.45	13.3	10.4	2.9

[1] For 1984 only, employees were allowed a credit of 0.3 percent of taxable wages against their FICA tax liability, reducing the effective rate to 6.7 percent.

[2] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduced the FICA tax rate for employees by two percentage points for 2011. Specifically, the employer OASDI rate remains at 6.2 while the employee rate is reduced to 4.2.

2. Estate and gift tax

The United States generally imposes a gift tax on transfers of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise.[57] Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. An estate tax generally is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death and on certain property held by a nonresident alien if the property is located in the United States at the time of death.[58] The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death. The taxable estate generally equals the worldwide gross estate less certain allowable deductions. Since 1976, a generation-skipping transfer tax also has been imposed on certain transfers to "skip persons," generally, beneficiaries in a generation more than one generation below that of the transferor.

Prior to 1976, the estate and gift tax systems were two separate systems. The Tax Reform Act of 1976[59] unified the estate and gift taxes, with a single graduated rate table for both cumulative inter vivos gifts and taxable transfers at death. Since that time, the top marginal estate and gift tax rate has decreased significantly, from 70 percent in 1977 to 35 percent in 2011. The 1976 Act also combined separate estate and gift tax exemptions into a single "unified credit," which effectively exempts a certain dollar value in gifts or bequests from gift or estate tax. The exemption value of the unified credit has increased significantly since that time, from $120,667 in 1977 to $5 million in 2011.[60]

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")[61] gradually reduced the estate and generation skipping transfer taxes through 2009, and generally repealed the estate and generation-skipping transfer taxes for one year in 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[62] generally reinstated the estate and generation-skipping transfer taxes for 2010, but allowed a decedent's executor to

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[57] In determining their taxable gifts, taxpayers are permitted to exclude every year a specified dollar value of gifts to another person, provided the gift is a gift of a present interest in property. The gift tax annual exclusion has increased over time, from $3,000 in 1975 to $13,000 in 2011.

[58] Assets acquired from a decedent generally receive a fair market value ("stepped up") basis. In general, the tax basis of assets acquired by gift is carried over from the donor of the gift. Gifts and bequests generally are excluded from the recipient's gross income for income tax purposes.

[59] Pub. L. No. 94-455.

[60] Through 1976, and again from 2004 through 2010, the exemption value of the unified credit for estate and gift tax purposes differed. The generation-skipping transfer tax rate equals the highest marginal estate tax rate, and the generation-skipping transfer tax exemption equals the estate tax exemption in effect for the year.

[61] Pub. L. No. 107-16.

[62] Pub. L. No. 111-312.

elect out of the new regime (such that an estate tax would not apply); the Act set the generation-skipping transfer tax rate at zero percent.

The estate and gift tax laws include special rules, which have become more generous over time, for gifts or bequests to a spouse. Prior to 1976, for example, a marital deduction was permitted for 50 percent of the value of property transferred through an estate from a deceased spouse to the surviving spouse. The 1976 Act provided a 100-percent marital deduction for the first $250,000 of property transferred to a surviving spouse. Since 1981, the estate and gift tax laws generally have provided for unlimited deductions for gifts and bequests to spouses.

The estate and gift tax laws also include a number of special, preferential rules for transfers of interests in closely held businesses and farms, including special valuation rules and rules that allow for installment payment of estate taxes under certain circumstances. For example, a provision included in the 1976 Act generally permits a decedent's executor to value farm and other business real property for estate tax purposes at its current-use value instead of at its highest and best use value for estate tax purposes, subject to a maximum reduction in value.[63] This maximum reduction in value subject to tax has increased over time, from $500,000 in 1981 to $1 million in 2011.

Table A-2 below shows the evolution since 1975 of the gift tax annual exclusion, the estate and gift tax exemptions, the highest statutory estate and gift tax rates, and the threshold above which such rates apply.

Table A-2.–Estate and Gift Tax Rates and Exemption Amounts, 1975-2011

Year	Annual gift exclusion	Exemption value of unified credit (gift exemption when not unified)	Threshold of highest statutory tax rate	Highest statutory tax rate (percent)
1975-1976	$3,000	$60,000 ($30,000)	$10 million	57.75 gift; 77 estate
1977	$3,000	$120,667	$5 million	70
1978	$3,000	$134,000	$5 million	70
1979	$3,000	$147,333	$5 million	70
1980	$3,000	$161,563	$5 million	70
1981	$10,000	$175,625	$5 million	70
1982	$10,000	$225,000	$4 million	65
1983	$10,000	$275,000	$3.5 million	60
1984	$10,000	$325,000	$3 million	55
1985	$10,000	$400,000	$3 million	55
1986	$10,000	$500,000	$3 million	55
1987-1997	$10,000	$600,000	$3 million	55
1998	$10,000	$625,000	$3 million	55

[63] Sec. 2032A.

Year	Annual gift exclusion	Exemption value of unified credit (gift exemption when not unified)	Threshold of highest statutory tax rate	Highest statutory tax rate (percent)
1999	$10,000	$650,000	$3 million	55
2000-2001	$10,000	$675,000	$3 million	55
2002	$11,000	$1 million	$2.5 million	50
2003	$11,000	$1 million	$2 million	49
2004	$11,000	$1.5 million ($1 million)	$2 million	48
2005	$11,000	$1.5 million ($1 million)	$2 million	47
2006	$12,000	$2 million ($1 million)	$2 million	46
2007-2008	$12,000	$2 million ($1 million)	$1.5 million	45
2009	$13,000	$3.5 million ($1 million)	$1.5 million	45
2010[64]	$13,000	$5 million ($1 million)	$500,000[65]	35
2011	$13,000	$5 million	$500,000[66]	35

3. Excise taxes

In general

The Federal tax system imposes excise taxes on selected goods and services.[67] In addition to excise taxes the primary purpose of which is revenue production, excise taxes also are imposed to promote adherence to other policies (e.g., penalty excise taxes). Generally, excise taxes are taxes imposed on a per unit or ad valorem (i.e., percentage of price) basis on the

[64] Under the 2010 Act, executors of estates of decedents who die during 2010 generally may elect to have the EGTRRA 2010 estate tax and basis rules apply as if the estate tax provisions of the 2010 Act had never been enacted. In the event of such an election: (1) no estate tax would apply; (2) the generation skipping transfer tax would remain in effect with a $5 million exemption and a zero-percent rate; (3) The gift tax exemption and rate would be $1 million and 35 percent; and (4) basis of assets acquired from the decedent would take a modified carry-over basis under section 1022.

[65] The 2010 Act modifies the rate table in section 2001(c) to provide for a $500,000 threshold for the highest statutory rate of 35 percent. However, the estate and gift tax exemptions for 2010 exceed this threshold amount, with the result that any transfers up to the exemption amounts will not be taxed. Therefore, in practice, the 35-percent rate applies only to 2010 transfers that exceed a taxpayer's estate or gift tax exemptions, and any lower marginal rates listed in the section 2001(c) rate table will not apply.

[66] The 2010 Act modifies the rate table in section 2001(c) to provide for a $500,000 threshold for the highest statutory rate of 35 percent. However, the estate and gift tax exemptions for 2011 exceed this threshold amount, with the result that any transfers up to the exemption amounts will not be taxed. Therefore, in practice, the 35-percent rate applies only to 2011 transfers that exceed a taxpayer's estate or gift tax exemptions, and any lower marginal rates listed in the section 2001(c) rate table will not apply.

[67] For a more detailed description of Federal excise taxes, see, Joint Committee on Taxation, *Present Law and Background Information on Federal Excise Taxes* (JCS-1-11), January 2011.

production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous activities and products, coal, telephone communications, certain wagers, and vehicles lacking in fuel efficiency.[68]

In 2010, the Congress enacted several new excise taxes. These taxes are: the Patient-Centered Outcomes Research Trust Fund taxes;[69] the annual fee on branded prescription pharmaceutical manufacturers and importers;[70] the excise tax on indoor tanning services;[71] the excise tax on certain medical devices;[72] the annual fee on health insurance providers;[73] the excise taxes on individuals without minimum essential health coverage;[74] the excise tax on certain large employers not offering health care coverage;[75] the excise tax on insurers for high-cost employer-sponsored health coverage;[76] and the foreign procurement excise tax.[77]

Revenues from certain Federal excise taxes are dedicated to trust funds (e.g., the Highway Trust Fund) for designated expenditure programs. Revenues from other excise taxes (e.g., alcoholic beverages) go to the General Fund for general purpose expenditures.

The largest excise taxes in terms of revenue (for fiscal year 2009) are those for gasoline motor fuels ($25.1 billion), domestic cigarettes ($11.0 billion), diesel motor fuel ($8.5 billion), and domestic air ticket taxes ($7.3 billion).

The following summarizes the key changes to the alcohol, cigarette, and motor fuel excise taxes since 1975.

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[68] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, pp. 478-516 for discussion of various Federal excise taxes.

[69] Sec. 4375 (relating to health insurance); and sec. 4376 (relating to self-insured health plans).

[70] Sec. 9008 of Pub. L. No 111-148, as amended by sec. 1404 of Pub. L. No. 111-152.

[71] Sec. 5000B.

[72] Sec. 4191.

[73] Sec. 9010 of Pub. L. No. 111-148, as amended by sec. 10905 of such Act, as further amended by sec. 1406 of Pub. L. No. 111-152.

[74] Sec. 5000A.

[75] Sec. 4980H.

[76] Sec. 4980I.

[77] Sec. 5000C.

Alcohol

Taxes are imposed at different rates for distilled spirits, beer, and wines, and are imposed on these products when produced or imported. Table A-3 below shows the alcohol excise tax rates since 1975.

A-3.–Alcohol Excise Taxes

Type of Alcohol	1975	1985	1990-Present
Distilled Spirits (per proof gallon)	$10.50	$12.50	$13.50
Beer (per barrel)	9.0	9.0	18.0
Wines (per wine gallon)			
"Still wines" not more than 14 percent alcohol	.17	.17	1.07
"Still wines" 14-21% alcohol	.67	.67	1.57
"Still wines" 21-24% alcohol	2.25	2.25	3.15
"Still wines" more than 24% alcohol	Taxed as spirits	Taxed as Spirits	Taxed as Spirits
Champagne and sparkling wines	3.40	3.40	3.40
Artificially carbonated wines	2.40	2.40	3.30

Cigarettes

In 1975 the excise tax rate on small cigarettes was eight cents per pack, the same rate that had been in effect since 1951.[78] Table A-4 below shows the cigarette excise tax rates since 1975.

Table A-4.–Cigarette Excise Tax Rates

Year	1975 - 1981	1982 - 1990	1991 - 1992	1993 - 1996	1997 - 2008	2009 - Present
Small Cigarettes Tax Rate (cents per pack)	8	16	20	24	39	100.66

Motor fuels

The tax on gasoline in 1975 was four cents per gallon and the revenues raised from the tax were allocated to the Highway Trust Fund ("HTF"), created by the Highway Revenue Act of

[78] Small cigarettes are those weighing three pounds or less per thousand.

1956.[79] The tax on diesel fuel was also four cents per gallon in 1975. Table A-5 below shows motor fuel excise tax rates since 1975.

Table A-5.–Motor Fuel Excise Tax Rates

Year	1975	1983	1984	1987	1990	1993-Present[1]
Gasoline (cents per gallon)	4	9	9	9.1	14.1	18.4
Diesel (cents per gallon)	4	9	15	15.1	20.1	24.4

[1] The current gasoline and diesel rates of 18.4 cents per gallon and 24.4 cents per gallon, respectively, consist of 18.3 cents per gallon (gasoline) and 24.3 cents per gallon (diesel) allocated to the HTF, and 0.1 cent per gallon allocated to the Leaking Underground Storage Tank Trust Fund.

[79] Pub. L. No. 84-627.

B. Historical Federal Receipts by Source - Supplemental Material

Tables A-6 through A-8 below show data from 1950 to 2010 on the aggregate receipts collected from the individual income tax, the corporate income tax, social insurance taxes, excise taxes, the estate and gift taxes, and other receipts. Table A-6 shows the aggregate revenues collected by source, in millions of dollars.

Table A-7 shows the same aggregate revenues by source, but as a percentage of Gross Domestic Product ("GDP"). As a share of GDP, the individual income tax has generally oscillated around its average value of eight percent over this period of time. By contrast, corporate income taxes and excise taxes have generally declined as a share of GDP during this period, while social insurance taxes have risen substantially as a share of GDP over this period. In 2010, total taxes averaged 14.9 percent of GDP, well below the average of the 1950-2010 period of 17.9 percent.

Table A-8 shows Federal receipts by source as a percentage of all Federal receipts. Reflecting the same facts as above, the individual income tax has oscillated around its average share over this period of 44.8 percent, the corporate and excise taxes have declined as a percentage of all revenues, and social insurance taxes have risen substantially from around 10 percent of the total in the early 1950s to levels generally varying between 35 and 40 percent in recent years. Social insurance taxes as a share of all taxes reached a historic high of 42.3 percent in 2009, owing to sharp declines in individual and corporate income taxes.

Figure A-1 shows the components of adjusted gross income as a percentage of total adjusted gross income from 1950 to 2008. Since 1980, salary and wage income has fallen as a share of adjusted gross income, while business net income has risen substantially.

Table A-6.–Aggregate Federal Receipts by Source, 1950-2010
[millions of dollars]

Fiscal Year	Individual Income Tax	Corporate Income Tax	Employment[1] Taxes	Excise Taxes	Estate and Gift Taxes	Other[2] Receipts	Total
1950	15,755	10,449	4,338	7,550	698	653	39,443
1951	21,616	14,101	5,674	8,648	708	870	51,616
1952	27,934	21,226	6,445	8,952	818	892	66,167
1953	29,816	21,238	6,820	9,877	881	976	69,608
1954	29,542	21,101	7,208	9,945	934	971	69,701
1955	28,747	17,661	7,862	9,131	924	926	65,451
1956	32,188	20,880	9,320	9,929	1,161	1,109	74,587
1957	35,620	21,167	9,997	10,534	1,365	1,307	79,990
1958	34,724	20,074	11,239	10,638	1,393	1,568	79,636
1959	36,719	17,309	11,722	10,576	1,333	1,588	79,249
1960	40,715	21,494	14,683	11,676	1,606	2,317	92,492
1961	41,338	20,954	16,439	11,860	1,896	1,900	94,388
1962	45,571	20,523	17,046	12,534	2,016	1,985	99,676
1963	47,588	21,579	19,804	13,194	2,167	2,228	106,560
1964	48,697	23,493	21,963	13,731	2,394	2,337	112,613
1965	48,792	25,461	22,242	14,570	2,716	3,037	116,817
1966	55,446	30,073	25,546	13,062	3,066	3,642	130,835
1967	61,526	33,971	32,619	13,719	2,978	4,009	148,822
1968	88,726	28,665	33,923	14,079	3,051	4,529	152,973
1969	87,249	36,678	39,015	15,222	3,491	5,227	186,882
1970	90,412	32,829	44,362	15,705	3,644	5,855	192,807
1971	86,230	26,785	47,325	16,614	3,735	6,450	187,139
1972	94,737	32,166	52,574	15,477	5,436	6,919	207,309
1973	103,246	36,153	63,115	16,260	4,917	7,109	230,799
1974	118,952	38,650	75,071	16,844	5,035	8,702	263,224
1975	122,386	40,621	84,534	16,551	4,611	10,387	279,090
1976	131,603	41,409	90,769	16,963	5,216	12,101	298,060
1977	157,626	54,892	106,485	17,548	7,327	11,681	355,559
1978	180,988	59,952	120,967	18,376	5,285	13,993	399,561
1979	217,841	65,677	138,939	18,745	5,411	16,690	463,302
1980	244,069	64,600	157,803	24,329	6,389	19,922	517,112
1981	285,917	61,137	182,720	40,839	6,787	21,872	599,272
1982	297,744	49,207	201,498	36,311	7,991	25,015	617,766
1983	288,938	37,022	208,994	35,300	6,053	24,256	600,562
1984	298,415	56,893	239,376	37,361	6,010	28,382	666,438
1985	334,531	61,331	265,163	35,992	6,422	30,598	734,037
1986	348,959	63,143	283,901	32,919	6,958	33,275	769,155
1987	392,557	83,926	303,318	32,457	7,493	34,536	854,288
1988	401,161	94,508	334,335	35,227	7,594	36,393	909,238
1989	445,690	103,291	359,416	34,386	8,745	39,576	991,105
1990	466,884	93,507	380,047	35,345	11,500	44,674	1,031,958
1991	467,827	98,086	396,016	42,402	11,138	39,519	1,054,988
1992	475,964	100,270	413,689	45,569	11,143	44,574	1,091,208
1993	509,680	117,520	428,300	48,057	12,577	38,201	1,154,335
1994	543,055	140,385	461,475	55,225	15,225	43,202	1,258,566
1995	590,244	157,004	484,473	57,484	14,763	47,822	1,351,790
1996	656,417	171,824	509,414	54,014	17,189	44,195	1,453,053
1997	737,466	182,293	539,371	56,924	19,845	43,333	1,579,232
1998	828,586	188,677	571,831	57,673	24,076	50,885	1,721,728
1999	879,480	184,680	611,833	70,414	27,782	53,263	1,827,452
2000	1,004,462	207,289	652,852	68,865	29,010	62,713	2,025,191
2001	994,339	151,075	693,967	66,232	28,400	57,069	1,991,082
2002	858,345	148,044	700,760	66,989	26,507	52,491	1,853,136
2003	793,699	131,778	712,978	67,524	21,959	54,376	1,782,314
2004	808,959	189,371	733,407	69,855	24,831	53,691	1,880,114
2005	927,222	278,282	794,125	73,094	24,764	56,124	2,153,611
2006	1,043,908	353,915	837,821	73,961	27,877	69,387	2,406,869
2007	1,163,472	370,243	869,607	65,069	26,044	73,550	2,567,985
2008	1,145,747	304,346	900,155	67,334	28,844	77,565	2,523,991
2009	915,308	138,229	890,917	62,483	23,482	74,570	2,104,989
2010	898,549	191,437	864,814	66,909	18,885	122,130	2,162,724

[1] Employment taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad social security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of [1] customs duties and fees, and [2] deposits of earnings by the Federal Reserve system.

Source: Office of Management and Budget, *Historical Tables, Budget of the U.S. Government, Fiscal Year 2012, Tables 2.1 and 2.5, and JCT calculations.*

Table A-7.–Federal Receipts by Source, As a Percentage of GDP, 1950-2010

Fiscal Year	Individual Income Tax	Corporate Tax	Employment[1] Taxes	Excise Taxes	Estate and Gift Taxes	Other[2] Receipts	Total
1950	5.8	3.8	1.6	2.8	0.3	0.2	14.4
1951	6.8	4.4	1.8	2.7	0.2	0.3	16.1
1952	8.0	6.1	1.8	2.5	0.2	0.3	19.0
1953	8.0	5.7	1.8	2.7	0.2	0.3	18.7
1954	7.8	5.6	1.9	2.6	0.2	0.3	18.5
1955	7.3	4.5	2.0	2.3	0.2	0.2	16.5
1956	7.5	4.9	2.2	2.3	0.3	0.3	17.5
1957	7.9	4.7	2.2	2.3	0.3	0.3	17.7
1958	7.5	4.4	2.4	2.3	0.3	0.3	17.3
1959	7.5	3.5	2.4	2.2	0.3	0.3	16.2
1960	7.8	4.1	2.8	2.3	0.3	0.4	17.8
1961	7.8	4.0	3.1	2.2	0.4	0.4	17.8
1962	8.0	3.6	3.0	2.2	0.4	0.3	17.6
1963	7.9	3.6	3.3	2.2	0.4	0.4	17.8
1964	7.6	3.7	3.4	2.1	0.4	0.4	17.6
1965	7.1	3.7	3.2	2.1	0.4	0.4	17.0
1966	7.3	4.0	3.4	1.7	0.4	0.5	17.3
1967	7.6	4.2	4.0	1.7	0.4	0.5	18.4
1968	7.9	3.3	3.9	1.6	0.4	0.5	17.6
1969	9.2	3.9	4.1	1.6	0.4	0.6	19.7
1970	8.9	3.2	4.4	1.6	0.4	0.6	19.0
1971	8.0	2.5	4.4	1.5	0.3	0.6	17.3
1972	8.1	2.7	4.5	1.3	0.5	0.6	17.6
1973	7.9	2.8	4.8	1.2	0.4	0.5	17.6
1974	8.3	2.7	5.2	1.2	0.4	0.6	18.3
1975	7.8	2.6	5.4	1.1	0.3	0.7	17.9
1976	7.6	2.4	5.2	1.0	0.3	0.7	17.1
1977	8.0	2.8	5.4	0.9	0.4	0.6	18.0
1978	8.2	2.7	5.5	0.8	0.2	0.6	18.0
1979	8.7	2.6	5.6	0.7	0.2	0.7	18.5
1980	9.0	2.4	5.8	0.9	0.2	0.7	19.0
1981	9.4	2.0	6.0	1.3	0.2	0.7	19.6
1982	9.2	1.5	6.3	1.1	0.2	0.8	19.2
1983	8.4	1.1	6.1	1.0	0.2	0.7	17.5
1984	7.8	1.5	6.2	1.0	0.2	0.7	17.3
1985	8.1	1.5	6.4	0.9	0.2	0.7	17.7
1986	7.9	1.4	6.4	0.7	0.2	0.8	17.5
1987	8.4	1.8	6.5	0.7	0.2	0.7	18.4
1988	8.0	1.9	6.7	0.7	0.2	0.7	18.2
1989	8.3	1.9	6.7	0.6	0.2	0.7	18.4
1990	8.1	1.6	6.6	0.6	0.2	0.8	18.0
1991	7.9	1.7	6.7	0.7	0.2	0.7	17.8
1992	7.6	1.6	6.6	0.7	0.2	0.7	17.5
1993	7.7	1.8	6.5	0.7	0.2	0.6	17.5
1994	7.8	2.0	6.6	0.8	0.2	0.6	18.0
1995	8.0	2.1	6.6	0.8	0.2	0.7	18.4
1996	8.5	2.2	6.6	0.7	0.2	0.6	18.8
1997	9.0	2.2	6.6	0.7	0.2	0.5	19.2
1998	9.6	2.2	6.6	0.7	0.3	0.6	19.9
1999	9.6	2.0	6.6	0.8	0.3	0.6	19.8
2000	10.2	2.1	6.6	0.7	0.3	0.6	20.6
2001	9.7	1.5	6.8	0.6	0.3	0.6	19.5
2002	8.1	1.4	6.6	0.6	0.3	0.5	17.6
2003	7.2	1.2	6.5	0.6	0.2	0.5	16.2
2004	6.9	1.6	6.3	0.6	0.2	0.5	18.1
2005	7.5	2.2	6.4	0.6	0.2	0.5	17.3
2006	7.9	2.7	6.3	0.6	0.2	0.5	18.2
2007	8.4	2.7	6.3	0.5	0.2	0.5	18.5
2008	8.0	2.1	6.3	0.5	0.2	0.5	17.5
2009	6.5	1.0	6.3	0.4	0.2	0.5	14.9
2010	5.2	1.3	6.0	0.5	0.1	0.8	14.9
1950-2010 Avg.	8.0	2.8	5.0	1.3	0.3	0.5	17.9

[1] Employment taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad Social Security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of (1) customs duties and fees, and (2) deposits of earnings by the Federal Reserve system.

Source: Office of Management and Budget, *Historical Tables, Budget of the U.S. Government, Fiscal Year 2012, Table 2.3*; Economic Report of the President, 2011, Table B-78 for fiscal year GDP Figures.

Table A-8.–Federal Receipts by Source, As a Percentage of Total Revenues, 1950-2010

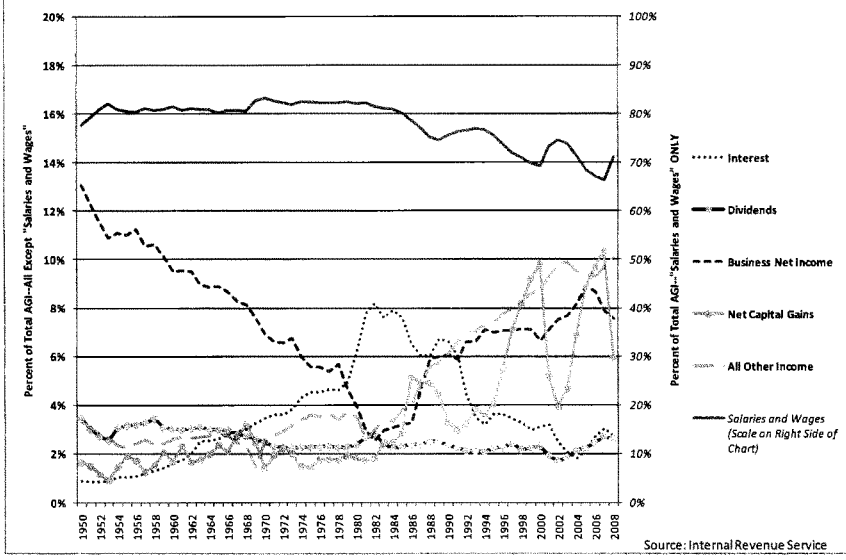
Fiscal Year	Individual Income Tax	Corporate Tax	Employment[1] Taxes	Excise Taxes	Estate and Gift Taxes	Other[2] Receipts
1950	39.9	26.5	11.0	19.1	1.8	1.7
1951	41.9	27.3	11.0	16.8	1.4	1.7
1952	42.2	32.1	9.7	13.4	1.2	1.3
1953	42.8	30.5	9.8	14.2	1.3	1.4
1954	42.4	30.3	10.3	14.3	1.3	1.4
1955	43.9	27.3	12.0	14.0	1.4	1.4
1956	43.2	28.0	12.5	13.3	1.6	1.5
1957	44.5	26.5	12.5	13.2	1.7	1.6
1958	43.6	25.2	14.1	13.4	1.7	2.0
1959	46.3	21.8	14.8	13.3	1.7	2.0
1960	44.0	23.2	15.9	12.6	1.7	2.5
1961	43.8	22.2	17.4	12.6	2.0	2.0
1962	45.7	20.6	17.1	12.6	2.0	2.0
1963	44.7	20.3	18.6	12.4	2.0	2.1
1964	43.2	20.9	19.5	12.2	2.1	2.1
1965	41.8	21.8	19.0	12.5	2.3	2.6
1966	42.4	23.0	19.5	10.0	2.3	2.8
1967	41.3	22.8	21.9	9.2	2.0	2.7
1968	44.9	18.7	22.2	9.2	2.0	3.0
1969	46.7	19.6	20.9	8.1	1.9	2.8
1970	46.9	17.0	23.0	8.1	1.9	3.0
1971	46.1	14.3	25.3	8.9	2.0	3.4
1972	45.7	15.5	25.4	7.5	2.6	3.3
1973	44.7	15.7	27.3	7.0	2.1	3.1
1974	45.2	14.7	28.5	6.4	1.9	3.3
1975	43.9	14.6	30.3	5.9	1.7	3.7
1976	44.2	13.9	30.5	5.7	1.7	4.1
1977	44.3	15.4	29.9	4.9	2.1	3.3
1978	45.3	15.0	30.3	4.6	1.3	3.5
1979	47.0	14.2	30.0	4.0	1.2	3.6
1980	47.2	12.5	30.5	4.7	1.2	3.9
1981	47.7	10.2	30.5	6.8	1.1	3.6
1982	48.2	8.0	32.6	5.9	1.3	4.0
1983	48.1	6.2	34.8	5.9	1.0	4.0
1984	44.8	8.5	35.9	5.6	0.9	4.3
1985	45.6	8.4	36.1	4.9	0.9	4.2
1986	45.4	8.2	36.9	4.3	0.9	4.3
1987	46.0	9.8	35.5	3.8	0.9	4.0
1988	44.1	10.4	36.8	3.9	0.8	4.0
1989	45.0	10.4	36.3	3.5	0.9	4.0
1990	45.2	9.1	36.8	3.4	1.1	4.3
1991	44.3	9.3	37.5	4.0	1.1	3.7
1992	43.6	9.2	37.9	4.2	1.0	4.1
1993	44.2	10.2	37.1	4.2	1.1	3.3
1994	43.1	11.2	36.7	4.4	1.2	3.4
1995	43.7	11.6	35.8	4.3	1.1	3.5
1996	45.2	11.8	35.1	3.7	1.2	3.0
1997	46.7	11.5	34.2	3.6	1.3	2.7
1998	48.1	11.0	33.2	3.3	1.4	3.0
1999	48.1	10.1	33.5	3.9	1.5	2.9
2000	49.6	10.2	32.2	3.4	1.4	3.1
2001	49.9	7.6	34.9	3.3	1.4	2.9
2002	46.3	8.0	37.8	3.6	1.4	2.8
2003	44.5	7.4	40.0	3.8	1.2	3.1
2004	43.0	10.1	39.0	3.7	1.3	2.9
2005	43.1	12.9	36.9	3.4	1.1	2.6
2006	43.4	14.7	34.8	3.1	1.2	2.9
2007	45.3	14.4	33.9	2.5	1.0	2.9
2008	45.4	12.1	35.7	2.7	1.1	3.1
2009	43.5	6.6	42.3	3.0	1.1	3.5
2010	41.5	8.9	40.0	3.1	0.9	5.6
1950-2010 Avg.	44.8	15.7	27.7	7.3	1.5	3.0

[1] Employment taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad Social Security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of (1) customs duties and fees, and (2) deposits of earnings by the Federal Reserve system.

Source: Office of Management and Budget, *Historical Tables, Budget of the U.S. Government, Fiscal Year 2012, Table 2.2.*

Figure A-1.—Components of AGI as Percentage of Total, 1950-2008



Source: Internal Revenue Service

C. Variety of Business Organizations - Supplemental Data

Table A-9.–Number of Different Types of Business Returns, 1978-2008

Year	Non-Farm Sole Props	C Corporations	S Corporations	Partnerships	Farms	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	514,907	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349
2000	17,902,791	2,184,795	2,860,478	2,057,500	2,086,789	27,092,353
2001	18,338,190	2,149,105	2,986,486	2,132,117	2,006,871	27,612,769
2002	18,925,517	2,112,230	3,154,377	2,242,169	1,995,072	28,429,365
2003	19,710,079	2,059,631	3,341,606	2,375,375	1,997,116	29,483,807
2004	20,590,691	2,039,631	3,518,334	2,546,877	2,004,898	30,700,431
2005	21,467,566	1,987,171	3,684,086	2,763,625	1,981,249	31,883,697
2006	22,074,953	1,968,032	3,872,766	2,947,116	1,958,273	32,821,140
2007	23,122,698	1,878,956	3,989,893	3,096,334	1,989,690	34,077,571
2008	22,614,483	1,797,278	4,049,943	3,146,006	1,948,054	33,555,764

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Table A-10.– Distribution of C Corporations, 2008

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent Returns	Cumulative Percent Total Assets
$0 or less	296,074	0	16.47%	0.00%
$1 to $25,000	363,899	2,668	36.72%	0.00%
$25,001 to $50,000	136,343	4,695	44.31%	0.01%
$50,001 to $100,000	174,776	11,908	54.03%	0.03%
$100,001 to $250,000	253,837	39,698	68.15%	0.08%
$250,001 to $500,000	181,186	64,539	78.24%	0.17%
$500,001 to $1,000,000	139,966	98,766	86.02%	0.30%
$1,000,001 to $10,000,000	193,443	549,528	96.79%	1.05%
$10,000,001 to $50,000,000	29,932	654,387	98.45%	1.94%
$50,000,001 to $100,000,000	7,290	519,178	98.86%	2.65%
More than $100,000,000	20,530	71,486,474	100.00%	100.00%
All Assets	1,797,278	73,431,840		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent Returns	Cumulative Percent Total Receipts
$0 or less	223,061	-15,496	12.41%	-0.07%
$1 to $2,500	46,820	49	15.02%	-0.07%
$2,501 to $5,000	29,231	113	16.64%	-0.07%
$5,001 to $10,000	42,501	317	19.01%	-0.07%
$10,001 to $25,000	98,843	1,671	24.51%	-0.06%
$25,001 to $50,000	108,038	3,996	30.52%	-0.04%
$50,001 to $100,000	154,729	11,337	39.13%	0.01%
$100,001 to $250,000	276,747	45,667	54.53%	0.23%
$250,001 to $500,000	212,272	77,224	66.34%	0.59%
$500,001 to $1,000,000	195,168	141,202	77.20%	1.26%
$1,000,001 to $10,000,000	337,815	1,020,309	95.99%	6.07%
$10,000,001 to $50,000,000	52,541	1,092,809	98.91%	11.22%
More than $50,000,000	19,510	18,843,110	100.00%	100.00%
All Receipts	1,797,278	21,222,309		

* Details do not add to totals due to rounding.

Source: JCT calculations on SOI data.

Table A-11.– Distribution of S Corporations, 2008

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
$0 or less	722,118	0	17.83%	0.00%
$1 to $25,000	1,002,508	7,857	42.58%	0.23%
$25,001 to $50,000	415,105	14,177	52.83%	0.65%
$50,001 to $100,000	415,052	28,505	63.08%	1.50%
$100,001 to $250,000	568,719	90,348	77.12%	4.18%
$250,001 to $500,000	345,585	122,359	85.66%	7.81%
$500,001 to $1,000,000	239,203	167,535	91.56%	12.79%
$1,000,001 to $10,000,000	301,953	839,356	99.02%	37.72%
$10,000,001 to $50,000,000	32,765	644,961	99.83%	56.87%
$50,000,001 to $100,000,000	3,611	250,689	99.92%	64.31%
More than $100,000,000	3,326	1,201,517	100.00%	100.00%
All Assets	4,049,944	3,367,304		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	552,003	-8,165	13.63%	-0.14%
$1 to $2,500	96,972	100	16.02%	-0.14%
$2,501 to $5,000	54,264	198	17.36%	-0.14%
$5,001 to $10,000	80,680	597	19.36%	-0.13%
$10,001 to $25,000	219,584	3,750	24.78%	-0.07%
$25,001 to $50,000	260,228	9,718	31.20%	0.09%
$50,001 to $100,000	400,774	29,242	41.10%	0.57%
$100,001 to $250,000	707,617	117,275	58.57%	2.51%
$250,001 to $500,000	536,784	191,812	71.83%	5.68%
$500,001 to $1,000,000	467,402	331,675	83.37%	11.17%
$1,000,001 to $10,000,000	585,763	1,637,854	97.83%	38.27%
$10,000,001 to $50,000,000	73,682	1,476,065	99.65%	62.69%
More than $50,000,000	14,192	2,253,935	100.00%	100.00%
All Receipts	4,049,944	6,044,056		

* Details do not add to totals due to rounding.
Source: JCT calculations on SOI data.

Table A-12. –Distribution of Partnerships, 2008

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent Returns	Cumulative Percent Total Assets
$0 or less	831,112	-124,983	26.42%	-0.65%
$1 to $25,000	326,725	2,463	36.80%	-0.64%
$25,001 to $50,000	112,035	4,206	40.36%	-0.62%
$50,001 to $100,000	165,193	12,295	45.62%	-0.56%
$100,001 to $250,000	337,546	58,018	56.34%	-0.26%
$250,001 to $500,000	302,787	111,844	65.97%	0.32%
$500,001 to $1,000,000	293,703	210,331	75.31%	1.41%
$1,000,001 to $10,000,000	648,573	1,960,646	95.92%	11.59%
$10,000,001 to $50,000,000	95,883	1,972,643	98.97%	21.83%
$50,000,001 to $100,000,000	14,272	994,910	99.42%	27.00%
More than $100,000,000	18,180	14,057,430	100.00%	100.00%
All Assets	3,146,006	19,259,804		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent Returns	Cumulative Percent Total Receipts
$0 or less	1,940,561	0	61.68%	0.00%
$1 to $2,500	88,435	89	64.49%	0.00%
$2,501 to $5,000	30,168	108	65.45%	0.00%
$5,001 to $10,000	56,704	418	67.26%	0.01%
$10,001 to $25,000	125,287	2,036	71.24%	0.06%
$25,001 to $50,000	97,436	3,661	74.34%	0.14%
$50,001 to $100,000	120,238	8,651	78.16%	0.34%
$100,001 to $250,000	206,257	34,255	84.71%	1.12%
$250,001 to $500,000	141,415	50,313	89.21%	2.26%
$500,001 to $1,000,000	118,379	83,280	92.97%	4.15%
$1,000,001 to $10,000,000	187,050	547,902	98.92%	16.61%
$10,000,001 to $50,000,000	26,111	540,309	99.75%	28.90%
More than $50,000,000	7,965	3,126,814	100.00%	100.00%
All Receipts	3,146,006	4,397,835		

* Details do not add to totals due to rounding.
Source: JCT calculations on SOI data.

Table A-13.–Distribution of Nonfarm Sole Proprietorships, 2008

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	1,151,951	0	5.09%	0.00%
$1 to $2,500	4,487,073	5,291	24.94%	0.41%
$2,501 to $5,000	2,457,593	8,913	35.80%	1.09%
$5,001 to $10,000	3,009,684	21,815	49.11%	2.77%
$10,001 to $25,000	4,522,767	72,407	69.11%	8.33%
$25,001 to $50,000	2,694,233	95,710	81.02%	15.68%
$50,001 to $100,000	1,903,231	133,731	89.44%	25.95%
$100,001 to $250,000	1,506,201	233,793	96.10%	43.91%
$250,001 to $500,000	519,138	179,845	98.40%	57.72%
$500,001 to $1,000,000	227,167	154,542	99.40%	69.59%
$1,000,001 to $10,000,000	132,164	273,398	99.99%	90.59%
$10,000,001 to $50,000,000	2,907	53,060	100.00%[1]	94.67%
More than $50,000,000	375	69,419	100.00%	100.00%
All Receipts	22,614,483	1,301,922		

* Details do not add to totals due to rounding.

[1] The actual figure is 99.9983 percent which rounds to 100.00 percent.

Source: JCT calculations on SOI data.

Table A-14a.–Distribution of Net Income by Gross Receipts and Entity Type, 2008

	Net Income (millions of dollars)		
Firms classified by receipts	**S Corporations**	**Partnerships**	**Nonfarm Sole Proprietorships**
$0 or less	-12,897	-132,165	-4,479
$1 to $2,500	-558	-703	-6,687
$2,501 to $5,000	-392	-280	-417
$5,001 to $10,000	-752	-917	6,311
$10,001 to $25,000	-1,541	-1,791	29,049
$25,001 to $50,000	-1,190	-2,309	33,783
$50,001 to $100,000	1,641	-2,088	43,637
$100,001 to $250,000	9,874	-888	65,726
$250,001 to $500,000	13,076	-67	40,290
$500,001 to $1,000,000	20,007	1,770	27,883
$1,000,001 to $10,000,000	83,359	25,270	26,740
$10,000,001 to $50,000,000	54,503	18,052	2,166
More than $50,000,000	74,896	206,921	505
All Receipts	240,026	110,806	264,508

Table A-14b.–Percent of Firms with a Net Operating Loss by Gross Receipts and Entity Type, 2008

Firms classified by receipts	**S Corporations**	**Partnerships**	**Nonfarm Sole Proprietorships**
$0 or less	58	27	83
$1 to $2,500	77	70	40
$2,501 to $5,000	69	56	30
$5,001 to $10,000	58	65	22
$10,001 to $25,000	52	54	15
$25,001 to $50,000	45	49	13
$50,001 to $100,000	34	41	12
$100,001 to $250,000	30	39	12
$250,001 to $500,000	31	37	12
$500,001 to $1,000,000	28	39	12
$1,000,001 to $10,000,000	26	33	18
$10,000,001 to $50,000,000	26	33	34
More than $50,000,000	21	28	59
All Receipts	38	34	25

* Details do not add to totals due to rounding.
Source: JCT calculations on SOI data.

Table A-15a.–Distribution of Net Income by Gross Receipts of C Corporations, 2008

Firms classified by receipts	Net Income (millions of dollars)
$0 or less	-72,237
$1 to $2,500	-956
$2,501 to $5,000	-483
$5,001 to $10,000	-789
$10,001 to $25,000	-1,577
$25,001 to $50,000	-1,830
$50,001 to $100,000	-2,502
$100,001 to $250,000	-4,500
$250,001 to $500,000	-3,848
$500,001 to $1,000,000	-3,985
$1,000,001 to $10,000,000	-8,585
$10,000,001 to $50,000,000	26,220
More than $50,000,000	819,389
All Receipts	744,316

Table A-15b.–Percent of C Corporations with a Net Operating Loss by Gross Receipts, 2008

Firms classified by receipts	C Corporations
$0 or less	71
$1 to $2,500	67
$2,501 to $5,000	60
$5,001 to $10,000	54
$10,001 to $25,000	56
$25,001 to $50,000	52
$50,001 to $100,000	51
$100,001 to $250,000	46
$250,001 to $500,000	46
$500,001 to $1,000,000	42
$1,000,001 to $10,000,000	35
$10,000,001 to $50,000,000	31
More than $50,000,000	32
All Receipts	48

* Details do not add to totals due to rounding.
Source: JCT calculations on SOI data.

D. Corporate Income Tax Supplement - General Business Credits

The general business credit is the sum of various business credits determined under the Code. The component credits of the general business credit are listed below.

The general business credit may not reduce a taxpayer's net income tax below an amount equal to the taxpayer's tentative minimum tax (or, if greater, 25 percent of so much of the taxpayer's regular tax liability as exceeds $25,000). For purposes of applying this rule to certain credits (the alcohol fuels credit, the low-income housing credit, portions of the renewable electricity production credit, the employer Social Security credit, the railroad track maintenance credit, the small employer health insurance credit, the energy credit, the rehabilitation credit, and work opportunity credit), the tentative minimum tax is treated as being zero.

General business credits determined in a taxable year that exceed the amount allowable in that year generally may be carried back one year and forward up to 20 years. Credits for small businesses determined in 2010 were allowed a five-year carryback.

Table A-16.–Components of the General Business Credit for 2011*

Provision	Description
Rehabilitation credit (sec. 47)	Credit for restoring certain pre-1936 buildings and certain historic buildings
Energy credit (sec. 48)	Credit for investing in certain solar, geothermal, fuel cell, and other energy property
Advanced coal project credit (sec. 48A)	Credit for investing in advanced coal power facilities
Gasification project credit (sec. 48B)	Credit for investing in gasification facilities
Advanced energy project credit (sec. 48C)	Credit for investing in facilities that manufacture certain renewable power or other advanced energy equipment or products
Work opportunity credit (sec. 51)	Credit for hiring employees from certain targeted groups
Alcohol fuels credit (sec. 40)	Credit for producing ethanol and other alcohol fuels
Research credit (sec. 41)	Credit for conducting research in the United States
Low-income housing credit (sec. 42)	Credit for owners of qualified low-income rental housing
Disabled access credit (sec. 44)	Credit to offset costs incurred by small businesses to comply with the Americans With Disabilities Act of 1990
Renewable electricity production credit (sec. 45)	Credit for producing power from wind, biomass, and other renewable resources
Empowerment zone employment credit (sec. 1396)	Credit for employing people in certain designated areas with high levels of unemployment and poverty
Indian employment credit (sec. 45A)	Credit for employing native Americans living and working on Indian reservations

Table A-16.–Components of the General Business Credit for 2011*	
Provision	**Description**
Employer Social Security credit (sec. 45B)	Credit for an employer's portion of Social Security taxes paid on employee cash tips in excess of the minimum wage
Orphan drug credit (sec. 45C)	Credit for clinical testing of drugs used to treat certain rare diseases or conditions
New markets tax credit (sec. 45D)	Credit for investing in community development entities, which serve low income communities
Small employer pension plan startup cost credit (45E)	Credit for small employers that start qualified pension plans
Employer-provided child care credit (sec. 45F)	Credit for building or running an employer-provided child care facility
Railroad track maintenance credit (sec.45G)	Credit for railroad track maintenance expenses
Biodiesel fuels credit (sec. 40A)	Credit for producing biodiesel
Distilled spirits credit (sec. 5011)	Credit to wholesalers, distillers, and importers of distilled spirits that approximates the interest cost resulting from the early imposition of certain excise taxes
Advanced nuclear power production credit (sec. 45J)	Credit for producing nuclear power at advanced nuclear power facilities
New energy efficient homes credit (sec. 45L)	Credit for building energy efficient homes
Energy efficient appliance credit (sec. 45M)	Credit for manufacturing energy efficient appliances
Alternative fuel refueling property credit (sec. 30C)	Credit for installing certain biofuel, electric, and alternative fuel refueling property
Mine rescue team training credit (sec. 45N)	Credit for training mine rescue team employees
Agricultural chemicals security credit (sec. 45O)	Credit for conducting backgrounds checks, installing security devices, and taking other measures to safeguard certain fertilizers and pesticides used on farms
Differential wage payment credit (sec. 45P)	Credit for small employers who supplement the military pay of their employees called to active duty
Carbon dioxide sequestration credit (sec. 45Q)	Credit for sequestering industrial source carbon dioxide
Alternative motor vehicle credit (sec. 30B)	Credit for fuel cell vehicles and hybrid vehicle conversions
Plug-in electric drive motor vehicle credit (secs. 30 and 30D)	Credit for plug-in electric drive motor vehicles
Small employer health insurance credit (sec. 45R)	Credit for small employers who provide health insurance to their employees

* Excludes expired and phased-out credits.

E. New Tax Expenditures since the Tax Reform Act of 1986

The Tax Reform Act of 1986[80] "represents one of the most comprehensive revisions of the Federal income tax system since its inception."[81] Among other considerations, Congress was concerned that erosion of the tax base required tax rates to be higher than otherwise would be necessary. With the elimination of various tax expenditures and other preferences and the enactment of other base-broadening provisions, the Act sharply reduced individual income tax rates. The Act retained some of the tax expenditures most widely utilized by individuals and business tax expenditures believed to be beneficial to the economy.

Numerous changes to the Code have been enacted in subsequent tax legislation. The information that follows provides a list of the new tax expenditures contained in legislation since the passage of the Tax Reform Act of 1986.[82] Modifications and extensions of pre-existing tax expenditures are not listed. Items are grouped by the legislation by which they were created. Items that have since expired are shown in italics.

Technical and Miscellaneous Revenue Act of 1988, enacted on November 10, 1988 (Pub. L. No. 100-647).

- Exclusion of income from United States savings bonds used to pay higher education tuition and fees

Omnibus Budget Reconciliation Act of 1990, enacted on November 5, 1990 (Pub. L. No. 101-508).

- Enhanced oil recovery credit
- Credit for small producers of ethanol
- Credit for cost of providing access for disabled individuals
- *Credit for health insurance costs for coverage of children*
- Reduced rate of tax on capital gains (effective with increase in individual income tax rates)

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[80] Pub. L. No. 99-514.

[81] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 6.

[82] This list may not be exhaustive. Differences in the methodology for (1) identifying tax expenditures (including negative tax expenditures) generally, (2) determining what constitutes a new provision versus a modification or extension of an existing provision, and (3) determining whether a provision is *de minimis* may yield a different list of provisions.

Omnibus Budget Reconciliation Act of 1993, enacted on August 10, 1993 (Pub. L. No. 103-66).

- Exclusion for gain from certain small business stock
- Rollover of gain from sale of publicly traded securities into specialized small business investment companies
- *Tax incentives for businesses in empowerment zones, enterprise communities, and rural development investment areas*
- Accelerated depreciation for property on Indian reservations
- Indian employment credit
- Modification of passive loss rules for certain real estate professionals
- Modification of unrelated business taxable income rules relating to real estate
- Exclusion of income from discharge of indebtedness incurred in connection with qualified real property
- Credit for portion of employer paid FICA taxes on tips

Small Business Job Protection Act of 1996, enacted on August 20, 1996 (Pub. L. No. 104-188).

- Deferral of gain on involuntary conversions resulting from Presidentially-declared disasters
- Exclusion of contributions in aid of construction for water and sewer utilities
- Adoption tax credit
- Exclusion of employer adoption assistance programs
- Deferral of tax on earnings of qualified State tuition programs
- Tax-free transfer of assets from common trust funds to mutual funds

Health Insurance Portability and Accountability Act of 1996, enacted on August 21, 1996 (Pub. L. No. 104-191).

- Medical savings accounts

Taxpayer Relief Act of 1997, enacted on August 5, 1997 (Pub. L. No. 105-34).

- Tax credit for taxpayers with qualifying children under the age of 17
- HOPE and Lifetime Learning credits for tuition for post-secondary education
- Exclusion of earnings of trust or custodial accounts for paying higher education expenses
- Deduction for interest on qualified higher education loans

- *Credit for holders of qualified zone academy bonds*
- Tax incentives for D.C. Enterprise Zones
- D.C. first-time homebuyer tax credit
- Welfare-to-work tax credit
- Income averaging for farmers
- Expensing of environmental remediation expenditures
- *Tax refund to Amtrak based on the carryback of its net operating losses against the tax attributes of its predecessor railroads*
- Exclusion for certain disaster mitigation payments
- Exclusion of survivor annuities paid to families of public safety officers killed in the line of duty

Tax and Trade Relief Extension Act of 1998, as part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999 (Pub. L. No. 105-277).

- Special five-year carryback period for net operating losses attributable to farming

FSC Repeal and Extraterritorial Income Exclusion Act of 2000, enacted on November 15, 2000 (Pub. L. No. 106-519).

- *Extraterritorial income exclusion*

Community Renewal Tax Relief Act of 2000, incorporated by reference in the Consolidated Appropriations Act, 2001, enacted on December 2, 2000 (Pub. L. No. 106-554).

- *Renewal community tax incentives*
- New markets tax credit

Economic Growth and Tax Relief Reconciliation Act of 2001, enacted on June 7, 2001 (Pub. L. No. 107-16).

- Deduction for qualified higher education expenses
- Tax credit for employers who provide child care for employees
- Exclusion for certain restitution payments made to individuals who were persecuted for racial or religious reasons by Nazi Germany or other Axis regimes
- Credit for certain individuals for elective deferrals and IRA contributions
- Nonrefundable credit for administrative and retirement-education expenses for new pension plans adopted by small businesses
- Treatment of electing Alaska Native Settlement Trusts

Job Creation and Worker Assistance Act of 2002, enacted on March 9, 2002 (Pub. L. No. 107-147).

- Additional first-year depreciation deduction for qualified property to which the general rules of MACRS apply
- Above the line deduction for teacher classroom expenses
- Additional first-year depreciation deduction for qualified New York Liberty Zone property
- Authority to issue $8 billion of tax-exempt private activity bonds to finance the construction and rehabilitation of nonresidential real property and residential rental real property in the New York Liberty Zone
- Authority for one additional advance refunding for certain bonds for facilities located in New York City
- A five-year recovery period was provided for qualified New York Liberty Zone leasehold improvement property

Trade Act of 2002, enacted on August 6, 2002 (Pub. L. No. 107-210).

- Tax credit for the purchase of health insurance coverage by certain taxpayers

Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted on May 28, 2003 (Pub. L. No. 108-27).

- Reduced rates of tax on qualified dividends

Military Family Tax Relief Act of 2003, enacted on November 11, 2003 (Pub. L. No. 108-121).

- Exclusion for amounts received under Department of Defense Homeowners Assistance Program
- Deduction for overnight travel expenses of National Guard and Reserve members

Medicare Prescription Drug, Improvement, and Modernization Act of 2003, enacted on December 8, 2003 (Pub. L. No. 108-173).

- Exclusion of untaxed Medicare benefits: Prescription drug insurance (Part D)
- Exclusion of subsidies to employers who maintain prescription drug plans for Medicare retirees
- Health savings accounts

American Jobs Creation Act of 2004, enacted on October 22, 2004 (Pub. L. No. 108-357).

- Production activity deduction

- Deduction of film and television production costs
- Tax credit for expenditures for maintaining railroad tracks
- Elective "tonnage tax" in lieu of corporate income tax on taxable income from certain shipping activities
- Tax credit for biodiesel blenders
- Charitable deduction for certain expenses incurred in carrying out sanctioned whaling activities
- Incentives for small refiners to comply with EPA sulfur regulations
- Exclusion of interest on State and local government bonds for qualified green building and sustainable design projects
- Deferral of gain from the disposition of electric transmission property to implement Federal Energy Regulatory Commission restructuring policy

H.R. 241, enacted on January 7, 2005 (Pub. L. No. 109-1).

- Accelerated deduction for cash contributions for Indian Ocean tsunami victims

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, enacted on August 10, 2005 (Pub. L. No. 109-59).

- Tax credit for the cost of carrying tax-paid distilled spirits in wholesale inventories
- Exclusion of interest on State and local government qualified private activity bonds for highway projects and rail-truck transfer facilities

Energy Tax Incentives Act of 2005, enacted on August 8, 2005 (Pub. L. No. 109-58).

- Tax credit for the holders of clean renewable energy bonds
- Tax credit for the production of electricity from qualifying advanced nuclear power facilities
- Tax credits for investments in clean coal power generation facilities
- Temporary election for refiners to expense up to 50 percent of the cost of qualified property used in the refining of liquid fuels
- Two-year amortization for certain geological and geophysical costs incurred in connection with oil and gas exploration
- Deduction for expenditures on qualified energy-efficient commercial building property
- Tax credit for the purchase of qualified energy efficiency improvements to existing homes
- Tax credit for the production of certain energy-efficient appliances

- Tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property used exclusively for purposes other than heating swimming pools and hot tubs
- Tax credit for eligible contractors for the construction of qualified energy-efficient homes
- Tax credits for alternative technology vehicles
- Tax credit for the cost of installing clean-fuel vehicle refueling property
- Temporary five-year carryback period for a portion of the net operating losses of certain electric utility companies
- Tax credits for biodiesel fuels

The Katrina Emergency Tax Relief Act of 2005, enacted on September 23, 2005 (Pub. L. No. 109-73).

- Tax credit for employee retention for employers affected by Hurricanes Katrina, Rita, and Wilma
- Additional personal exemption for taxpayers who provide 60 days or more of free housing in their personal residence to individuals displaced by Hurricane Katrina
- Exclusion for the income from certain discharges of nonbusiness debt owed by individuals harmed by Hurricane Katrina

The Gulf Opportunity Zone Act of 2005, enacted on December 21, 2005 (Pub. L. No. 109-135).

- Additional first-year depreciation deduction for qualified Gulf Opportunity Zone property
- Partial expensing for Gulf Opportunity Zone clean-up costs
- Ten-year carryback period for casualty losses of Gulf Opportunity Zone public utility property by reason of Hurricane Katrina
- Five-year carryback period for net operating losses attributable to expenses
- Tax credit for the holders of Gulf Tax Credit Bonds
- Five-year carryback period for casualty losses of public utility property attributable to Hurricane Katrina
- Tax credit for Gulf Opportunity Zone employers providing in-kind lodging for employees and income exclusion for the employees

Tax Increase Prevention and Reconciliation Act of 2005, enacted on May 17, 2006 (Pub. L. No. 109-222).

- Exclusion for earnings of certain environmental settlement funds

- Reduced rates of tax for gains from the sale or exchange of self-created musical works
- Elective five-year amortization of expenses paid or incurred for the creation or acquisition of musical compositions

The Tax Relief and Health Care Act of 2006, enacted on December 20, 2006 (Pub. L. No. 109-432).

- Tax credit for corporate income earned in American Samoa
- Special depreciation allowance for cellulosic biomass ethanol plant property
- Partial expensing for investments in advanced mine safety equipment
- Credit for costs incurred in training qualified mine rescue team employees
- Deduction for premiums paid or accrued for qualified mortgage insurance
- 25-percent exclusion from gross income for capital gains from the conservation sale of a qualifying mineral or geothermal interest located on eligible Federal land

Hokie Spirit Memorial Fund, enacted December 19, 2007 (Pub. L. No. 110-141).

- Exclusion of amounts received from the Hokie Spirit Memorial Fund, established by the Virginia Tech Foundation

Mortgage Forgiveness Debt Relief Act of 2007, enacted December 20, 2007 (Pub. L. No. 110-142).

- Exclusion of indebtedness income arising from discharge of qualified principal residence indebtedness
- Exclusion of benefits provided to volunteer firefighters and emergency medical responders

Economic Stimulus Act of 2008, enacted February 13, 2008 (Pub. L. No. 110-185)

- Recovery rebates for individual taxpayers
- Additional first year depreciation deduction for qualified property

Food, Conservation, and Energy Act of 2008, enacted May 22, 2008 (Pub. L. No. 110-234 and 110-246).

- Exclusion of Conservation Reserve Program payments from SECA tax for individuals receiving Social Security retirement or disability payments
- Deduction for endangered species recovery expenditures
- Credit for cellulosic biofuel
- Tax credit bonds for qualified forestry conservation projects

- Agricultural chemicals security tax credit

Heroes Earnings Assistance and Relief Tax Act of 2008, enacted June 17, 2008 (Pub. L. No. 110-245).

- Employer wage credit for activated military reservists
- Exclusion of certain State and local payments to military personnel

Housing and Economic Recovery Act of 2008, enacted July 30, 2008 (Pub. L. No. 110-289).

- First time homebuyer credit
- Additional standard deduction for State and local real property taxes
- Bonds guaranteed by Federal Home Loan Banks eligible for treatment as tax-exempt bonds

Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008, and Tax Extenders and Alternative Minimum Tax Relief Act of 2008, enacted October 3, 2008 (Pub. L. No. 110-343).

- New clean renewable energy bonds
- Credit for carbon dioxide sequestration
- Alternative motor vehicle credit and plug in electric vehicle credit
- Qualified energy conservation bonds
- Accelerated recovery period for depreciation of smart meters and smart grid system
- Special depreciation allowance for certain reuse and recycling property
- Treatment of amounts received in connection with the Exxon Valdez litigation.
- Tax exempt bond financing for the Midwestern Disaster Area
- Expensing for certain demolition and clean up costs
- Tax credit bonds
- Additional personal exemption for housing displaced individuals in the Midwestern Disaster area
- Mileage reimbursements to charitable volunteers excluded from gross income
- Exclusions for certain cancellations of indebtedness by reason of Midwestern disasters
- Expensing of qualified disaster expenses
- Special depreciation allowance for qualified disaster property
- Increased expensing for qualified disaster assistance property

The American Recovery and Reinvestment Act of 2009, enacted on February 17, 2009 (Pub. L. No. 111-5).

- Making work pay credit
- Exclusion from gross income for up to $2,400 of unemployment compensation
- Deduction for any State or local sales or excise tax imposed on the purchase of a new car, light truck, motorcycle, or motor home
- Election to receive an investment credit in lieu of a renewable electricity production credit
- Credit for alternative motor vehicles
- Deferral of income arising from business indebtedness discharged by the reacquisition of a debt instrument
- Credit for investment in advanced energy property
- Issuance of recovery zone economic development bonds and recovery zone facility bonds
- Tribal economic development bonds
- Suspension of classification of tax-exempt interest on certain bonds as a tax preference for AMT purposes
- Qualified school construction bonds
- Build America bonds
- Credit against income taxes owed for tax year 2009 for individuals who receive a government pension or annuity from work not covered by social security
- Premium subsidy for COBRA continuation coverage for unemployed workers and their families

Hiring Incentives to Restore Employment Act, enacted on March 18, 2010 (Pub. L. No. 111-147).

- Credit for retention of certain newly hired workers

Patient Protection and Affordable Care Act, enacted March 23, 2010 (Pub. L. No. 111-148), in combination with the Health Care and Education Reconciliation Act of 2010, enacted March 30, 2010 (Pub. L. No. 111-152).

- Credits and subsidies for participation in exchanges
- Tax credit for small businesses purchasing employer insurance
- Annual fees imposed on any covered entity engaged in the business of providing health insurance with respect to United States health risks are not deductible as ordinary and necessary business expenses

- Limits on deductible compensation for insurance companies
- Exclusion of Indian health care benefits
- *Therapeutic research credit*
- Surtax on unearned income

The Small Business Jobs Act of 2010, enacted on September 27, 2010 (Pub. L. No. 111-240).

- Extended carryback period for eligible small business credits from one year to five years

F. Historical Trends in the Largest Tax Expenditures, Individual and Corporate

Individual Tax Expenditures

The tables below illustrate in five-year segments the top ten largest tax expenditures for individuals since 1975.

Table A-17.–Largest Tax Expenditures, Individual 1975-1979

Tax Expenditure	Total Amount (1975-1979) (Billions of dollars)
Exclusion of capital gains at death	37.6
Deduction for nonbusiness State and local taxes (other than State and local property taxes on owner-occupied homes)	37.3
Net exclusion of pension contributions and earnings: employer plans	32.4
Capital gain (other than farming and timber)	32.0
Deduction for mortgage interest on owner-occupied homes	25.7
Exclusion of employer contributions to medical insurance premiums and medical care	21.2
Deduction for State and local property taxes on owner-occupied homes	21.0
Exclusion of untaxed social security and railroad retirement benefits	17.7
Deduction for charitable contributions, other than for education and health	16.9
Exclusion of unemployment insurance benefits	13.6

Table A-18.–Largest Tax Expenditures, Individual 1980-1984

Tax Expenditure	Total Amount (1980-1984) (Billions of dollars)
Deduction for nonbusiness State and local taxes (other than State and local property taxes on owner-occupied homes)	104.9
Exclusion of employer contributions to medical insurance premiums and medical care	91.5
Deduction for mortgage interest on owner-occupied homes	89.5
Net exclusion of pension contributions and earnings: employer plans	85.5
Capital gains (other than farming and timber)	80.4
Deduction for State and local property taxes on owner-occupied homes	53.2
Exclusion of untaxed social security and railroad retirement benefits	53.1
Deduction for charitable contributions, other than for education and health	39.4
Deduction for medical expenses	23.2
Exclusion of interest on life insurance savings	23.0

Table A-19.–Largest Tax Expenditures, Individual 1985-1989

Tax Expenditure	Total Amount (1985-1989) (Billions of dollars)
Net exclusion of pension contributions and earnings: employer plans	334.6
Deduction for nonbusiness State and local taxes (other than State and local property taxes on owner-occupied homes)	143.5
Exclusion of employer contributions to medical insurance premiums and medical care	133.4
Capital gains, other than agricultural, timber, iron ore and coal	111.0
Deduction for mortgage interest on owner-occupied homes	75.6
Exclusion of untaxed social security and railroad retirement benefits	71.6
Deduction for charitable contributions, other than for education and health	62.4
Deduction for State and local property tax on owner-occupied homes	61.7
Individual retirement plans	59.3
Deduction for nonmortgage interest in excess of investment income	41.1

Table A-20.–Largest Tax Expenditures, Individual 1990-1994

Tax Expenditure	Total Amount (1990-1994) (Billions of dollars)
Net exclusion of pension contributions and earnings: employer plans	272.9
Exclusions of contributions by employers for medical insurance premiums and medical care	205.5
Deduction for mortgage interest on owner-occupied homes	133.5
Exclusion of untaxed social security and railroad retirement benefits	127.2
Deduction of nonbusiness State and local government income and personal property taxes (other than State and local property taxes on owner-occupied homes)	109.4
Deferral of capital gains on sales of principal residences	57.4
Deduction for charitable contributions, other than for education and health	55.8
Exclusion of interest on general purpose State and local government debts	54.1
Individual retirement plans	52.5
Deduction for State and local property tax on owner-occupied homes	43.5

Table A-21.–Largest Tax Expenditures, Individual 1995-1999

Tax Expenditure	Total Amount (1995-1999) (Billions of dollars)
Net exclusion of pension contributions and earnings: employer plans	391.6
Deduction for mortgage interest on owner-occupied homes	302.1
Exclusion of employer contributions for medical insurance premiums and medical care	269.7
Deduction of nonbusiness State and local government income and personal property taxes (other than State and local property taxes on owner-occupied homes)	139.0
Exclusion of untaxed social security and railroad retirement benefits	125.5
Deferral of capital gains on sales of principal residences	79.4
Exclusion of capital gains at death	77.5
Deduction for charitable contributions, other than for education and health	77.0
Deduction for State and local property tax on owner-occupied homes	76.8
Exclusion on investment income on life insurance and annuity contracts	61.8

Table A-22.–Largest Tax Expenditures, Individual 2000-2004

Tax Expenditure	Total Amount (2000-2004) (Billions of dollars)
Net exclusion of pension contributions and earnings: employer plans	416.0
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	324.1
Deduction for mortgage interest on owner-occupied homes	301.4
Reduced rates of tax on long-term capital gains	194.6
Deduction of nonbusiness State and local government income and personal property taxes (other than State and local property taxes on owner-occupied homes)	190.0
Exclusion of capital gains at death	136.1
Exclusion of untaxed social security and railroad retirement benefits	131.9
Deduction of charitable contributions, other than for education and health	124.3
Exclusion of investment income on life insurance and annuity contracts	121.8
Deduction for State and local property taxes on owner-occupied residences	101.3

Table A-23.–Largest Tax Expenditures, Individual 2005-2009

Tax Expenditure	Total Amount (2005-2009) (Billions of dollars)
Net exclusion of pension contributions and earnings: employer plans	567.8
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	493.7
Deduction for mortgage interest on owner-occupied homes	434.2
Reduced rates of tax on dividends and long-term capital gains	356.8
Tax credit for children under age 17	231.7
Exclusions of capital gains at death	215.6
Earned income credit	195.1
Deduction of nonbusiness State and local government income, sales and personal property taxes	185.8
Deductions for charitable contributions, other than for education and health	159.2
Exclusion of benefits provided under cafeteria plans	134.4

Table A-24.–Largest Tax Expenditures, Individual 2010-2014

Tax Expenditure	Total Amount (2010-2014) (Billions of dollars)
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	659.4
Deduction for mortgage interest on owner-occupied homes	484.1
Reduced rates of tax on dividends and long-term capital gains	402.9
Net exclusion of pension contributions and earnings: Defined benefit plans	303.2
Earned income credit	268.8
Deduction of nonbusiness State and local government income, sales and personal property taxes	237.3
Net exclusion of pension contributions and earnings: Defined contribution plans	212.2
Exclusions of capital gains at death	194.0
Deductions for charitable contributions, other than for education and health	182.4
Exclusion of untaxed social security and railroad retirement benefits	173.0

Corporate Tax Expenditures

The tables below illustrate in five-year segments the top ten largest corporate tax expenditures since 1975.

Table A-25.–Largest Tax Expenditures, Corporate 1975-1979

Tax Expenditure	Total Amount (1975-1979) (Billions of dollars)
Investment Credit	29.0
Corporate surtax exemption	22.0
Exclusion of interest on general purpose State and local debt	15.7
Asset depreciation range	8.2
Deferral of income of domestic international sales corporations	6.8
Excess of percentage over cost depletion	6.2
Expensing of construction period interest and taxes	5.3
Capital gain: corporate (other than farming and timber)	4.5
Financial institutions: excess bad debt reserves	3.6
Expensing of research and development expenditures	3.5

Table A-26.–Largest Tax Expenditures, Corporate 1980-1984

Tax Expenditure	Total Amount (1980-1984) (Billions of dollars)
Investment Credit, other than for TRASOPs and for rehabilitated structures	89.4
Reduced rates on first $100,000 of corporate taxable income	41.6
Exclusion of interest on general purpose State and local debt	21.9
Asset depreciation range	18.9
Exclusion of interest on State and local housing bonds	12.0
Expensing of research and development expenditures	11.3
Expensing of exploration and development costs	9.6
Deferral of income of domestic international sales corporations	8.0
Excess of percentage over cost depletion	7.5
Excess bad debt reserves of financial institutions	5.2

Table A-27.–Largest Tax Expenditures, Corporate 1985-1989

Tax Expenditure	Total Amount (1985-1989) (Billions of dollars)
Investment Credit, other than for ESOPs, rehabilitation of structures, reforestation, leasing and energy property	176.0
Accelerated depreciation on equipment other than leased property	79.9
Exclusion of interest on general purpose State and local debt	54.4
Reduced rates on first $100,000 of corporate taxable income	45.6
Exclusion of interest on State and local government industrial development bonds	19.1
Expensing of research and development expenditures	16.3
Capital gains, other than agricultural, timber, iron ore and coal	15.0
Tax credit for ESOPs	12.2
Exclusion of possessions source income	8.8
Expensing of exploration and development costs: oil and gas	8.0

Table A-28.–Largest Tax Expenditures, Corporate 1990-1994

Tax Expenditure	Total Amount (1990-1994) (Billions of dollars)
Depreciation of equipment in excess of alternative depreciation system	70.9
Reduced rates on first $75,000 of corporate taxable income	28.6
Inventory property sales source rule exception	15.9
Merger rules for banks and thrift institutions	11.7
Exclusion and tax credit for corporations with possessions source income	11.5
Deduction of unpaid loss reserves for property and casualty insurance companies	8.2
Expensing of research and development expenditures	8.1
Investment credit other than ESOPs, rehabilitation of structures, reforestation and energy property	7.1
Exclusion of interest on general purpose State and local government debt	6.6
Exclusion of income of foreign sales corporations	4.3

Table A-29.–Largest Tax Expenditures, Corporate 1995-1999

Tax Expenditure	Total Amount (1995-1999) (Billions of dollars)
Depreciation of equipment in excess of alternative depreciation system	97.7
Reduced rates for first $10,000,000 of corporate taxable income	21.7
Tax credit for section 936 income	19.7
Inventory property sales source rule exception	18.3
Exclusion of interest on general purpose State and local government debt	17.5
Depreciation on buildings other than rental housing in excess of alternative depreciation system	13.0
Special treatment of life insurance company reserves	12.5
Deduction of unpaid property loss reserves for property and casualty insurance companies	9.7
Exclusion of income of foreign sales corporations	7.5
Deferral of income of controlled foreign corporations	5.7

Table A-30.–Largest Tax Expenditures, Corporate, 2000-2004

Tax Expenditure	Total Amount (2000-2004) (Billions of dollars)
Depreciation of equipment in excess of alternative depreciation system	119.0
Exclusion of interest on public purpose State and local government debt	27.2
Reduced rates for first $10,000,000 of corporate taxable income	22.0
Inventory property sales source rule exception	22.0
Deferral of active income of controlled foreign corporations	19.8
Tax credit for Puerto Rico and possession income, and Puerto Rico economic activity	17.6
Tax credit for qualified research expenditures	17.3
Exclusion of income of foreign sales corporations	15.6
Expensing of research and experimental expenditures	14.9
Deduction for unpaid property loss reserves for property and casualty insurance companies	14.7

Table A-31.–Largest Tax Expenditures, Corporate 2005-2009

Tax Expenditure	Total Amount (2005-2009) (Billions of dollars)
Depreciation of equipment in excess of alternative depreciation system	71.3
Exclusion of interest on public purpose State and local government debt	38.3
Inventory property sales source rule exception	30.9
Expensing of research and experimental expenditures	28.5
Deferral of active income of controlled foreign corporations	25.8
Reduced rates for first $10,000,000 of corporate taxable income	23.7
Deduction for income attributable to domestic production activities	19.8
Tax credit for low-income housing	17.5
Exclusion of investment income on life insurance and annuity contracts	12.8
Tax credit for qualified research expenditures	10.7

Table A-32.–Largest Tax Expenditures, Corporate 2010-2014

Tax Expenditure	Total Amount (2010-2014) (Billions of dollars)
Deferral of active income of controlled foreign corporations	70.6
Exclusion of interest on public purpose State and local government debt	45.3
Deduction for income attributable to domestic production activities	43.2
Inventory property sales source rule exception	38.0
Depreciation of equipment in excess of alternative depreciation system	37.1
Inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument	28.8
Tax credit for low-income housing	27.0
Expensing of research and experimental expenditures	25.6
Inventory methods and valuation: Last in first out	20.0
Reduced rates for first $10,000,000 of corporate taxable income	15.9

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SEP 28 2011

Honorable Patty Murray
United States Senate
Joint Select Committee on Deficit Reduction
448 Russell Senate Office Building
Washington, D.C. 20510

Honorable Jeb Hensarling
U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon HOB
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This is in response to separate questions raised by Co-Chariman Hensarling and Congressman Clyburn regarding the distribution of income and employment taxes at the September 22, 2011, hearing of the Joint Select Committee on Deficit Reduction.

Table 1 shows the estimated distribution of combined Federal income, employment, and excise taxes by income category, for 2011. Table 1 also separately shows the estimated distribution of individual income taxes and the estimated distribution of employment taxes. Table 1 also reports average combined Federal tax rates by income category, as well as average income tax rates and average employment tax rates by income category. As Table 1 shows, individual income taxes are more concentrated at the top of the income distribution, while employment taxes are more evenly spread through the income distribution, though with a decline at the very top of the distribution.

Table 2 shows the estimated distribution of selected sources of income for 2011. As the table shows, certain sources of income, such as capital gain, dividend, and Schedule E (partnership, S-corporation, and other pass-throughs) income are relatively more concentrated at the top of the income distribution.

Lastly, Table 3 shows, for 2011, the estimated distribution of returns that have employment taxes (including the employer share of these taxes) in excess of income Because of the progressive income tax structure and the generally flat structure of employment taxes, the likelihood employment taxes will exceed income taxes increases as income levels decline. Thus, for example, in the $40,000 to $50,000 income group, 80.5 percent of tax returns have employment taxes greater than income taxes, while in the $100,000 to $200,000 group 55.2 percent of returns have employment taxes greater than income taxes. Overall, for 2011, 75.4 percent of returns are estimated to have employment taxes in excess of income taxes.

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JOINT COMMITTEE ON TAXATION
Washington, DC 20515–6453

I hope this information is helpful. If you have further questions related to these materials, please let me know.

Sincerely,

Thomas A. Barthold

Enclosures

cc: Honorable Max Baucus
Honorable Xavier Becerra
Honorable Dave Camp
Honorable James E. Clyburn
Honorable John F. Kerry
Honorable Jon Kyl
Honorable Rob Portman
Honorable Pat Toomey
Honorable Fred Upton
Honorable Chris Van Hollen
Mark Prater

Table 1.–Distribution of Income and Taxes, and Average Tax Rates in 2011

INCOME CATEGORY (1)	Number of Returns (2) (Thousands)	Share of Returns	Income (Millions of Dollars)	Share of Income	COMBINED INCOME, SOCIAL INSURANCE, AND EXCISE TAXES UNDER PRESENT LAW (3)			INDIVIDUAL INCOME TAXES			EMPLOYMENT TAXES		
					$ Billions	Percent Share	Average Tax Rate	$ Billions	Percent Share	Average Tax Rate	$ Billions	Percent Share	Average Tax Rate
Less than $10,000	20,429	13.1%	83,306	0.8%	4.4	0.2%	5.3%	-8.7	-0.9%	-10.4%	8.3	1.1%	10.0%
$10,000 to $20,000	16,910	10.8%	258,398	2.4%	1.6	0.1%	0.6%	-24.1	-2.5%	-9.3%	21.3	2.7%	8.3%
$20,000 to $30,000	18,400	11.8%	457,489	4.2%	23.9	1.3%	5.2%	-13.5	-1.4%	-2.9%	31.7	4.0%	6.9%
$30,000 to $40,000	15,387	9.8%	538,090	5.0%	46.2	2.5%	8.6%	0.3	0.0%	0.1%	40.2	5.1%	7.5%
$40,000 to $50,000	13,602	8.7%	610,307	5.7%	64.3	3.5%	10.5%	13.3	1.4%	2.2%	45.4	5.8%	7.4%
$50,000 to $75,000	26,719	17.1%	1,650,375	15.3%	212.1	11.7%	12.8%	73.6	7.8%	4.5%	125.4	15.9%	7.6%
$75,000 to $100,000	16,955	10.8%	1,466,089	13.6%	218.6	12.1%	14.9%	91.8	9.7%	6.3%	116.8	14.8%	8.0%
$100,000 to $200,000	22,128	14.1%	2,967,912	27.6%	574.1	31.7%	19.3%	282.8	29.8%	9.5%	274.2	34.8%	9.2%
$200,000 to $500,000	4,945	3.2%	1,355,166	12.6%	327.2	18.1%	24.1%	224.9	23.7%	16.6%	96.8	12.3%	7.1%
$500,000 to $1,000,000	631	0.4%	423,207	3.9%	113.3	6.2%	26.8%	95.9	10.1%	22.6%	16.0	2.0%	3.8%
$1,000,000 and over	330	0.2%	960,890	8.9%	226.9	12.5%	23.6%	213.3	22.5%	22.2%	12.8	1.6%	1.3%
Total, All Taxpayers	156,435	100.0%	10,771,229	100.0%	1,812.4	100.0%	16.8%	949.6	100.0%	8.8%	789.0	100.0%	7.3%

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2011 levels.

(2) Includes nonfilers, excludes dependent filers and returns with negative income.

(3) Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax (attributed to employees), and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The average tax rate is equal to Federal taxes described in footnote (3) divided by income described in footnote (2).

Source: Staff of the Joint Committee on Taxation.

Table 2.–Distribution of Selected Sources of Income in 2011

INCOME CATEGORY (1)	Wages	Capital Gains in AGI	Dividend Income	Interest Income	Schedule C Income	Schedule E Income
	$ Billions	$ Billions	$ Billions	$ Billions	$ Billions	$ Billions
Less than $10,000	46.7	0.3	1.2	2.3	15.4	-2.6
$10,000 to $20,000	128.0	0.3	1.9	2.1	30.6	-1.7
$20,000 to $30,000	215.5	0.5	2.4	3.7	18.6	-0.7
$30,000 to $40,000	279.7	0.7	4.6	7.2	15.5	0.7
$40,000 to $50,000	317.3	1.5	6.4	9.4	13.5	1.7
$50,000 to $75,000	878.6	6.7	20.9	26.5	28.8	6.4
$75,000 to $100,000	814.3	9.6	19.1	23.6	24.2	9.0
$100,000 to $200,000	1,984.4	32.0	39.9	37.0	57.8	42.9
$200,000 to $500,000	910.9	42.9	26.6	21.3	48.0	100.7
$500,000 to $1,000,000	231.5	34.2	16.1	10.0	13.6	84.0
$1,000,000 and over	224.4	257.2	60.5	42.8	13.1	312.2
Total, All Taxpayers	6,031.3	385.9	199.5	186.0	279.0	552.6

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2011 levels.

(2) Includes nonfilers, excludes dependent filers and returns with negative income.

Source: Staff of the Joint Committee on Taxation.

Table 3.–Tax Returns with Income or Employment Taxes in 2011

INCOME CATEGORY (1)	Millions of Returns	Individual Income Taxes	Employment Taxes	Returns with Employment Taxes Greater than Income Taxes	Returns with Employment Taxes Less than Income Taxes	Fraction of Returns with Employment Taxes Greater than Income Taxes
		$ Billions	$ Billions	Millions of Returns	Millions of Returns	
Less than $10,000	13.4	-8.7	8.3	13.4	0.0	99.9%
$10,000 to $20,000	13.7	-24.1	21.3	13.3	0.4	97.3%
$20,000 to $30,000	13.3	-13.5	31.7	12.8	0.6	95.7%
$30,000 to $40,000	13.1	0.3	40.2	11.6	1.5	88.8%
$40,000 to $50,000	12.4	13.3	45.4	10.0	2.4	80.5%
$50,000 to $75,000	24.9	73.6	125.4	18.2	6.7	73.1%
$75,000 to $100,000	16.7	91.8	116.8	10.4	6.3	62.3%
$100,000 to $200,000	22.1	282.8	274.2	12.2	9.9	55.2%
$200,000 to $500,000	4.9	224.9	96.8	0.3	4.7	5.6%
$500,000 to $1,000,000	0.6	95.9	16.0	0.0	0.6	1.9%
$1,000,000 and over	0.3	213.3	12.8	0.0	0.3	1.5%
Total, All Taxpayers	135.5	949.6	789.0	102.2	33.3	75.4%

(1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 2011 levels.

(2) Includes nonfilers, excludes dependent filers and returns with negative income.

(3) Less than 50,000.

Source: Staff of the Joint Committee on Taxation.

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OCT 17 2011

Honorable Patty Murray
United States Senate
Joint Select Committee on Deficit Reduction
448 Russell Senate Office Building
Washington, D.C. 20510

Honorable Jeb Hensarling
U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon HOB
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This is in response to a question raised by Senator Baucus at the September 22nd hearing of the Joint Select Committee on Deficit Reduction, regarding which industries benefit from which major corporate tax expenditures in present law.

Some of the major corporate tax expenditures include the deferral of active income of controlled foreign corporations ("CFCs"), the exclusion of interest on public purpose State and local government obligations, the deduction for income attributable to domestic production activities, accelerated depreciation, the credit for research activities, and the tax credit for low-income housing. The attached table provides information on the distribution of amounts related to these items as claimed on tax returns of active corporations, including C corporations and other active corporations for 2008 by industrial sector. It does not report a distribution of the tax expenditure benefits. In addition it provides information on the distribution of total corporate tax returns filed, total assets, total receipts, net income (less deficit), and total income tax after credits for reference.

While the greatest percentage of corporations are concentrated in the professional, scientific, and technical services and construction sectors, each of these accounts for only about one percent of total assets. The finance and insurance sector has the largest share of total assets at 44.1 percent, though the assets in this sector are not generally depreciable or depletable assets subject to accelerated cost recovery. The manufacturing sector accounts for the largest share of receipts, net income, and total income tax after credits.

Direct data are not available on the deferral of active income of CFCs. However, one may infer information about the distribution by sector of deferred income of CFCs from the

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distribution of other data reported on tax returns. The attached table reports a measure of current year deferred income for CFCs with positive earnings and profits before income taxes.[1] The most recent year for which data are available is 2006.[2] The manufacturing sector accounts for 30.1 percent of this measure of deferred income of CFCs. Holding companies (18.7 percent), the finance and insurance sector (16.7 percent), and wholesale trade sector (10.1 percent) also have significant deferred income.

The vast majority (80 percent) of tax-exempt interest on State and local government obligations reported by corporations is reported by corporations in the finance and insurance sector. Holding companies report 13.9 percent of such interest, while the manufacturing sector accounts for 2.1 percent. All other industries report less than one percent of the total.

Manufacturing accounts for largest share of the domestic production activities deduction (66 percent). The information (12.1 percent) and mining (seven percent) sectors are the only other sectors in which the domestic production activities deduction exceeds five percent.

Depreciation deductions are also heavily concentrated in the manufacturing sector (27.7 percent). These deductions do not represent the extent to which tax depreciation is in excess of the alternative depreciation system or some other measure of economic depreciation. However, to the extent that accelerated depreciation is likely to benefit those sectors with a larger share of depreciation deductions in general, the manufacturing sector likely receives a large share of the benefit from accelerated depreciation. Other sectors with a large share of depreciation deductions include information (10.9 percent), retail trade (7.5 percent), wholesale trade (seven percent), and utilities (seven percent).

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[1] The table reports the distribution of current earnings and profits after income taxes for foreign corporations with positive before-tax current earnings and profits. To adjust this amount for income subject to current U.S. income tax, it is necessary to subtract dividends paid to controlling U.S. corporations and total subpart F income. This measure does not measure the deferred active income of CFCs to the extent that current year dividends are paid out of prior year earnings and profits, prior year earnings and profits were deferred, and other provisions which may influence multiple tax years.

[2] Lee Mahony and Randy Miller, "Controlled Foreign Corporations, 2006," *Statistics of Income Bulletin*, 30(3), Winter 2011, pp. 197-259.

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Depletion is heavily concentrated in the mining (65.9 percent) and manufacturing (23.7 percent) sectors. As with depreciation, the deductions shown here do not represent the extent to which tax rules provide more generous treatment than the underlying economic decline in value of the assets over time would warrant. However, to the extent that the benefits of accelerated depletion are correlated with depletion deductions in general, the mining and manufacturing sectors likely receive a large share of these benefits.

The tax credit for research activities and the tax credit for low-income housing are the two largest components of the general business credit, which also includes dozens of smaller credits. These two credits have very little overlap in their beneficiaries. More than 90 percent of the total dollar amount of the research credit is claimed by corporations in the manufacturing (69.3 percent); information (11.4 percent); or professional, scientific, and technical services (9.5 percent) sectors. These sectors collectively only claim about five percent of the low-income housing tax credit. Two sectors claim over 90 percent of low-income housing tax credits: holding companies (48.8 percent), and finance and insurance (41.8 percent).

The general business credit is composed of dozens of smaller credits. The final column of the attached table reports the distribution of selected remaining components of the general business credit for which data are available. Holding companies claim 19.7 percent of the other general business credits, primarily attributable to the new markets tax credit, followed by manufacturing (19.2 percent). The accommodation and food services sector accounts for the next largest share of the other general business credits (16.3 percent), primarily attributable to the credit for employer Social Security and Medicare taxes on tips and the work opportunity tax credit. The retail trade sector claims nearly 10 percent of other general business credits, including claiming the largest share of the work opportunity tax credit.

The utilities sector is responsible for 8.9 percent of other general business credits. Chief among these are the investment tax credit (including the energy credit) and the renewable electricity production credit.

Present law also includes additional energy-related tax expenditures, many of which primarily benefit the mining, utilities, and manufacturing sectors. These include incentives for renewable and alternative fuels, energy conservation credits, alternative fuel vehicle credits,

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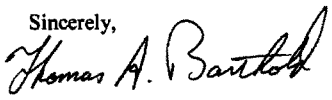
special cost recovery provisions, various fossil fuel energy credits, tax-exempt bond provisions, and other energy provisions.[3]

I hope this information is helpful. If you have further questions related to these materials, please let me know.

Sincerely,



Thomas A. Barthold

cc: Honorable Max Baucus
Honorable Xavier Becerra
Honorable Dave Camp
Honorable James E. Clyburn
Honorable John F. Kerry
Honorable Jon Kyl
Honorable Rob Portman
Honorable Pat Toomey
Honorable Fred Upton
Honorable Chris Van Hollen
Mark Prater

Attachment

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[3] For a summary of present-law energy -related Federal tax incentives, see Joint Committee on Taxation, *Present Law and Analysis of Energy-Related Tax Expenditures and Description of the Revenue Provisions Contained in H.R. 1380, the New Alternative Transportation to Give Americans Solutions Act of 2011* (JCX-47-11), September 20, 2011.

Percentage Distribution of Corporate Income Tax Returns and Selected Tax Items by Sector, 2008

Sector	Total Returns	Total assets	Total receipts	Net income (less deficit)	Total income tax after credits	CFC current earnings and profits less adjustments[2]	Interest on Government obligations: State and local	Domestic production activities deduction	Depreciation deduction	Depletion deduction	Current year research activities credit	Current year low-income housing credit	General busines credit (excl. R&E, LIHTC)
Agriculture, Forestry, Fishing, and Hunting	2.3%	0.2%	0.6%	0.1%	0.3%	0.2%	0.1%	0.6%	1.2%	0.3%	0.1%	(1)	0.3%
Mining	0.7%	1.2%	1.6%	5.0%	4.3%	7.7%	0.1%	7.0%	4.4%	65.9%	0.4%	(1)	0.3%
Utilities	0.1%	2.1%	2.7%	0.7%	2.6%	1.4%	0.2%	3.3%	7.0%	2.0%	0.6%	0.8%	8.9%
Construction	13.1%	1.0%	5.2%	2.7%	1.6%	0.4%	0.3%	2.6%	3.2%	0.7%	0.1%	1.7%	1.4%
Manufacturing	4.6%	13.5%	28.6%	40.3%	32.2%	30.1%	2.1%	66.0%	27.7%	23.7%	69.3%	2.8%	19.2%
Wholesale Trade	6.5%	2.6%	13.8%	8.0%	8.5%	10.1%	0.5%	4.4%	7.0%	4.6%	4.2%	0.5%	3.0%
Retail Trade	10.3%	2.1%	12.4%	5.9%	8.8%	1.7%	0.5%	1.0%	7.5%	0.1%	1.0%	0.3%	9.8%
Wholesale and Retail Trade not Allocable	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Transportation and Warehousing	3.3%	0.9%	2.9%	1.3%	2.4%	0.8%	0.2%	0.0%	5.7%	0.1%	0.1%	0.7%	2.9%
Information	2.0%	3.2%	3.9%	5.7%	7.4%	2.8%	0.7%	12.1%	10.9%	(1)	11.4%	2.4%	0.2%
Finance and Insurance	4.3%	44.1%	12.9%	16.1%	16.0%	16.7%	80.0%	0.3%	5.3%	0.9%	1.7%	41.8%	7.2%
Real Estate and Rental and Leasing	11.1%	1.9%	1.2%	1.9%	1.0%	1.2%	0.5%	0.1%	6.4%	0.3%	0.1%	0.1%	0.6%
Professional, Scientific, and Technical Services	14.5%	1.0%	3.7%	3.6%	2.8%	6.9%	0.4%	1.5%	2.2%	0.3%	9.5%	(1)	4.2%
Holding Companies	0.8%	24.4%	3.6%	1.9%	7.8%	18.7%	13.9%	0.4%	4.6%	0.4%	0.7%	48.8%	19.7%
Administrative and Support and Waste Management and Remediation Services	4.7%	0.4%	1.7%	1.6%	1.2%	0.7%	0.1%	0.1%	1.4%	0.6%	0.3%	(1)	3.2%
Educational Services	0.9%	0.1%	0.2%	0.3%	0.3%	0.1%	0.1%	(1)	0.2%	(1)	(1)	(1)	(1)
Health Care and Social Assistance	7.1%	0.4%	2.3%	3.1%	1.2%	0.1%	0.2%	(1)	1.7%	(1)	0.4%	(1)	1.9%
Arts, Entertainment, and Recreation	2.1%	0.1%	0.4%	0.2%	0.2%	0.1%	(1)	(1)	0.7%	(1)	(1)	(1)	0.3%
Accommodation and Food Services	5.0%	0.6%	1.6%	1.1%	1.0%	0.4%	(1)	0.3%	2.3%	(1)	(1)	(1)	16.3%
Other Services	6.3%	0.2%	0.7%	0.4%	0.3%	0.2%	0.1%	0.1%	0.7%	(1)	(1)	(1)	0.5%
Not Allocable	(1)	(1)	(1)	(1)	(1)	0.0%	(1)	(1)	(1)	(1)	(1)	(1)	(1)
All	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

(1) Less than 0.1 percent.
(2) Data from 2006.
Source: Joint Committee on Taxation staff calculations based on Internal Revenue Service, Statistics of Income data.

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SEP 23 2011

Honorable Patty Murray
United States Senate
Joint Select Committee on Deficit Reduction
448 Russell Senate Office Building
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Honorable Jeb Hensarling
U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon HOB
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This letter is in response to a question from Senator Portman during Thursday's hearing of the Joint Select Committee on Deficit Reduction concerning the revenue effect of repealing or "patching" the alternative minimum tax ("AMT").

Present law imposes an alternative minimum tax on individuals. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of: (1) 26 percent of the first $175,000 of the excess of alternative minimum taxable income ("AMTI") over the AMT exemption amount; and (2) 28 percent of the remaining excess. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of the specified preferences and adjustments.

The exemption amount is $48,450 ($74,450 in the case of married individuals filing a joint return) for tax year 2011. For taxable years beginning after 2011, the exemption amount is $33,750 ($45,000 in the case of married individuals filing a joint return).

For taxable years beginning before 2012, nonrefundable personal credits are allowed to the extent of the full amount of the individual's regular and alternative minimum tax. From 2006 to 2011, the AMT exemption amount has been increased annually to hold the number of taxpayers affected by the AMT at a specified level. The target for the number of taxpayers affected by the AMT has changed over time.

One proposal (included in the President's Fiscal Year 2012 Budget Proposal) is to change the AMT exemption amounts to hold the number of taxpayers affected by the AMT at a given level would be to index the AMT exemption amounts for inflation. Under this alternative, the

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individual AMT exemption amounts, the thresholds for the phase out of the exemption amounts, and the income threshold for the beginning of the 28-percent bracket would be indexed for inflation. In addition, nonrefundable personal credits would be allowed to apply against the AMT. A second proposal suggested by Senator Portman would repeal the individual AMT.

For both proposals, we are providing estimates of the proposals under the present law baseline and under an alternative baseline that assume the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the Job and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") are permanently extended.

For purposes of estimating the proposals, we have assumed the proposals would be effective for taxable years beginning after December 31, 2011. We estimate that the proposals would have the following effect on Federal fiscal year budget receipts:

	Fiscal Years [Billions of Dollars]											
Item	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
Index the individual AMT income bracket, exemption phase out, and exemption amount, and allow personal credits against the AMT:												
Present-law baseline	-9.0	-92.5	-39.5	-45.4	-53.3	-62.5	-73.9	-88.0	-103.5	-121.0	-239.7	-688.6
EGTRRA/JGTRRA extended	-9.0	-129.9	-105.8	-118.7	-134.1	-151.1	-171.7	-195.6	-220.7	-247.9	-497.6	-1,484.6
Repeal the AMT:												
Present-law baseline	-12.4	-125.9	-49.4	-55.9	-64.4	-74.1	-86.2	-100.7	-116.5	-134.4	-308.1	-820.1
EGTRRA/JGTRRA extended	-12.4	-177.2	-140.1	-155.6	-173.7	-193.4	-216.9	-243.0	-270.3	-299.8	-659.0	-1,882.4

NOTE: Details may not add to totals due to rounding.

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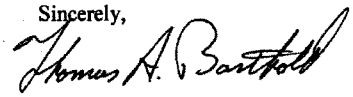
I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,



Thomas A. Barthold

cc: Honorable Max Baucus
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Honorable Chris Van Hollen
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OCT 04 2011

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448 Russell Senate Office Building
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Honorable Jeb Hensarling
U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon HOB
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This is in response to a question raised by Senator Portman at the September 22nd hearing of the Joint Select Committee on Deficit Reduction regarding the effect on economic growth of modifying or curtailing accelerated depreciation.

Economic growth depends in part on the growth of investment. The cost of capital for new investment is influenced not only by accelerated depreciation and other capital cost recovery rules, but also by income tax rates for individuals and corporations, the tax treatment of dividends and capital gains, and whether a taxpayer is in a net loss position. To estimate the cost of capital, it is also necessary to make judgments about future interest and inflation rates, as these affect the real (inflation-adjusted) cost of funds used to finance the investment. The user cost of capital also incorporates the rate of economic depreciation, that is, the rate at which the productivity of different types of plant and equipment decline with respect to age. Firms must earn enough from capital investments to recover this economic depreciation; otherwise they would be better off investing in some other asset.

Curtailing accelerated depreciation would increase the cost of new capital investment, which could reduce the overall incentive to save and invest and have a negative effect on economic growth. Without other changes to the tax system, this change could also affect the choice of investment. For example, curtailing accelerated depreciation raises the effective tax rate on business investment without changing the tax treatment of investments in owner-occupied housing. This increases the tax advantage of owner-occupied housing relative to other investments. Furthermore, because those assets that receive accelerated depreciation under present law are more heavily concentrated in the corporate sector, curtailing accelerated depreciation generally increases the difference in taxation between corporate and noncorporate investment. However, to the extent that different types of assets face different degrees of accelerated depreciation under present law, curtailing accelerated depreciation could improve the

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allocation of investment capital within the corporate and noncorporate sectors. If the net effect of these changes improves the neutrality of the tax system with respect to investment choice, this could have a positive effect on economic growth.[1]

A reduction in the corporate tax reduces the cost of new capital investment, which may encourage additional investment and economic growth. However, this reduction applies to the returns both to new investment and old investment alike and thus in part provides a benefit to investment decisions made in the past without offering an additional incentive for new investment. A rate reduction could also affect economic growth through its effect on the composition of investment. It reduces the burden on investment in the corporate sector relative to the noncorporate sector, helping to equalize the treatment between the two. A rate reduction also reduces the distortional effect of other provisions of the corporate income tax, which could have a positive effect on economic growth.

In general, modifying or curtailing accelerated depreciation and using the proceeds to reduce the statutory corporate income tax rate would have offsetting effects on economic growth. Without information about the specifics of a particular proposal, it is not possible to determine which effects on economic growth would dominate.

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[1] A study by the U.S. Department of the Treasury suggests that the overall effect on the neutrality of the tax system by such a change may be negligible. U.S. Department of the Treasury, *Report to the Congress on Depreciation Recovery Methods*, July 2000, p.48.

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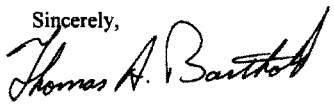
I hope this information is helpful. If you have further questions related to these materials, please let me know.

Sincerely,



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OCT 07 2011

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Honorable Jeb Hensarling
U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon HOB
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This letter is a response to a question asked by Senator Portman at the September 22 hearing of the Joint Select Committee on Deficit Reduction. Senator Portman inquired about how a corporate tax rate reduction, achieved by repealing business tax expenditures, could be designed so as not to disadvantage passthrough entities.

Present Law

As discussed in greater detail in my testimony, businesses may be organized under a number of different legal forms. An owner of a business may conduct business as a sole proprietorship which does not involve a legal entity separate from the owner. However, for a variety of business and other reasons, a business is often conducted through a separate legal entity.[1]

Under present law, the tax consequences of conducting business through a separate entity depend on the type of entity chosen. Partnerships, limited liability companies that are taxed as partnerships, and S corporations generally are not subject to tax at the entity level, but rather, their partners, members or shareholders, respectively, take into account partnership or S

[1] Note that an individual conducting business through a wholly-owned limited liability company is treated for nontax purposes as doing business as a legal entity; however, for Federal income tax purposes, if the limited liability company qualifies as a disregarded entity, the individual is not treated as doing business through a separate legal entity.

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corporation items of income, gain, loss, deduction and credit. For this reason, partnerships and S corporations are commonly referred to as "passthrough" or "flowthrough" entities. Income of these passthrough entities is taxable to the partners or shareholders whether or not such income is actually distributed.

In contrast, the income of a C corporation is taxed at the corporate level. Shareholders are taxed on corporate after-tax earnings only when paid as dividends, or upon disposition of their shares of stock of the corporation (to the extent gain on sale (if any) is attributable to undistributed corporate income). Thus, the income of a C corporation may be subject to tax at both the corporate and the shareholder levels, but is subject to tax at the shareholder level only when distributed (or realized upon a stock disposition).

Under present law, there are no restrictions on the persons that may be partners in a partnership (or members of an LLC) or shareholders in a C corporation. However, permitted shareholders of an S corporation are limited to individuals (excluding nonresident alien individuals), estates, certain trusts owned entirely by citizens or residents of the United States, and certain types of tax-exempt organizations. Accordingly, both individuals and nonbusiness entities that are shareholders in an S corporation, or partners in a partnership, can benefit from tax expenditures that apply to business activities conducted by such S corporation or partnership. Therefore, as noted by Senator Portman in the context of his inquiry, if a corporate tax rate reduction is funded, in whole or in part, by limiting or eliminating business tax expenditures, it is possible that individuals conducting business as sole proprietorships or in passthrough form could lose the benefit of those expenditures without an offsetting tax rate reduction.

Analysis

There are a variety of ways one might attempt to mitigate the impact of limiting or eliminating business tax expenditures on persons conducting business as sole proprietors or in passthrough form. However, each of the alternatives has significant drawbacks and could require a significant investment of time to develop and administer. Also, noteworthy is that business tax expenditures take different forms. The choice of expenditures eliminated may itself mitigate the impact on individuals, or it may be the case that one alternative would be more appropriate than another depending upon the specific expenditure subject to limitation. For example, the deduction for income attributable to domestic production activities is a deduction calculated at the partner or shareholder level in the case of partnerships and S corporations.

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Accordingly, eliminating this expenditure for corporations would not impact the ability of individuals to claim the deduction directly, or through a passthrough entity. On the other hand, as discussed in greater detail below, the elimination of other expenditures (like accelerated depreciation) is more complicated. Following is a brief discussion of some alternatives and issues each presents.

Limit or eliminate expenditures for C corporations only

One alternative is to limit or eliminate business tax expenditures for C corporations only. In other words, different Federal income tax rules governing a deduction, credit or other provision would apply for C corporations on one hand and other businesses on the other.

Although intuitively appealing, this option presents significant administrative difficulties in particular circumstances. Consider, for example, the depreciation of equipment in excess of the alternative depreciation system. If the depreciation rules for a piece of equipment differ depending upon whether the equipment is held by a partnership or by a C corporation, tiered structures and joint ventures involving both corporations and partnerships could make determination of allowable depreciation complex. Among other issues, those depreciation rules would have to address the depreciation of an asset owned by a partnership with corporate and noncorporate partners, and the related complexity presented by tiers of partnerships.

For example, a simple approach that provides one rule for corporations and another rule for noncorporate entities may have little effect, because a corporation subject to a less favorable depreciation rule might restructure its asset holdings to exploit the rule difference. Alternatively, in the simple case of a partnership with two partners, one a corporation and the other an individual, there are at least three conceptual approaches to the issues presented: (1) maintain two depreciation schedules for each partnership asset; (2) compute partnership income twice, once for corporate partners and once for noncorporate partners; and (3) treat any partnership with a corporate partner as a corporation for purposes of the expenditure. The practicality of these (or other) alternatives would require further assessment.

Maintain separate schedules

In a partnership with corporate and noncorporate partners, one could attempt to split each partnership asset into a corporate piece and a noncorporate piece according to the ownership

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interests of each and depreciate the asset accordingly. Practically, this option would be exceedingly difficult to implement. Given the inherent flexibility of partnerships, a partner's interest in particular partnership assets may be difficult to ascertain. In addition, while assets are depreciated on an annual basis, the composition of a partnership's partners may change at any time, including during the course of a single taxable year. Perhaps more importantly, a partnership may not always know the tax status of its ultimate partners, particularly if partnerships are tiered. For example, a partnership interest may be held by another partnership with many partners, some of which may be partnerships themselves. This tiering of partnerships could make it practically impossible for a partnership to know how to split an asset for depreciation purposes.

Calculate taxable income twice

As an alternative to splitting partnership assets, a partnership with corporate and noncorporate partners could be required to calculate its taxable income twice, first depreciating its assets according to the corporate rules and a second time according to the noncorporate rules. The partnership could then send two K-1s to partners, one for corporations and the other for other taxpayers. Apart from doubling the accounting work required for partnerships, this option presents difficulties similar to those discussed above. In a partnership with another partnership as partner, it is unclear whether the partnership should use the individual K-1, the corporate K-1, or a pro rata portion of each in computing its own taxable income. In addition, although the partnership could report income separately, it is unclear how one would calculate the partnership's basis in the asset for purposes of calculating, for example, partnership gain or loss if the asset were sold.

Treat certain partnerships as corporations for expenditure purposes

One could attempt to solve the tiered partnership issue with a rule that any partnership with a corporate partner would be treated as a corporation for purposes of the relevant expenditure (in this example, depreciation). Without a reporting requirement, tiered partnerships would not know whether to treat other partnerships as corporations for this purpose. For example, under this approach, a lower-tier partnership could be required to change the depreciation of its assets because an individual partner in an upper-tier partnership transferred his interest to a corporation, and yet such lower-tier partnership would not (under present law) have any reason to know of the transfer. Moreover, a rule requiring partnerships with direct or

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indirect corporate partners to apply corporate rules for certain purposes would also change the tax results for individuals in such partnerships.

Establish a preferential rate for passthrough business income

A second alternative is to repeal (or partially repeal) tax expenditures for all types of business, but to compensate individual owners by providing a preferential tax rate for the business income of individuals in the case of businesses conducted as sole proprietorships or through passthrough entities. For purposes of illustration, assume that deferral of gain on like-kind exchanges were repealed, and that this raises $16 billion from corporations and $2 billion from individuals. Then corporate rates could be reduced to lose $16 billion and the income tax rate on the business income of individuals could be reduced to lose $2 billion. There are a variety of ways to accomplish a rate reduction for just the business income of individuals. For example, Congress could establish a separate rate for such income, just as there are preferential rates for long-term capital gain. Alternatively, Congress could provide a deduction for income attributable to business activities similar to the deduction for domestic production activities.

A number of practical issues would have to be resolved to implement such approaches. An initial question is how to define "business income" for which a lower rate would be allowed. A related question is whether to benefit all persons with such income, or to restrict the lower rate to a subset of qualifying persons with qualified income. Another question is how the lower rate would be determined. The above example uses a uniform reduction determined by the amount of money raised. However, it is unlikely that the impact of limiting expenditures would be uniform across all passthrough entities and individuals, and not all individuals pay individual income taxes at the same rate.

Broader concepts

It should be noted that, although not directly responsive to your inquiry, other broader approaches to reducing the taxation of corporate earnings have been proposed over the years. For example, there have been a number of different proposals to effectively eliminate the

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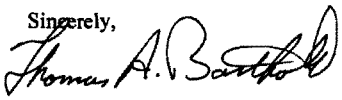
corporate income tax by integrating the corporate and individual income taxes.[2] Corporate integration proposals are complex, and present a variety of policy issues including, for example, the proper treatment of tax-exempt entities and foreign persons in an integrated system. Any corporate integration proposal would require transition rules and would take time to develop and implement.

I hope that this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,



Thomas A. Barthold

cc: Honorable Max Baucus, Honorable Xavier Becerra, Honorable Dave Camp, Honorable James E. Clyburn, Honorable John F. Kerry, Honorable Jon Kyl, Honorable Rob Portman, Honorable Pat Toomey, Honorable Fred Upton Honorable Chris Van Hollen, and Mark Prater

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[2] For a more extensive discussion of the background and issues related to integration, see Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes* (Tax Analysts, 1998); Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Tax Issues* (JCX-41-06), September 19, 2006, pp. 26-30; Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS-1-89), January 18, 1989, pp. 82-103. Four integration prototypes are detailed in the 1992 Treasury report, *A Recommendation for Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (1992).

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OCT 03 2011

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448 Russell Senate Office Building
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Honorable Jeb Hensarling
U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon HOB
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This letter is a response to a question asked by Senator Kerry at the September 22 hearing of the Joint Select Committee on Deficit Reduction. Senator Kerry asked whether the staff of the Joint Committee on Taxation could provide information about the territorial tax systems of other countries and about options for reform of the U.S. rules for taxing cross-border business income.

The staff of the Joint Committee recently has researched territorial taxation. In connection with a May 24, 2011, House Ways and Means Committee hearing, we prepared a pamphlet that describes the current U.S. international tax system and issues related to that system and that provides information about the territorial tax systems of nine Asian, European, and North American countries. As described in detail in that pamphlet, territorial tax regimes share common characteristics. Territorial systems generally exempt foreign business income from home-country tax by means of a dividend exemption. These systems typically impose tax on passive or highly mobile income. Many systems impose home-country tax on income subject to low foreign tax rates. Territorial systems do not typically disallow deductions for expenses related to exempt foreign income, but as an alternative to disallowing deductions some systems tax a portion (for instance, five percent) of otherwise exempt dividends.

Within these broad similarities found among countries that have adopted territorial systems, there is great variety in the rules of various jurisdictions. For example, different countries have different rules for the treatment of foreign branches. Some countries restrict deductions for domestic interest expense. And some countries have special rules for the taxation of income related to intangible property.

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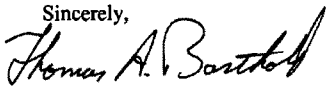
Honorable Patty Murray
Honorable Jeb Hensarling
Joint Select Committee on Deficit Reduction

In case your Committee would like to have more information about the current U.S. international tax rules and about territorial taxation generally and in nine select countries, I have enclosed our recent pamphlet.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,



Thomas A. Barthold

Enclosure: JCX-33-11 *

cc: Honorable Max Baucus
Honorable Xavier Becerra
Honorable Dave Camp
Honorable James E. Clyburn
Honorable John F. Kerry
Honorable Jon Kyl
Honorable Rob Portman
Honorable Pat Toomey
Honorable Fred Upton
Honorable Chris Van Hollen
Mark Prater

* See "Background and Selected Issues Related to the U. S. International Tax System and Systems that Exempt Foreign Business Income," Joint Committee on Taxation staff report, May 24, 2011 (JCX-33-11), *http://www.jct.gov/publications.html?func=startdown&id=3793.*

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OCT 17 2011

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U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon House Office Building
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This letter is in response to a question raised by Representative Van Hollen at the September 22, 2011, hearing of the Joint Select Committee on Deficit Reduction regarding information about the capital asset types that are taxed either as long or short term capital gains.

Under present law, generally, equity investments held for more than a year receive preferential treatment with a lower tax rate of 15 percent (0 percent for taxpayers otherwise in the 15 percent ordinary income bracket) in 2011. After December 31, 2012, the preferential rate increases to 20 percent (and 10 percent). Capital losses may be claimed to the extent of capital gains plus $3,000 ($1,500 in the case of a married filing separate return). Losses in excess of the $3,000 threshold may be carried forward to future years.

From time to time, the Statistics of Income division of the Internal Revenue Service edits and compiles data on the sales of capital assets. The most recent comprehensive data set is from tax year 2007. The following table shows the distribution of capital gains by asset type. The table below shows the dollar value of gains and the percentage distribution by asset type. Columns 1 shows the net gain or loss from short and long term capital gains reported on 2007 tax year individual income tax returns. Column 2 reports the percentage distribution. Twenty five percent is identified as corporate stock. However, mutual fund distributions that show up in two different lines on the table below (Mutual funds, except tax-exempt bond funds, and Capital gain distributions) could also contain corporate stock. Mutual funds represent 12.5 percent of the total amount of gains in line 1 column 1. Assuming that mutual funds assets are distributed similarly to the rest of capital gains (excluding pass-through income and mutual funds) would add an additional 7.4 percent to the total amount of corporate stock, for a total of 32.3 percent of short and long term capital gains and losses.[1] Column 3 reports the capital gains excluding any losses for short and long term gains and column 4 reports the percentage of the "total" reported in

[1] Total capital gains in column1 excluding pass through gains and mutual funds is $383.829 billion. Corporate stock as a share of the $383.829 is 59.4 percent. Multiplying the $114.2 billion in mutual funds by 59.4 percent results in an additional $67.8 billion, or 7.4 percent, attributable to corporate stock.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515–6453

column 3 ($1.1 trillion). 28.9 percent is reported as corporate stock. Grossing this number up in a similar manner as above for the mutual funds results in 36 percent of capital gains attributable to corporate stock. Similar calculations for columns 5 and 7 result in 33.4 percent of long-term gains and losses, and 36 percent of long-term gains are attributable to corporate stock.

I hope this information is helpful. If you have further questions related to these materials, please let me know.

Sincerely,

Thomas A. Barthold

Enclosure

cc: Honorable Max Baucus
Honorable Xavier Becerra
Honorable Dave Camp
Honorable James E. Clyburn
Honorable John F. Kerry
Honorable Jon Kyl
Honorable Rob Portman
Honorable Pat Toomey
Honorable Fred Upton
Honorable Chris Van Hollen
Mark Prater

Tax Year 2007 Individual Sales of Capital Assets

Asset Type	Short and Long Term Capital Gains				Long Term Capital Gains			
	All Transactions		Gain Transactions		All Transactions		Gain Transactions	
	Net Gain/Loss (1)	Percent of Total (2)	Gain (3)	Percent of Total (4)	Net Gain/Loss (5)	Percent of Total (6)	Gain (7)	Percent of Total (8)
Total	**914,042,040**		**1,106,865,343**		**872,954,607**		**970,360,118**	
Corporate stock	227,899,475	24.9%	320,121,692	28.9%	223,289,657	25.6%	271,314,848	28.0%
U.S. Government obligations	211,005	0.0%	695,864	0.1%	48,897	0.0%	301,382	0.0%
State and local government obligations	784,132	0.1%	2,230,513	0.2%	900,335	0.1%	2,027,500	0.2%
Other bonds, notes, and debentures	-238,117	0.0%	1,825,251	0.2%	120,725	0.0%	1,503,882	0.2%
Put and call options	2,674,767	0.3%	11,175,605	1.0%	1,050,906	0.1%	1,583,689	0.2%
Futures contracts	8,381,409	0.9%	19,276,305	1.7%	221,912	0.0%	452,510	0.0%
Mutual funds, except tax-exempt bond funds	28,129,389	3.1%	43,612,621	3.9%	28,333,592	3.2%	36,788,137	3.8%
Tax-exempt bond mutual funds	-691,750	-0.1%	755,948	0.1%	-346,380	0.0%	678,035	0.1%
Partnership, S corporation, and estate or trust interests	49,145,134	5.4%	58,928,225	5.3%	48,952,209	5.6%	56,299,450	5.8%
Livestock	2,411,515	0.3%	2,748,594	0.2%	2,230,920	0.3%	2,435,480	0.3%
Timber	1,366,931	0.1%	1,425,844	0.1%	1,360,156	0.2%	1,403,844	0.1%
Involuntary conversions	256,902	0.0%	562,436	0.1%	487,267	0.1%	533,212	0.1%
Residential rental property	37,311,783	4.1%	42,569,377	3.8%	36,248,279	4.2%	40,437,234	4.2%
Depreciable business personal property	2,297,692	0.3%	3,536,167	0.3%	2,207,324	0.3%	3,070,205	0.3%
Depreciable business real property	26,357,298	2.9%	27,843,783	2.5%	25,788,332	3.0%	27,077,263	2.8%
Farmland	4,584,038	0.5%	4,649,821	0.4%	4,560,809	0.5%	4,608,429	0.5%
Other land	25,682,168	2.8%	26,813,625	2.4%	25,024,681	2.9%	26,001,027	2.7%
Residences	12,832,996	1.4%	14,861,287	1.3%	12,549,713	1.4%	14,503,330	1.5%
Other assets	25,724,929	2.8%	44,093,416	4.0%	29,148,237	3.3%	37,117,308	3.8%
Unidentifiable	5,981,865	0.7%	8,340,659	0.8%	5,902,814	0.7%	7,173,447	0.7%
Passthrough gains or losses	366,909,407	40.1%	384,769,237	34.8%	338,845,149	38.8%	349,020,830	36.0%
Capital gain distributions	86,029,074	9.4%	86,029,074	7.8%	86,029,074	9.9%	86,029,074	8.9%

NOTE: Source: Statistics of Income Sales of Capital Assets by Asset Type, 2007.

112TH CONGRESS, 1ST SESSION

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OCT 04 2011

Honorable Patty Murray
United States Senate
Joint Select Committee on Deficit Reduction
448 Russell Senate Office Building
Washington, D.C. 20510

Honorable Jeb Hensarling
U.S. House of Representatives
Joint Select Committee on Deficit Reduction
129 Cannon HOB
Washington, D.C. 20515

Dear Senator Murray and Mr. Hensarling:

This is in response to questions raised by Representative Van Hollen at the September 22, 2011, hearing of the Joint Select Committee on Deficit Reduction regarding the amount of revenue that would need to be raised in order to maintain deficit neutrality if corporate income tax rates were decreased.

The relationship between the top corporate income tax rate and corporate tax revenues is not uniform, and the revenues needed to offset an additional one percentage point drop in the top corporate income tax rate grows as the top corporate income tax rate is reduced. To offer a range of estimates of the revenue loss from each percentage point decline, the ten-year cost of a one percentage point reduction in the top corporate income tax rate from 35 percent to 34 percent is approximately $95 billion while the 10-year cost of a one-percentage point reduction from 26 percent to 25 percent is approximately $113 billion.

Please also be aware that reductions in the top corporate income tax rate will interact with many revenue raising provisions such as eliminating corporate income deductions. As a result, if the revenue loss from reducing the top corporate income tax rate is offset by eliminating some deductions to corporate income, eliminating these provisions will raise less revenue than would be the case if no changes were made to the top income tax rate. Thus, depending on the form of the revenue raising provisions, additional revenues will be necessary to account for this interaction. Oppositely, if the corporate base were broadened before the Congress decided to reduce corporate tax rates, each point of rate reduction would cost more than reported above.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515–6453

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold

cc: Honorable Max Baucus
Honorable Xavier Becerra
Honorable Dave Camp
Honorable James E. Clyburn
Honorable John F. Kerry
Honorable Jon Kyl
Honorable Rob Portman
Honorable Pat Toomey
Honorable Fred Upton
Honorable Chris Van Hollen
Mark Prater

Representative Jeb Hensarling

Opening Statement

In last week's testimony regarding the drivers of our structural debt we heard Congressional Budget Office Director Doug Elmendorf say that although government revenues are certainly temporarily down, he expects them to again reach their historic norm of a little over 18 percent of GDP in short order. However, he reminded us that spending is due to explode to over 34 percent of GDP in the years to come. That is principally-driven by entitlement spending programs, some of which are growing two, three, and four times the expected rate of growth of our economy.

As I have maintained from the first meeting of the Joint Select Committee, there are many actions that this committee could take that would be helpful in addressing our structural debt crisis. However, we cannot and will not succeed unless our primary focus is about saving and reforming social safety net programs that are not only beginning to fail many of their beneficiaries but simultaneously going broke.

If we fail to do this and choose to solely or primarily address our debt crisis by increasing the nation's tax burden, I fear the consequences.

Former CBO Director Rudy Penner, in testimony before the Simpson-Bowles Commission, stated, "the U.S. total tax burden, which is considerably below the OECD average, would be higher than today's OECD average by mid-century and within a few years after that we would be the highest taxed nation on earth."

Also appearing before the Simpson-Bowles Commission was former CBO Director and current Social Security and Medicare Trustee Robert Reischauer who stated, "The longer we delay, the greater risk of catastrophic economic consequences. ... The magnitude of the required adjustments is so large that ... raising taxes on the rich or corporations, closing tax loopholes, eliminating wasteful or low-priority programs, and prohibiting earmarks simply won't be enough."

Finally, when he served as CBO Director, Dr. Peter Orszag in a letter to Budget Committee Chairman Paul Ryan stated, "The tax rate for the lowest tax bracket would have to be increased from 10 percent to 25 percent; the tax rate on incomes in the current 25 percent bracket would have to be increased to 63 percent; and the tax rate of the highest bracket would have to be raised from 35 percent to 88 percent. The top corporate income tax rate would also increase from 35 percent to 88 percent."

The ability, wisdom and consequences of addressing our debt crisis through tax increases will continue to constitute a rigorous debate by our Committee.

My hope though is that we may be able to achieve rigorous agreement that fundamental tax reform, even if limited to just American businesses, can result in both revenue from economic growth for the federal government and more jobs for the American people.

Seemingly, both the President of the United States and the Speaker of the House agree. Most Americans agree that there is something fundamentally wrong with our tax code when a small business in East Texas pays 35 percent and a large Fortune 500 company pays little or nothing. There is also something fundamentally wrong with our tax code when an American company pays 35 percent and its chief European competitor only pays 25 percent. We should seize the opportunity and correct this for the sake of both bringing in more revenues through economic growth and addressing our jobs crisis at the same time.

Senator Patty Murray

Opening Statement

"Thank you Co-Chairman Hensarling. I want to thank our witness, Thomas Barthold, for taking the time to be here. As well as my colleagues and the members of the public in the audience and watching on television.

"The American people are looking at this Committee with great optimism—but also with real skepticism. They have heard the partisan rhetoric that has dominated our nation's capital recently – and quite frankly they're tired of it.

"When it comes to this Committee and its work: They don't care how it impacts one party's fortunes vs. the other. They don't care how it impacts one special interest vs. another. Their only question is, can it impact their lives?

"They want to know: Can we help put their spouse, or family member, or neighbor back to work? Can we make a real dent in the deficit so their children are able to compete and succeed? And can it be done in time for families that are losing faith with each passing day?

"Answering those questions is going to take honesty from every member of this Committee, honesty with one another, and honesty with the American people about what it's going to take.

"It's going to mean looking at every part of our budget and realizing that there is: Spending that has grown too fast, job investment that still have to be made, entitlements that are expanding too quickly, and a tax code that's become riddled with corporate giveaways and special-interest carve-outs for the richest Americans.

"But more than anything else, it's going to take the shared realization that solving our deficit crisis and putting Americans back to work will mean taking a truly balanced approach.

"Now to this point in Congress, we have begun the process of addressing spending. In fact, the Budget Control Act that established this Committee cut more than $1 trillion from our national deficit And this was on top of caps to appropriations bills we already put in place.

"But as the overwhelming majority of American families, economists, and every serious, bipartisan commission that has examined this issue has agreed—spending cuts alone aren't going to put Americans back to work or put our budget back in balance.

"We have to address both spending and revenue.

"So I am looking forward to hearing from Mr. Barthold about the tax reforms and revenue this Committee can explore.

"I am interested in hearing about the loopholes and tax expenditures my colleagues on both sides of the aisle have agreed are too often wasteful and market-distorting. About our options for broadening the base, lowering the rate, boosting the economy, and bringing in additional revenue. And about keeping our tax code truly progressive.

"Revenue and the tax code is just one side of the ledger—but it is an important one. And it needs to be a part of the balanced and bipartisan plan we owe it to Americans to come together to pass.

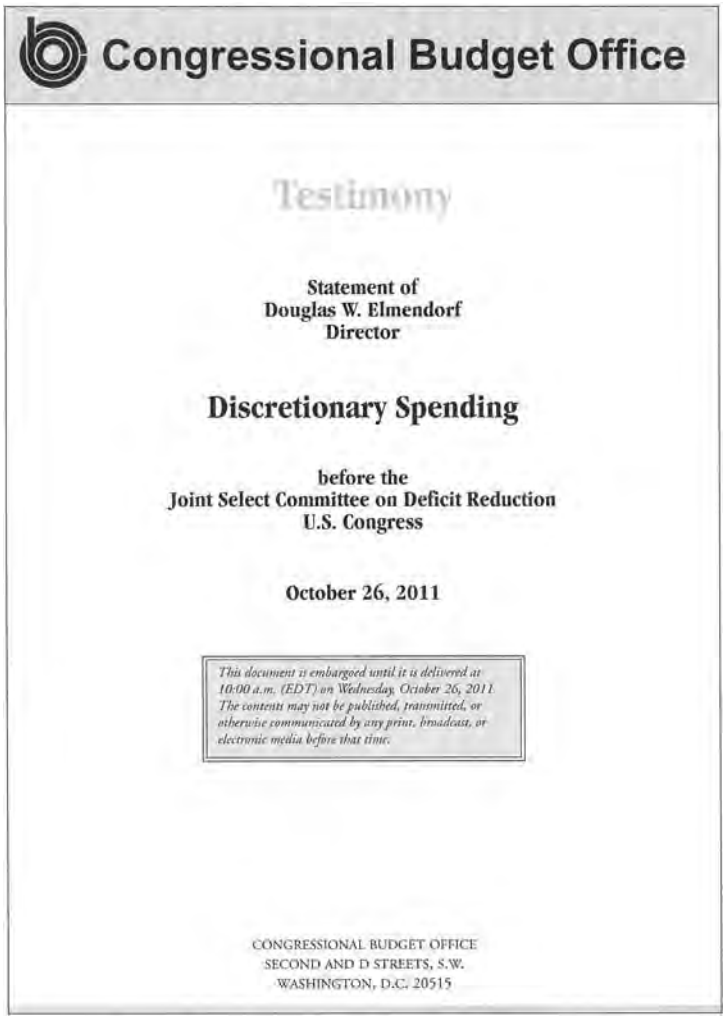
"I'm pleased that this Committee has begun the hard work of negotiations over these last weeks. And I am hopeful that we can come together and deliver the results Americans deserve.

"A balanced plan that helps get our economy back on track, gives businesses the stability to hire again, and ensures that middle class families and the most vulnerable are not bearing the burden of balancing our budget alone.

"Thank you."

October 26, 2011

Overview: Discretionary Outlays, Security and Non-Security



Congressional Budget Office

Testimony

Statement of
Douglas W. Elmendorf
Director

Discretionary Spending

before the
Joint Select Committee on Deficit Reduction
U.S. Congress

October 26, 2011

This document is embargoed until it is delivered at 10:00 a.m. (EDT) on Wednesday, October 26, 2011. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Senator Murray, Congressman Hensarling, and Members of the Committee, thank you for the invitation to testify about discretionary spending in the federal budget.

Discretionary outlays—the part of federal spending that lawmakers generally control through annual appropriation acts—totaled about $1.35 trillion in 2011, or close to 40 percent of federal outlays.[1] Slightly more than half of that spending was for defense. The remainder went for a wide variety of government programs and activities, with the largest amounts spent for education, training, employment, and social services; transportation; income security (mostly housing and nutrition assistance); veterans' benefits (primarily for health care); health-related research and public health; international affairs; and the administration of justice.

Discretionary outlays declined from about 10 percent of gross domestic product (GDP) during much of the 1970s and 1980s to 6.2 percent in 1999, mostly because defense spending, as a share of GDP, declined over that period. Since then, discretionary outlays have risen relative to the size of the economy, totaling about 9 percent of GDP in 2010 and 2011, in part because of military operations in Afghanistan and Iraq and in part because of the discretionary funding provided by the American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5). The 2010 and 2011 figures were the highest in about 20 years.

However, lawmakers have already taken significant steps to constrain discretionary spending. Budget authority—the authority to incur financial obligations—provided for defense activities in 2011 was $3 billion (or less than 1 percent) below the amount provided the year before; budget authority for discretionary nondefense programs (plus the obligation limitations that govern spending for certain discretionary transportation programs whose budget authority is not classified as discretionary) was $39 billion (or 7 percent) below the amount provided in 2010. As a result, total discretionary funding (that is, budget authority plus obligation limitations) in 2011 was the lowest, as a share of GDP, since 2002. Nevertheless, discretionary outlays in 2011 were close to the amounts spent in 2010, the Congressional Budget Office (CBO) estimates, because of spending from funds appropriated in previous years.

In addition, the Budget Control Act of 2011 (P.L. 112-25) instituted statutory caps on discretionary appropriations for each of the fiscal years 2012 through 2021. (By contrast, in most recent years the total amount of annual appropriations—except for those designated as emergency requirements—was governed by annual funding allocations agreed to by the House of Representatives and the Senate but not enacted into law.) The new caps do not constrain spending for the war in Afghanistan or similar activities or for designated emergencies; however, if implemented as written in the act, the caps would keep other appropriations for 2012 and 2013 below the amounts pro-

1. The data presented for 2011 come from Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2011). Although the amount of total spending for 2011 has been reported by the Department of the Treasury, the data available to date do not identify the amounts of discretionary and mandatory outlays.

vided for 2011 and would limit the growth of those appropriations to about 2 percent a year from 2014 to 2021. Compared with allowing nonwar discretionary appropriations to grow at the rate of inflation, the capped amount of discretionary budget authority would be about 4 percent lower in 2012 and 9 percent lower in 2021; as a result, budget deficits would be reduced by $778 billion between 2012 and 2021, CBO estimates (not counting the savings in interest payments resulting from lower outlays).[2]

The future path of discretionary spending may be affected by the actions of the Joint Select Committee on Deficit Reduction. Under provisions of the Budget Control Act, legislation originating from this Committee could directly alter the path of such spending, for example, by changing the caps. Alternatively, if legislation originating from this Committee and estimated to produce at least $1.2 trillion in deficit reduction (including an allowance for interest savings) is not enacted by January 15, 2012, automatic procedures to cut spending will take effect in January 2013. CBO expects that 71 percent of the net savings from the automatic procedures would come from reductions in discretionary appropriations. If those procedures were triggered, appropriations for defense, excluding funding for overseas contingency operations (war-related funding), would be $110 billion—or 16 percent—lower by 2021 than they would be if they kept up with inflation; funding for nondefense activities would be $99 billion—or 15 percent—lower.

Moreover, for some programs, a comparison with inflation-adjusted funding understates the magnitude of reductions relative to the cost of maintaining current policies or plans. For example, implementing the Administration's multiyear defense plans would require nonwar defense spending to grow faster than the rate of inflation, and the demands for veterans' health care and Pell grants for higher education have also been growing more quickly than inflation. In contrast, the funding required for war-related activities—in Afghanistan and other countries—will be smaller than the amounts provided in recent years if the number of deployed troops is smaller and the pace of operations is diminished.

Regardless of the constraints placed on discretionary spending through the Budget Control Act or other actions taken by this Congress, subsequent Congresses will make the final decisions about future discretionary appropriations. Those decisions might or might not satisfy the constraints put in place by this Congress. Nevertheless, CBO

2. In its letter to the Honorable John A. Boehner and the Honorable Harry Reid analyzing the impact on the deficit of the Budget Control Act of 2011 (August 1, 2011), CBO estimated that the act's caps on nonwar discretionary budget authority would reduce projected deficits by $756 billion between 2012 and 2021 compared with CBO's March 2011 baseline adjusted to reflect enactment of full-year appropriations for 2011 (and not counting the savings in interest payments that would result from lower outlays). CBO's most recent baseline, prepared in August, incorporated slightly higher projections of inflation and reflected other technical adjustments; as a result, the caps are now estimated to reduce discretionary outlays by a slightly larger amount compared with what would be spent if appropriations grew at the rate of inflation.

assumes in its baseline projections that discretionary funding subject to the caps in the coming years will be equal to the amounts currently specified in law for those caps. As a result, legislation that reduced the funds available for a particular discretionary acrivity or achieved savings in undertaking a particular activity would only reduce projected total appropriations if the legislation also lowered the caps; without a reduction in the caps, funding for other discretionary activities would probably fill the gap created by the specific reduction or savings.

Concepts and Definitions Related to Discretionary Spending

Discretionary spending can be categorized and analyzed in a variety of ways. Some of the metrics derive from differences between how much spending authority is provided and how much is disbursed in a given year. Others derive from distinctions between types and purposes of discretionary spending. Still others stem from legislation that has aggregated discretionary spending into specific categories.

Budget Authority and Outlays

Appropriation acts provide authority to federal agencies to incur financial obligations. Such *budget authority* generally takes the form of a direct appropriation of funds from the Treasury or authority to obligate and expend certain collections.

Agencies use their budget authority to make commitments over the course of a fiscal year (and sometimes longer), and the money is spent sometime after the commitment is made. Some appropriations (such as for employees' salaries) are spent quickly, but others (such as for major construction projects) are disbursed over several years. *Outlays* are the amount of money spent each year. In any given year, discretionary outlays include spending from both new budget authority and budget authority provided in previous years. Thus, the Congress specifies the amount of budget authority provided each year, but it does not directly control when outlays occur.

Several transportation programs have an unusual budgetary treatment: Their budget authority is provided in authorizing legislation, rather than in appropriation acts, but their spending is constrained by *obligation limitations* imposed by appropriation bills. Consequently, their budget authority is considered mandatory, but their outlays are discretionary. (The largest of those programs is the Federal-Aid Highway Program, which is funded from the Highway Trust Fund.) As a result, total discretionary outlays in the budget are greater than total discretionary budget authority. In some presentations, the amounts of those obligation limitations are added to discretionary budget authority to produce a measure of the total *funding* provided for discretionary programs.

Categories of Spending: Defense/Nondefense and Security/Nonsecurity

Budget presentations often divide discretionary spending between defense and nondefense activities, where defense spending is defined as the sums that are recorded in budget function 050 (which is labeled "national defense").[3] That budget function includes all of the spending on military activities of the Department of Defense plus spending for the Department of Energy's atomic energy defense activities and some defense-related activities of other agencies.

The Budget Control Act set caps on discretionary budget authority for 2012 and 2013 using a different set of categories: security and nonsecurity. Under that act, the security category includes most (but not all) funding normally categorized as for national defense, but it also includes discretionary appropriations for the Department of Homeland Security, the Department of Veterans Affairs, and accounts in budget function 150 (international affairs). The nonsecurity category comprises all discretionary appropriations not included in the security category. Those separate security and nonsecurity caps apply only for fiscal years 2012 and 2013; for each of the fiscal years 2014 through 2021, the Budget Control Act specified a single cap on most discretionary funding. The caps do not encompass funding for the war in Afghanistan or similar activities (overseas contingency operations).[4]

If legislation originating from the Joint Select Committee on Deficit Reduction achieving at least $1.2 trillion in deficit reduction over the 2012–2021 period is not enacted, the Budget Control Act will trigger further reductions in discretionary spending. The act specifies a set of caps to be used as a starting point for the automatic reductions. Those caps are equal in total to the ones that apply in the absence of the automatic reductions, but they divide the spending differently, separating defense spending (budget function 050) from nondefense spending (although the act continues to apply the terms "security" and "nonsecurity" to describe the two categories).

Baseline Projections

CBO's baseline projections incorporate the assumption that current law remains in place so that those projections can serve as a benchmark for policymakers to use in considering possible changes to law. Although that current-law concept is generally straightforward for spending under permanent laws (such as that for many entitle-

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3. Federal spending is categorized in 20 general-subject categories, or budget functions, so that budget authority and outlays can be presented according to the purposes the spending is intended to serve.

4. The law allows for adjustments to the caps when appropriations are provided for certain purposes. Funding for overseas contingency operations would lead to an increase in the caps, as would other funding designated as an emergency requirement. Furthermore, the law allows for an increase in the caps if additional budget authority is provided for program integrity initiatives aimed at reducing improper benefit payments in the Disability Insurance and Supplemental Security Income programs, Medicare, Medicaid, and the Children's Health Insurance Program. Finally, the caps would be increased if appropriations were provided for disaster relief, but the adjustments would be limited on the basis of historical averages for such funding.

ment programs), it may be less clear what benchmark should be used in the context of discretionary spending because appropriations are revisited each year.

In the absence of discretionary caps (such as those established by the Budget Control Act), CBO's baseline for discretionary spending has incorporated the assumption that such appropriations grow with inflation from the most recent year's level. That approach for a baseline for discretionary spending was specified in the Balanced Budget and Emergency Deficit Control Act of 1985.[5] With the imposition of caps on discretionary funding in the Budget Control Act, CBO's August 2011 baseline also incorporates the assumption that total discretionary appropriations—other than those for overseas contingency operations—will equal the caps set in that act. To reduce discretionary spending below that projected in CBO's baseline, legislation would have to lower those caps or restrain discretionary spending not constrained by the caps, such as funding for the war in Afghanistan or for similar activities. Reducing spending for individual discretionary programs without changing the caps would not necessarily change total discretionary funding or result in savings.

CBO's baseline includes a placeholder of $1.2 trillion in projected deficit reduction between 2012 and 2021 that is assumed to stem either from legislation produced by this Committee or from the automatic cuts that would be triggered if such legislation is not enacted. Because the composition of that additional deficit reduction would depend on the specific provisions of any legislation resulting from the Committee's proposals and the extent of any automatic reductions that would be triggered, CBO did not allocate the $1.2 trillion between revenues and outlays. Hence, the baseline projections for discretionary spending do not incorporate any such additional reductions.

Funding for Wars

Funding for the wars in Afghanistan and Iraq and for similar activities has often been separated from other types of discretionary appropriations. In the early years of those wars, budget authority was routinely provided through supplemental appropriations and often designated as meeting an emergency requirement. Perhaps as a result of the timing of such appropriations and a perception that such funding was "temporary" in nature, it was treated separately from other appropriations. The caps set by the Budget Control Act of 2011 also treat funding for the wars separately—the caps do not constrain funding for overseas contingency operations (or funding designated as an emergency requirement). Consequently, for its baseline projections, CBO follows the standard procedures specified in law and assumes that budget authority for overseas contingency operations will continue at current levels with adjustments for inflation.

Placing caps on appropriations for overseas contingency operations could result in estimated savings relative to those current-law projections. Such savings, however, might simply reflect policy decisions that have already been made and that would be realized even without such funding constraints. Moreover, if future policymakers

5. Section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985 specifies the rules for constructing the baseline (see 2 U.S.C. 907).

believed that national security required appropriations above the capped levels, they would almost certainly provide emergency appropriations that would not, under current law, be counted against the caps.

The baseline projections that CBO published in August were based on appropriations for fiscal year 2011, which totaled $159 billion for overseas contingency operations. Since then, appropriations for overseas contingency operations have been set for the first part of fiscal year 2012 (through November 18, 2011) at an annual level of $119 billion, reflecting the planned drawdown of troops in Afghanistan and withdrawal of U.S. forces from Iraq. Reflecting those latest appropriations, the total budget authority that CBO would now project for overseas contingency operations over the 2012–2021 period is about $440 billion less than the amount shown in CBO's August baseline. Therefore, if CBO were to make estimates today of savings from any caps on such funding, those estimates would be based on those lower projections.

What Does Discretionary Funding Comprise?

Discretionary funding for 2011 totaled $1,277 billion: budget authority of $712 billion for defense and funding totaling $566 billion for nondefense activities, including $54 billion in obligation limitations for some transportation programs (see Table 1). Budget authority provided for defense activities in 2011 was $3 billion (or less than 1 percent) below the amount provided the year before; the sum of discretionary budget authority and obligation limitations for nondefense programs was $39 billion (or 7 percent) below the amount provided in 2010. Nevertheless, discretionary outlays in 2011 were close to the amounts spent in 2010, CBO estimates, because of spending from funds appropriated in previous years.

No full-year appropriations have been enacted for fiscal year 2012, which began on October 1. However, the Congress has enacted a continuing resolution to provide discretionary funding through November 18, 2011. That continuing resolution provides funding at an annualized level of $1,216 billion, about 5 percent less than the amount provided for 2011. That amount equals the sum of the security and nonsecurity caps for 2012 established in the Budget Control Act ($1,043 billion), obligation limirations for transportation programs provided by the continuing resolution ($54 billion), and funding for overseas contingency operations provided by the continuing resolution (just under $119 billion).

Funding for National Defense

Three major categories of funding for the Department of Defense (DoD) accounted for 83 percent of the defense appropriation in 2011: funding for operation and maintenance ($308 billion), military personnel ($154 billion), and procurement ($129 billion) (see Figure 1). Operation and maintenance accounts, which constitute the single largest category of defense spending, fund the day-to-day activities of the military, the training of military units, the majority of costs for the military's health care program,

Table 1.

Discretionary Funding for 2011

(Billions of dollars)

	2011 Funding
Defense[a]	
Operation and maintenance	308
Military personnel	154
Procurement	129
Research, development, test, and evaluation	76
Other Department of Defense	21
Other	23
Subtotal, defense	712
Nondefense	
Education, training, employment, and social services	92
Transportation[b]	85
Income security	63
Veterans' benefits and services	57
Health	55
International affairs	52
Administration of justice	50
Other	
Natural resources and environment	33
General science, space, and technology	30
General government	17
Community and regional development	15
Agriculture	6
Medicare	6
Social Security	6
Energy	4
Commerce and housing credit	-6
Subtotal, other	112
Across-the-board reductions[c]	-1
Subtotal, nondefense	566
Total	**1,277**

Source: Congressional Budget Office.

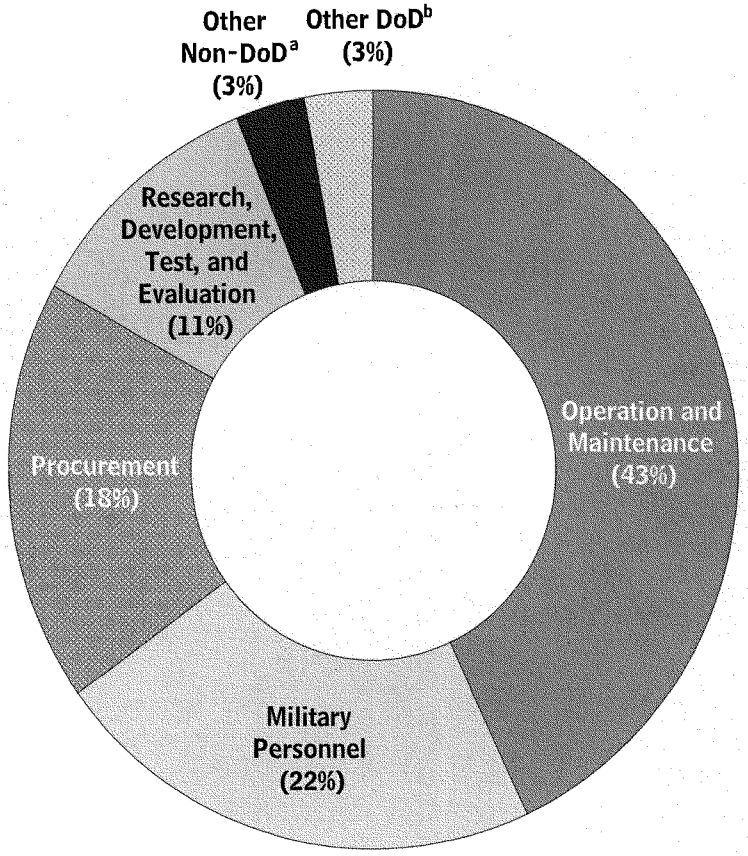
a. Includes funding for overseas contingency operations such as the wars in Afghanistan and Iraq.

b. Includes $54 billion in budgetary resources provided by obligation limitations for certain ground and air transportation programs.

c. Full-year appropriations for 2011 included an across-the-board cut of 0.2 percentage points for all nondefense discretionary accounts.

Figure 1.

Defense Discretionary Funding for 2011



Source: Congressional Budget Office.

Note: Discretionary funding for defense includes funding for overseas contingency operations such as the wars in Afghanistan and Iraq.

a. Includes spending on some defense-related activities by government entities other than the Department of Defense (DoD).

b. Includes funding for military construction and family housing.

and compensation for most of DoD's civilian employees. The military personnel accounts fund compensation for uniformed service members, including pay, housing and food allowances, and related activities, such as moving service members and their families to new duty stations. Procurement accounts fund the purchase of new weapon systems and other major equipment and upgrades to existing weapon systems.

Appropriations for research, development, test, and evaluation ($76 billion), which fund basic and applied research as well as the development and testing of weapon systems, accounted for another 11 percent of total funding for national defense. The rest of the appropriations (about 6 percent) were for military construction, family housing, and other programs in DoD ($21 billion); the atomic energy defense activities of the Department of Energy ($17 billion); and various defense-related programs in other departments and agencies ($7 billion).

Appropriations for the wars in Afghanistan and Iraq and related activities in 2011 were distributed across several of the categories just described and are included in the amounts of funding reported here. Such appropriations totaled $159 billion in 2011, accounting for about 22 percent of the total funding for national defense.

Funding for Nondefense Activities

Seven broad budget categories, or budget functions, account for about 80 percent of the $566 billion in resources provided for nondefense discretionary activities in 2011. Education, training, employment, and social services programs together received $92 billion in funding, claiming 16 percent of total nondefense discretionary funding (see Figure 2).[6] Nearly $40 billion of that total funded grants to state and local governments for elementary, secondary, and vocational education, and another $28 billion supported programs for higher education.

Transportation programs received $85 billion, or 15 percent, of the total resources, which included $54 billion in obligation limitations for several surface and air transportation programs. (Although those programs receive mandatory budget authority through authorizing legislation, the annual appropriation acts govern spending because they limit how much of that authority the Department of Transportation can obligate in a given year.) About one-half of all discretionary funding for transportation is for highway programs.

Income security programs (mostly for housing and nutrition assistance) received funding totaling $63 billion, representing 11 percent of nondefense appropriations.[7]

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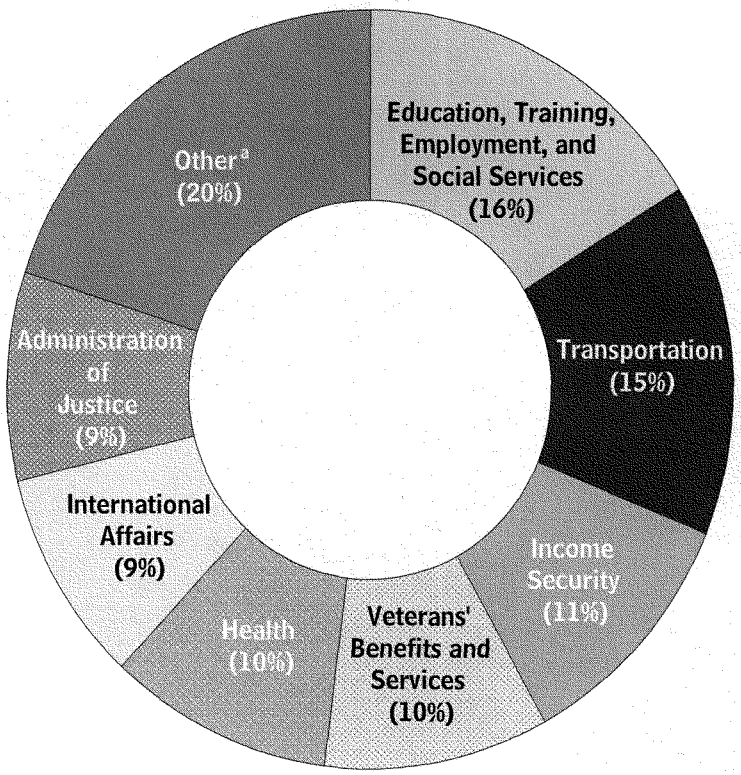
6. The student loan program and several other programs in that category are not included in that total because their funding is considered mandatory.

7. Other income security programs, such as unemployment compensation, the Supplemental Nutrition Assistance Program (formerly known as Food Stamps), and Temporary Assistance for Needy Families, are not included in the total because they are included in mandatory spending.

Figure 2.

Nondefense Discretionary Funding for 2011



Source: Congressional Budget Office.

Note: Nondefense discretionary funding includes budgetary resources provided by obligation limitations for certain ground and air transportation programs.

a. Includes funding for natural resources and environment; general science, space, and technology; general government; community and regional development; agriculture; Medicare and Social Security (for administrative activities); energy; and commerce and housing credit.

Discretionary appropriations for veterans' benefits (primarily for health care) and for health-related research and public health were $57 billion and $55 billion, respectively, each constituting 10 percent of total discretionary funding for nondefense activities. More than half of the discretionary funding for health-related research and public health is devoted to the National Institutes of Health. Finally, international affairs accounted for roughly 9 percent, as did the administration of justice.[8]

About one-third of total nondefense discretionary spending is disbursed in the form of grants to state and local governments. Of those grants, about one-third are devoted to education and training programs and one-quarter to transportation programs, with the remainder going to environmental protection, economic development, law enforcement, and various other purposes.

The funding provided for nondefense discretionary programs in 2011 was $39 billion lower than it was in 2010. The largest reduction ($8 billion, including a rescission in 2011 of $2 billion in unobligated balances) occurred because the decennial census was carried out in 2010 and therefore did not require much spending in 2011; lower amounts for disaster relief and high-speed rail ($4 billion and $2.5 billion less, respectively) constituted the next largest reductions. In addition, net gains of the Federal Housing Administration's Mutual Mortgage Insurance Fund are estimated to have risen by $4.6 billion in 2011. (Those gains, which are calculated on a present-value basis, are recorded as an offset against discretionary appropriations.)

Funding for the Federal Workforce

According to CBO's estimates, the federal government provided about $200 billion in funding to compensate federal civilian workers in 2011; that amount represents about 15 percent of total discretionary spending. Of that $200 billion, about $80 billion (or 11 percent of defense appropriations) was for civilian personnel working in the Department of Defense and on other defense-related activities, and about $120 billion (or 21 percent of nondefense discretionary funding) was for nondefense personnel; most of those nondefense personnel work in the Departments of Veterans Affairs, Homeland Security, Justice, and the Treasury (including the Internal Revenue Service).

What Have Been the Trends in Discretionary Outlays?

Discretionary outlays declined from about 10 percent of GDP during much of the 1970s and 1980s to 6.2 percent in 1999, mostly because defense spending, as a share of GDP, declined over that period.[9] Those outlays then began to increase somewhat relative to the size of the economy, reaching 7.0 percent of GDP in 2002 and 7.9 percent in 2008 (see Figure 3). The rise between 2002 and 2008 can be attributed

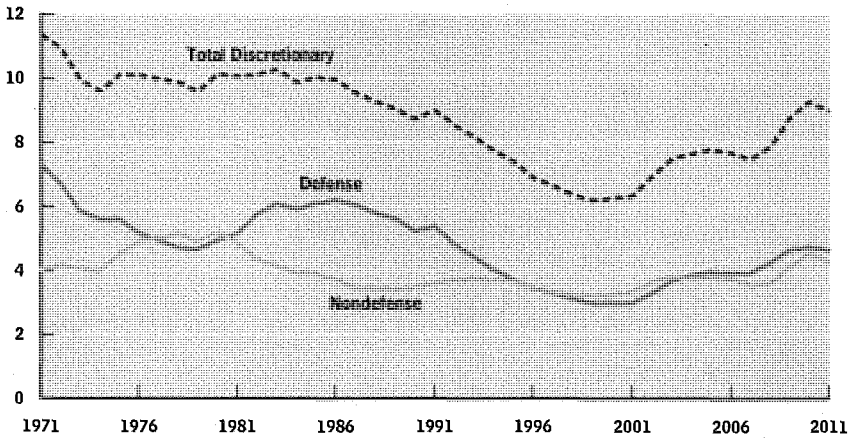
8. Funding for programs that are intended to enhance homeland security is spread across budget functions, including some of those mentioned here, and it is not recorded in a single place in the budget.

9. This discussion is framed in terms of outlays, rather than budget authority, because more long-term historical data are available for outlays.

Figure 3.

Defense, Nondefense, and Total Discretionary Outlays, 1971 to 2011

(Percentage of gross domestic product)



Source: Congressional Budget Office.

to the actions taken in response to the terrorist attacks of September 11, 2001, and subsequent military operations in Afghanistan and Iraq. In 2009 and 2010, discretionary outlays jumped to 8.8 percent and 9.3 percent of GDP, respectively, in part because of $281 billion in discretionary funding provided by the American Recovery and Reinvestment Act of 2009. The 2010 figure was the highest since 1988 (in part because much of the ARRA funding provided in 2009 was disbursed in 2010). By CBO's estimate, discretionary spending in 2011 was about 9.0 percent of GDP; those outlays stemmed from budgetary resources provided for 2011 and for earlier years, including some from ARRA.

Defense Spending

Trends in discretionary outlays during the past few decades have been heavily influenced by spending on defense. In 1971, defense discretionary outlays accounted for 7.3 percent of GDP; however, that share fell rapidly over the following several years, dropping to 4.7 percent of GDP by 1978. Such spending then rose, reaching 6.2 percent in 1986. From that point, defense outlays resumed their slide, dropping to a low of 3.0 percent of GDP between 1999 and 2001.

In 2002, defense outlays rose back to 3.3 percent of GDP, not only because of operations in Afghanistan and other war-related activities (see Appendix A) but also because of initiatives that were planned before September 11, 2001. Outlays for defense activities continued to climb as military operations began in Iraq, and by 2005, defense outlays equaled 4.0 percent of GDP. Such outlays subsequently

increased further relative to the size of the economy, reaching 4.7 percent of GDP (or $689 billion) in 2010 and about the same share of GDP in 2011. That level is the highest relative to GDP since 1992 but well below the average for defense spending since World War II.

Nondefense Spending

Outlays for nondefense discretionary programs have averaged about 4 percent of GDP during the past 40 years, with significant variation over time but little apparent trend. Thus, on average, such outlays increased during that period roughly in line with the size and income of the population.

Such outlays rose from 4.0 percent of GDP in 1971 to a high of 5.2 percent of GDP in 1980 before declining. Nondefense outlays as a share of GDP fell through the rest of the 1980s and were relatively stable from 1990 through 2008, ranging between 3.2 percent and 3.8 percent. However, funding from ARRA then helped push that share higher—to 4.5 percent of GDP in 2010. In 2011, nondefense discretionary outlays dropped to 4.3 percent of GDP, CBO estimates, in part because spending of ARRA funds declined.

How Will Discretionary Spending Evolve Over the Next Decade Under Current Law?

CBO's baseline for discretionary funding reflects the caps placed on such budget authority for 2012 through 2021 by the Budget Control Act. Discretionary budget authority subject to the caps will be limited to $1,043 billion in 2012 and $1,047 billion in 2013, and increases will be restricted to about 2 percent per year after that, with discretionary budget authority reaching a maximum of $1,234 billion in 2021.

The baseline also incorporates projections of obligation limitations for certain transportation programs (calculated by adjusting for inflation the $54 billion provided in 2011). Combining the budget authority subject to the caps with those obligation limitations, CBO projects that such discretionary funding will decline from 7.0 percent of GDP in 2012 to 5.5 percent of GDP in 2021 (see Figure 4).

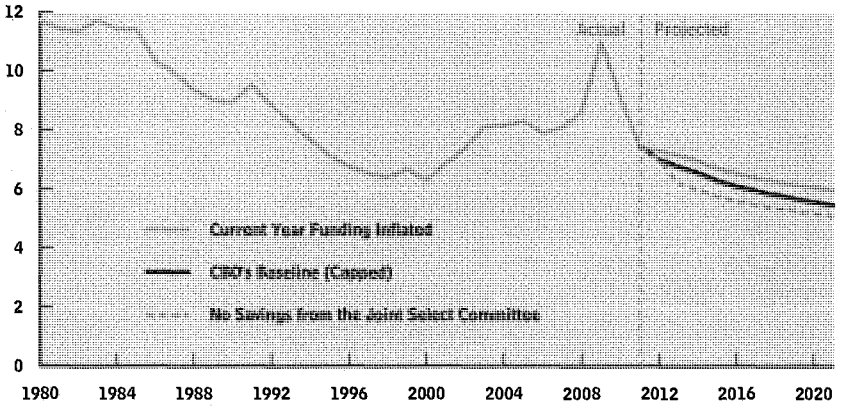
Appropriations of those amounts will mean reductions in the real (inflation-adjusted) resources available for the government's programs. Compared with allowing discretionary appropriations to grow at the rate of inflation, the capped amount of discretionary budget authority is about 4 percent lower in 2012 and 9 percent lower in 2021. Compared with allowing discretionary budget authority to grow at the rate of nominal GDP, the caps are about 6 percent lower in 2012 and about 28 percent lower in 2021.

According to CBO's estimates, if appropriations in the next 10 years are equal to the caps on discretionary spending, implementing those caps will reduce budget deficits by $778 billion between 2012 and 2021 (not counting the savings in interest payments that will result from lower outlays) compared with what would occur if discretionary budget authority was allowed to grow at the rate of inflation.

Figure 4.

Total Discretionary Funding Excluding War Funding, 1980 to 2021

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: Funding includes budget authority as well as budgetary resources provided by obligation limitations for certain ground and air transportation programs.

The future path of discretionary spending may be affected by the actions of this Committee. Legislation originating from the Committee could directly alter the path of discretionary spending, for example, by changing the caps. Alternatively, if legislation originating from the Committee and estimated to produce at least $1.2 trillion in deficit reduction (including an allowance for interest savings) is not enacted by January 15, 2012, automatic procedures to cut spending will take effect. According to the law, such procedures would lead to a sequestration (that is, a cancellation) of discretionary resources in 2013 and a reduction in the caps in subsequent years—as well as reductions in mandatory spending.[10] The magnitude of those cuts would depend on any shortfall in the estimated effects of legislation originating from this Committee relative to the trigger point of $1.2 trillion.

Automatic Enforcement Procedures Under the Budget Control Act

The automatic reductions in spending under the Budget Control Act—if triggered—would take the form of equal cuts (in dollar terms) in funding for defense and nondefense programs from 2013 through 2021. Those reductions would be achieved by lowering the caps on discretionary budget authority specified in the Budget Control Act and by automatically cancelling budgetary resources for some programs and

10. Mandatory spending is the budget authority provided by laws other than appropriation acts and the outlays that result from that budget authority.

activities financed by mandatory spending.[11] The law exempts a significant portion of mandatory spending from sequestration, however.

CBO has estimated the changes in discretionary and mandatory spending that would occur if the automatic enforcement mechanisms were triggered because no new deficit reduction legislation was enacted (see Table 2). CBO's analysis can only approximate the ultimate results; the Administration's Office of Management and Budget would be responsible for implementing any such automatic reductions on the basis of its own estimates.

Under those circumstances, the automatic enforcement procedures would reduce budgetary resources for defense by $492 billion between 2013 and 2021. Such annual reductions would be split proportionally between mandatory and discretionary defense spending. Because mandatory spending makes up much less than 1 percent of all defense spending, however, CBO estimates that only about $150 million would be sequestered from mandatory defense programs over the 2013–2021 period. Consequently, almost all of the required deficit reduction in the defense category would have to be achieved by lowering the caps on future discretionary appropriations for defense activities.

Estimating automatic reductions for nondefense programs is more complicated, particularly because of provisions in the Budget Control Act that limit cuts in most spending for Medicare benefits to 2 percent. CBO estimates that about 90 percent of Medicare spending would be subject to that limit, and another 8 percent of such spending would be exempt from sequestration altogether, leaving just 2 percent of Medicare spending subject to the same sequestration as nonexempt mandatory programs.

The act would require the same total reductions—$492 billion over the 2013–2021 period—in the budgetary resources for nondefense activities as in those for defense. In calculating the reductions required in the nondefense spending category, the targeted savings would first be allocated proportionally between nonexempt discretionary and mandatory programs. CBO estimates that mandatory spending accounts for roughly 58 percent of all nondefense spending that would be subject to enforcement procedures under the Budget Control Act during those nine years. Of that nonexempt mandatory spending, the vast majority is for Medicare programs and activities that would be subject to the 2 percent limit. In the absence of such a limit, reductions in budgetary resources for Medicare would total $256 billion between 2013 and 2021, CBO estimates; with the 2 percent ceiling, however, such reductions would total $123 billion over that period. The other $133 billion in required reductions that could not be accomplished because of the 2 percent limit would be reallocated

11. Budgetary resources consist of all sources of authority provided to federal agencies that permit them to incur financial obligations, including new budget authority, unobligated balances, direct spending authority, and obligation limitations. For 2013, reductions in discretionary budget authority would take place via sequestration rather than through a reduction in the caps.

Table 2.

CBO's Estimates of Sequestration Amounts for Mandatory Spending and Reductions in Caps on Discretionary Budget Authority

(Billions of dollars)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total, 2013-2021
Defense[a]										
Mandatory sequestration	*	*	*	*	*	*	*	*	*	*
Reduction in the cap on discretionary budget authority[b]	-55	-55	-55	-55	-55	-55	-55	-55	-55	-492
Total	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-492**
Nondefense[a]										
Mandatory sequestration										
Medicare spending subject to 2 percent limit	-11	-11	-12	-13	-13	-14	-15	-16	-17	-123
Other nonexempt programs	-3	-3	-4	-4	-3	-3	-3	-3	-3	-30
Additional sequestration applied to other programs because of the 2 percent limit for Medicare[c]	-2	-2	-2	-2	-2	-2	-2	-2	-2	-17
Subtotal	-16	-17	-18	-19	-19	-19	-20	-21	-22	-170
Reduction in the cap on discretionary budget authority[b]										
Preliminary reductions	-25	-24	-24	-23	-23	-23	-22	-21	-21	-206
Further reductions because of the 2 percent limit for Medicare	-14	-14	-13	-13	-13	-13	-12	-12	-12	-116
Total	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-55**	**-492**
Memorandum:										
Percentage Cut to Nonexempt Budget Accounts										
Defense	10.0	9.8	9.7	9.5	9.3	9.1	8.9	8.7	8.5	n.a.
Nondefense										
Discretionary	7.8	7.4	7.1	6.8	6.6	6.4	6.1	5.8	5.5	n.a.
Mandatory										
Medicare spending subject to 2 percent limit	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	n.a.
Other	7.8	7.4	7.1	6.8	6.6	6.4	6.1	5.8	5.5	n.a.

Source: Congressional Budget Office.

Notes: * = between -$500 million and zero; n.a. = not applicable.

Budget authority refers to the authority provided by law to incur financial obligations, which eventually result in outlays.

a. For the purposes of this table, "defense" refers to all accounts in budget function 050, and "nondefense" refers to all other budget accounts.

b. For 2013, reductions in discretionary budget authority would take place via sequestration rather than through a reduction in the caps.

c. Because a portion of Medicare spending cannot be subject to a sequestration of more than 2 percent, the remaining amount of required reductions must be reallocated proportionally among other nonexempt mandatory programs and nondefense discretionary funding.

proportionally among the remaining nonexempt mandatory programs and discretionary programs in the nondefense category.

Altogether, the majority of the savings from the automatic spending reductions would stem from further cuts in discretionary programs beyond those embodied in the Budget Control Act's caps on discretionary budget authority. CBO expects that 71 percent of the net savings from the automatic procedures would come from lowering the caps on discretionary appropriations (and from a sequestration of those appropriations in 2013), 13 percent would come from a net reduction in mandatory spending, and 16 percent would result from lower debt-service costs arising from those other cuts.[12]

Of course, outcomes could be different from the figures in the table. The Congress could enact legislation originating from this Committee that would produce $1.2 trillion in savings through changes that differ significantly from the automatic reductions that would be required in the absence of such legislation. Or such legislation could yield some savings, but less than $1.2 trillion, so the automatic procedures would have a smaller impact than CBO has estimated here. Alternatively, this Committee could recommend, and the Congress could enact, legislation saving significantly more than $1.2 trillion.

Defense Spending

To illustrate the potential impact of the caps on discretionary appropriations set in the Budget Control Act and of the automatic enforcement procedures contained in that act, CBO has projected defense and nondefense appropriations and outlays under several different assumptions. For defense, those projections exclude appropriations and outlays for overseas contingency operations.

Compliance with the caps on discretionary funding could occur through many different combinations of defense and nondefense funding. For example, defense and nondefense appropriations might be cut proportionally relative to the funding that would be necessary to keep pace with inflation. In that case, funding for defense programs apart from overseas contingency operations would drop from $552 billion in 2011 to $538 billion in 2012 before rising again and reaching $637 billion in 2021 (see Table 3). Between 2012 and 2021, such funding would be $445 billion less than the amount that would occur if the amount of funding for 2011 grew at the rate of inflation. When measured as a share of GDP, funding for defense would decline by about 1 percentage point from 2011 to 2021, or by more than one-fourth (see Figure 5). Funding for defense in 2021 (excluding overseas contingency operations) would represent 2.7 percent of GDP; by comparison, annual funding for defense (excluding overseas contingency operations) has averaged 3.4 percent of GDP during the past decade.

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12. For further details, see Congressional Budget Office, *Estimated Impact of Automatic Budget Enforcement Procedures Specified in the Budget Control Act* (September 2011).

Table 3.

Projections of Discretionary Budget Authority for Defense Programs

(Billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
	Projected Budget Authority												
Funding for 2011 (Excluding overseas contingency operations) Adjusted for Inflation[a]	552	562	574	586	599	614	630	646	664	682	700	2,935	6,256
Potential Paths for Defense Discretionary Budget Authority Subject to the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from defense[c]	552	532	531	516	524	531	541	550	560	569	578	2,634	5,432
Proportional reductions	552	538	541	550	560	571	584	597	610	623	637	2,760	5,811
No reductions from defense	552	562	574	586	599	614	630	646	664	682	700	2,935	6,256
If No Savings Result from the Joint Select Committee[d]	552	538	491	501	511	522	535	548	561	575	589	2,565	5,374
	Reduction in Budget Authority Relative to the Funding for 2011 Adjusted for Inflation												
Potential Paths for Defense Discretionary Budget Authority Subject to the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from defense[c]	0	-30	-43	-70	-76	-82	-89	-96	-104	-113	-122	-301	-825
Proportional reductions	0	-24	-33	-36	-39	-42	-46	-50	-54	-58	-63	-175	-445
No reductions from defense	0	0	0	0	0	0	0	0	0	0	0	0	0
If No Savings Result from the Joint Select Committee[d]	0	-24	-83	-85	-88	-91	-94	-98	-102	-106	-110	-371	-882

Continued

Table 3. Continued

Projections of Discretionary Budget Authority for Defense Programs

(Billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
Memorandum:													
Overseas Contingency Operations[e]													
August 2011 baseline	159	161	164	167	169	172	176	180	183	188	191	834	1,752
Extrapolation of annualized amount provided in continuing resolution for fiscal year 2012	n.a.	119	121	124	126	129	132	135	139	142	146	619	1,314

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. These amounts were estimated by assuming that budget authority for fiscal years 2012 to 2021 will be equal to the 2011 appropriation adjusted for inflation.

b. No caps were in place in 2011. Excludes overseas contingency operations.

c. In 2012 and 2013, reductions in defense funding would not be sufficient to meet the caps on "nonsecurity" funding; therefore, some reductions would have to come from nondefense programs even if all available defense funding classified as nonsecurity was eliminated. Caps for those two years are allocated to "security" and "nonsecurity" spending. The security category comprises discretionary appropriations for the Department of Defense, the Department of Homeland Security, the Department of Veterans Affairs, the National Nuclear Security Administration, the intelligence community management account (95-0401-0-1-054), and discretionary accounts in budget function 150 (international affairs). The nonsecurity category comprises all discretionary appropriations not included in the security category. Excludes overseas contingency operations.

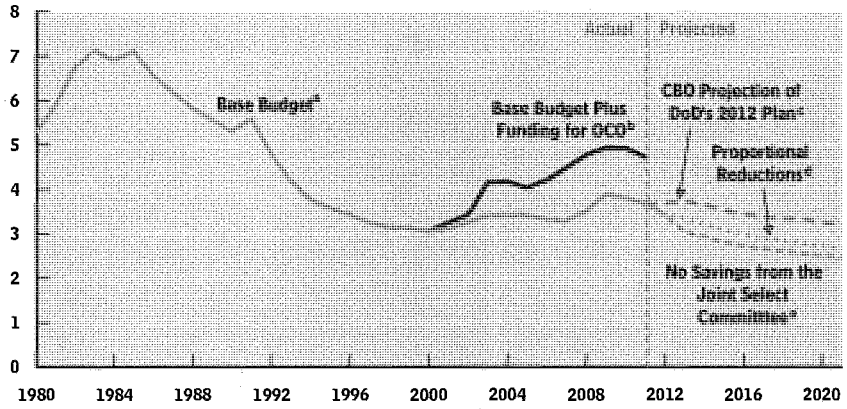
d. Assumes that the automatic enforcement procedures delineated in the Budget Control Act would take effect and, therefore, that caps for each year from 2013 through 2021 would be reset to cover defense (budget function 050) and nondefense budget authority. The caps for 2012 set in the Budget Control Act would not be affected by the automatic enforcement procedures. Because no adjustment to the caps for 2012 would be made if the automatic enforcement procedures take effect, CBO has assumed that the reductions in 2012 would be proportional.

e. The caps do not constrain appropriations for military operations in Afghanistan (or for similar activities). For its August 2011 baseline, CBO projected future war-related funding by adjusting for inflation the $159 billion appropriated for 2011. The Continuing Appropriations Act, 2012 (Public Law 112-36) funded such operations through November 18, 2011, at an annual rate of $119 billion.

Figure 5.

Defense Discretionary Budget Authority, 1980 to 2021

(Percentage of gross domestic product)



Source: Congressional Budget Office.

a. The base budget funds the normal activities of the government for national defense, including the development and procurement of weapon systems and day-to-day operations of the military and related civilian workforce. Base-budget data include supplemental and emergency funding unrelated to operations in Afghanistan, Iraq, and the war on terrorism.

b. For 2001 to 2011, supplemental and emergency funding for overseas contingency operations (OCO), such as those in Afghanistan and Iraq, and for other purposes is shown separately from the base-budget data.

c. The CBO projection of the Department of Defense's (DoD's) Future Years Defense Plan for 2012 (without funding for overseas contingency operations) incorporates costs that are consistent with DoD's recent experience. It also assumes that the non-DoD portions of defense discretionary funding remain at 2011 levels, adjusted only for inflation.

d. Assumes proportional reductions in defense and nondefense discretionary budget authority subject to the caps as set in the Budget Control Act of 2011.

e. Assumes that the automatic enforcement procedures delineated in the Budget Control Act would take effect and, therefore, that caps for each year from 2013 through 2021 would be reset to cover defense and nondefense budget authority. Because no adjustment to the caps for 2012 would be made if the automatic enforcement procedures take effect, CBO has assumed that the reductions in 2012 would be proportional.

Alternatively, nearly all reductions in appropriations that would be needed to meet the caps—relative to the funding that would be necessary to keep pace with inflation—could come from defense activities. In that case, budget authority for defense programs apart from overseas contingency operations would drop from $552 billion in 2011 to $516 billion in 2014 before beginning to rise again.[13] By 2021, such funding would total $578 billion and would equal 2.4 percent of GDP, one-third less than the 3.7 percent of GDP represented by 2011 defense appropriations excluding overseas contingency operations.

As another possibility, defense funding could grow at the rate of inflation, and all reductions needed to meet the caps could come from nondefense programs. In that case, CBO projects, defense appropriations would total $700 billion, or 2.9 percent of GDP, in 2021—still a decline of more than a fifth from the funding in 2011, when the amounts are measured as a share of GDP.

If none of the specified savings of $1.2 trillion was obtained through legislation originating with this Committee, the estimated reduction in defense funding in 2013 would require a sequestration of 10.0 percent in discretionary budget authority for defense (see the memorandum in Table 2). The percentage reductions in the caps for later years would be successively slightly smaller, amounting to 8.5 percent in 2021. By 2021, defense budget authority (excluding funding for overseas contingency operations) would be about $110 billion—or 16 percent—lower than it would be if such appropriations kept up with inflation. During the 2012–2021 period as a whole, defense funding would be $882 billion less than the amount that would occur if the amount of funding for 2011 grew at the rate of inflation (see Table 3).[14] By 2021, such funding would equal 2.5 percent of GDP. (Discretionary outlays for defense that would result from these different streams of budget authority are presented in Appendix B.)

The caps do not constrain appropriations for the war in Afghanistan or for similar activities, and the automatic enforcement procedures would not affect funding for such purposes.

Nondefense Spending

Alternative ways of keeping discretionary spending within the caps specified in the Budget Control Act would have different implications for nondefense spending as well.

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13. In 2012 and 2013, the total amount of nonsecurity funding that would be available within the defense category if 2011 funding was adjusted for inflation is not large enough—even if all such funding was eliminated—to meet the caps on nonsecurity funding; therefore, to adhere to the caps on nonsecurity funding, some reductions would have to come from nondefense programs.

14. That amount is the sum of two components: (1) the estimated amount of the automatic reductions that would apply to defense funding ($492 billion) and (2) the difference between the defense caps specified in law that are to be used as the basis for such automatic reductions and what funding for defense would be if appropriations after 2011 grew at the rate of inflation ($390 billion).

If defense and nondefense appropriations were cut proportionally relative to the funding that would be necessary to keep pace with inflation, nondefense budget auhority would decrease from $511 billion in 2011 to $505 billion in 2012 before rising again and reaching $597 billion in 2021 (see Table 4). Between 2012 and 2021, budget authority for nondefense purposes would be $418 billion less than the amount that would be provided if funding grew at the rate of inflation after 2011. Under an assumption that the obligation limitations for certain transportation programs grow over time at the rate of inflation, nondefense funding in 2021 would represent 2.8 percent of GDP; by comparison, such funding has averaged 4.1 percent of GDP during the past decade (see Figure 6).

Alternatively, if all reductions in appropriations—relative to the funding that would be necessary to keep pace with inflation—came from nondefense activities, budget authority for nondefense programs would drop from $511 billion in 2011 to $473 billion in 2013 before beginning to rise again. By 2021, budget authority would total $534 billion. Combining that amount with the projected obligation limitations would result in total nondefense funding equal to 2.5 percent of GDP, a drop of about one-third relative to the 3.8 percent of GDP represented by 2011 nondefense funding.

As another possibility, nondefense funding could grow nearly at the rate of inflation, and almost all reductions needed to meet the caps could come from defense programs.[15] In that case, CBO projects, nondefense budget authority would total $656 billion in 2021. The resulting funding (including obligation limitations) would equal 3.0 percent of GDP—a decline of nearly a fifth from the funding in 2011, when the amounts are measured as a percentage of GDP.

If no savings were obtained through legislation originating with this Committee, the estimated reduction in nondefense funding in 2013 would require a sequestration of 7.8 percent in discretionary budget authority for nondefense purposes (see the memorandum in Table 2). The percentage reductions in the caps for later years would be successively smaller, amounting to 5.5 percent in 2021. By 2021, nondefense budget authority would be $99 billion—or 15 percent—lower than it would be if such appropriations kept up with inflation, and total nondefense funding (including obligation limitations) would equal 2.6 percent of GDP. During the 2012–2021 period as a whole, nondefense funding would be $794 billion less than the amount that would occur if the amount of funding for 2011 grew at the rate of inflation.[16] (Discretionary outlays for nondefense activities that would result from these different streams of budget authority are presented in Appendix B.)

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15. In 2012 and 2013, reductions in defense funding would not be sufficient to meet the caps on nonsecurity funding; therefore, some reductions would have to come from nondefense programs even if all available defense funding classified as nonsecurity was eliminated.

16. That amount is the sum of two components: (1) the estimated amount of the automatic reductions that would apply to nondefense funding ($322 billion) and (2) the difference between the nondefense caps specified in law that are to be used as the basis for such automatic reductions and what funding for nondefense activities would be if appropriations after 2011 grew at the rate of inflation ($473 billion).

Table 4.

Projections of Discretionary Budget Authority for Nondefense Programs

(Billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
	Projected Budget Authority												
Funding for 2011 Adjusted for Inflation[a]	511	528	538	550	562	576	590	606	622	639	656	2,753	5,867
Potential Paths for Nondefense Discretionary Budget Authority Subject to the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from nondefense	511	481	473	480	487	493	501	510	518	526	534	2,414	5,004
Proportional reductions	511	505	506	516	526	536	547	559	572	585	597	2,589	5,449
No reductions from nondefense[c]	511	511	516	550	562	576	590	606	622	639	656	2,715	5,828
If No Savings Result from the Joint Select Committee[d]	511	505	462	472	483	494	505	518	532	545	557	2,416	5,072
	Reduction in Budget Authority Relative to the Funding for 2011 Adjusted for Inflation												
Potential Paths for Nondefense Discretionary Budget Authority Subject to the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from nondefense	0	-47	-65	-70	-76	-82	-89	-96	-104	-113	-122	-340	-863
Proportional reductions	0	-23	-31	-34	-37	-40	-43	-47	-50	-55	-59	-164	-418
No reductions from nondefense[c]	0	-17	-22	0	0	0	0	0	0	0	0	-38	-38
If No Savings Result from the Joint Select Committee[d]	0	-23	-76	-78	-79	-82	-85	-88	-90	-95	-99	-338	-794

Source: Congressional Budget Office.

a. These amounts were estimated by assuming that budget authority for fiscal years 2012 to 2021 will be equal to the 2011 appropriation adjusted for inflation.

b. No caps were in place in 2011.

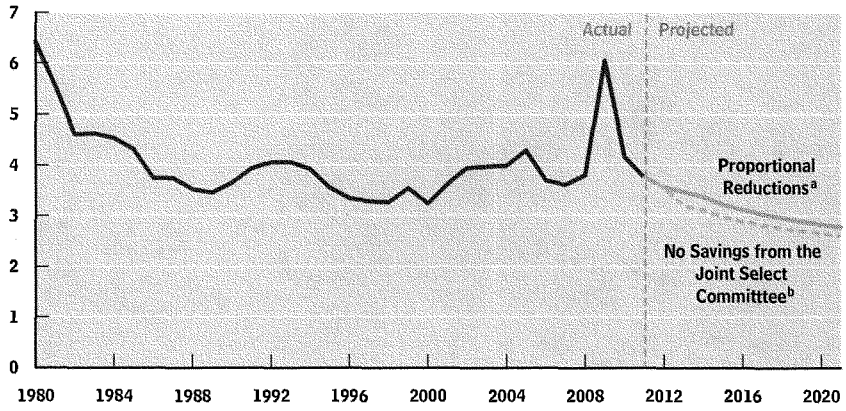
c. In 2012 and 2013, reductions in defense funding would not be sufficient to meet the caps on "nonsecurity" funding; therefore, some reductions would have to come from nondefense programs even if all available defense funding classified as nonsecurity was eliminated. Caps for those two years are allocated to "security" and "nonsecurity" spending. The security category comprises discretionary appropriations for the Department of Defense, the Department of Homeland Security, the Department of Veterans Affairs, the National Nuclear Security Administration, the intelligence community management account (95-0401-0-1-054), and discretionary accounts in budget function 150 (international affairs). The nonsecurity category comprises all discretionary appropriations not included in the security category. Excludes overseas contingency operations.

d. Assumes that the automatic enforcement procedures delineated in the Budget Control Act would take effect and, therefore, that caps for each year from 2013 through 2021 would be reset to cover defense (budget function 050) and nondefense budget authority. The caps for 2012 set in the Budget Control Act would not be affected by the automatic enforcement procedures. Because no adjustment to the caps for 2012 would be made if the automatic enforcement procedures take effect, CBO has assumed that the reductions in 2012 would be proportional.

Figure 6.

Nondefense Discretionary Funding, 1980 to 2021

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Note: Funding includes budget authority as well as budgetary resources provided by obligation limitations for certain ground and air transportation programs.

a. Assumes proportional reductions in defense and nondefense discretionary budget authority subject to the caps as set in the Budget Control Act of 2011.

b. Assumes that the automatic enforcement procedures delineated in the Budget Control Act would take effect and, therefore, that caps for each year from 2013 through 2021 would be reset to cover defense and nondefense budget authority. Because no adjustment to the caps for 2012 would be made if the automatic enforcement procedures take effect, CBO has assumed that the reductions in 2012 would be proportional.

How Might the Path of Discretionary Spending Be Altered?

Because discretionary spending is determined by the appropriation process each year, it is not always clear what metric should be used when thinking about future needs and measuring the impact of policy changes.

One metric is to assume that current funding grows at the rate of inflation (that is, that it stays the same in real terms). For some programs, however, such an approach understates the cost of maintaining current policies or plans. For example, early in 2011 the Administration put forth a plan to address future defense needs that would require defense spending to grow faster than the rate of inflation. As further examples, the demands for veterans' health care and Pell grants for higher education are growing more quickly than inflation. In addition, current funding for some programs is less than many analysts believe is necessary to address the nation's needs. An example in this category is spending on transportation and other forms of infrastructure.

In contrast, the funding needed for overseas contingency operations, such as the war in Afghanistan, may decline during the coming decade. Indeed, the appropriations currently in place for such operations for fiscal year 2012 are well below the amounts provided in 2011.

Regardless of the constraints placed on discretionary spending through the Budget Control Act, legislation proposed by this Committee, or other actions by this Congress, the amounts of future discretionary appropriations will ultimately be enacted by future lawmakers. The limitations already enacted into law, or others that may be set in the future, might or might not be upheld by subsequent Congresses.

Nevertheless, CBO assumes in its baseline projections that discretionary funding subject to the caps in the coming years will be equal ro the amounts specified in current law for those caps. As a result, changes that would reduce the funds necessary to accomplish a particular discretionary activity or that achieved savings in undertaking a particular activity would reduce projected total appropriations only if legislation also lowered the caps; without a reduction in the caps, funding for other discretionary activities would probably fill the gap created by the specific reduction or savings.

Defense Spending

Even if budget authority for defense programs (other than overseas contingency operations) grew at the rate of inflation, that amount of funding would be insufficient to pay for the Future Years Defense Program (FYDP) provided to the Congress in April 2011 by the Department of Defense. CBO has examined the programs and plans contained in that document, which did not include war-related activities, and projected their budgetary impact.[17] According to CBO's calculations, over the period from 2012 to 2021, the funding needed to implement DoD's plan (and finance the small portion of defense spending carried out by other agencies) would exceed by about $480 billion the amounts projected by assuming that current budget authority increased at the rate of inflation. (The funding needed to implement that plan and keep the non-DoD portion of defense spending growing at the rate of inflation would represent 3.2 percent of GDP in 2021; see Figure 5.) Thus, if the discretionary spending caps were met through proportional reductions in defense and nondefense appropriations relative to the funding that would be necessary to keep pace with inflation, the shortfall in defense appropriations during the 2012–2021 period relative to the amounts needed to implement the FYDP (and keep the non-DoD portion of defense spending growing at the rate of inflation) would be roughly $925 billion.[18]

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17. See Congressional Budget Office, *Long-Term Implications of the 2012 Future Years Defense Program* (June 2011).

18. That amount is the sum of the $480 billion difference just noted and the $445 billion gap (described on page 17) between what future defense funding would be if it were maintained at the 2011 level with adjustments for inflation and what it would be if proportional reductions were made to comply with the discretionary caps.

In contrast, the funding required for war-related activities—in Afghanistan and other countries—will be smaller than the amounts provided in recent years if the number of deployed troops is smaller and the pace of operations is diminished. Recently, the Congress recognized that the need for such funding has lessened; in the continuing resolution now in place, lawmakers provided appropriations for such purposes at an annualized level of $119 billion—a drop of about $40 billion from the $159 billion provided for 2011. If the current amount, $119 billion, was provided in future years with adjustments for inflation, the budget authority over the 2012–2021 period would sum to $1.3 trillion, about $440 billion less than a projection based on the 2011 appropriation.

If the number of troops deployed continues to decline and if the pace of operations continues to diminish, even less funding may suffice in future years. To illustrate, CBO formulated an alternative budget scenario that assumes a reduction in the deployment of forces abroad for military actions. On the basis of data through June 2011, CBO estimates, the number of U.S. active-duty, reserve, and National Guard personnel deployed for war-related activities in 2011 averaged about 180,000. Under that alternative scenario, the average number of military personnel deployed for war-related purposes would decline over four years: from 130,000 in 2012 to 95,000 in 2013; 65,000 in 2014; and 45,000 in 2015 and thereafter. (Those numbers could represent various allocations among Afghanistan and other countries.) Under that alternative scenario, total discretionary outlays for the period from 2012 through 2021 would be $700 billion less than the amount based on extending appropriations in the continuing resolution. Of course, the scope of such activities 10 years from now is highly uncertain, and many other scenarios—some costing more and some less—also are possible.

Assessing large, sustained reductions in defense spending would involve considering their effects on military capabilities. Cuts could be targeted toward personnel levels, pay rates, and benefits; training and supplies; day-to-day operating and administrative costs; operation and maintenance of existing weapon systems; procurement of new weapon systems; and research and development related to more-advanced weapon systems. Such reductions in funding could require changes in broad strategic objectives—such as the number of simultaneous conflicts in which the military could engage and their intensity, duration, and overlap—or changes in how the nation seeks to achieve those broad objectives. Trade-offs could involve, for example, the choice between fielding a smaller force with more-capable weapon systems and maintaining the current number of units but forgoing some of the upgrades to their weapon systems. A smaller force might not be able to handle as many conflicts at the same time, but it could be structured to maximize its flexibility to fight a variety of opponents with different capabilities or in different parts of the world. Conversely, a larger force would be better able to sustain longer-term counterinsurgency or peacekeeping operations.[19]

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19. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011).

Nondefense Spending

Even if budget authority for nondefense programs grew at the rate of inflation, that amount of funding would be insufficient to continue some current policies over the 2012–2021 period. For example, the cost of veterans' health benefits—under an assumption that current enrollment rules remain unchanged—is projected to rise more rapidly than inflation and thus to exceed the budget authority calculated simply by extrapolating the current year's appropriations at the projected rate of inflation. CBO has estimated that this gap will total $70 billion over the 2012-2021 period.[20] Similarly, maintaining current award amounts for Pell grants would require funding above what would be shown in a projection based on inflating 2011 appropriations.

Moreover, many analysts believe that current funding for some programs is insufficient to meet the nation's future needs. For example, many analysts believe that current national spending on infrastructure is inadequate to provide enough roads, bridges, and other capital assets to maintain the current level of highway services or to fund all of the projects whose benefits exceed their costs. Projections from the Federal Highway Administration (FHWA) suggest that maintaining the current level of services from highway infrastructure would require increasing federal capital spending on highways from $43 billion in 2010 to $57 billion per year (in 2010 dollars), assuming that the federal government and state and local governments continue to pay their historical shares of such costs. In addition, if the FHWA's assessment is accurate, undertaking all highway infrastructure investment for which benefits equal or exceed their costs would require $94 billion per year (in 2010 dollars), more than twice the spending in 2010.[21] Analyses of other types of infrastructure—such as aviation, mass transit systems, water supply, and wastewater treatment—reach qualitatively similar conclusions about the need to increase funding to maintain current services or meet growing demand for such services.[22]

However, if spending on certain programs is allowed to grow faster than inflation, then less room under the caps will be available for other nondefense discretionary activities. Cuts in nondefense discretionary spending could affect a broad range of activities, and decisions about particular programs have impacts that would need to be weighed against the effects of alternative decisions. Many programs—especially in the areas of education and transportation—involve financing from federal, state, and local governments. Reducing federal support for such activities would force other levels of government to make decisions about decreasing the scope of the activities, increasing their own funding, or some combination of the two.

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20. See Congressional Budget Office, *Potential Costs of Veterans' Health Care* (October 2010).

21. See Statement of Joseph Kile, Assistant Director, Congressional Budget Office, before the Senate Committee on Finance, *The Highway Trust Fund and Paying for Highways* (May 17, 2011).

22. See Congressional Budget Office, *Public Spending on Transportation and Water Infrastructure* (November 2010) and *Issues and Options in Infrastructure Investment* (May 2008).

Lowering pay rates for federal civilian employees could hamper efforts to recruit and retain workers (particularly in some occupations), which could reduce the overall skill level of the federal workforce over time. Having fewer federal workers would probably lower the levels of service that federal agencies provide to the public, unless cuts in the agencies' workforces were accompanied by actions to enhance productivity. Charging users—such as drivers, air travelers, and users of waterways—for services they receive from federal programs would allow those programs to operate more efficiently and reduce the amount of government spending needed to maintain or improve service, but such charges would impose added burdens on users compared with current arrangements.[23]

Federal income support payments and education grants to low-income households could be reduced or provided to fewer households, which would mean less assistance for people who may value those benefits highly. A variety of federal activities could simply be curtailed—ranging from research by the National Institutes of Health to export promotion by the Department of Commerce—but curtailing those activities could have costs as well.

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23. See Congressional Budget Office, *Alternative Approaches to Funding Highways* (March 2011).

Appendix A: Funding for Operations in Iraq and Afghanistan and for Related Activities

Since September 2001, lawmakers have provided almost $1.3 trillion in budget authority for operations in Afghanistan and Iraq and related activities (see the table). That amount includes funding for military and diplomatic operations in Afghanistan, Iraq, and certain other regions; for some veterans' benefits and services; and for related activities of the Department of Justice. Appropriations specifically designated for those purposes averaged about $100 billion a year from 2003 through 2006, rose to $170 billion in 2007 and $187 billion in 2008, and then declined to an average of $159 billion over the 2009–2011 period. The Continuing Appropriations Act, 2012 (Public Law 112-36) provides funding for war-related activities in the current fiscal year through November 18, 2011, at an annual rate of $119 billion.

Funding through the end of fiscal year 2011 for military operations and other defense activities totaled $1.1 trillion, most of which went to the Department of Defense (DoD). Lawmakers also provided $66 billion to train and equip indigenous security forces in Afghanistan and Iraq.[1] In addition, they have made $52 billion available for diplomatic operations and aid to Afghanistan, Iraq, and other countries assisting the United States in those efforts.

DoD reports that in fiscal year 2011, obligations for operations in Afghanistan and Iraq and for related activities averaged $11.6 billion per month (through July, the last month for which data are available). That monthly average is almost $1 billion less than the amount reported for 2010. Obligations were lower in the first half of the year, while the department operated with funding from a series of continuing resolutions, but increased to over $13 billion in May after the enactment of a regular appropriation, and to $19 billion in July. Operation Enduring Freedom (in and around Afghanistan) accounted for 67 percent of those obligations in 2011—up from 51 percent in 2010 and 34 percent in 2009. Operation New Dawn (formerly Operation Iraqi Freedom) accounted for 33 percent of those obligations, down from 49 percent in 2010 and 65 percent in 2009. Additional security missions that have taken place in the United States since the terrorist attacks of September 11, 2001—such as combat air patrols over Washington, D.C., and New York City, known as Operation Noble Eagle—accounted for less than 1 percent of obligations in 2011.

1. That $66 billion includes $5 billion provided for Iraqi security forces in 2004 in an appropriation for the State Department's Iraq Relief and Reconstruction Fund.

Table A-1.

Estimated Appropriations Provided for U.S. Operations in Iraq and Afghanistan and for Other War-Related Activities, 2001 to 2011

(Billions of dollars of budget authority)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total, 2001-2011
Military Operations and Other Defense Activities[a]												
Iraq	0	0	51	70	50	85	113	133	90	59	42	693
Afghanistan	0	12	12	13	8	12	24	29	38	87	98	332
Other[b]	14	5	18	5	11	13	15	13	13	5	6	117
Subtotal	14	18	80	88	69	110	152	175	140	151	146	1,142
Indigenous Security Forces[c]												
Iraq	0	0	0	5	6	3	6	3	1	1	2	26
Afghanistan	*	0	0	0	1	2	7	3	6	9	12	40
Subtotal	*	0	0	5	7	5	13	6	7	10	13	66
Diplomatic Operations and Foreign Aid[d]												
Iraq	0	0	3	15	1	3	3	3	2	2	0	32
Afghanistan	0	*	1	2	1	*	1	1	5	2	0	13
Other	*	1	5	*	*	*	*	*	1	*	0	8
Subtotal	*	2	8	17	3	3	4	5	7	4	0	52
Other Services and Activities[e]												
Iraq	0	0	*	0	*	*	1	1	*	0	0	2
Afghanistan	0	0	0	0	*	*	*	*	*	0	0	*
Other	0	0	0	0	*	*	*	*	*	0	0	1
Subtotal	0	0	*	0	*	*	1	2	*	0	0	3
Total Budget Authority	**14**	**19**	**88**	**110**	**79**	**118**	**170**	**187**	**154**	**165**	**159**	**1,263**

Source: Congressional Budget Office.

Notes: The Continuing Appropriations Act, 2012 (Public Law 112-36) provided funding in budget function 050 (National Defense) for war-related operations through November 18, 2011, at an annual rate of $119 billion, similar to the amount requested for such operations by the President for the current year. The President also requested about $9 billion for diplomatic operations and foreign aid related to overseas contingency operations. (Such spending would be recorded in budget function 150, International Affairs.) P.L. 112-36 did not specify funding for those purposes. Final appropriations for fiscal year 2012 could be greater or less than the amount provided to date. Funding for fiscal year 2012 is not included in this table.

* = between zero and $500 million.

Continued

Table A-1. Continued

Estimated Appropriations Provided for U.S. Operations in Iraq and Afghanistan and for Other War-Related Activities, 2001 to 2011

(Notes, continued)

a. CBO estimated funding provided for operations in Afghanistan and Iraq by allocating funds on the basis of information in budget justification materials from the Department of Defense and in monthly reports on its obligations. Some allocations for prior years have been adjusted on the basis of more recent information.

b. Includes Operation Noble Eagle (homeland security missions, such as combat air patrols, in the United States), the restructuring of Army and Marine Corps units, classified activities other than those funded by appropriations for the Iraq Freedom Fund, efforts to increase the size of the Army and Marine Corps, and other operations. (For fiscal years 2005 through 2011, funding for Operation Noble Eagle has been intermingled with regular appropriations for the Department of Defense; that funding is not included in this table.)

c. Funding for indigenous security forces is used to train and equip local military and police units in Afghanistan and Iraq. That funding was appropriated in accounts for diplomatic operations and foreign aid (budget function 150) in 2004, and in accounts for defense (budget function 050) starting in 2005.

d. Beginning in 2010, most funding for diplomatic operations in, and foreign aid to, countries helping the United States fight terrorism has been in regular appropriations, and cannot be separated from appropriations for activities unrelated to those operations.

e. Includes funding for some veterans' benefits and services, as well as certain activities of the Department of Justice. Excludes about $12 billion in spending by the Department of Veterans Affairs (VA) for the incremental costs for medical care, disability compensation, and survivor benefits for veterans of operations in Afghanistan and Iraq and the war on terrorism. That amount is CBO's estimate of spending from regular appropriations for the Department of Veterans Affairs and was not explicitly appropriated for war-related expenses.

Because most appropriations for operations in Afghanistan and Iraq and for related activities appear in the same budget accounts as appropriations for DoD's other functions, it is impossible to determine precisely how much has been spent on those activities. The Congressional Budget Office (CBO) estimates that the $1.2 trillion appropriated for military operations, other defense activities, and indigenous security forces in those two countries resulted in outlays of just over $1 trillion through 2011; about $160 billion of that occurred in 2011. Of the $52 billion appropriated for international affairs activities related to the war efforts, about $50 billion was spent through 2011, CBO estimates, including $5 billion in 2011. In total, outlays for all of those activities amounted to about $165 billion last year.

Appendix B: Projections of Discretionary Outlays

This testimony has focused on discretionary funding rather than on outlays because the Congress specifies the amount of funding provided each year but it does not directly control when outlays occur. In addition, enactment of the Budget Control Act of 2011 in August instituted statutory caps on discretionary budget authority for each of the fiscal years 2012 through 2021. If legislation originating from this Committee producing at least $1.2 trillion in deficit reduction (including an allowance for interest savings) is not enacted by January 15, 2012, automatic procedures would further reduce discretionary appropriations starting in 2013.

Discretionary funding could follow a variety of paths over the next decade, and the outlays stemming from such funding decisions will affect the deficit (which is computed as the difference between revenues and outlays). To more easily make historical comparisons (historical data are typically expressed in terms of outlays), CBO has estimated the effect on outlays of a range of potential changes to both defense funding (Table B-1) and nondefense funding (Table B-2). (For a further discussion of the various scenarios shown in the tables, see pages 17 to 24.)

Table B-1.

Projections of Discretionary Outlays for Defense Programs

(Billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
	Projected Outlays												
Funding for 2011 (Excluding overseas contingency operations) Adjusted for Inflation[a]	542	546	562	575	589	607	618	629	651	668	686	2,880	6,132
Potential Paths for Defense Outlays Resulting from the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from defense[c]	542	527	528	520	522	531	535	539	553	562	571	2,628	5,388
Proportional reductions	542	531	536	543	553	567	575	582	600	613	626	2,730	5,726
No reductions from defense	542	546	562	575	589	607	618	629	651	668	686	2,880	6,132
If No Savings Result from the Joint Select Committee[d]	542	531	505	501	507	520	526	534	552	565	579	2,564	5,320
	Reduction in Outlays Relative to the Outlays from Adjusting 2011 Funding for Inflation												
Potential Paths for Defense Discretionary Outlays Resulting from the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from defense[c]	0	-19	-34	-55	-68	-76	-84	-91	-98	-106	-115	-252	-744
Proportional reductions	0	-15	-26	-32	-36	-40	-43	-47	-51	-55	-60	-150	-407
No reductions from defense	0	0	0	0	0	0	0	0	0	0	0	0	0
If No Savings Result from the Joint Select Committee[d]	0	-15	-57	-74	-82	-87	-92	-95	-99	-103	-107	-316	-812

Continued

Table B-1. Continued

Projections of Discretionary Outlays for Defense Programs

(Billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
Memorandum:													
Overseas Contingency Operations[e]													
August 2011 baseline	161	163	165	166	167	170	172	174	179	182	186	830	1,723
Extrapolation of annualized amount provided in continuing resolution for fiscal year 2012	161	148	136	129	126	127	130	132	135	139	142	666	1,345

Source: Congressional Budget Office.

a. These amounts were estimated by assuming that budget authority for fiscal years 2012 to 2021 will be equal to the 2011 appropriation adjusted for inflation.

b. No caps were in place in 2011. Excludes overseas contingency operations.

c. In 2012 and 2013, reductions in defense funding would not be sufficient to meet the caps on "nonsecurity" funding; therefore, some reductions would have to come from nondefense programs even if all available defense funding classified as nonsecurity was eliminated. Caps for those two years are allocated to "security" and "nonsecurity" spending. The security category comprises discretionary appropriations for the Department of Defense, the Department of Homeland Security, the Department of Veterans Affairs, the National Nuclear Security Administration, the intelligence community management account (95-0401-0-1-054), and discretionary accounts in budget function 150 (international affairs). The nonsecurity category comprises all discretionary appropriations not included in the security category. Excludes overseas contingency operations.

d. Assumes that the automatic enforcement procedures delineated in the Budget Control Act would take effect and, therefore, that caps for each year from 2013 through 2021 would be reset to cover defense (budget function 050) and nondefense budget authority. The caps for 2012 set in the Budget Control Act would not be affected by the automatic enforcement procedures. Because no adjustment to the caps for 2012 would be made if the automatic enforcement procedures take effect, CBO has assumed that the reductions in 2012 would be proportional.

e. The caps do not constrain appropriations for military operations in Afghanistan (or for similar activities). For its August 2011 baseline, CBO projected future war-related funding by adjusting for inflation the $159 billion appropriated for 2011. The Continuing Appropriations Act, 2012 (Public Law 112-36) funded such operations through November 18, 2011, at an annual rate of $119 billion.

Table B-2.

Projections of Discretionary Outlays for Nondefense Programs

(Billions of dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total 2012-2016	Total 2012-2021
						Projected Outlays							
Funding for 2011 Adjusted for Inflation[a]	646	631	621	621	625	632	643	657	672	689	707	3,130	6,498
Potential Paths for Nondefense Discretionary Outlays Resulting from the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from nondefense[c]	646	604	571	559	555	555	560	566	574	583	592	2,845	5,720
Proportional reductions	646	619	598	592	592	595	603	613	625	639	652	2,995	6,127
No reductions from nondefense	646	622	605	615	623	632	643	657	672	689	707	3,096	6,464
If No Savings Result from the Joint Select Committee[d]	646	619	575	555	551	555	562	572	585	599	612	2,855	5,783
	Reduction in Outlays Relative to the Outlays from Adjusting 2011 Funding for Inflation												
Potential Paths for Nondefense Discretionary Outlays Resulting from the Caps as Set in the Budget Control Act of 2011[b]													
All reductions from nondefense	0	-27	-49	-62	-70	-77	-84	-91	-98	-106	-115	-285	-778
Proportional reductions	0	-12	-23	-29	-33	-37	-40	-43	-47	-51	-55	-135	-371
No reductions from nondefense[c]	0	-8	-16	-6	-2	-1	*	0	0	0	0	-33	-33
If No Savings Result from the Joint Select Committee[d]	0	-12	-46	-66	-74	-78	-82	-84	-87	-91	-95	-275	-714

Source: Congressional Budget Office.

Note: * = between -$500 million and zero.

a. These amounts were estimated by assuming that budget authority for fiscal years 2012 to 2021 will be equal to the 2011 appropriation adjusted for inflation.

b. No caps were in place in 2011.

c. In 2012 and 2013, reductions in defense funding would not be sufficient to meet the caps on "nonsecurity" funding; therefore, some reductions would have to come from nondefense programs even if all available defense funding classified as nonsecurity was eliminated. Caps for those two years are allocated to "security" and "nonsecurity" spending. The security category comprises discretionary appropriations for the Department of Defense, the Department of Homeland Security, the Department of Veterans Affairs, the National Nuclear Security Administration, the intelligence community management account (95-0401-0-1-054), and discretionary accounts in budget function 150 (international affairs). The nonsecurity category comprises all discretionary appropriations not included in the security category. Excludes overseas contingency operations.

d. Assumes that the automatic enforcement procedures delineated in the Budget Control Act would take effect and, therefore, that caps for each year from 2013 through 2021 would be reset to cover defense (budget function 050) and nondefense budget authority. The caps for 2012 set in the Budget Control Act would not be affected by the automatic enforcement procedures. Because no adjustment to the caps for 2012 would be made if the automatic enforcement procedures take effect, CBO has assumed that the reductions in 2012 would be proportional.

Representative Jeb Hensarling
Co-Chair, Joint Select Committee on Deficit Reduction

"I thank the co-chair for yielding, and want to thank her again for her leadership on this committee and the spirit of negotiation that she brings.

"There is no such thing as an un-important hearing when it comes to dealing with our nation's structural debt crisis, and certainly within our nation's discretionary budget are contained many challenges and, frankly, many important priorities that have to be debated and negotiated. Not the least of which is what many view as the number one function of our federal government, and that is to protect us from all enemies foreign and domestic, and specifically our national defense budget which continues to shrink as a percentage of our economy, shrink as a percentage of our budget, as we continue to live in a dangerous world.

"When I look at the totality of our discretionary budget, I do again find some common ground with my co-chair. And again, although there is no such thing as an unimportant hearing or unimportant section of the budget, in many respects today we may be debating the 'pennies, nickels and dimes' in a debt crisis that is demanding 'half dollars and dollar bills.' There have been huge run-ups in our discretionary spending since the president has come to office. This is not the forum to debate the policies but I think the numbers speak for themselves: without the stimulus program the Commerce Department has increased from '08 to '10, 102.9 percent; without the stimulus, EPA has increased 35.7 percent; subtracting the stimulus, Housing and Urban Development has increased 22.2 percent; the State Department without the stimulus, up 132.2 percent, and the list goes on. Again, it is not at this forum to debate these particular polices, but it is important to note the numbers—that when these particular budgets are growing, the family budget which pays for federal budget has unfortunately contracted, and it is the family budget that has to pay for the federal budget.

"As an order of magnitude, we know that the discretionary spending of our nation is roughly 40 percent and shrinking, our entitlement spending is roughly 60 percent of the budget and growing. We know outside of interest payments on our national debt that our mandatory spending is principally driven by our health care and retirement programs, which are simultaneously starting to disserve their beneficiaries and driving the nation broke as they grow at 5 and 6 and 7 percent a year where unfortunately our nation, over the last few years, has actually seen negative economic growth."

"So to put this in even a larger context, under the Budget Control Act, we collectively have a goal—a goal of $1.5 trillion in deficit reduction, but we have a duty—a duty to provide recommendations in legislative language that will significantly improve the short-term and long-term fiscal imbalance of the federal government. Thus the challenge before us remains, that we must find quality health care solutions, quality retirement security solutions, for our nation at a cost that does not compromise our national security, does not compromise job growth and our economy, and does not mortgage our children's future.

"Everything else we do, including dealing with the discretionary budget, will be helpful. Nothing else will solve the structural debt crisis or allow this committee to meet its statutory duty; only these reforms. And so prudent stewardship of our discretionary budget is going to be helpful. It alone cannot solve the crisis. It continues, though, to be an important matter. I look forward to hearing from our witness, and with that I will yield back, Madam Chair."

Senator Patty Murray
Co-Chair, Joint Select Committee on Deficit Reduction

"The Committee will come to order. First, I want to thank my co-chair Representative Hensarling, my fellow committee members, and Dr. Elmendorf for joining us today—as well as the members of the public here in person or watching at home.

"This committee has been working hard over the last few weeks to come together around a balanced and bipartisan plan to reduce the deficit and rein in the debt.

"We have received input from: our colleagues, standing House and Senate Committees, groups from around the country, and close to 185,000 members of the public through our website, deficitreduction.gov. And we continue our work today with a hearing on "Discretionary Outlays, Security and Non-Security."

"I am glad we are talking about this today, because it's important for us to understand how these pieces fit into our overall deficit and debt.

"Non-defense discretionary spending represents less than one-fifth of total federal spending. But listening to the debates here in D.C. over the last few months—you would think this small piece of the pie was a whole lot bigger.

"As I expect we'll hear more about from Dr. Elmendorf today, Congress has gone back to this relatively small pot with cuts and spending caps again and again—while leaving many other pieces of the budget essentially untouched. Including the law that created this Joint Committee, which cut roughly $800 billion in discretionary spending.

"And all the focus on this one area is especially striking given that we are spending roughly the same on non-defense discretionary programs in 2011 as we did in 2001—while mandatory programs have increased, defense spending has increased, and revenues have plummeted.

"So as this committee works together toward a bipartisan plan to reduce the deficit, we need to keep in mind the cuts that have already been made, the role discretionary spending plays in our overall deficit and debt problem, and the impact irresponsible slashing could have on our economic recovery and middle class families across the country.

"Because as we all know—these aren't just numbers on a page. They affect real people, in real ways.

"When food assistance for women and infants is cut—that means greater challenges for struggling families.

"When infrastructure investments are shelved—that means fewer jobs and more crumbling roads.

"And when research, education, and student loans are slashed—that means fewer opportunities for our businesses and the next generation of workers. Which is really no savings at all—since we end up paying for it in the future.

"So while we should certainly examine every piece of the budget to see where we can responsibly make additional cuts—it doesn't make sense to simply keep slashing at one small part of the budget that disproportionally affects middle class families and the most vulnerable Americans.

"There needs to be balance.

"Today, Dr. Elmendorf will also be discussing discretionary security spending, which has grown significantly in the years since 9/11.

"This is an area where the stakes for our nation are high. From both a national security as well as a budgetary perspective—we need to get this right. And as many of my colleagues have noted over the past few weeks, it's an area that would be hit especially hard if this Committee doesn't come to a deal and we move to sequestration.

"So I'm looking forward to a robust conversation today with my colleagues and Dr. Elmendorf about these critical pieces of our federal budget.

"Before I turn it over to my co-chair, I just want to say that over the last few weeks this committee has been working hard to find common ground and a path toward a balanced and bipartisan plan that can pass through Congress and get signed into law.

"We aren't there yet, but I'm confident we are making progress. And I'm hopeful we are moving quickly enough to meet our rapidly-approaching deadline.

"As I have said from the start, if this committee is going to work—and I believe it must—we all need to be willing to make some tough decisions and real compromises. I am willing to do that. And I know many of my colleagues are as well.

"Every day we hear more and more about what the effects of failure would be on our nation's long-term fiscal health and creditworthiness. And over the next few weeks, it is going to be up to all of us to demonstrate to the American people that we can deliver the kind of results they expect and deserve.

"I would now like to recognize my co-chair, Representative Hensarling, for his opening statement."

November 1, 2011
Overview of Previous Debt Proposals

Testimony Before the Joint Select Committee on Deficit Reduction
November 1, 2011

Erskine Bowles and Sen. Alan Simpson
Co-Chairman of the National Commission on Fiscal Responsibility and Reform

Chairman Hensarling, Chairwoman Murray, members of the Committee, thank you for inviting us here today to discuss the recommendations of the National Commission on Fiscal Responsibility and Reform, and thank you for your continued hard work to improve our nation's fiscal situation. We know, a little too well, how difficult your job is.

As Co-Chairmen of the National Commission on Fiscal Responsibility and Reform, we spent more than half of 2010 studying the cold, hard facts concerning our nation's fiscal situation, which you are undoubtedly over familiar with at this point. When asked why we did it, we originally said that it was for our 15 grandkids. However, the deeper we got into the numbers, the more dire we understood our Country's financial situation to be. And we quickly realized we were not doing this for our kids, much less our grandkids, we were doing it for all of us.

We realized that the fiscal problems facing our Country were enormous, the solutions would all be painful, and there simply was no easy way out. We are all going to have to share in the sacrifice that is needed to put our fiscal house in order. Everything must be on the table, and Washington must lead. And right now, this Committee has a unique opportunity to do just that.

While we know better than most how challenging the task in front of you is, we can tell you that the American public is looking for leaders who will make tough choices, and that if the Committee puts forward a credible plan the public will support you. If you are bold, you can put forward a smart, well-formulated deficit reduction plan that not only reduces our deficit, but also maintains our economic health and restores public confidence in America's ability to govern wisely and prudently.

Unfortunately, time is not on our side and we truly can no longer afford to wait. Washington needs to enact a fiscal plan NOW -- not next year, not after the next election, but now. Continuing to kick the can down the road by enacting short-term, temporary fixes is bad policy, and doesn't change the fact that we will have to make these difficult choices no matter what – be it now or in the future, when our debt holders force us to take action. The longer we put these choices off, the more difficult and potentially harmful they become.

There are no other ways to say it. We simply cannot delay these difficult choices anymore. Our great Nation's fiscal house is now made out of straw and any significant blow – an oil shock, a collapse in Europe – can blow our house down. This is certainly no way for such a great country to exist.

We all know how big and real the problem is – we heard it from countless economists and budget experts, and we know that you have too. We aren't here to repeat those numbers for the millionth time. We're here to share what we learned as co-chairmen of the Fiscal Commission, in the hopes that it helps all of you to reach a similar deal.

Our plan was developed following six main principles:

FISCAL COMMISSION'S GUIDING PRINCIPLES

1. First, we didn't want to do anything that would disrupt what is still a fragile economic recovery. So we made smaller cuts in 2011 and 2012 and big cuts in 2013, cuts of such magnitude that we would get back to pre-crisis (2008) levels of spending in real terms by 2013. At the same time, we heeded the advice of economists who told us that putting into place a credible plan to reduce future deficits would have a positive effect on the economy by increasing market confidence and providing a more certain fiscal outlook.

2. Next, we wanted to protect the truly disadvantaged. In our budget you won't see any cuts in SSI or Food Stamps or Workers Compensation. And we proposed changes to strengthen the safety net features of Social Security that cost money and made achieving our fiscal goals harder.

3. We also wanted to ensure that we did nothing to jeopardize the safety and security of the country -- we could not put forward a plan that fixes the budget but leaves our nation vulnerable. We agreed with Admiral Mullen, former Chairman of the Joint Chiefs of Staff, when he said that our Nation's greatest National Security problem is this debt. Thus, while it's clear that defense spending must be on the table, we made sure that the safety of the United States was our top priority.

4. We have to protect our nation's most important investments, like education, infrastructure, and high value-added research. We need to make these investments in a fiscally responsible manner by taking our limited resources and using them more wisely. Limited resources force you to make choices, and we must make the choices now and work carefully to prioritize our spending.

5. We must reform the broken tax code in order to promote growth as well as reduce the deficit. We have the most anti-competitive, inefficient, ineffective tax code man could dream up. The tax code must be reformed to broaden the base, lower rates for individuals and employers and reduce the deficit. We also need to reform the corporate tax system, to create jobs and to make the United States the best place in the world to start and grow a business.

6. We have to cut spending wherever we find it -- in the defense budget, the non-defense discretionary budget, the tax code, and in the entitlement programs. It's simply a fact that our politicians in both parties over a long, long period of time have made promises that they can't keep.

PLAN SUMMARY/MAJOR ELEMENTS

Using those six principles, we crafted a plan that received support from a bipartisan supermajority: five Democrats, five Republicans and one Independent. We cut $4 trillion over ten years, stabilizing debt as a percentage of GDP and putting it on a downward trajectory.

DISCRETIONARY SPENDING CUTS: Any serious attempt to reduce the deficit will require deliberate, planned reductions in both domestic and defense spending. The government will not be able to protect those in need or invest to achieve our nation's long-term potential growth if Washington squanders taxpayer dollars on duplicative or marginal programs with no measurable results. Our plan imposes tough discretionary spending caps to force budget discipline and recommend significant cuts in both security and non-security spending by cutting low-priority programs and streamlining government operations.

The Commission proposal set limits for discretionary spending that would freeze discretionary spending for 2012, a 5 percent cut in 2013, followed by growth at about half inflation through 2020. This would bring discretionary spending back to pre-crisis (2008) levels in real terms by 2013. We applied the same approach to security and non-security. These caps required spending to be cut by nearly $1.7 trillion below the President's fiscal year 2010 budget request. Much of these savings have been achieved as a result of the spending cuts enacted in the fiscal year 2011 appropriations bills as well as the Budget Control Act. However, our caps would require more than $400 billion in savings beyond the Budget Control Act, primarily by holding the growth of discretionary spending to half the rate of inflation after 2015 in order to keep pressure on agencies to increase efficiencies and squeeze out waste and low priority spending.

We also required the President to propose limits on war spending consistent with the projected needs under current policies, with the spending levels in the CBO troop drawdown scenario as the starting point. We did not claim savings from putting limits on war spending, but rather sought to ensure that the savings from the drawdown in troops that was already planned would go to deficit reduction and not be used for new spending or to get around the limits on regular defense spending. We also put in place a strict definition of war spending to prevent the war spending account from being used as a slush fund for unrelated defense spending.

The Commission also recommended several reforms of discretionary spending to improve the transparency and accountability of spending. We proposed budgeting for disaster spending, placing greater restrictions on the use of emergency funds and establishing strict criteria for war supplementals. Finally we proposed making spending from transportation trust funds mandatory spending, limited to actual dedicated revenues collected by the trust fund in the prior year, and proposed a 15 cent increase in the gas tax to make the trust funds whole or a reduction in spending to match the actual revenues coming in to the trust fund.

COMPREHENSIVE TAX REFORM: Rather than tinker around the edges of the existing tax code, the Commission proposed fundamental and comprehensive tax reform that would sharply reduce rates, broaden the base, simplify the tax code, and reduce the deficit by reducing the many "tax expenditures" – another name for spending through the tax code. Our proposal also reforms corporate taxes to make America the best place to start a business and create jobs.

The Commission proposed a "zero based budgeting" approach to tax reform: starting with a clean tax code that didn't have any tax expenditures and had much lower rates and then deciding which tax expenditures should be added back and which rates should be increase to pay for them. We estimated that if all tax expenditures were eliminated we could eliminate the Alternative Minimum Tax, bring individual income tax rates down to 8 percent, 14 percent, and 23 percent and reduce the corporate rate to 26 percent while achieving $80 billion in deficit reduction in 2015 and $180 billion in 2020

We realized that elimination of some tax expenditures could cause unintended problems and that Congress would want to preserve some of the tax expenditures. However, we concluded that starting with a completely clean tax code and forcing advocates of various tax expenditures to justify why they should be added back and how the costs should be offset would result in a much simpler, efficient tax code than would be possible if we started with the status quo.

We developed an illustrative plan to show how some tax expenditures important to commission members could be restored in a modified form while still keeping rates low. This plan demonstrated that it is possible both to reduce rates dramatically and to achieve significant deficit reduction if tax expenditures are eliminated or scaled back and better targeted. The illustrative plan would set rates at 12 percent, 22 percent, and 28 percent, create a 12 percent credit for mortgage interest and charitable giving, consolidates and limits the size of retirement accounts and gradually phase out the health exclusion, among other changes. The illustrative plan would preserve the EITC and child credit in their current form or an equivalent alternative. The result of this illustrative plan is a tax reform package that is more progressive than current law and achieves the deficit reduction targets in the Commission plan while dramatically reducing marginal tax rates.

The Commission recommended corporate tax reforms which would eliminate all tax expenditures for business, establishing a single corporate rate at the same level as the top individual tax rate (between 23 and 29 percent) and provides for a competitive territorial system, thus making America a globally competitive place to start and grow a business and attracting billions of dollars back to the country.

HEALTH CARE COST CONTAINMENT: Our plan included specific policies to achieve nearly $500 billion in health care savings in the near term, with a portion of that used to offset the cost of repealing the CLASS Act; over the long term we put federal health care costs in a budget.

Our plan included specific policies to achieve at least $400 billion in net health care savings in the near term, with additional savings to offset the cost of repealing the CLASS Act, and over the long term put federal health care costs in a budget. The near term savings would come from health care providers and drug companies through adjustments in payment formulas and increased drug rebates for Medicaid and Medicare, from beneficiaries through more rational cost-sharing rules that discourage the overutilization of care, and more from lawyers through tort reform. We also achieved savings by eliminating state gaming of Medicaid, reforming federal employee health benefit program and reforms of TRICARE.

Our belief was that these savings, in addition to the savings from the Affordable Care Act, would reduce the costs of federal health care programs to GDP plus one percent. But we proposed backing that up with a review process to ensure that cost growth is reduced to GDP plus one percent and recommended that Congress consider more aggressive reforms, such as premium support, a robust public option and increasing the Medicare eligibility age.

MANDATORY SAVINGS: Our goal in this area was to reduce low priority or wasteful spending, including subsidies that are poorly targeted or create perverse incentives. We felt that income support programs for the most disadvantaged, such as unemployment compensation, food stamps, and Supplemental Security Income (SSI), should not be touched. These programs provide vital means of support for the disadvantaged, and the commission did not recommend any fundamental policy changes to these programs. The plan achieves savings from reducing agriculture subsidies, modernizing military and civil service retirement systems, putting the Pension Benefit Guarantee Corporation on a sustainable path and other reforms.

SOCIAL SECURITY REFORMS TO ENSURE LONG-TERM SOLVENCY: We did not propose reforms of Social Security to reduce the deficit; the Social Security plan would have very little impact on the budget in the near term and we did not count any of those effects in meeting our deficit reduction targets. Rather, we proposed reforms of Social Security to ensure that the program remains strong and financially viable for future generations and to meet our mandate of making recommendations to "meaningfully improv(ing) the long run fiscal outlook" – which is part of this committee's mandate as well. We wanted to make sure the system is sustainably solvent over the long term – to make sure it can continue to provide the foundation for a secure retirement not just for old guys like us, but for our kids and our grandkids. That's why we have focused on 75-year sustainable solvency for Social Security.

Saving Social Security will require shared sacrifice. Those at the top will have to contribute the most, both through higher payroll taxes and lower-than-scheduled growth in benefits. Middle income workers will also have to contribute, but can do so primarily by working a little longer, to the extent they are able. Those who are most vulnerable should actually receive additional protections, in order to make sure Social Security is fulfilling its fundamental mission to keep seniors out of poverty. Our plan would restore solvency through a combination of a gradual increase in the eligibility age for Social Security, with a hardship exemption to cover individuals with physically demanding jobs, progressive changes in the benefit formula that would reduce benefits for middle and upper income workers, a gradual increase in the amount of wages subject to payroll taxes and more accurate COLAs. It also provided greater poverty protections by implementing a higher new minimum benefit and providing a bump up for older beneficiaries who are more likely to end up in poverty as a result of exhausting private savings.

The plan developed by the Commission would achieve sustainable solvency – meaning we would continue to have balance in the 75th year – in a way that phases in changes quite gradually while providing greater poverty protections than current law and making the program more progressive.

PROCESS CHANGES: The Commission proposal included recommendations that would achieve enough savings to more than restore primary balance and stabilize the debt under current projections. However, members of the Commission thought that it is important for Congress and the President to remain vigilant to ensure the budget remains on a course to primary balance and a stable debt to GDP ratio. We therefore recommended an enforcement mechanism to ensure the budget achieves primary balance by 2015 and the debt is stabilized thereafter by requiring the President and Congress to take action if the debt begins to grow as a percentage of GDP.

A TWO-STAGE PROCESS TO GO BIG

This Committee has been given a mandate to find at least $1.2 to $1.5 trillion in deficit reduction. While this will not solve our fiscal problems or avoid a fiscal crisis (at best, $1.2 trillion would merely delay it), it is supremely important that the committee succeed – for the sake of our economy and public confidence in their leaders.

A failure by this committee might result in another downgrade. The only thing worse than the committee failing to agree on savings would be if Congress followed that by voting to turn off the sequester. Thus, removing that option by successfully voting out a plan should be strived for. At best, a failure would shake public confidence. None of these options are acceptable. So the Committee should work to reach agreement on as many specific options for savings as possible that can be ready to go by the November 23rd deadline.

While $1.2 trillion in deficit-reduction would be a small step forward, it's important that the American people understand and the Congress realizes that $1.2 trillion in deficit reduction will not solve our long-term fiscal problems and that significantly more deficit reduction will need to be done to stabilize the debt and put it on a downward path as a percent of GDP. By now everyone must understand that $4 trillion dollars of deficit reduction is not the maximum we need to reduce the deficit over the next ten years, it is not the ideal amount, it is the minimum amount we need to reduce the deficit to put our fiscal house in order and to stabilize our debt and get it on a downward path as a percent of GDP.

We understand that it may not be possible for the Committee to have the major entitlement or tax reforms that will be necessary to stabilize the debt drafted into legislative language and scored by CBO by the November 23rd reporting deadline. But this should not prevent the Committee from making recommendations in these areas as part of a comprehensive plan to stabilize the debt. The "Gang of Six" proposal provides a model to address the time concern: a two stage process that builds on the specific savings they can be enacted now, with a process for completing the job.

This Committee can agree on an overall framework that includes tax and entitlement reforms sufficient to stabilize the debt. The Committee's plan for deficit reduction could be implemented in a two stage process, with as many specific savings as possible enacted as part of the Committee recommendations. These savings would be accompanied an outline for the process for implementing the rest of the agreement.

This is similar to previous deficit reduction packages such as the 1997 Balanced Budget Agreement, in which negotiators reached agreement on broad parameters and some specific policies that were reflected in a budget resolution with additional policy details later resolved and legislative language drafted through the budget reconciliation process.

A two-stage approach would maximize the prospects for reaching agreement on at least $1.2 trillion in savings immediately and putting in place a process reduce the deficit by at least $4 trillion over the next ten years and thereby stabilize the debt as a percentage of GDP. Finally, it gives the committees of jurisdiction, who have expertise on relevant policy areas, the time to work through the policy issues involved in a thoughtful manner and creates buy-in for the final legislative process by giving more members an opportunity for input through the committee process.

LESSONS FROM THE COMMISSION

We learned a lot from our time as co-chairs of the Fiscal Commission that may be helpful to you as you get down to the hard work of trying to reach agreement on a responsible plan.

First, we learned that any fiscally responsible plan must be bold and comprehensive. It should restrain spending across the federal budget, reform the tax code, bring down health care costs, and make Social Security solvent and strong for the next 75 years and beyond.

We understand that Congress rarely does anything big or bold all at once and that many Washington insiders are telling you that trying to go beyond your mandate to achieve the amount of savings necessary to stabilize the debt will make an already difficult challenge impossible. But in this case, a bold and comprehensive approach could actually help you reach your goals. Our experience on the fiscal commission proves it – the more comprehensive we made our plan, the easier our job became.

Many of these same Washington insiders who are advising that trying for a "go big" solution will lead to failure were shocked that we so aggressively exceeded our mandate when we presented our co-chairmen's proposal to the rest of the fiscal commission in November and were sure that the proposal would need to be scaled back to get a majority vote. It turned out that the opposite was true.

The tougher we made our proposal, the more people came aboard. Commission members were willing to take on their own sacred cows and fight special interests — but if and only if they saw others doing the same and if what they were voting for really did solve the country's problems. This spirit of shared sacrifice gained us broad bipartisan support, spanning from Democratic Sen. Dick Durbin to Republican Sen. Tom Coburn. We would not have garnered that type of support had we not taken on defense, domestic programs, the solvency of Social Security, health care, and spending in the tax code all at once. a comprehensive approach is necessary not only to match the magnitude of the problem, but to allow for the tradeoffs and balance necessary to reach a bipartisan agreement.

Second, putting together a responsible fiscal plan is not simply a matter of arithmetic. The strength of a fiscal plan depends not only on how much savings are achieved but how those savings are achieved. We face a structural problem that requires structural solutions that puts the budget on a solid long term path. You have to be smart in how you achieve savings. It is important to set priorities, such as reducing lower-priority spending while preserving funding for key investments necessary to compete in a knowledge-based global economy. And you should not make cuts that would harm the disadvantaged.

Third, Washington must lead the way. A realistic plan will require shared sacrifice by all but the most vulnerable in society. In order to ask for such sacrifices, we need to create a more efficient and cost-effective government, and root out waste wherever we find it.

Fourth, revenues need to be part of the solution, but as part of fundamental tax reform that moves beyond the zero sum argument about the Bush tax cuts that both parties have been fighting for and against over the last decade. The answer instead should focus on reforming revenues through a more efficient tax code that promotes economic growth. Today, we spend over $1.1 trillion a year on "tax expenditures" – credits, deductions, loopholes and exclusions which are really just spending by any other name. If we reform or eliminate these tax breaks, we can dramatically reduce personal and corporate tax rates, improve economic growth, and at the same time reduce the deficit. By reforming them, we can reduce individual and corporate tax rates in a way that keeps the tax code progressive while promoting economic growth and reducing the deficit at the same time.

Fifth, a plan to reduce the deficit must therefore promote economic growth and not undermine the economic recovery. In order to avoid shocking the fragile economy, the Commission recommended waiting until 2012 to begin enacting programmatic spending cuts, and waiting until fiscal year 2013 before making large nominal cuts. In addition, revenue changes would not begin until calendar year 2013, after spending cuts are already well underway.

Finally, and perhaps most importantly, we found that it is possible to put forward a serious, responsible fiscal plan to bring the debt under control while protecting the priorities and principles of both parties. We can raise revenues in a way that does not increase tax rates and promotes economic growth by removing economic distortions from tax expenditures and reducing marginal tax rates while improving progressivity in the tax code — because these tax expenditures disproportionately benefit upper-income taxpayers. Our work also showed us that it's possible to reform entitlement programs in a way that preserves and even strengthens the safety net for the most vulnerable while achieving significant savings.

CONCLUSION

In conclusion, the most important thing we learned is that neither party can fix this problem on its own, and both parties have a responsibility to do their part. We are all going to have to share in the sacrifice that is needed to put our fiscal house in order. Americans are counting on us to put politics aside, pull together not pull apart, and agree on a plan to live within our means and make America strong for the long haul.

The political system, by its very nature, moves slowly and sloppily. But we don't have a lot of time to act if we are to avert fiscal calamity.

Winston Churchill once said that "Americans almost always get it right, but only after they have tried everything else." All we know is that we better get it right soon or we're going to spend ourselves into the poor house before you know it.

The two of us are optimistic by nature and are hopeful that you will act decisively and as one. We believe that there is a real chance this super committee will put politics aside and pull together not pull apart. If you do, we're confident the future of this country will be very bright and we can withstand any blow that comes our way. And if we don't, we think America could become a second rate power in our lifetime, and the opportunities our children will have will for the first time in American history, be less than those experienced by their parents. The national interest, not special interests, must prevail.

Thank you again for inviting us to appear today. We look forward to your questions.

BIPARTISAN POLICY CENTER

TESTIMONY BY SEN. PETE V. DOMENICI AND DR. ALICE RIVLIN

CO-CHAIRS, BIPARTISAN POLICY CENTER DEBT REDUCTION TASK FORCE

TO

THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION, U.S. CONGRESS

NOVEMBER 1, 2011

BIPARTISAN POLICY CENTER

Senator Murray, Representative Hensarling and Members of the Joint Select Committee on Deficit Reduction , thank you for inviting us to testify on the enormous fiscal and economic challenges confronting our nation.

The testimony we have submitted summarizes more than one and a half years of deliberation by nineteen former senior policy makers ranging from former Democratic mayors of large cities to former governors, to former members of presidential cabinets. The Task Force represented a very diverse cross-section of the nation's economic and political interests.

The United States faces two huge challenges: (1) accelerating growth and job creation and (2) reducing future deficits to stabilize the debt so that it is no longer growing faster than the economy. These objectives reinforce each other. Faster growth will reduce deficits, and stabilizing the debt will cut future interest rates, reduce uncertainty and enhance growth. This Committee, with its extraordinary powers, has both the opportunity and the obligation to address both challenges.

The Bipartisan Policy Center's Debt Reduction Task Force urges you put ideology aside, cooperate across partisan lines, and craft a Long term budget plan that will put the country on a path to sustainable prosperity and responsible budgeting. To achieve success, the Committee will have go well beyond the minimum charge of identifying at least $1.2-$1.5 trillion in savings over the next ten years, because even savings of this magnitude would still leave the debt rising faster than economic growth. We believe you should craft a grand bargain involving structural entitlement and tax reform that would save at least $4 trillion over ten years. In order to do so, the Committee should take full advantage of the authority given to it by the Budget Control Act (BCA) in Section 404, and write instructions to compel authorizing committees to produce fundamental tax and entitlement reform and provide for "fast-track" consideration of those reforms.

We believe that a grand bargain would have enormous economic benefits and would also reassure citizens and markets that our political process is functioning in the public interest, not stuck in partisan gridlock or overwhelmed by special interests. Failure to reach agreement (or even settling for the minimal $1.2 trillion savings) would increase the chances of continuing weakness in the economy, high joblessness, and deep distrust of the ability of elected leaders to govern.

The BPC recommends a three-step process in order to spur our economy, achieve savings and stabilize our debt:

- **Step 1** was passage of the BCA, which provided $900 billion in discretionary savings, similar to the amount recommended by the BPC's Task Force.

- **Step 2** – in progress – calls on the Committee to **identify a down-payment of $1.2-$1.5 trillion in net deficit reduction over ten years, which should be accompanied by a full payroll tax holiday to spur the economy**. The deficit reduction should utilize the many bipartisan plans that have been released, combining spending cuts from all parts of the budget with revenues. These savings also must be *real* – no budgetary gimmicks. Many of these policies will not be overly popular, but a comprehensive plan – one that addresses every aspect of the budget – is the most politically palatable approach.

- **Step 3** requires the Committee to take full advantage of Section 404 of the BCA and **instruct the relevant authorizing committees to legislate further reform**. The two primary areas of focus should be fundamental, pro-growth *tax reform that raises revenue*, and *structural Medicare reform* to ensure the future sustainability and efficiency of the program, as explained in the Domenici-Rivlin Protect Medicare Act.

Should the Committee fail to reach agreement on major reforms that will encourage growth and stabilize our fiscal situation, you will have missed an historic opportunity to set the country on the right track, and the consequences both to the economy and to public confidence could be dire. A sequester would produce mindless, possibly harmful cuts in spending, and even avoiding the sequester by finding $1.2 trillion would only kick the biggest part of the rising debt problem down the road. We urge you to seize the opportunity to get the job done.

The central elements of any grand bargain to stabilize our debt are clear:

1) Policies to promote growth and create jobs now;
2) Savings from discretionary accounts (which have already been enacted in the Budget Control Act);
3) Fundamental health care reform, especially Medicare; and
4) Fundamental tax reform that raises revenue.

The Bipartisan Policy Center's Debt Reduction Task Force, which we co-chaired, only was able to achieve consensus by addressing all four.

Payroll Tax Holiday

To jumpstart the struggling economy, we recommend enacting a full Social Security payroll tax holiday for both employers and employees for one full year. This immediately will increase consumer spending and business hiring, thereby delivering economic growth and creating jobs. The tax cut will provide financial relief for roughly 160 million American workers, many of whom are having difficulty making ends meet in the aftermath of the worst recession in nearly

eighty years. A significant portion of the additional take-home pay will be spent quickly by consumers. Some of the money will undoubtedly go towards paying down debt, but household deleveraging is a necessary precondition for a return to low unemployment and sustained growth. A payroll tax holiday will help people get out of debt faster by adding roughly $3,000 to the average worker's paycheck.

Fundamental Health Care Reform

The fundamental problem to be addressed by this Committee is that federal spending is projected to rise faster than revenues for the foreseeable future leaving a widening gap to be financed by borrowing. The primary drivers of increased spending are the health care programs, including Medicare, Medicaid, and the subsidies to be provided by the Affordable Care Act (ACA). Huge projected increases in the number of older people, combined with persistent increases in health care spending per person account for this upward pressure on spending. Hence, reducing the rate of growth of these programs is essential to any long run debt stabilization plan. (See Chart)

Spending on mandatory healthcare programs is projected to increase from 23 percent of non-interest federal spending in 2011 to 34 percent by 2021.

Rising federal spending on health care is, of course, a part of the more general trend of increasing spending for health care in the economy as a whole. Over time, national health spending has grown about 2 percentage points per year faster than GDP and health care spending nationally is nearly 17 percent of GDP and rising. The objective of reforming federal health programs should not be to shift federal costs onto the private sector, but to use the federal programs to lead the way toward more effective and less wasteful delivery of health care, no matter how that care is paid for.

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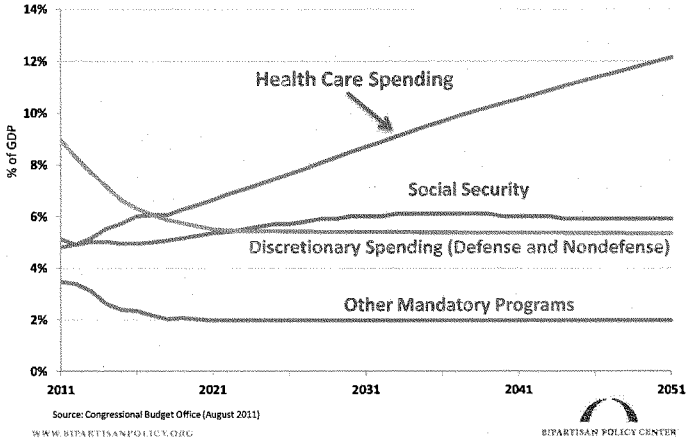
HEALTH CARE COSTS ARE THE PRIMARY DRIVER OF THE DEBT



The Task Force plan includes both demand- and supply-side approaches to slowing the growth in overall health spending and federal spending specifically. Some aspects target the health system in general, while others focus specifically on Medicare and Medicaid.

The major demand-side strategy is to cap and then phase out the tax exclusion of employer-sponsored health insurance (ESI) benefits. This policy will result in more cost-conscious choices by purchasers of health insurance.

Also on the demand side is a proposal to modernize patient cost sharing in the Medicare program. The modernized benefit structure will include a combined annual deductible for Parts A and B, and will provide catastrophic coverage – a protection that is sorely lacking today – thereby more closely matching recent trends in private health care plans.

The key supply-side strategy is to reform provider payment incentives. Moving payment away from fee-for-service and toward broader payment units will incentivize providers to seek more efficient delivery systems. Health reform – i.e., the ACA – took some very important steps toward reforming provider payments in Medicare. The Task Force proposes to build on this by bundling payments for post-acute care into the payment for inpatient care. Many other options

for supply-side reform have received bipartisan support – this committee would be wise to select from some of those, as well.

For Medicaid, in the short term, the Task Force proposes to remove barriers to greater use of managed care for those dually eligible for Medicare and Medicaid. For the long term, significant changes to the program are needed – both narrowly-targeted and fundamental reform proposals should be given serious consideration.

Although each of these proposals will have beneficial effects for the national healthcare system help control federal costs, much of the long-run savings in the Task Force plan will come from transitioning Medicare from fee-for-service to a defined support option. This new system will marshal both demand- and supply-side leverage to transform the national healthcare infrastructure into a more efficient and effective vehicle. As such, this is the proposal that we primarily will focus on today:

Domenici-Rivlin Protect Medicare Act

Simply put, there can be no lasting solution to the U.S. debt crisis without structural changes in the Medicare program to slow its cost growth. This can be done through our proposal to transition Medicare to a "defined support" plan. Such a system will provide major incentives to increase the efficiency and effectiveness of health care delivery to seniors – without abolishing current Medicare, or forcing any beneficiary to move to a different system – and cap total Medicare spending while protecting low-income seniors.

The Domenici-Rivlin defined support proposal will preserve Medicare for future generations. It will allow beneficiaries who wish to stay in traditional Medicare to do so, but also control program costs by providing them the option of choosing among competing private plans that could save them money. It will restrain the growth in total Medicare spending, while protecting low-income beneficiaries from any increases in their cost. In short, the Domenici-Rivlin plan both will preserve Medicare as a choice and also save money by flattening the now-steeply-rising Medicare cost curve.

The Domenici-Rivlin proposal restructures Medicare to achieve fiscal soundness in three ways:

1) A new federally-run Medicare Exchange will provide beneficiaries with a truly competitive marketplace in which they can choose among private healthcare plans and traditional fee-for-service Medicare (FFS). The private plans will be required to cover at least the same services as FFS Medicare, and their government subsidy will be adjusted up (or down) if they attract patients whose illnesses are more (or less) expensive than

average. The Exchange will provide understandable information about the costs and health outcomes of plans so that beneficiaries can choose plans that are best for them, and will allow beneficiaries, if they are not satisfied, to change plans in an annual open season. This competition will incentivize healthcare plans to innovate in every facet of their operations and benefit designs to keep premiums down and quality of care up.

2) By using competitive bidding, this system will tie the federal contribution to the cost of the 2nd-cheapest approved plan or FFS Medicare in each area, whichever is cheaper. Thus, the government will no longer have to pay extra to private healthcare plans in areas where the public FFS plan provides cheaper coverage, nor will they have to overpay to provide FFS Medicare in areas where approved private plans offer the same care at lower cost.

3) These two cost-control features should flatten the cost curve. However, an additional element will ensure substantial savings. The growth in per-beneficiary federal support will be limited to one percentage point faster than the growth of the economy – "GDP+1%" – compared to the current projection of growth that is 1.7 percentage points faster. If costs rise faster than the established limit, Medicare beneficiaries will have to pay higher premiums. However, individuals whose Part B premiums are paid by Medicaid programs will not be affected. Additionally, to smooth the transition to the defined-support system, current beneficiaries with low incomes will be guaranteed access to traditional Medicare with no additional premiums. This subsidy will phase out at higher income levels.

How the Exchanges Work

In each regional market – be it a metropolitan area, or a large rural area where population density is low – all of the private healthcare plans and traditional FFS Medicare will submit bids (subject to strict quality and coverage standards) to provide the standard Medicare benefit package for Parts A and B to an average-risk beneficiary. The FFS "bid" will be based on average FFS costs for the same type of standardized beneficiary in the bidding area. The amount that the government contributes to premiums in that area will then be based on the 2nd-lowest private bid or FFS Medicare's bid, whichever is lower. This will be referred to as the "benchmark" bid.

Beneficiaries who choose to enroll in a plan that is more expensive than the benchmark – even if that plan is FFS Medicare – will be required to pay the incremental additional cost. A beneficiary who enrolls in the plan with the lowest bid will be rebated the full difference in cost from the benchmark

The Exchange will be federally run, presumably by the Centers for Medicare and Medicaid Services (CMS), require guaranteed issue (under which insurers may not decline any applicant), and enforce guidelines for the structure of the benefit package. CMS also will utilize risk adjustment by distributing the government subsidy among insurers according to the health status of those whom they enroll.

Why is this proposal an improvement over the current Medicare system?

Medicare Advantage already offers private plans to Medicare beneficiaries. However, if a private healthcare plan currently has lower costs than FFS Medicare in its area, it cannot offer a rebate to enrollees as an incentive to sign up. Instead, it must increase benefits – which in and of itself increases Medicare spending. Therefore, beneficiaries in areas with high FFS Medicare costs who enroll in private plans receive a host of free supplementary benefits, financed by the government. There is no policy justification for selectively offering free, government-financed supplementary benefits to beneficiaries in one geographic region but not another.

Instead, the new Medicare Exchange will provide strong incentives for plans to manage care-delivery efficiently and to offer the public evidence that their plans achieve quality outcomes at comparatively low cost – because low-bidding plans would be rewarded with increased enrollment.

The Domenici-Rivlin proposal also guarantees that the federal support per beneficiary will *not* grow faster than GDP+1%, thereby assuring the federal government of budgetary savings. The cap on the growth rate also should increase the pressure on plans to develop more efficient methods of care delivery, and might increase political support – by Medicare beneficiaries, their children, and those approaching Medicare eligibility – for federal policies that promote cost containment in health care. The Affordable Care Act already established a cap on the growth of Medicare; moving to a defined support model creates the incentives to make that cap stick.

In the event that Medicare spending per beneficiary rises at a faster rate, enrollees will have to pay higher premiums to cover the difference.[1] However, individuals whose Part B premiums are paid by Medicaid programs will not be affected. Additionally, to smooth the transition to the defined-support system, current beneficiaries with low incomes will be guaranteed access to traditional Medicare with no additional premiums. The new system also could be structured to provide a higher subsidy to those with lower incomes and a lower subsidy to those with higher incomes.

[1] To promote stability, the proposal calls for employing a five-year historical trend of per-capita GDP rather than measuring the change over a single year.

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Fundamental, Pro-growth Tax Reform

Unfortunately, even if we are able to significantly bend health care's cost curve through the Protect Medicare Act and rein in other spending, the aging of the population and retirement of the baby boom generation is not something that we can control. In order to stabilize the debt, therefore, we must raise more revenue. But, this can be achieved through fundamental tax reform that broadens the base, lowers tax rates, and promotes economic growth.

The Bipartisan Policy Center's Tax Reform Plan represents a radical simplification of the current tax code and raises $2.2 trillion more in revenue than current policy[2] (or, $1.7 trillion less than current law). In fact, to best explain it, forget what you know about the complexities of the current tax system, and start fresh. Outlined below are the core elements of the plan:

- A **two-bracket income tax with rates of 15% and 28%**. Because there is no standard deduction or personal exemptions, the 15% rate applies to your 1st dollar of income.[3]

- The **corporate tax rate will be set at 28%**, instead of the current 35% level.

- Capital gains and dividends will be taxed **as ordinary income (with a top rate of 28%)**, excluding the first $1,000 of realized net capital gains (or losses).[4]

- To replace the overly-complex Earned Income Tax Credit (EITC) and to help offset the elimination of personal exemptions, the standard deduction and the child credit, the BPC Plan will establish:
    - A flat **refundable per child tax credit of $1,600** (higher than current law); and
    - A **refundable earnings credit** similar in structure to the recent Making Work Pay credit, but substantially higher.

- Instead of the current system of itemized deductions, which disproportionately subsidizes the housing consumption and charitable giving of upper-income taxpayers, the BPC Plan will:
    - Provide a **flat 15% refundable tax credit for charitable contributions** and for up to $25,000 per year, not indexed, **mortgage interest on a primary residence**.
    - Eliminate the deduction for state and local taxes.

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[2] Current policy baseline assumes that all 2001/2003/2010 income and estate tax cuts are extended and that the AMT is indexed to inflation.
[3] The 27% rate applies approximately to income above $51,000 for single filers and $102,000 for couples.
[4] $500 for singles and heads of household

  - Provide a flat, **15% refundable tax credit** or a deduction (for those in the higher bracket) **for contributions to retirement saving accounts** up to 20% of earnings or a maximum of $20,000.

- Include 100% of Social Security benefits in taxable income, but:
  - Create a non-refundable credit for Social Security beneficiaries equal to 15% of the current standard deduction; and
  - Create a non-refundable credit equal to 15% of an individual's Social Security benefits.

- Allow deduction of medical expenses in excess of 10% of AGI (as in current law).

- Allow deduction of miscellaneous itemized deductions in excess of 5% of AGI.

The BPC Plan achieves a massive simplification of the tax code by **aligning the top individual, capital gains and dividend tax rates, significantly reducing the corporate tax rate, and eliminating the AMT**. Additionally, **most individuals will no longer have to file an annual tax return**[5] beyond an initial declaration of status because the most commonly taken deductions have either been turned into refundable credits, determined solely based on the number of children and earnings, or can only be deducted above a substantial floor. Despite a low top rate of 28%, the new tax system created under the BPC Plan will be **more progressive than the current system** and **raise the requisite revenue to achieve a sound debt-reduction goal**.

How the Joint Select Committee on Deficit Reduction can reach the grand bargain

To put our country's budget back on a sustainable path, these three elements are essential. However, time is short. With the deadline to report recommendations only three weeks away, writing legislation to fundamentally reform Medicare or the tax code is unrealistic. **Still, this Committee can achieve these objectives.**

Section 404 of the Budget Control Act (BCA) provides this Committee the power to draft legislation that must be voted on by the House and the Senate and, if approved, presented to the president for his signature. Significantly, such legislation could:

- Order the committees with jurisdiction over entitlements and revenues to report legislative language by a specific date next year (for example, April 15, 2012), after the

[5] According to Tax Policy Center projections, only 50% of tax units would be required to file tax returns, as opposed to 88% under the current tax system.

expiration of the Joint Select Committee (JSC) itself, to change their programs to reduce projected federal deficits by an amount certain.

- In that order, the JSC could specify explicitly not only the deficit reduction targets to be met, but also the nature of the structural program changes to be made – and by so doing, enforce what would be a true and binding agreement between the two political parties that had been negotiated within the JSC.

- The legislation developed by the instructed committees would be reported back to the House and Senate Rules Committees (or the Budget Committees) and combined into one bill, which would be scored by the Congressional Budget Office.
- The JSC, further, could order that the legislation reported back by the instructed committees receive "fast-track" treatment in the House and Senate, which could be similar to the fast-track treatment afforded to some other types of legislation, and would be determined by the recommendations of the JSC itself.

- Lastly, the JSC could draft the legislative language so that failure to produce the substantive legislation would trigger a sequestration, either conforming to the instructions given to the committees and in the amount of the deficit reduction targets required by the JSC, or in some new manner that could be specified by the JSC.

In sum, Section 404 of the BCA gives the JSC the power to do much more than just find savings of $1.2 trillion to $1.5 trillion; it also has the power to establish and enforce a process that uses existing congressional committees to change entitlement and tax policies.

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APPENDICES

TESTIMONY BY SEN. PETE V. DOMENICI AND DR. ALICE RIVLIN

CO-CHAIRS, BIPARTISAN POLICY CENTER DEBT REDUCTION TASK FORCE

TO

THE JOINT SELECT COMMITTEE ON DEFICIT REDUCTION, U.S. CONGRESS

NOVEMBER 1, 2011

1. 3-step process, $1.2-1.5 trillion spreadsheet and JSC instructions for authorizing committees: How the super committee could stabilize the debt
2. Background document on savings of $1.2 trillion (Step 2): A $1.2 trillion down payment on deficit reduction
3. Section 404 one-pager: The super committee's "super" authority under the Budget Control Act
4. Domenici-Rivlin Medicare Act: Protecting and reforming Medicare
5. Tax reform summary: Creating a simple, pro-growth tax system
6. Payroll tax holiday brief: Economic growth and the payroll tax holiday

THE ROAD TO THE GRAND BARGAIN

STEP I → **STEP II** → **STEP III**

DONE

- Establish Joint Committee on Deficit Reduction
- Cap discretionary spending to save $917 billion

IN PROCESS

- $1.2-1.5 trillion in additional savings
- Mandatory spending restraint
- Eliminate some tax expenditures
- Grow the economy through the enactment of a full Social Security payroll tax holiday

THE GOAL

- Issue instructions to committees
- Change programs within their jurisdiction to achieve fundamental tax and entitlement reform
- Report changes by a date certain
- Expedited legislative process

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How to "go big" within the Budget Control Act (BCA) Framework

- **STEP #1:** Approximately $900 billion in domestic and defense discretionary spending cuts over 10 years that were contained in the initial stage of the Budget Control Act.

- **STEP #2:** Approximately $1.65 trillion in deficit reduction policies over 10 years and a Social Security payroll tax holiday for CY2012 to be proposed by the Joint Select Committee (JSC)
  - The net $1.2 trillion in savings could consist roughly of:
    1. $100 billion in further discretionary cuts (half defense, half domestic)
    2. ≈ $350 billion in other mandatory cuts
       a. Switch to the chained CPI measure of inflation, civilian and military retirement reforms, cut back on farm subsidies, and increase some fees, among others
    3. ≈ $600 billion in health care savings
       a. Update Medicare's cost-sharing rules, introduce a surcharge for first-dollar Medigap coverage, malpractice reform, among others
    4. ≈ $450 billion in small tax expenditure cuts / revenue increases
       a. Switch to the chained CPI measure of inflation, eliminate the mortgage deduction for 2nd homes, remove many energy subsidies, among others
    5. ≈ $450 Social Security payroll tax holiday (employees: full holiday, employers: full holiday on first $3 million in payroll and all newly added payroll)
    6. ≈ $150 billion in interest savings

- **STEP #3:** Using the authority given to the Joint Select Committee in the Budget Control Act, the JSC should write legislation that compels fundamental reform in entitlement spending and in the tax code.
  - Section 404 of the BCA, in combination with other language in the Act, gives the JSC broad powers of an unprecedented nature. It can recommend further sequester action, for example, if it wishes. It can order committees of jurisdiction to make changes in entitlements and taxes and report those changes back in the form of legislative language by a date certain. What we propose, then, is that the work done by the JSC not only meet the mandate of the $1.2-1.5 trillion in savings in the next decade, but focus on how those changes in law would flow naturally to changes of a more fundamental and far-reaching nature in order to stabilize our national debt as a percentage of GDP.
  - In particular, we recommend that the JSC legislate:
    - A tax reform trigger to force tax reform by a date certain (e.g., April 15, 2012) that the CBO scores as providing net tax relief of no more than $1.7 trillion against current law through 2021;
    - A health care reform trigger to force additional health care savings to offset a permanent "doc fix" and passage of a premium support system for Medicare by a date certain;
    - And a trigger to force the passage of reforms to make Social Security sustainably solvent.

Net totals for the Budget Control Act (off of current policy baseline):
- Spending Cuts (including interest) ≈ $2.8 trillion
- Revenues ≈ $2.2 trillion
- Total Budget Savings ≈ $5 trillion

BPC'S RECOMMENDATIONS TO THE JOINT SELECT COMMITTEE (One Way to Achieve a Net $1.2 Trillion in Savings for Step 2)

***Indicates that there is more than one option for that policy listed in the background information**

Page	*Medicare Savings*	Approximate Savings (in billions of $)
1	Update Medicare's cost-sharing rules, provide catastrophic coverage + introduce a Part B premium surcharge for beneficiaries that purchase near first-dollar Medigap coverage	91
3	Reduce Medicare coverage of patients' bad debts	20
3	Accelerate home health savings in the ACA*	9
4	Introduce home health co-payments	40
5	Use Medicare's buying power to increase rebates from pharmaceutical companies	154
8	Bundle Medicare's payments / reform provider payments for post-acute care to reduce costs*	42
10	Better align graduate medical education payments w/ patient care costs*	60
12	Reduce or Eliminate Subsidies to fund hospitals in Medicare*	17
14	Increase Part B deductible for new beneficiaries	4
14	Eliminate provider carve outs from IPAB	—
14	Make reforms to Medicare's Quality Improvement Organizations (QIOs)	3
15	One-year SGR fix	12
	Total Medicare	**430**

	Medicaid Savings	
16	Eliminate state gaming of Medicaid tax gimmick	16
16	Apply a single blended matching rate to Medicaid, CHIP, and exchanges	21
17	Release Medicaid disproportionate share hospital (DSH) allotments in 2021	4
17	Limit Medicaid reimbursement of durable medical equipment (DME) based on Medicare rates	4
17	Shorten exclusivity period for brand name biologic drugs	4
18	Prohibit "pay for delay" agreements to increase the availability of generic drugs and biologics	1
19	Track high prescribers and utilizers of prescription drugs in Medicaid	4
19	Reduce Medicaid fraud	3
	Total Medicaid	**67**

Other Healthcare Savings

21	Limit medical malpractice torts	62
23	Increase TRICARE annual premiums and Rx copayments	22
24	Decrease investment in prevention and public health fund	4
25	Include Social Security benefits in income calculation to determine Exchange subsidy eligibility	15
	Total Other Health Care	**103**
	TOTAL HEALTHCARE	**600**

Other Mandatory Savings

26	Switch to the chained CPI measure of inflation	145
27	Reform civilian retirement	40
28	Reform military retirement	4
29	Reduce farm program spending	35
33	Reform the aviation passenger security fee to more accurately reflect the costs of aviation security	25
34	Adjust Pension Benefit Guarantee Corporation fees to better cover unfunded liabilities	16
36	Actuarially adjust flood insurance subsidies for risk*	12
38	Auction radio spectrum to expand wireless broadband and invest in a broadband network for public safety users	16
39	Index mandatory user fees to inflation	2
59	Restructure the power marketing administrations to charge market rates	2
60	Transfer the Tennessee Valley Authority's electric utility functions and associated assets and liabilities	4
42	Gradually lower the conforming loan limits for Fannie/Freddie	6
43	Increase guarantee fees charged by Fannie/Freddie	27
45	Provide Postal Service Financial Relief and Undertake Reform	19
46	Improve Collection of Pension Information from States and Localities	3
66	Get rid of unneeded Federal real property	4
47	Extend unemployment benefits through next year	30
	Total Other Mandatory	**350**

Discretionary Spending Savings

	Nondefense Discretionary	50
	Defense Discretionary	50
	Budget appropriate amount in a disaster fund	-
	Convert to Security/Non-Security breakdown	-
	TOTAL DISCRETIONARY	**100**

Revenue/Tax Expenditure Savings

48	Switch to the chained CPI measure of inflation	72
49	Eliminate ethanol/biodiesel subsidies	15
52	Cut subsidies for employee parking expenses	38
52	Eliminate the mortgage deduction for 2nd homes/yachts	15
53	Tax carried interest as ordinary income	21
55	Cut subsidies for private-purpose state and local bonds	23
56	Eliminate Hollywood tax breaks	1
57	Timber subsidies	5
58	Remove many energy subsidies (solar, wind, oil and gas, coal)	61
59	Include All Income Earned Abroad by U.S. Citizens in Taxable Income	71
59	Exclusion of Certain Allowances for Federal Employees Abroad	18
60	Eliminate LIFO and LCM Inventory Accounting Methods	100
62	End certain economic development tax breaks	15
	1-year AMT offset	4
	TOTAL REVENUES	**450**

Growth Initiative

	Mandate enactment of a full payroll tax holiday for employees and a full payroll tax holiday for employers (for up $3 million of payroll and all new hires) *(BPC)*	**≈ -450**
	TOTAL INTEREST SAVINGS (estimate)	**150**
	TOTAL SAVINGS	**1,200**

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LEGISLATIVE INSTRUCTIONS FOR STEP 3

GENERAL[6]

CBO (with customary input from the Joint Committee on Taxation) is the umpire.[7]

CBO should provide economic analysis of the proposal over at least 20 years.[8]

CBO's static analysis should be the official score.[9]

For informational purposes only, CBO should provide a "dynamic analysis" of the ***entire*** legislative proposal, according to the procedures it inaugurated in *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, March 2003.[10]

For informational purposes only, CBO should provide an alternative analysis of the proposal assuming that the Federal Reserve holds interest rates at their current level beyond the two years specified in its August 9 statement.[11]

Each bill from the Committees of jurisdiction will be held at the desk until all are completed.[12]

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[6] These "general" instructions might be added to each Committee's instructions, or put forward in some other way.
[7] There should be no estimate-shopping, else all discipline will be lost. CBO's methodologies and procedures have long standing, and have been accepted on all sides. Anyone who wants to refer arguments and analyses of others to CBO for their consideration is of course free to do so.
[8] In the long run, deficit reduction will increase economic growth by increasing national saving – and therefore business investment. If CBO is given only one consensus agreement, this procedural rule will have limited effect. If, however, as part of the process of developing a consensus plan, CBO is presented alternative proposals including some that provide less deficit reduction, this rule will illuminate the long-term consequences.
[9] This follows long-standing practice. It prohibits supply-side estimates of ***either*** tax cuts ***or*** investment spending. Note that a tax proposal that increase revenues beyond expectations will provide additional deficit reduction.
[10] CBO has used a range of alternative "dynamic" methods to estimate the effects of ***complete*** packages of proposals. The differences between CBO's static estimates and the alternative dynamic estimates have been (a) small and (b) roughly equally divided between deficit increases and decreases. Some non-governmental organizations have issued dynamic estimates, but their efforts have widely been regarded as far less rigorous.
[11] Some on both political extremes argue that deficit reduction harms economic growth, and so is undesirable for the foreseeable future. However, we need a firm commitment to deficit reduction within the foreseeable future. We square this circle if the Federal Reserve maintains low interest rates longer, stimulating economic growth while the budget transits from stimulus to deficit reduction. CBO's baseline budget forecast has the economy resuming normal growth and the Federal Reserve increasing interest rates as that occurs. If the deficit is reduced but the Federal Reserve follows an unchanged interest rate policy, then growth will suffer. An alternative interest rate forecast can assume the more accommodative policy that the Fed would be likely to follow if there were a firm commitment to deficit reduction.
[12] This simply dictates that, for example, concessions from one side on Medicare reform cannot become law without compensating concessions from the other side on taxes.

TAX POLICY

The Ways & Means / Finance bill shall not decrease revenues by more than $1.7 trillion over ten years compared to current law.

Taking into account estimable program changes in Social Security, Medicare and all other benefit programs, the bill shall use refundable tax credits to hold harmless, on average, the households in the lowest 20 percent of the income distribution.[13]

On the same basis and using static estimates, the bill shall decrease the after-tax income in each quintile ranked by gross income by a lesser percentage than for those quintiles with higher incomes.[14]

The maximum tax rate on individuals and corporations shall be no higher than 28 percent.[15]

MEDICARE POLICY

Beneficiaries (present and future) who wish to enroll in the current conventional Medicare program must have that option.[16]

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[13] The proposal of the Bipartisan Policy Center (http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf) demonstrates that this is possible.

[14] In other words, the tax changes should be consistently progressive by income quintile, using the change in after-tax income as the criterion. Specifying the criterion is important, and this one would be the choice of most experts. Although it might seem constructive to reference also smaller upper-income groups such as the top 10 percent, the top 5 percent, the top 1 percent, etc., distributional measures for those groups often have wiggles in them even for sound tax reform proposals. Excessively specific distributional criteria could possibly undermine what could be a fundamentally progressive deficit-reducing tax reform. Note also that the level of the top-bracket rate affects the potential to eliminate or reduce the highly regressive and complicating tax preferences for capital gains and dividends. In 1986, the Congress was willing to eliminate the capital gains exclusion in exchange for a top rate of 28 percent (which had been the capital gains rate since 1979). The higher the top bracket rate, the lower the probability of political acceptance of a lesser preference for capital gains; and the larger the capital gains preference, the less progressive the distributional result of the tax change. In the extreme, the result can be a vicious cycle or "Catch-22" in which progressivity requires a higher top-bracket rate, but the higher top-bracket rate brings on a bigger capital gains preference, and the bigger capital gains preference results in an unacceptable distributional result.

[15] This principle maximizes the chance of achieving a tax reform that is politically acceptable and fair, and that contributes to deficit reduction.

[16] The health care of current Medicare beneficiaries must not be interrupted. Future beneficiaries (such as rural residents who have limited choices among providers) who for whatever reason wish to participate in the current program must be allowed to do so. The option of using the current known system will be reassuring to many. But at the same time, the practice of health care in Medicare must change fundamentally to reduce current unsustainable cost growth. The best way to achieve efficiency in Medicare is to give beneficiaries the option of choosing among competing plans that must provide quality care at affordable cost to prosper. This is simply allowing competition to work as it does everywhere else in the economy. It is the Rivlin-Domenici approach. There is nothing else on the table that shows any prospect of success. It will be especially attractive to current workers who have coverage with which they are satisfied, and who might lose that coverage and their ongoing relationships with their providers if they are forced to switch to current Medicare when they turn 65. With a guarantee of access to conventional

Beneficiaries must have the option of enrolling in a wide range of competing private plans, in addition to the conventional Medicare program.

Medicare policy changes must fully offset a permanent fix to the sustainable growth rate formula within the 10-year window, and must provide increasing annual amounts of savings in later years.[17]

SOCIAL SECURITY POLICY

Separate from the deficit-reduction effort, legislation shall be prepared to achieve 75-year sustainable solvency of Social Security.[18]

All savings from the Social Security legislation shall be credited to the Social Security trust fund.[19]

Medicare, it should be acceptable to other informed beneficiaries. This instruction builds the foundation for all beneficiaries to have the coverage they want.

[17] This instruction requires the Committees of jurisdiction to find the necessary near-term program savings (as opposed to fundamental reform) to reach the deficit-reduction target. It also sets the general requirement that the savings from longer-term structural reforms must grow over time.

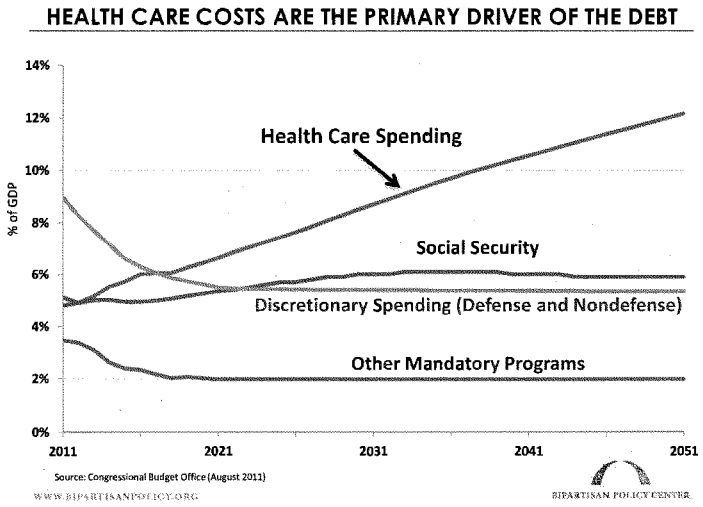
[18] Early repair of Social Security's finances will get the program out of the political line of fire, which all program advocates ought to support. Rhetorically, it must be clear that Social Security will be repaired for its own sake, not to balance the budget (though that of course is a subsidiary benefit). The sustainable-solvency standard means that the program is to be made sound not only over 75 years, but also in the 75th and subsequent years. That would avoid the uncertainty and political controversy that followed the 1983 legislation, which built up an oversized trust fund but allowed the program's finances to become unstable once the trust fund needed to be drawn down (i.e., now).

[19] This is one more rhetorical way to explain why the program itself is the primary winner if its finances are strengthened.

Domenici-Rivlin Protect Medicare Act

The principal driver of future federal deficits is the rapidly mounting cost of Medicare. The huge growth in the number of eligible seniors over the coming years is due to both increasing longevity and the retirement of the baby boomers. Then, that beneficiary growth is multiplied by continuing increases in the cost of health care. Without a significant change in this trend, the cost of Medicare will continue to rise faster than the economy can possibly grow. Even if revenues are raised and other spending is restrained (both of which the BPC supports), the exploding cost of Medicare is unsustainable.

Simply put, there can be no lasting solution to the U.S. debt crisis without structural changes in the Medicare program to slow its cost growth. This can be done through our proposal to transition Medicare to a "defined support" plan. Such a system will provide major incentives to increase the efficiency and effectiveness of health care delivery to seniors – without abolishing current Medicare, or forcing any beneficiary to move to a different system – and cap total Medicare spending while protecting low-income seniors.



The Domenici-Rivlin defined support proposal will preserve Medicare for future generations. It will allow beneficiaries who wish to stay in traditional Medicare to do so, but also control program costs by providing them the option of choosing among competing private plans that could save them money. It will restrain the growth in total Medicare spending, while protecting low-income beneficiaries from any increases in their cost. In short, the Domenici-Rivlin plan both will preserve Medicare as a choice and also save money by flattening the now-steeply-rising Medicare cost curve.

The Domenici-Rivlin proposal restructures Medicare to achieve fiscal soundness in three ways:

4) A new federally-run Medicare Exchange will provide beneficiaries with a truly competitive marketplace in which they can choose among private healthcare plans and traditional fee-for-service Medicare (FFS). The private plans will be required to cover at least the same services as FFS Medicare, and their government subsidy will be adjusted up (or down) if they attract patients whose illnesses are more (or less) expensive than average. The Exchange will provide understandable information about the costs and health outcomes of plans so that beneficiaries can choose plans that are best for them, and will allow beneficiaries, if they are not satisfied, to change plans in an annual open season. This competition will incentivize healthcare plans to innovate in every facet of their operations and benefit designs to keep premiums down and quality of care up.

5) By using competitive bidding, this system will tie the federal contribution to the cost of the 2nd-cheapest approved plan (subject to capacity constraints) or FFS Medicare in each area, whichever is cheaper. Thus, the government will no longer have to pay extra to private healthcare plans in areas where the public FFS plan provides cheaper coverage, nor will they have to overpay to provide FFS Medicare in areas where approved private plans offer the same care at lower cost.

6) These two cost-control features should flatten the cost curve. However, an additional element will ensure substantial savings. The growth in per-beneficiary federal support will be limited to one percentage point faster than the growth of the economy – "GDP+1%" – compared to the current projection of growth that is 1.7 percentage points faster. If costs rise faster than the established limit, Medicare beneficiaries will have to pay higher premiums. However, individuals whose Part B premiums are paid by Medicaid programs will not be affected. Additionally, to smooth the transition to the defined-support system, current beneficiaries with low incomes will be guaranteed access to traditional Medicare with no additional premiums. This subsidy will phase out at higher income levels.

How the Exchanges Work

In each regional market – be it a metropolitan area, or a large rural area where population density is low – all of the private healthcare plans and traditional FFS Medicare will submit bids (subject to strict quality and coverage standards) to provide the standard Medicare benefit package for Parts A and B to an average-risk beneficiary. The FFS "bid" will be based on average FFS costs for the same type of standardized beneficiary in the bidding area. The amount that the government contributes to premiums in that area will then be based on the 2nd-lowest private bid or FFS Medicare's bid, whichever is lower. This will be referred to as the "benchmark" bid.

Beneficiaries who choose to enroll in a plan that is more expensive than the benchmark – even if that plan is FFS Medicare – will be required to pay the incremental additional cost. A beneficiary who enrolls in the plan with the lowest bid will be rebated the full difference in cost from the benchmark

The Exchange will be federally run, presumably by the Centers for Medicare and Medicaid Services (CMS), require guaranteed issue (under which insurers may not decline any applicant), and enforce guidelines for the structure of the benefit package. CMS also will utilize risk adjustment by distributing the government subsidy among insurers according to the health status of those whom they enroll.

Why is this proposal an improvement over the current Medicare system?

Medicare Advantage already offers private plans to Medicare beneficiaries. However, if a private healthcare plan currently has lower costs than FFS Medicare in its area, it cannot offer a rebate to enrollees as an incentive to sign up. Instead, it must increase benefits – which in and of itself increases Medicare spending. Therefore, beneficiaries in areas with high FFS Medicare costs who enroll in private plans receive a host of free supplementary benefits, financed by the government. There is no policy justification for selectively offering free, government-financed supplementary benefits to beneficiaries in one geographic region but not another.

Instead, the new Medicare Exchange will provide strong incentives for plans to manage care-delivery efficiently and to offer the public evidence that their plans achieve quality outcomes at comparatively low cost – because low-bidding plans would be rewarded with increased enrollment.

The Domenici-Rivlin proposal also guarantees that the federal support per beneficiary will *not* grow faster than GDP+1%, thereby assuring the federal government of budgetary savings. The cap on the growth rate also should increase the pressure on plans to develop more efficient

methods of care delivery, and might increase political support – by Medicare beneficiaries, their children, and those approaching Medicare eligibility – for federal policies that promote cost containment in health care. The Affordable Care Act already established a cap on the growth of Medicare; moving to a defined support model creates the incentives to make that cap stick.

In the event that Medicare spending per beneficiary rises at a faster rate, enrollees will have to pay higher premiums to cover the difference.[20] However, individuals whose Part B premiums are paid by Medicaid programs will not be affected. Additionally, to smooth the transition to the defined-support system, current beneficiaries with low incomes will be guaranteed access to traditional Medicare with no additional premiums. The new system also could be structured to provide a higher subsidy to those with lower incomes and a lower subsidy to those with higher incomes.

Cumulative savings in billions of dollars, 2016 through:				
	2021	**2025**	**2030**	**2040**
Domenici-Rivlin Protect Medicare Act (beginning in 2016)	$241	$569	$1,337	$4,906

[20] To promote stability, the proposal calls for employing a five-year historical trend of per-capita GDP rather than measuring the change over a single year.

Bipartisan Policy Center (BPC) Tax Reform
Quick Summary

The BPC Tax Reform Plan represents a radical simplification of the current tax code and would raise approximately $1.3 trillion less than the system under current law. In fact, to best explain it, forget what you know about the complexities of the current tax system, and start fresh. Outlined below are the core elements of the plan:

- A **two-bracket income tax with rates of 15% and 28%**. Because there is no standard deduction or personal exemptions, the 15% rate applies to your 1st dollar of income.[21]

- The **corporate tax rate will be set at 28%**, instead of the current 35% level.

- Capital gains and dividends will be taxed **as ordinary income (with a top rate of 28%)**, excluding the first $1,000 of realized net capital gains (or losses).[22]

- To replace the overly-complex Earned Income Tax Credit (EITC) and to help offset the elimination of personal exemptions, the standard deduction and the child credit, the BPC Plan will establish:
  - A flat **refundable per child tax credit of $1,600** (higher than current law); and
  - A **refundable earnings credit**[23] similar in structure to the recent Making Work Pay credit, but substantially higher.

- Instead of the current system of itemized deductions, which disproportionately subsidizes the housing consumption and charitable giving of upper-income taxpayers, the BPC Plan will:
  - Provide a **flat 15% refundable tax credit for charitable contributions** and for up to $25,000 per year, not indexed, **mortgage interest on a primary residence**.
  - Eliminate the deduction for state and local taxes.
  - Provide a flat, **15% refundable tax credit** or a deduction (for those in the higher bracket) **for contributions to retirement saving accounts** up to 20% of earnings or a maximum of $20,000.

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[21] The 28% rate applies approximately to income above $51,000 for single filers and $102,000 for couples.
[22] $500 for singles and heads of household
[23] The refundable earnings credit is equal to 17.5% of the first $20,000 of earnings.

- Include 100% of Social Security benefits in taxable income, but:
  - Create a non-refundable credit for Social Security beneficiaries equal to 15% of the current standard deduction; and
  - Create a non-refundable credit equal to 15% of an individual's Social Security benefits.

- Effective in 2015, cap and then phase out over 10 years the tax exclusion for employer-sponsored health insurance benefits.

- Allow deduction of medical expenses in excess of 10% of AGI (as in current law).

- Allow deduction of miscellaneous itemized deductions in excess of 5% of AGI.

The BPC Plan achieves a massive simplification of the tax code by **aligning the top individual, capital gains and dividend tax rates, significantly reducing the corporate tax rate, and eliminating the AMT**. Additionally, **most individuals will no longer have to file an annual tax return**[24] beyond an initial declaration of status because the most commonly taken deductions have either been turned into refundable credits, determined solely based on the number of children and earnings, or can only be deducted above a substantial floor. Despite a low top rate of 28%, the new tax system created under the BPC Plan will be **more progressive than the current system** and **raise the requisite revenue to achieve our debt-reduction goal**.

[24] According to Tax Policy Center projections, only 50% of tax units would be required to file tax returns, as opposed to 88% under the current tax system.

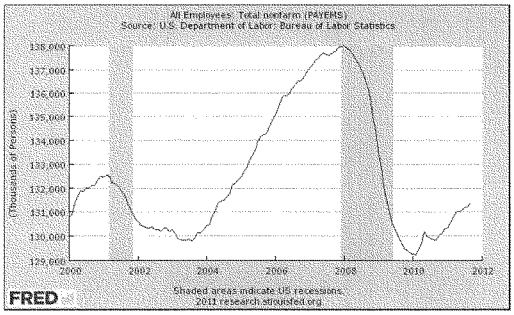
It's Time for a Holiday!

The United States is mired in the slowest recovery from the deepest recession since the Great Depression. Unemployment has hovered around 9 percent for over two years, and there is serious concern about a double dip recession. Any realistic plan to address these problems must garner bipartisan support, and now is the time for action. In order to spur economic growth and business activity, we will need agreement on an effective proposal to boost the flagging economy. The Domenici-Rivlin Task Force's full Social Security payroll tax holiday for calendar year 2012 fits the bill.

The holiday provides much better "bang-for-the-buck" than many other growth measures. It will immediately increase consumer spending and business hiring, thereby providing economic growth and jobs. The tax cut will provide financial relief for roughly 160 million American workers, many of whom are having difficulty making ends meet in the aftermath of the worst recession in nearly a century. A significant portion of the additional take-home pay will be spent quickly by consumers. Some of the money will undoubtedly go towards paying down debt, but household deleveraging is a necessary precondition for a return to low unemployment and sustained growth. A payroll tax holiday will help people get out of debt faster by adding roughly $3,000 to the average worker's paycheck.

The Social Security payroll tax directly funds Social Security. Employees and employers each pay 6.2 percent of salaries – up to a cap of $106,800 per employee – in payroll taxes. Because of this cap, a payroll tax holiday proportionally will direct more money into the pockets of working- and middle-class Americans, those who are most likely to spend it in short order. On the business side, a holiday will reduce the cost of hiring additional workers for every one of America's six million employers, the vast majority of them small business owners.

The Congressional Budget Office (CBO) projects that a full Social Security payroll tax holiday will create between 2.5 and 7 million jobs over two years. With almost 7 million fewer people employed now than before the recession, these jobs are sorely needed. The costs of continued long-term unemployment are steep and likely are already beginning to eat away at our future growth. Long-term unemployment leads to a permanent deterioration of the skills and productivity of our workforce. Therefore, returning unemployed Americans to work as quickly as possible must be a priority.



Temporarily suspending the payroll tax for employees and employers will ***not*** have any net effect on the Social Security Trust Fund. The General Fund of the government will transfer dollar for dollar back to the Trust Fund, such that it is made whole in real time with *no impact* on Social Security's financing.

A payroll tax holiday must be coupled with a strong deficit reduction plan in order to both strengthen the economy and reduce the debt. Restoring the economy to steady growth will help stabilize and reduce the debt, but given the severity of our fiscal imbalance, growth alone is not a panacea. A bold deficit reduction package is necessary, as well.

By providing more money to consumers and business alike right away, however, the payroll tax holiday will help to quickly reignite the struggling economy. It provides more near-term benefits than almost any other proposal in circulation, and will be an effective growth- and job-creator for the United States. That is why the payroll tax holiday is needed now, and should be included in any comprehensive economic recovery plan.

State	# of People Benefiting from Payroll Tax Holiday (millions)	Total Number of Businesses	Total Amount of Payroll Tax Cut (billions of $)	State	# of People Benefiting from Payroll Tax Holiday (millions)	Total Number of Businesses	Total Amount of Payroll Tax Cut (billions of $)
Alabama	2.3	79,812	8.1	**Nebraska**	1	42,302	4.1
Alaska	0.4	16,529	1.7	**Nevada**	1.2	49,956	4.7
Arizona	2.9	109,823	11.6	**New Hampshire**	0.8	32,334	3.5
Arkansas	1.4	52,699	4.7	**New Jersey**	4.7	202,600	23.8
California	16.7	717,133	74.5	**New Mexico**	0.9	37,549	3.5
Colorado	2.5	130,297	9.9	**New York**	10.1	443,992	46.0
Connecticut	2	75,842	9.3	**North Carolina**	4.7	176,196	18.0
Delaware	0.5	20,364	2.3	**North Dakota**	0.4	17,922	1.2
Florida	9	414,799	33.2	**Ohio**	5.7	199,647	20.9
Georgia	4.6	179,576	18.0	**Oklahoma**	1.9	73,310	6.4
Hawaii	0.7	26,360	2.9	**Oregon**	1.9	92,335	7.6
Idaho	0.8	39,368	2.9	**Pennsylvania**	6.7	237,055	27.9
Illinois	6.5	260,225	27.3	**Rhode Island**	0.6	25,818	2.3
Indiana	3.6	115,466	13.4	**South Carolina**	2.2	83,427	8.1
Iowa	1.7	65,015	6.4	**South Dakota**	0.5	21,797	1.7
Kansas	1.6	60,989	5.8	**Tennessee**	3.2	102,398	11.6
Kentucky	2.1	71,510	7.6	**Texas**	11.4	396,412	45.4
Louisiana	2.1	82,301	7.6	**Utah**	1.3	60,271	5.2
Maine	0.8	34,942	2.3	**Vermont**	0.4	19,282	1.7
Maryland	3.1	112,392	15.1	**Virginia**	4.3	154,808	19.2
Massachusetts	3.4	141,843	16.3	**Washington**	3.5	150,991	15.7
Michigan	5.1	182,606	19.8	**West Virginia**	0.9	30,873	2.9
Minnesota	3.1	120,950	13.4	**Wisconsin**	3.2	115,003	12.8
Mississippi	1.4	47,489	4.7	**Wyoming**	0.3	18,104	1.2
Missouri	3.1	120,145	11.1				
Montana	0.6	32,570	1.7	**United States**	158.6	6,095,427	641.0

Sources: **U.S. Census Bureau, Tax Policy Center, and Center on Budget and Policy Priorities**

BIPARTISAN POLICY CENTER

November 10, 2011

The Honorable Patty Murray
Co-Chair
Joint Select Committee on
Deficit Reduction
448 Russell Senate Office Building
Washington, D.C. 20510

The Honorable Jeb Hensarling
Co-Chair
Joint Select Committee on
Deficit Reduction
129 Cannon House Office Building
Washington, D.C. 20515

Dear Senator Murray and Representative Hensarling:

Thank you for affording us the opportunity to testify before the Joint Select Committee on Deficit Reduction on Tuesday, November 1, regarding the report and recommendations of the Bipartisan Policy Center's Debt Reduction Task Force. We hope that our testimony will be helpful in your difficult but crucial work.

Due to the time restrictions at the hearing we would like to submit a complete response to the questions regarding our tax reform plan and the capital gains exclusion. We hope that this information provides helpful background for the Joint Select Committee as you continue your deliberations and would be grateful if this answer could be included as part of the official record.

As was stated in the hearing, all of the witnesses, and indeed all of the members of the BPC Debt Reduction Task Force, concluded that both increased revenues and outlay cuts will be necessary to contain the nation's rising public debt. Because the Task Force recognized that fact, we spent considerable time developing a fundamental tax reform package, which we believe would meet three essential criteria: increase revenue, stimulate economic growth, and distribute the additional burden according to the ability to pay. To achieve all three goals, we determined that it would be essential to eliminate the current preferential tax treatment of capital gains.

Fortunately, we have a precedent for our recommendation. The Tax Reform Act of 1986, passed by a Republican Senate and a Democratic House and signed by President Ronald Reagan, eliminated the tax preference for capital gains and reduced the top-bracket individual income tax rate to 28 percent. The Task Force proposal is quite similar.

Please allow us to discuss our proposal with respect to capital gains in the context of all three criteria.

Revenue

The evidence shows that the elimination of the capital gains exclusion in the 1986 Act did not significantly reduce sales of assets. In fact, tax revenues on capital gains increased immediately after the effective date of the 1986 Act.

The effect of the 1986 Act on the amount of capital gains realizations involves some nuance.

From the very beginning of the 1986 legislative process, it was clear that the preferential treatment of capital gains would be at least reduced. The prior law provided a 60 percent exclusion for long-term capital gains. The so-called "Treasury I" proposal from the Department to President Reagan eliminated the exclusion in exchange for inflation indexation of the cost basis of assets, which would have increased taxes significantly for comparatively large gains accrued over comparatively short times. The "Treasury II" proposal by President Reagan cut the exclusion to 50 percent. The 1985 House bill cut the exclusion to 42 percent. And then the 1986 Senate bill (which passed the Finance Committee unanimously on May 6), and the conference agreement, eliminated the exclusion entirely.

Throughout this process, the designers of the 1986 Act, including Senate Finance Committee Chairman Bob Packwood and House Ways & Means Committee Chairman Dan Rostenkowski, recognized that the significant reduction in the capital gains preference could raise questions of fair transition. Accordingly, they wrote the law with a prospective effective date (January 1, 1987), so that taxpayers who had contemplated selling an asset using the prior law preference could do so. This created a "fire sale" opportunity for realization of gains at what was in effect a temporarily low rate. Realizations in 1986 were expected to increase substantially, and they did. Revenues from capital gains realized in 1986 were fully double the level of 1985 – the largest increase on record by a factor of two. But that was fully expected and intended to be a one-time phenomenon, as should be obvious from the attached chart.

The open question was what would happen to capital gains tax revenues in 1987, given that many of the gains that were realized in 1986 likely were accelerated from 1987 (and later years) to take advantage of the "fire sale" on the expiring exclusion. Surprising to some, tax receipts on capital gains were higher in 1987 than they were in 1985, the last "normal" year – i.e., without the influence of the transition to taxation of gains as ordinary income – under the prior law. This was true both in dollars and – even more significantly – as a percentage of GDP. In fact, in 1987, tax revenues from capital gains hit the largest percentage in recorded history, discounting the "fire sale" year of 1986 – and then were superseded immediately by a new record tax revenue year in 1988. This result was remarkable, especially in light of the likely acceleration of the realization of significant amounts of gains from 1987 and 1988 forward to 1986 because of the temporary tax advantage to do so.

Subsequent years confirmed that the 1986 Act was conducive to revenue growth from realizations of capital gains. The treatment of capital gains remained essentially unchanged through 1996. Between 1987 and 1996, after a decline because of the 1990-1991 recession, tax revenues from capital gains increased as a share of the GDP, and doubled in dollar terms. The 1996 ratio displaced that of 1988 as the highest "normal" year on record, not that far below the 1986 "fire sale" year. And overall tax revenue was growing with the economy, combining with spending restraint to narrow the previously troublesome budget deficit from the then-record level of $290 billion (4.7 percent of GDP) in 1992 to only $107 billion (1.4 percent of GDP) in 1996. In that period, federal revenues had increased from 17.5 percent to 18.8 percent of GDP, while outlays had declined from 22.1 to 20.2 percent of GDP, contributing to the reduction in the deficit.

We believe that the simple amount of tax revenue on capital gains realizations actually understates the federal government's revenue gain from 1986-style tax reform. Under the BPC proposal, the top-bracket tax rates for ordinary income, capital gains, and corporate income all will be equal. There will no longer be a reward for legal manipulation to re-characterize ordinary income as capital gain, capital loss as ordinary loss, or an individual business as a corporate business (or vice versa). The manipulation between capital and ordinary gain or loss has been widely cited as by far the greatest source of actual day-to-day tax

complexity. Such manipulation also, obviously, reduces tax revenue. Even economic growth can suffer, as labor and investment capital are moved from their best uses in the free marketplace to their best uses on the tax form. True tax reform, such as the Task Force proposal, would increase revenues in part merely by ending such manipulation. The portion of the 1986 Act that ended such manipulation ***increased*** total revenues, but ***decreased*** measured revenue from the taxation of capital gains. This fact makes the rise in capital gains revenues from the 1986 experience even more striking: the revenues rose more than enough to fully offset the measured negative effect of cracking down on manipulation.

Economic Growth

Experience has demonstrated that the 1986 Act was conducive not only to revenue growth, but also to economic growth. By 1996, under essentially the same capital gains tax treatment as in the 1986 Act, the economy had recovered from the 1990-1991 recession, economic growth was robust, and a full-fledged investment boom was underway. Business investment in equipment, which had fallen to 6.9 percent of the GDP in the 1990-1991 recession, was up to 8.3 percent in 1996. Real GDP grew by an average of 3.3 percent over 1992-1996, and 3.7 percent in 1996.

This result follows from basic economics. Economists know that the income tax on capital gains is a very small part of the cost of capital. Far greater is the cost of funds – the interest rate itself. The main mission of the Joint Select Committee – deficit reduction – is far more important for capital investment than anything that might be done to protect the tax preference for capital gains.

Capital gains tax preferences are also much more a bonus for the already-wealthy portfolio investor than an incentive for the budding entrepreneur. The capital gains tax preference is irrelevant for the many entrepreneurs who hope to build and run successful businesses and earn salaries from them. Even for such entrepreneurs who look forward eventually to selling their businesses upon retirement, the capital gains tax is years away, and its impact on their ultimate outcomes will be overwhelmed by the degree of their success in running their businesses.

The much greater part of capital gains realized by individuals is on sales of corporate stock by portfolio investors, rather than sales of businesses owned by entrepreneurs. In the latest (2007) data released by the Internal Revenue Service, tax-favored long-term capital gain or loss transactions on corporate stock accounted for 53 percent of all transactions, and 26 percent of all net capital gain. In stark contrast, capital gain or loss transactions on partnership, S corporation and estate or trust interests accounted for only 2 percent of all transactions, and less than 6 percent of all net capital gain – only about one-fifth the amount of sales of shares of established corporations. Net ordinary income from businesses and professions was nearly seven times the amount of capital gains from sales of businesses – and that does not include any of the entrepreneurial income that is reported as simple salary income. And of course, a tax preference afforded to all capital gains steers scarce resources also to all other kinds of investments – including precious metals, collectibles, U.S. government bonds, and so on – instead of to the rewards to true entrepreneurs, much of which flow in the form of ordinary income.

As noted earlier, a lower tax rate for capital gains directs more capital into investments that are more likely to throw off income as capital gains, at the expense of some other uses that might actually have higher rates of return. Capital gains treatment historically has been one of the key ingredients in the classic tax shelter, which wastes society's scarce resources on investments that generate tax losses to offset other income, rather than profits earned in the free marketplace. And misleadingly, because the eventual cash

receipts from liquidating tax shelters are reported as realized capital gains, this sheer economic waste makes the tax receipts from capital gains look larger.

The Task Force proposal includes a substantial reduction in the corporate income tax rate, to 28 percent. That makes the corporate rate approximately equal to the average across all developed nations. Because firms usually want to locate in the markets in which they sell, and because the United States is the largest market in the world, this competitive corporate tax rate should encourage the location of more production activity in the United States, with resulting benefits for employment. And the reduction of the tax rate for corporate-source income will provide a benefit to owners of corporate stock who would lose the capital gains preference.

In sum, we believe that the Task Force tax proposal would on net be more conducive to economic growth than the current system, while also reducing the deficit directly.

Fairness

The capital gains preference is a key reason why many people of extraordinary wealth can pay lower tax rates on their income, at the margin, than people of far more modest means who simply work for a living.

Because capital gains are such an important source of income for those at the top of the income scale, this tax preference has great leverage over the distributional results that are used to judge the progressivity and fairness of the tax system. More than three quarters (78.5 percent) of all tax returns with adjusted gross income (AGI) of over $1 million report tax-preferred long-term capital gains income, and on average those capital gains equal almost two fifths (39.0 percent) of the amount of their AGI. (Of returns with over $10 million of income, 92.8 percent have tax-preferred gains, equal to 52.1 percent of their AGI.) In stark contrast, of the income group ($30,000 to $40,000) of the median taxpayer, only 5.2 percent have any tax-preferred capital gains, constituting only 0.9 percent of their total income. Accordingly, if there is a capital gains preference in an alternative tax system as part of budget deficit reduction, the larger that preference, the higher must be the tax rate on ordinary income. In other words, we cannot have lower capital gains tax rates for free; they must be offset by higher tax rates on ordinary income. But increasing the capital gains preference and increasing the tax rate on ordinary income explicitly transfers income from people who work – including many job-creating entrepreneurs – to people who already have accumulated wealth. That such an outcome should be perceived as fair is far from clear, not to mention the economically distorting effects of the higher ordinary-income tax rate.

Conclusion

In an uncertain world with complex issues at play, the tax reform proposal of the BPC Debt Reduction Task Force provides the best balance that we have found among the nation's revenue needs, the imperative of economic growth, and society's need for a foundation of fairness of contribution according to ability to pay.

The objection that we hear most often to the elimination of any tax preference, with the capital gains preference perhaps the most prominently cited, is that it will inhibit economic growth. We refer those who bear that concern to a column by Martin S. Feldstein in the *Wall Street Journal* of October 24, 2011, in which he estimates significant increases in taxable income as the result of the enactment of the Tax Reform Act of 1986. The Tax Reform Act of 1986, as you know, eliminated the tax preference for capital gains. We can only conclude that there is perhaps a broader than realized consensus among economists – not to

mention the endorsement of President Ronald Reagan – that the capital gains preference is not essential for economic growth, and does not increase tax revenues.

Again, thank you for the opportunity to testify. We hope that you find this expanded response helpful to you.

Sincerely,

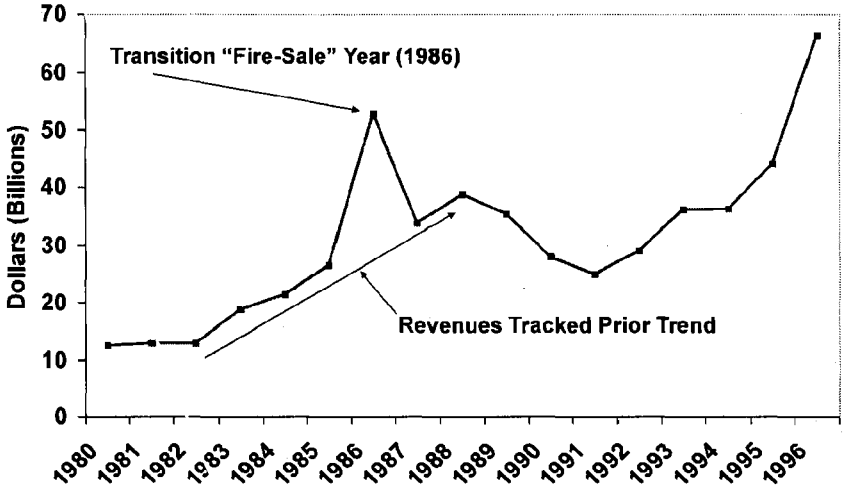
Senator Pete Domenici

Alice M. Rivlin

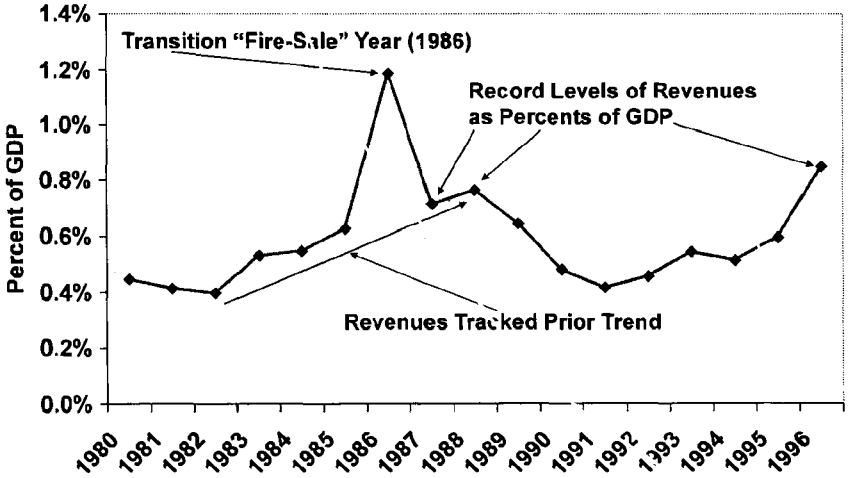
Year	Total Realized Capital Gains	Taxes Paid on Capital Gains	Average Effective Rate	Taxes Paid as a Percent of GDP	Maximum Tax Rate on Long Term Gains
1954	7,157	1,010	14.1	0.27%	25.00
1955	9,881	1,465	14.8	0.35%	25.00
1956	9,683	1,402	14.5	0.32%	25.00
1957	8,110	1,115	13.7	0.24%	25.00
1958	9,440	1,309	13.9	0.28%	25.00
1959	13,137	1,920	14.6	0.38%	25.00
1960	11,747	1,687	14.4	0.32%	25.00
1961	16,001	2,481	15.5	0.46%	25.00
1962	13,451	1,954	14.5	0.33%	25.00
1963	14,579	2,143	14.7	0.35%	25.00
1964	17,431	2,482	14.2	0.37%	25.00
1965	21,484	3,003	14.0	0.42%	25.00
1966	21,348	2,905	13.6	0.37%	25.00
1967	27,535	4,112	14.9	0.49%	25.00
1968	35,607	5,943	16.7	0.65%	26.90
1969	31,439	5,275	16.8	0.54%	27.50
1970	20,848	3,161	15.2	0.30%	32.21
1971	28,341	4,350	15.3	0.39%	34.25
1972	35,869	5,708	15.9	0.46%	36.50
1973	35,757	5,366	15.0	0.39%	36.50
1974	30,217	4,253	14.1	0.28%	36.50
1975	30,903	4,534	14.7	0.28%	36.50
1976	39,492	6,621	16.8	0.36%	39.88
1977	45,338	8,232	18.2	0.41%	39.88

1978	50,526	9,104	18.0	0.40%	39.875/33.85
1979	73,443	11,753	16.0	0.46%	28.00
1980	74,132	12,459	16.8	0.45%	28.00
1981	80,938	12,852	15.9	0.41%	28.00/20.00
1982	90,153	12,900	14.3	0.40%	20.00
1983	122,773	18,700	15.2	0.53%	20.00
1984	140,500	21,453	15.3	0.55%	20.00
1985	171,985	26,460	15.4	0.63%	20.00
1986	327,725	52,914	16.1	1.19%	20.00
1987	148,449	33,714	22.7	0.71%	28.00
1988	162,592	38,866	23.9	0.76%	28.00
1989	154,040	35,258	22.9	0.64%	28.00
1990	123,783	27,829	22.5	0.48%	28.00
1991	111,592	24,903	22.3	0.42%	28.93
1992	126,692	28,983	22.9	0.46%	28.93
1993	152,259	36,112	23.7	0.54%	29.19
1994	152,727	36,243	23.7	0.51%	29.19
1995	180,130	44,254	24.6	0.60%	29.19
1996	260,696	66,396	25.5	0.85%	29.19
1997	364,829	79,305	21.7	0.95%	29.19/21.19
1998	455,223	89,069	19.6	1.01%	21.19
1999	552,608	111,821	20.2	1.20%	21.19
2000	644,285	127,297	19.8	1.28%	21.19
2001	349,441	65,668	18.8	0.64%	21.17
2002	268,615	49,122	18.3	0.46%	21.16
2003	323,306	51,340	15.9	0.46%	21.05/16.05
2004	499,154	73,213	14.7	0.62%	16.05
2005	690,152	102,174	14.8	0.81%	16.05
2006	798,214	117,793	14.8	0.88%	15.70
2007	924,164	137,141	14.8	0.98%	15.70
2008	497,841	68,791	13.8	0.48%	15.35

Capital Gains Tax Revenues Grew After 1986 Act



Capital Gains Tax Revenues Grew After 1986 Act



Representative Jeb Hensarling

Co-Chair, Joint Select Committee on Deficit Reduction

"What I do believe we will hear from each of our witnesses is that America at least does indeed face a legitimate debt crisis. Not only are we operating on borrowed money, we are operating on borrowed time as well. In that vein, I never tire of reminding not only myself but the public and my colleagues that although we have a statutory goal to reduce the growth of the deficit over ten years by $1.5 trillion, backed up by a $1.2 trillion sequester should we fail, more importantly we have a statutory duty to proffer legislation that would significantly improve the nation's long term fiscal balance.

"What could not be clearer is that unless we offer fundamental and structural reforms to our nation's entitlement programs, especially health care, we will not only end up failing in our duty, we may fail our nation as well. Health care costs measured by GDP roughly have doubled since the time of my birth until I entered the workforce and have risen about two-thirds since then, and are growing at what all acknowledge to be an unsustainable rate. Every agency and think tank I am aware of, every academic study, shows that Medicare will go broke in 9-13 years.

"The president himself has said that, "the major driver of our long term liabilities, everybody here knows it, are Medicare and Medicaid, and our healthcare spending, nothing comes close." I continue to agree with the president. Unfortunately, Social Security faces its problems as well, my children will likely put more money into Social Security than they take out; at best generational unfairness, at worst a form of generational theft.

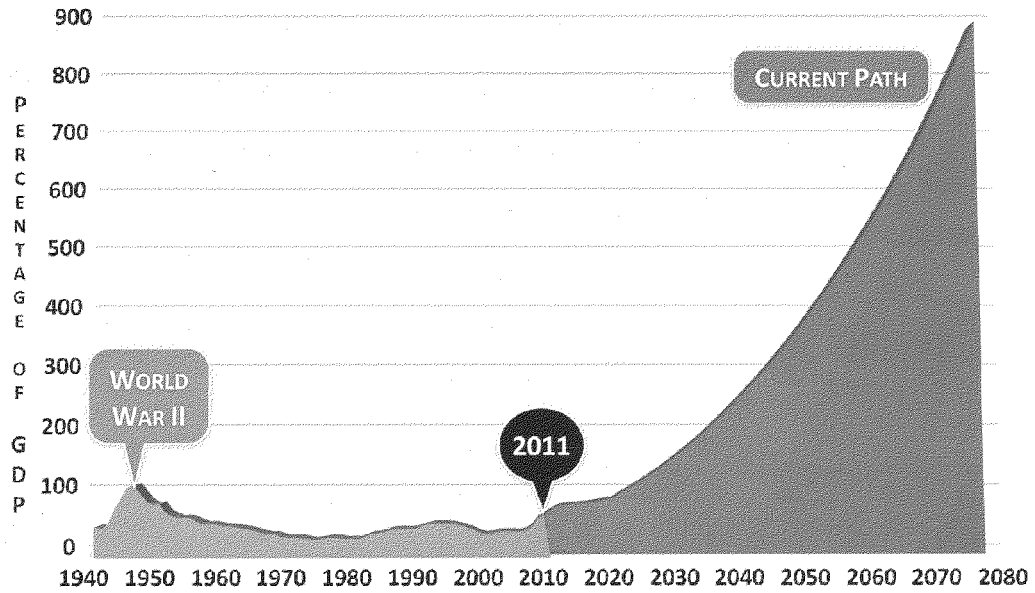
"We have previously heard from the Congressional Budget Office that tax revenues upon the recovery of this economy will once again produce roughly 18.5 percent of GDP, we also know that there are many tax increases already built into current law. But spending, principally driven by our health care and retirement programs, is due to roughly double in size to 40 percent of GDP over the course of a generation from where it was just a few short years ago.

"Certainly we cannot tax our way out of this crisis, we cannot solve it by simply tinkering around the edges of our entitlement programs. For the sake of our economy, our jobs, our national security, and our children's future, many people say it is time to "go big" I agree, but "going big" is not merely measured by slowing the rate of growth of the deficit over the next ten years. "Going big" must be measured in solving the problem—in other words, fundamental and structural reforms of our entitlement programs, giving every American the opportunity for quality healthcare and quality retirement security at a cost that does not harm our jobs and diminish our children's future."

Chart 1

Crushing Burden of Debt

(Debt as a Share of the Economy)



Source: OMB/CBO

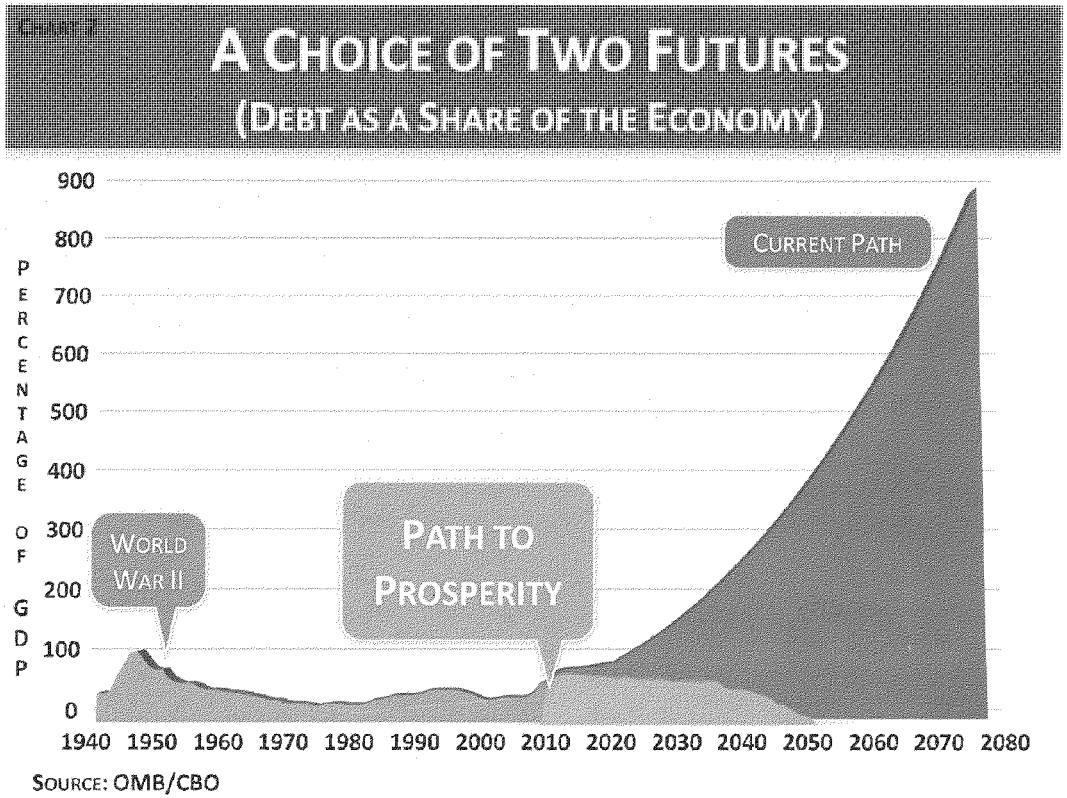
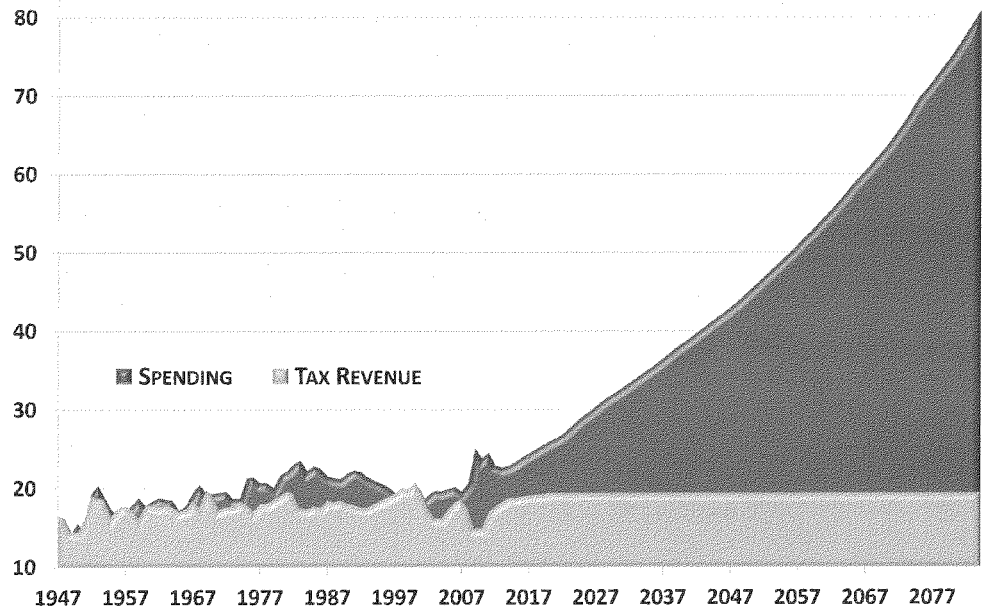


Chart 7
A Choice of Two Futures
(Debt as a Share of the Economy)
Percentage of GDP
900
800
700
600
500
400
300
200
100
0
1940 1950 1960 1970 1980 1990 2000 2010 2020 2030 2040 2050 2060 2070 2080
World War II
Path to Prosperity
Current Path
Source: OMB/CBO

Chart 3 We Are In A Spending-Driven Debt Crisis

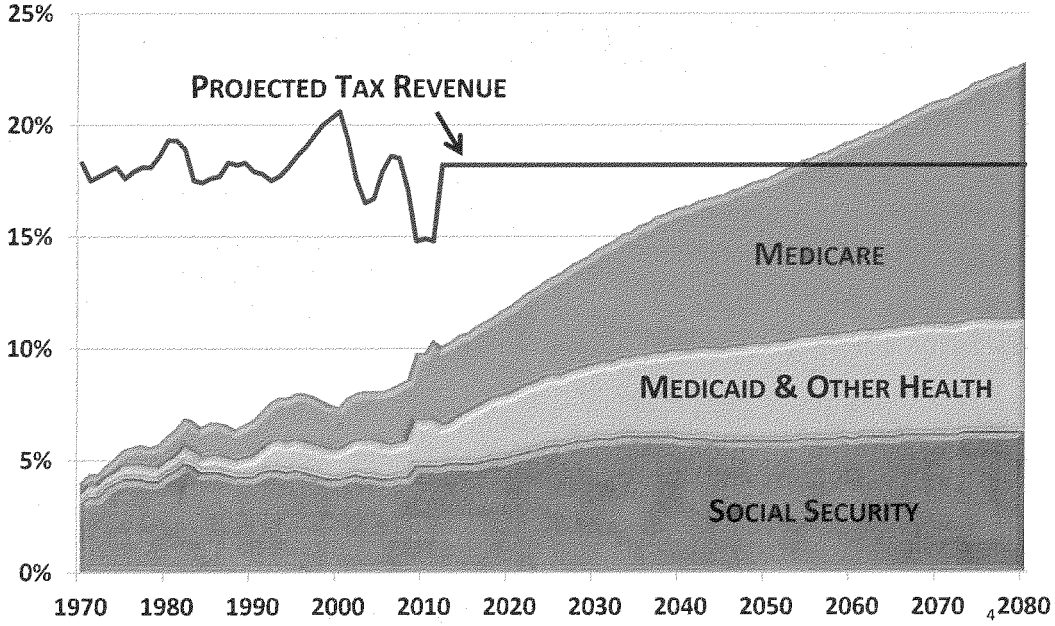
Historic/Projected Spending & Revenue As A Percentage Of The Economy



Source: Office of Management and Budget Historic Tables, Congressional Budget Office; projections based on the CBO's Alternative Fiscal Scenario.

What Drives Our Debt

(Government Spending as Share of Economy)



Source: CBO

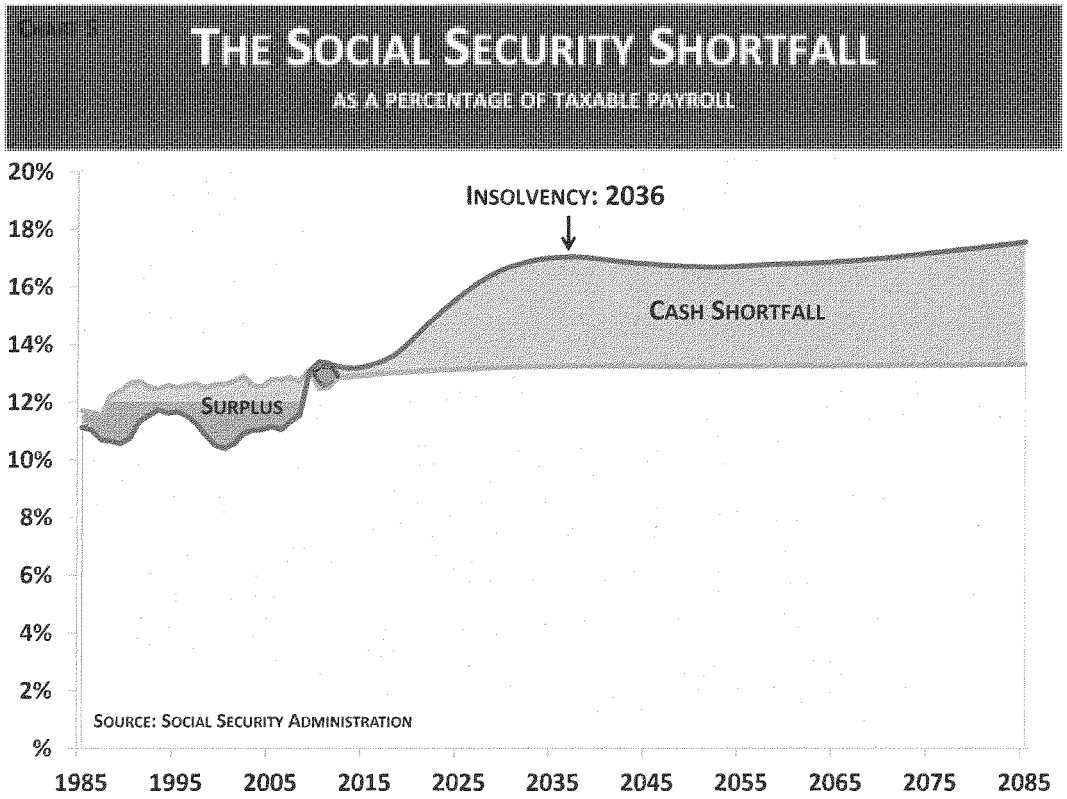
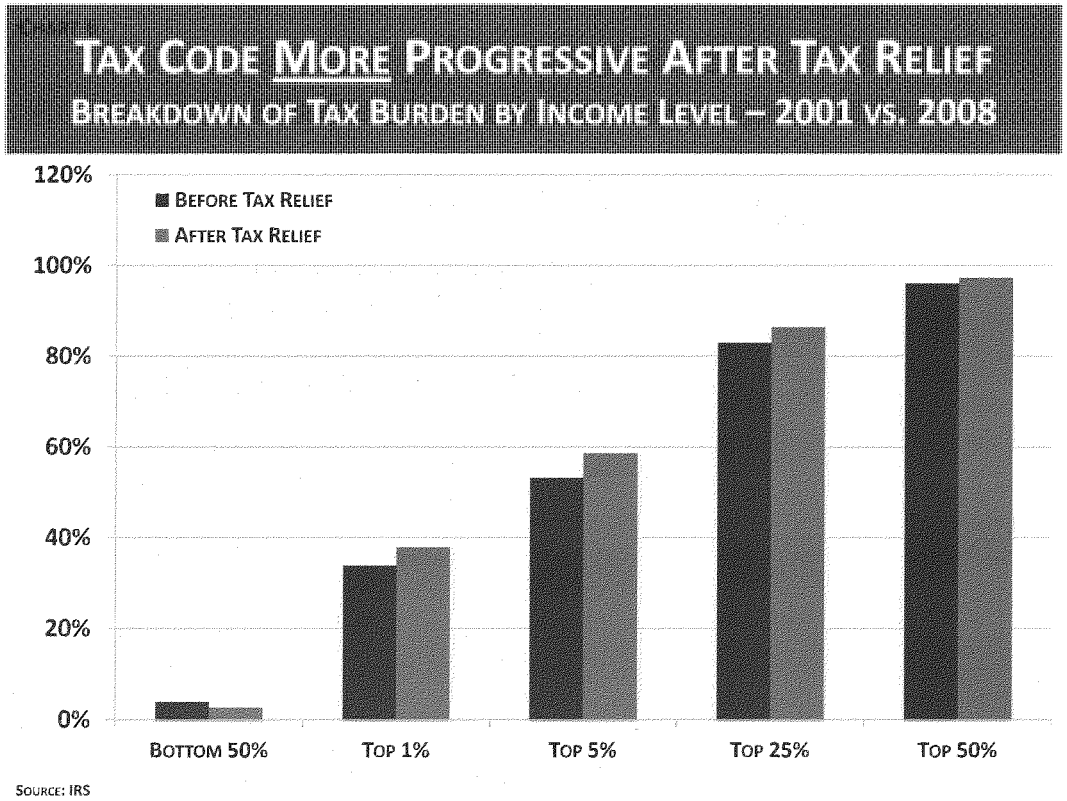


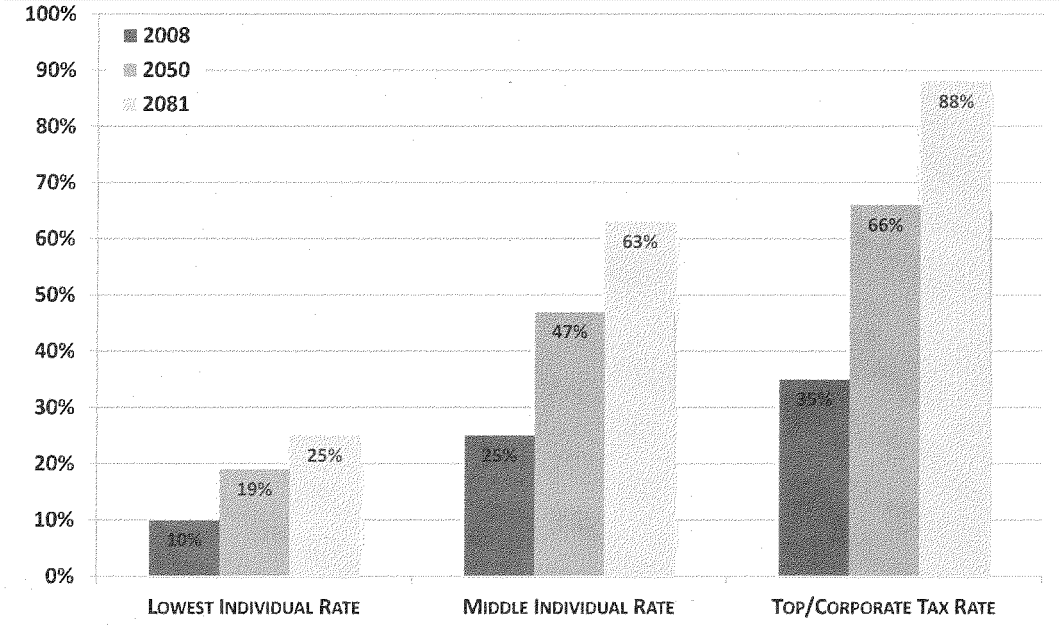
Chart 2:
THE SOCIAL SECURITY SHORTFALL
AS A PERCENTAGE OF TAXABLE PAYROLL
INSOLVENCY: 2036
CASH SHORTFALL
SURPLUS
SOURCE: SOCIAL SECURITY ADMINISTRATION
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
%
1985
1995
2005
2015
2025
2035
2045
2055
2065
2075
2085


Tax Code More Progressive After Tax Relief
Breakdown of Tax Burden by Income Level – 2001 vs. 2008
120%
100%
80%
60%
40%
20%
0%
Before Tax Relief
After Tax Relief
Bottom 50%
Top 1%
Top 5%
Top 25%
Top 50%

Source: IRS

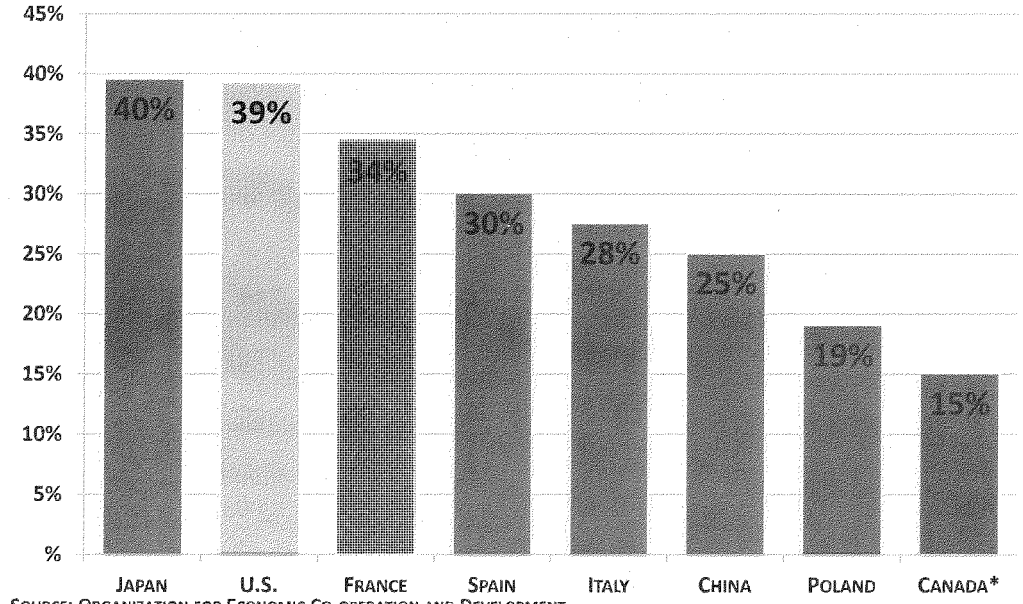
Chasing Higher Spending with Taxes

(Increase in Tax Rates Necessary to Keep Pace Spending)



Source: CBO

Corporate Income Tax Rates



Source: Organization for Economic Co-operation and Development

*=Canada 's Corporate tax rate will drop to 15% in January 2012

Senator Patty Murray

Co-Chair, Joint Select Committee on Deficit Reduction

"Thank you Representative Hensarling. And I want to thank all of my colleagues, our witnesses, and members of the public joining us today.

"We have been working hard together for the past two months, but with twenty three days left to go until our deadline, and with even less time before we need to have a plan ready to be voted on—we are now entering the critical final phase of this process.

"And as we all know, the consequences of failure are unacceptable. The triggers that have been put in place would be devastating for our national defense and for middle class families and the most vulnerable Americans who depend on education, housing, and nutrition assistance for women and infants.

"Markets, ratings agencies, and businesses across the country are watching closely to see if Congress can solve this problem.

"And the American people are looking to us to break out of the gridlock and partisan rancor that has dominated DC recently, and to deliver the kind of results they expect and deserve.

"That's why members of this Committee have been clear: we need to find a way to come together around a bipartisan deal.

"So I believe it's very appropriate that we are having this hearing, with these witnesses, as we move into the final few weeks.

"Before us we have Democrats and Republicans who were able to come together around big and balanced proposals that tackle some of the most difficult challenges facing our nation.

"The two groups went about it in slightly different ways, and I don't agree with every piece of each plan—but they provide serious models for big and balanced bipartisan proposals.

"And as I know we will hear more about today—these proposals achieved bipartisan support and came together only because they were balanced, they included concessions from all sides, and they required all Americans to share in the sacrifices that this endeavor calls for.

"Neither of these bipartisan proposals included only spending cuts, and they didn't simply address entitlements—or only raise revenue.

"They put everything on the table, they made the tough decisions—and because of that, they were able to put together balanced packages that garnered bipartisan support.

"So as this committee moves into the home stretch, hearing more about the importance of a balanced approach is going to be very helpful. Because as our witnesses today can address—a bipartisan deal isn't possible if members refuse to come out from their partisan or ideological corners.

"It's not enough for either side to simply say they want to reduce the deficit—now is the time when everyone needs to be putting some real skin in the game and offering serious compromises.

"Democrats have made clear we are prepared to do that. We've said we are very open to painful concessions and compromises if Republicans are as well—and we have put forward serious ideas that reflect this.

"But these concessions would only be made—and only considered—in the context of a balanced deal that doesn't just fall on the middle class and most vulnerable Americans—but that requires big corporations and the wealthiest among us to share in the sacrifices.

"The American people realize this. They overwhelmingly support a balanced approach.

"Which is why this is the kind of deal every bipartisan group that has successfully tackled this issue has made—it's the kind of deal I am looking forward to hearing more about from our witnesses today—and it's the kind of deal I am hopeful every member of this committee is prepared to make.

"So again, I want to thank our witnesses for being here with us today to have this critical conversation. The bipartisan, balanced work you've done provides a strong foundation for this committee. And I look forward to hearing your testimony and asking some questions."

Score of PPACA: 2014-2023*

Effects on the Federal Deficit	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014-2023
Medicaid & CHIP Outlays /c	30	55	77	84	87	98	97	105	113	121	861
Exchange Subsidies & Related Spending /d,e	23	55	87	104	115	123	130	137	144	151	1068
Small Employer Tax Credits /f	2	8	5	2	2	2	2	2	2	2	35
Gross Cost of Coverage Provisions	60	118	169	189	204	218	229	245	259	274	

1.964 Trillion

***Figures for 2022 and 2023 based on conservative committee estimates of the growth in PPACA spending
***Figures do not include potential higher costs of the increased Medicaid woodworking effect
***Figured do not include potential higher costs of Exchange subsidies due to increased employer drop rate