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TAX CUTS AND THE BUDGET SURPLUS

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TAX CUTS AND THE BUDGET SURPLUS

Monday, September 13, 1999

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The Committee met at 10:00 a.m., in Room SD-124 of the Dirksen Senate Office Building, the Honorable Connie Mack, Chairman of the Committee, presiding.

Present: Senator Mack. Representative Stark.

Staff present: Shelley S. Hymes, Chris Edwards, Joseph Pasetti, Kevin Doyle, Stephen Schultz, Kurt Schuler, Kerry Fennelly, Victor Wolski, Lawrence Whitman, Daphne Clones, Howard Rosen, James D. Gwartney, Chuck Skipton and Colleen J. Healy.

OPENING STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

Senator Mack. Let me call the Committee to order.

I came down the hallway and there was another hearing apparently getting ready to start, with a huge crowd outside. I thought for a moment, could this possibly be the interest in the country beginning to focus on some economic questions?

I was disappointed to find out that apparently it must be a hearing in which the issue is about who gets how much of the tax dollars, how much of the new spending. So there's more interest, which is not surprising. It has always been that way and always will be.

Anyway, I want to thank each of you. We do have another panel member and I suspect we will have a member or two showing up as well. Here comes Congressman Stark now.

I do want to thank each of you for coming.

Welcome.

Again, I want to welcome you to this hearing of the Joint Economic Committee on the very timely topic of Tax Cuts and the Budget Surplus.

There has been a lot of loose talk in the past few months concerning this Congress's tax relief package, with adjectives like "reckless" and "risky" being tossed about by opponents of tax relief. I am

confident that the distinguished panel we have assembled can substitute some light for the heat that has been generated in this debate.

One thing that has gone unnoticed in the budget debate is that both ends of Pennsylvania Avenue agree on the size of the surpluses over the next decade. The nonpartisan Congressional Budget Office, and the President's Office of Management and Budget, this summer released surplus calculations that are only $20 billion apart, and I say, only 20 billion in the context of three plus trillion dollars. When the budget baselines are adjusted to freeze discretionary spending at the 2002 caps, these surpluses total roughly $3.4 trillion over the next ten years.

So, all parties agree that the Federal Government will be overcharging the taxpayers by $3.4 trillion. The only real debate concerns what the government should do with these overpayments. This summer, the Congress passed a tax bill that would provide $792 billion in tax relief for the American people. This is less than 25 percent of the tax overpayments, a relatively modest portion. But despite the modest size of this tax cut, the President and his supporters have characterized or criticized the tax relief package as "too big," and have argued that the government cannot part with that much money.

But if you stop and think about it, every single argument being made against the tax cut is just plain wrong.

Some argue, from a Keynesian demand-side perspective, that tax cuts will overstimulate the economy. But even after a $792 billion tax cut, the Federal Government will run up over two trillion dollars in surpluses over the next ten years, and from a Keynesian viewpoint, two trillion in surpluses is not considered a stimulus, it is considered a drag on the economy. And with all of the lags, the delays, and the phase-ins, the bulk of the tax cuts will not arrive until years 2007, 2008, and 2009.

Can anyone seriously think that, in a nine trillion dollar economy, a $5.3 billion net tax cut for fiscal year 2000 will overstimulate consumer demand? This is just six hundredths of one percent of GDP. The net tax cut for fiscal year 2001 is barely noticeable, it is $1.1 billion. How can that possibly overheat the economy?

Clearly, the facts do not support the argument. In any event, from the demand-side perspective, the tax cut should be irrelevant. If we do not cut taxes by $792 billion, it is safe to say that spending will increase by $792 billion over the next decade—spending by the government, that is. That is what President Clinton means when he says we cannot afford to cut taxes. His bureaucrats are working overtime to dream up new ways to spend the money. In fact, including his Medicare proposal, the President has already proposed an increase in spending of $1.3 trillion

over the next decade—all but $54 billion of the on-budget surpluses, according to the CBO.

Furthermore, a tax cut that removes government barriers to savings and investment is not an "artificial stimulus" that the Federal Reserve Board would seek to offset with tighter money. Inflation, after all, is caused by too many dollars chasing too few goods, not by too many investors creating wealth and opportunity. An even stronger economy, fueled by the freedom and enthusiasm of our entrepreneurs, is not something to fear.

The argument is also raised that a $792 billion tax cut leaves no money to meet some other important government goals. But we still have about $2 trillion in Social Security surpluses that will be in a "lock-box" to retire debt and shore up our seniors' retirement security, and another $505 billion in non-Social Security surpluses that can be used for Medicare, National Defense, and other priorities.

There appear to be no good economic arguments against the tax relief package. The opposition to tax relief is based not on economics, but on philosophy. This all boils down to one basic, fundamental question: who has first claim on the income of Americans—does it belong to the government or to the individuals who create the income through the sweat of their brows and the genius of their intellect?

The current Administration acts like the money belongs to the government. It rejects our tax relief bill as "too big," as if taxpayers earn income at the sufferance of the government. Under this view, Uncle Sam does not live under a budget, he sets the budget for every American family, which must be content with the table scraps after the enormous appetite for Washington spending has been satiated.

This President and his supporters in the Congress just don't get it. The tax burden on our citizens is at an all-time, peacetime high—20.6 percent of the economy. At the same time, we will be overcharging the taxpayers by more than three trillion dollars. A Nation that trusted its people, that protected their liberty, would not flinch from doing the right thing: cutting taxes so that our families can enjoy the fruits of their labor, instead of the greedy Federal Government.

We must remember that tax cuts are not about numbers, they are about people. The true measure of the merit of tax relief is not the revenue loss estimate by the bean counters—the value of tax relief is the gain in freedom and the enhancement of opportunity for our people. There can be no denying that the American people would be helped tremendously by the tax relief that we have passed. Consider some of the ways in which our tax relief bill would make a difference in the lives of

Americans. We make health and long-term care insurance fully deductible, and allow a dependent deduction for elderly family members. Education is more affordable through enhanced savings vehicles—savings accounts and pre-paid tuition plans. Tax rates are lowered across-the-board. We eliminate the marriage penalty for taxpayers in the lowest tax bracket and repeal the Alternative Minimum Tax for individuals.

According to analysis by the Heritage Foundation, once the tax relief is fully phased-in, a blue-collar family of four earning in the low $50,000s would save $381 on their tax bill, and a typical, unmarried teacher earning under $40,000 would see his or her tax bill shrink by 782 dollars. These are not trivial amounts. We cut taxes because of the 67 year old owner of a family business in Florida's panhandle, who is discouraged from reinvesting his hard-earned profits because the specter of the Federal death tax is hovering, waiting to swoop down and scoop up 55 percent of the increased value of his business.

We cut taxes because of the two-earner family, struggling to make ends meet, that has to pay over $1000 extra in taxes just because they are married. We cut taxes so that waitresses, truck drivers, teachers and carpenters can put an extra $1000 in their IRAs each year, to build a better nest egg for retirement. We cut taxes to enable a biomedical company to budget that one additional research project that just might lead to a breakthrough in the treatment of glaucoma or a cure for cancer. And we cut taxes to reduce government barriers to saving and investment, so the capital is available for the American entrepreneurs of the 21st Century to develop markets in technologies we cannot even imagine today.

High taxes are an infringement on the liberty of our families, who should not be straggling to make ends meet while their Federal servants hoard the wealth our families have created. When the question comes down to whether we trust the Federal Government or the family to use money wisely, I choose the family every time.

Now I will turn to my colleague and welcome you.

[The prepared statement of Senator Mack appears in the Submissions for the Record.]

Opening Statement of Representative Pete Stark, Ranking Minority Member

Representative Stark. Thank you, Mr. Chairman. After that introduction I hardly know what to say. As usual, I have this brilliant opening statement.

Senator Mack. We probably can just put it in the record.

Representative Stark. I do not think I can let you get away quite that easily.

I have a couple of concerns. Although everybody is talking about an on-budget surplus, and I do not dispute your numbers, there are many of us who are not so sure that that surplus will materialize over the next ten years.

It seems to me that we, the House and the Senate, would have to cut 15 to 20 percent out of discretionary spending in order to finance a large tax cut. That would not leave any money to fix Florida's hurricane that is about to hit in the next week or so, although I hope it misses the whole east coast. If it does, there will be no money to repair that damage.

The on-budget surplus, I suspect, depends on the actions of Congress for the next ten years and if the past ten years are any record, and that's all we have to go on, it's not likely to appear. So if there is any diminution of the on-budget surplus, we will not have any money to fix Social Security or will run deficits, and we won't have any money to keep Medicare solvent. I submit that 40, 50, 60 percent of this proposed tax cut would go to the wealthiest one or two percent in the country. My sense is that we ought to perhaps not give it to them and to spend some of that money to see that the 10 to 12 million children in this country who don't have health insurance get it. There's still 45 million uninsured for any health care in this country, and not having health insurance in this country means you get second-rate or no medical care.

We are certainly not the only industrialized nation in the world that would have a sixth of our population uninsured and receiving substandard medical care; we may be the only nation in the world to not provide medical care as a matter of right. Albeit, in some countries it is not very good, but everybody gets it.

I think that is unconscionable. I think that is far less conscionable than spending some of your or my tax dollars, Mr. Chairman, and members of Congress who would be well-to-do enough to get a fairly substantial cut and lower income people wouldn't. I don't think we should do that. I think we should spend our money first to insure Social Security, second to make sure that Medicare is solvent, and third to expand health care to all. And we have all kinds of problems like education and crime, where I think there's bipartisan agreement that those are programs that the Government should support. Now, maybe we shouldn't.

One of the problems is that if we make the tax cut we all know that it's somewhere between 10—and I will let the economists answer this—somewhere between 10 and 100 times easier to cut taxes than it is to raise taxes.

Senator Mack. That's certainly not been my experience.

Representative Stark. Yes, it is. It's an easier vote, let's put it that way; it is a more comfortable political position. And I see nothing wrong with saying if those extra surpluses develop after we've taken care of Social Security, Medicare and the uninsured, be my guest. But why put it in cement for ten years out?

Some people would say, and some of these expert economists might say, well, business needs to plan. Business is doing pretty well without the tax cuts. They can use a few pleasant surprises and I'm not sure business needs to plan as much for good news as they do for bad. The idea that you can't plan ahead, I think is a marginal issue. Basically we're not very sure that that surplus is going to arrive. If it doesn't, a major tax cut on the order of $300 billion or $500 billion is going to be devastating in my opinion to the programs that on a bipartisan basis we want to support.

I'd like to do a couple of things. I have a letter from 50 economists, we wouldn't have all 50 of them here to testify this morning, but they all signed a letter suggesting a view that's supported by Alan Greenspan and that is that we don't need a tax cut now. I would like for us to put that letter in the record.

Senator Mack. Without objection.

Representative Stark. And I would like to ask the four witnesses before us today, first of all, how does a large tax cut proposal improve the long-term security of Social Security and Medicare? And, then, does that proposal extend the benefits of the economic prosperity to more people than are enjoying it currently? And, how does the proposal improve the long-term health of the U.S. economy? If you could just kind of address your remarks to those as we go along, I would be quite interested in your conclusions, and thank you for holding the hearing.

[The prepared statement of Representative Stark and Dear Colleague appear in the Submissions for the Record.]

Senator Mack. Thank you, Congressman Stark.

Again I want to welcome the panel.

We have four panel members this morning. We will start with Dr. Jim Miller, Counselor, Citizens for a Sound Economy and former Director of the Office of Management and Budget. He will be followed by Dr. James Gwartney who is the Chief Economist for the Joint Economic Committee and a Professor of Economics at Florida State University. And then Mr. Bob Greenstein who is Director for the Center for Budget and Policy Priorities, and then with Wayne Angell, Chief Economist and Senior Managing Director of Bear Stearns and Company and former

member of the Board of Governors at the Federal Reserve batting clean up.

And so with that, Jim, we'll start with you.

STATEMENT OF DR. JIM MILLER, COUNSELOR, CITIZENS FOR A SOUND ECONOMY AND FORMER DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET

Dr. Miller. Thank you, Mr. Chairman and Mr. Stark. I appreciate the opportunity to be here. I am Counselor to Citizens for a Sound Economy, which has a quarter of a million members and supporters, and on their behalf as well as my own, I welcome this opportunity to respond to you.

I have a short piece of testimony that I would ask you to put in the record.

Senator Mack. Without objection.

Dr. Miller. Thank you, sir.

The first point I want to make is that we give all these numbers undue credibility, credibility they don't deserve. We don't know these numbers with great precision. Estimates of budget surpluses or deficits don't take into account changes in asset values of the Federal Government, change in liabilities of the Federal Government. You see these numbers aggregated over a ten- year period. They are not discounted, they don't discriminate between a big tax cut the first year and little tax cuts thereafter or vice versa.

Frankly, from experience doing some forecasting myself, and I'm sure the members of the panel here would agree with this, you can have a lot more confidence in the first year or the second year than you can in the so-called "out years"; I wouldn't bet the farm on anything past two or three years. Keep in mind that the budget surplus or budget deficit is the small difference between two very, very large numbers. And swings in those two numbers from just mistakes or errors in forecasting can result in big swings in those deficit or surplus numbers.

Also, both agencies, the Office of Tax Assessment in the Department of Treasury and the Joint Committee on Taxation here in the Congress still use quasi static models. There have been some improvements in the last few years, but it's basically static. So, for example, these models tend to overestimate the revenue hit of a tax cut. So those are sources of errors in these forecast numbers and I think that is important for us to bear in mind when we talk about a $792 billion surplus roughly you know, give or take a couple of hundred billion.

I think we can be more confident of the following two things. One is that taxes restrict economic growth. I gave some testimony last March

where I talked about this, building on— among other things — the work of Professor Gwartney and some of his colleagues.

Secondly, if Congress has the money, Congress will spend the money. And so we are talking about whether to put the money back in the pockets of taxpayers where it originates or whether to have Congress spend the money. I offer here today's Washington Post as Exhibit 1, pointed out to me by Mr. James Carter who is on the Committee staff, at page A-9. It's an advertisement by the Gateway Computing Company. And it says, "It's our annual 'spend your budget before it's gone' sale." It goes on, "With only weeks left before the end of the Federal Government's fiscal year, Gateway is making it easy for your agency to get the best technology at the best prices."

Another example: When I came to work for Herb Stein, who unfortunately passed away last week—a great economist and a great patriot — at the Counsel of Economic Advisors as a senior staff economist, my office had some wonderful drapes that I liked very much—paisley drapes. I came in one day and they were cut down on the floor. I said, "What happened to these drapes?" They said, "Well, it's the end of the fiscal year and we had money left over and we had to spend it." Now, that's a mindset. And I think that mindset permeates Washington's thinking about money, about taxpayers' money, and so it's a question of who is going to spend it — the government or the taxpayer?

So the third point I want to make is I urge you to stand firm on the tax cut package that you passed, and I hope the President will sign it. Not only because yours is a bigger tax cut than what the President has indicated he would accept, $300 billion or so over ten years, but because it is different in kind. There are two extremes in taxes. One is an across-the-board kind of tax cut which empowers people to make their own decisions. The other is like tax expenditures or what the Administration likes to call "targeted tax cuts" where basically the government channels you into certain kinds of activities, determining what they think is good for you and what is not so good for you.

And, of course, the other thing is that the President's budget incorporated dramatic increases in spending. And, for reasons that I outlined before this Committee in March, I think that government spending is too large a fraction of gross national product and ought to be curtailed.

Briefly in answer to you, Mr. Stark, I think the answer, and I'm sure my colleagues here on the panel will be responding in more detail, is that if you have a tax cut, you unbridled the economy, you enable the economy to grow faster and that this larger gross national product will

make it easier for people to obtain health insurance, and it will be easier for the government to solve the Social Security problem and to affirm Medicare. And to do these things, a tax cut is essential.

[The prepared statement of Dr. Miller and accompanying materials appear in the Submissions for the Record.]

Representative Stark. But as the—

Senator Mack. If I could ask you to wait until we have had heard from the panel.

Senator Mack. Dr. Gwartney.

STATEMENT OF DR. JAMES GWARTNEY, CHIEF ECONOMIST, JOINT ECONOMIC COMMITTEE AND PROFESSOR OF ECONOMICS, THE FLORIDA STATE UNIVERSITY

Dr. Gwartney. Mr. Chairman and Congressman Stark, it is a pleasure for me to have the opportunity to address this Committee. My background as Chairman Mack mentioned is that as a Professor of Economics at Florida State University and I'm used to speaking 50 minutes. So the question is whether I will be able to say anything in five minutes or not? Some people might argue college professors don't say very much in 50 minutes, so we'll see what they can do about five.

Well, I would like to provide some background related to the tax cut legislation. If you listen to the media, you would get the idea that two propositions permeated this debate. One of the propositions would be that the tax cut would essentially result in very few funds being used to pay down the national debt. We've got this big national debt and doesn't it make more sense to pay down the national debt rather than to cut taxes.

And the second would be that the President wants to pay down the national debt and the Republicans want to cut taxes rather than pay down the national debt.

Now, both of those propositions are false. And to indicate why they're false I would like to look a little bit closer at the data.

If you look at the size of the tax cut, and I think that you have some packets before you that have some exhibits in them, and I will make a few references to some of the exhibits that were in my packet. Figure 3 in that particular packet gives the size of the tax cut in relationship to GDP. The tax cut in the first five years is four-tenths of a percent of GDP. In the second five years it is 1 percent of GDP. So it's small relative to the size of the economy. It is small relative to the surpluses that are being projected by both the President and the CBO.

In the first five years the size of this tax cut ($156 billion) is only about 15 percent of the one trillion dollar surplus that is projected during that period.

In the second five years it's about a $600 billion tax cut and figures to be about 40 percent of the $1.5 trillion surpluses that are projected during the second five years. So the tax cut is small relative to the size of the surplus.

The tax cut is also small relative to the size of the national debt, and what is going to happen to the national debt—particularly net private debt. Exhibit 5 shows net privately held debt, which is the portion of the debt that the Federal Government really pays interest on. As the exhibit shows, net private debt is going to be paid down over the next ten years to the lowest level in the last 80 years. You would have to go all the way back to World War I in order to have a lower private debt. In the figure here, by the way, the projected figure for net private debt as a share of GDP assumes only the Social Security surplus (which is $1.9 trillion over this period) is used to pay off the debt and that we have a continuation of the Fed's holdings of bonds as they have been in the last five years. If there's no additional surplus, the net privately held debt will be paid down to less than 10 percent of GDP, its lowest level that it will have been since World War I.

Having argued that the tax cut is small and the debt is going to be paid down, the second point that I would like to make in relationship to the size of this tax cut, is that there is almost certainly an underestimate of the size of tax revenues that are going to come in and thus the size of these surpluses. There is an underestimate whether you look at either the CBO or the President's figures. The reason why it's a vast underestimate, not just a small underestimate, but a vast underestimate in the revenues that will be generated is because of the CBO's assumption of making its projections on the basis of a .94 tax revenue GDP elasticity. That is to say that if income increases by 10 percent, for example, the CBO says that the Federal Government's revenues are only going to increase by 9.4 percent. So, over the ten-year period, even though the CBO projects a 53 percent increase in revenue, they say tax revenues are only going to go up by 49 percent. We've got a progressive tax system. As incomes rise in real terms (sure, we've indexed for inflation, inflation will not do it) as they will do over this next ten years, the revenues derived by the Federal Government will increase more than proportionately.

As a result of the understatement of revenue, revenues in the first five years are $250 billion below what they would have been had the CBO anticipated or made their projections on the basis of a far more realistic income elasticity. In fact, 1.1 may even be on the low side, some would argue tax revenue elasticity would be as high as 1.3, in which case these projections for the next five years will be $500 billion on the low side.

And when you look at it over a ten-year period, given an elasticity of 1.1, revenues are understated by $950 billion.

If this is not bad enough, the CBO's growth estimate assumes a 2.5 percent, ten-year annual growth rate. Now, there are only four years out of the last 44 that we have had that low of real growth rate of GDP. The CBO is potentially taking an unrealistically low growth rate. If you low-balled it and took, by way of comparison, the last 15 years growth of real GDP in the United States has averaged 3.1 percent. If you look at the last 20 years or so, it has been still higher than the 2.5 percent period.

A more realistic growth assumption would be 2.8, or in the three point range, and with such, again there is an understatement of around $100 billion or more in the first five years, and around $300 billion or so on out into the next five years. So the revenue figures are understated.

Now, finally you might say, well, maybe we're undertaxed. Well, if you will look at Figure 9 in your packet, we look at tax revenues as a share of national income. We go all the way back in this figure to 1949, but you could go back prior to that into World War II, tax revenues as a share of national income are currently at an all-time high. There are only three periods that are at all close to that: during the Korean War, the other time was during the height of the Vietnam War, and most recently in the period just prior to the Reagan tax reduction in 1981. Those are the only three periods that are even close to that. Now, if you—even after you have the tax cut, and even with the very conservative assumptions that I am talking about, as a share of national income the tax revenues are going to be at or very near their all-time high during the next ten years.

Let me just pose this question to you; suppose that the—

Senator Mack. Jim, I am going to have to ask you to wrap this up, you are well over your time.

Dr. Gwartney. Oh, excuse me. I guess I was a Professor—

[Laughter.]

I will close with a question. Suppose the state of the economy was such that our growth rate—that our size of surpluses in the next five years were shaping up to be $200 billion under very conservative projections, and in the next five years $300 billion under very conservative projections, and that tax rates were at their all-time high, would you in fact vote under those kinds of circumstances for a roughly $800 billion increase in taxes? Most would not think that to be a prudent strategy, and I would not think it would be a prudent strategy. That is exactly what the conditions will be if the tax cut is in fact passed. So if we do not pass the tax cut, those figures will be much higher than otherwise would be the case.

Thank you.

[The prepared statement of Dr. Gwartney appears in the Submissions for the Record.]

Senator Mack. Thank you.

Mr. Greenstein.

STATEMENT OF MR. ROBERT GREENSTEIN, DIRECTOR, THE CENTER ON BUDGET AND POLICY PRIORITIES

Mr. Greenstein. Thank you, Mr. Chairman.

As I think you know, I hold a different view on this from other members of the panel.

I think there are three problems with the pending tax cut. Now, the first is that there is no non-Social Security surplus at the present time and it is unclear whether any significant one will materialize.

I think, as I will explain in a moment, a tax cut of the magnitude being discussed would be very likely to bring back substantial deficits in the non-Social Security budget, rather than resulting in paying down the debt.

Secondly I think it does pose problems in terms of resources for other high priority issues; Social Security and Medicare are two that Mr. Stark mentioned. And third, the tax cut is too heavily skewed towards the well-to-do.

Let me start by reviewing the budgetary situation. You said there was a three trillion dollar overpayment of taxes. But two trillion dollars of that is in Social Security and it isn't really an overpayment. It is collected because the baby boomers are in their peak earnings years and we are taking in more in Social Security taxes now than we are paying out in benefits. But every dollar of those Social Security so-called "additional payments" will be used for Social Security when the boomers retire, and, as you know, we are still short on Social Security.

So we then go to the non-Social Security side and that is where there is said to be a projected one trillion dollar surplus over the next ten years. That is the CBO figure.

As this chart shows, and I also have it in the charts in front of you, the CBO forecast assumes that Congress will comply with the discretionary caps and CBO assumes not only that the Congress will comply with the caps, but that there will be zero—zero—in emergency spending outside the caps through 2002, and for all years after 2002, Congress will simply stay with the 2002 cap adjusted for inflation.

The Congressional Budget Office has asked and answered the question: Of this trillion dollar surplus forecast, how much does that forecast assume that discretionary spending will be cut over the next ten

years below the fiscal year 99 non-emergency level adjusted for inflation only? And the answer is $595 billion. So if Congress can't do those kinds of cuts in discretionary spending, $595 comes back.

Now, if that $595 billion comes back, we also then get to the emergency area. Have we ever had a year where there was zero emergency spending? No. If we discard 1999 with extra emergency spending, we rule out Desert Storm in the early 1990s, we still have an average of eight billion dollars a year in emergency spending. So the question we asked was, suppose we simply take the 1999 level of discretionary spending adjusted for inflation and we limit the emergency spending, it's only 8 billion a year, the post non-Desert Storm, non- 99 average. What happens if you make those two assumptions? As the graph shows, between those costs and the interest payments on the debt associated with them, the surplus shrinks from a trillion dollars to $112 billion. There is no trillion dollars available for a tax cut.

Now, some people look at this and say to me, well, don't assume that there won't be any of these discretionary cuts made. We don't want to do big spending. But, Mr. Chairman, you're part of a Republican majority. If you look at the numbers that Congress is passing now, your party—and this is not a partisan statement—I agree Democrats would probably spend more. If you look at these amounts your party is passing in the appropriations bills moving through, they are on target to be above the 1999 level adjusted for inflation. My assumption may be conservative here.

There seems to be a misunderstanding. Some members think that if you designate something as an emergency, or if you direct CBO not to count outlays as outlays which has happened in two bills so far this year, that because they don't count against the caps, they don't count in figuring surpluses and deficits. But spending is spending, label it emergency or label it not, it counts in figuring out how much is left in the surplus.

The Congressional Budget Office reported last week, we're on target for a non-Social Security deficit again in fiscal year 2000.

The next chart that I have in the handouts, I don't have a board on this chart, what it shows you is that the Congressional budget resolution that made room for this $800 billion tax cut not only assumes the $595 billion over the next ten years in discretionary cuts below the 1999 level adjusted for inflation, but assumes another $180 billion in discretionary reductions on top of that. All of these are CBO numbers, not mine, CBO numbers. The CBO says the budget resolution assumes $775 billion in discretionary reductions over the next ten years.

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Now, I'm not here to debate the merits or demerits of various levels of spending. The point I am simply trying to make is that the forecast of a non-Social Security surplus on which this tax cut is based is not realistic. It is based on assumptions of large cuts that Congress is very unlikely to make. Since Congress is unlikely to make those cuts, that means two things. Number one, it puts us on track towards deficits in the non-Social Security budget, and eventually when the Social Security surplus disappears, when the boomers retire, towards deficits in the unified budget which also means less debt repayment.

Secondly, since the tax cut would consume more than 100 percent of the non-Social Security surplus when you take into account reasonable assumptions for discretionary spending, that means zero money will be allowed to transfer to either Medicare or Social Security to help shore up those programs. I'm in favor of some cost reforms in both Social Security and Medicare, but I know of no one on Capitol Hill—or almost no one—who favors changes in Medicare and Social Security which would truly restore solvency without any benefit cuts or payroll tax increases. And if we make no transfers at all from the non-Social Security budget into Social Security or into Medicare, the level of benefit cuts or payroll tax increases that would be required to restore long-term solvency exceed what either party is willing to pass.

The final point I would make is that in thinking about priorities, if surpluses eventually materialize or the economy goes down and we do want to consider tax cuts, I think they ought to be more equitably distributed than in this particular bill which gives 79 percent, according to the Treasury, 79 percent of the tax cuts to the top fifth and only 7.5 percent of the tax cuts to the bottom 60 percent of the population.

The CBO data which we released an analysis on about two weeks ago shows that the gap between the very wealthy and the middle class as well as the poor is wider now than at any time in recent memory, but the richest 1 percent of the population—about 2.7 million people— now has as much income as the bottom 100 million Americans. Given that, my top choice for a national priority would not be do a very large tax cut, which as of now it appears that we can't afford, and certainly don't give a large majority of benefits to the one group in the country that has done the best in the last 20 years and is pulling away from everybody else.

Thank you.

[Informational materials submitted by Mr. Greenstein appear in the Submissions for the Record.]

Senator Mack. Thank you.

Mr. Angell.

STATEMENT OF WAYNE ANGELL, CHIEF ECONOMIST AND MANAGING DIRECTOR, BEAR STEARNS AND COMPANY AND FORMER MEMBER OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Angell. Mr. Chairman and Mr. Stark, I would like to address specifically Mr. Stark's question of how the tax cut improves Social Security and Medicare, I am suggesting that the tax cut is essential to maintain the growth of the economy at the 3.9 percent real growth we have experienced over the last three and a half years, and there is nothing we can do better for Social Security and Medicare than have an economy with a real growth rate just shy of four percent.

We have one major imbalance in the U.S. economy that threatens our future. Up to now the Federal Reserve has been able to concentrate its monetary policy on domestic price stability considerations. But the risk that we have is that this high-tech capital spending economy generates fast growth in the demand for capital goods. Non-residential capital that was 8.8 percent of the GDP at the beginning of this expansion last quarter came in at 13.3 percent of GDP in 1999. Gross private domestic investment, valued in current dollars, is 16 percent of GDP and there is where the problem arises.

Savings—national savings rates including the Social Security fund surpluses, have fallen from 15.8 percent of GDP in 1985 to 13.3 percent of GDP today. Over the last several years savings is growing at the same rate as dollar GDP, about 5 percent per annum.

But gross private domestic investment in current dollar terms is growing at about a 9 percent annual rate. This flow of spending on capital goods above our national savings rate makes this country dependent upon the willingness of foreign central banks and foreign investors to hold dollars; at the current time our net obligations to foreigners is about $1.5 trillion. Under the best assumption over the next ten years our net external obligation is likely to grow to $4.3 trillion.

Our current net external debt is 17 percent of GDP. Even with a 5 percent nominal growth in GDP, that 4.3 trillion will rise to 30 percent of GDP.

Now, all of you know that I consider monetary policy to be a very important and underlying factor in our prosperity. I do not want the Federal Reserve to have to be under the cloud of having to have interest rates high enough to offset any imagined weakness in the dollar due to our continued unwillingness to save enough money.

Now, saving is an economic activity. People act in their best interest. We are going to have the after-tax rate of return on savings go higher one way or the other.

So the question is, do we want to imagine a future over the next ten years in which interest rates have to move higher in order to get the rest of the world to supply this under-saving as compared to our capital investments and don't we all understand that the growth rate and level of labor productivity is dependent upon the growth rate of capital. It is capital that increases labor productivity and thus provides the basis for increasing real wages.

So I am suggesting that this country has an unacceptable risk of not making alterations in the tax structure that will increase the savings rate.

Many of you know that I support the National Retail Sales Tax advocated by the Americans for Fair Taxation. I do that because I know it will alter our savings rate, and at the same time, increase our exports versus our imports. I am suggesting to you that I am not an individual that gives to crying the blues very easily. Among economists I have had the most optimistic forecast of economic growth and the most optimistic forecast on the equity market. But I am here to suggest to you that we are at risk if we do not alter the high tax rates that penalize savings, and we can go into the detail as the Committee sees fit.

Thank you.

[The prepared statement of Mr. Angell appears in the Submissions for the Record.]

Senator Mack. I thank you, Mr. Angell.

Dr. Gwartney, let me first raise a question with you. A recent study by the OECD found that most major countries substantially cut their tax rates between the mid-1980s and the late 1990s. For the 25 OECD countries, the average top individual tax rate fell by 12 percent and the average corporate income tax rate fell 10 percent. After cutting taxes in the 1980s the United States reversed course and raised its tax rates again in 1993. What do other countries know that apparently we don't? Should we cut rates again in order to retain our leadership position?

Dr. Gwartney. Well, let me respond to what the other countries know that we don't. I think the answer to that question is that some of the other countries have learned a lesson from the school of hard knocks. The lesson that they are beginning to learn is that high taxes and big government (large government expenditures as a share of GDP) is hard on economic growth. This debate is not about taxes, it is about spending.

On the one hand you have individuals who want more growth, and on the other hand you want individuals who want more spending. And that spending retards growth.

The study of the OECD countries and a short analysis of it is in my prepared remarks for the record, but my work in this area indicates that for every 10 percent increase in government expenditures as a share of GDP that economic growth is retarded by 1 percent.

So, as Dr. Angell referred to here, the key thing is, if you want to improve Social Security, if you want to improve the economic climate for Medicare (and those are things we all want) what you need to do is have more economic growth. And the way that you do that is control spending.

Senator Mack. I want to go back, Wayne, to your comments with respect to savings. I remember the debates through the 1980s and the 1990s that we heard from economists that if we could ever get to a situation where we eliminated Federal budget deficits that it would be a panacea with respect to savings.

Now we find ourselves in a situation where the Federal Government budget is in surplus, and likely will be in the future, and yet we now find out that the savings rate has declined. Why is that?

Mr. Angell. Yes. I call it the fallacy of the twin deficits. There was never such a thing as twin deficits. Each one stood on its own basis. Our new era economy generates huge appetites for capital goods. And there is only one way that we can be free from dependence upon foreign preference, and that is to save the money ourselves.

We, as a nation, we don't talk and advocate high savings. We ought to do that.

I talked to an individual representing a labor union. He says, laborers can't save money; and, yet the people of China with low, low incomes have a savings rate in the 25 to 40 percent range. So they save. People around the world save because they believe that their well-being is connected with saving.

Now, the problem is that as our external debt rises, there will be a shortage of Treasury debt to satisfy Federal Reserve and other central bank needs. We are not going to have enough Treasury debt even if we balanced the general government budget, to have a 1.9 trillion hogging of the non-publicly held debt by the Social Security trust fund, which is half of what we now have. So publicly held debt is now down to 41 percent of GDP, down from 50 percent a few years ago. If we balance the general government and 1.9 trillion surplus in Social Security over ten years we are not going to have enough government debt for the Federal Reserve and central banks to do their monetary function.

So I think we have not only misplaced this notion about a twin deficit, but we have really gone off the deep end in thinking that the optimum debt ratio for our Federal Government some deficits is zero. And I find that really absurd. These are two different issues; our reliance upon foreign savers is dependent upon our altering the tax conditions surrounding savings.

Senator Mack. Congressman Stark.

Representative Stark. Thank you, Mr. Chairman. And I want to thank the panel. I guess just some comments. Mr. Angell, if you would dedicate that Federal sales tax and make it somewhat progressive and dedicate it to health care, I will introduce the bill and sponsor it for you. I think that may very well be what we will have to come to just as a political reality, and to have a distinguished economist like you suggest that it may not destroy the economy, makes me want to go back and look at it again. Because I think perhaps we could get more bipartisan support for raising the funds than would be necessary for universal health care coverage. And I'm intrigued with the idea.

Jim, the only problem with the idea of growing economy is that it hasn't worked. Over the last ten years basically employers have dropped about three or four percentage points in the number of workers they cover with health insurance. Maybe because of the higher costs, but the growing economy has not helped them, and the uninsured has grown from 40 to 45 million. So as this economy has expanded, it has not brought any more health insurance with it. Which leads me to turn to Dr. Greenstein's issue. I believe that it is the cap system, to a large extent, which is responsible for the huge income gap. And my question would be, would a huge tax cut redistribute income—at least from my standpoint—the wrong way? It would be making that very small group of very wealthy people far more wealthy and either hammering down the lowest 20 percent or more, making their incomes flat or reduced and thereby exacerbating this discrepancy. Would you comment on that? You alluded to it a little earlier.

I was talking to Mr. Greenstein.

Mr. Greenstein. First let me say the report is on the widening of the income gap. Most of the widening of the income gap stems from trends in the national and international economy rather than national policy, but the point we did make in the paper was that when that occurs, at a minimum, government policy shouldn't exacerbate the trend.

In the case of tax policy, if you look at the effective tax rate on the richest 1 percent in the country—the people who now have income equal to the bottom 38 percent or lowest-income 100 million in the country—

you find that they have effectively a gotten tax cut averaging about $41,000 a year compared to what they would be paying if effective tax rates on people at the top were the same today as in 1977. Those changes in tax policy took an income gap that was widening primarily because of trends in the private economy and widened it further.

Now, a tax cut could either widen that gap further or narrow it a bit depending on the contours of the tax cut. This particular tax cut is disproportionately geared towards the top. Even if you talk about percentage of tax paid, the top fifth of the population pays 59 percent of Federal taxes and would get 79 percent of this tax cut. I don't think that's the best measure, but even if you use that measure, this tax cut definitely would widen disparities.

One last point on this thought is, I noted the only way you can afford this tax cut is if you do large cuts in discretionary programs. Discretionary programs tend to provide services and benefits primarily for middle income and lower income families. So if you cut their benefits and services to give a tax cut highly disproportionately to people at the top, I don't think there's much question but that you widen disparities further.

The counter-argument might be, you boost the economy and everybody benefits. I would challenge that. I think if you pour more money—whether through a tax cut or big new spending— into an economy as hot as the current one is, you make it more likely the FED will raise interest rates and that does not benefit anybody.

Representative Stark. Well, that brings me to my next question for the rest of the panel. I guess I would start with Dr. Angell and ask the others, you were a colleague of Chairman Greenspan's and he has said time, and time, and time again that we should be paying down the national debt before enacting any large tax cuts. Don't beat up on me, I know that most of you don't agree with that. What's wrong with his routine, or why do you differ from the Chairman?

Mr. Angell. Mr. Stark, I am not going to find fault in Alan Greenspan's reasoning. Alan Greenspan said, the worst of all of the possible cases is to maintain tax rates and for the Congress to spend it. So Alan Greenspan does not disagree with the position that Dr. Gwartney has laid out here. The worst of all the cases is to maintain our tax rates and have the government spend it because then we will have no savings benefit.

Representative Stark. So what you are really saying is—

Mr. Angell. Alan Greenspan knows—

Representative Stark. —we need to protect ourselves from ourselves?

Mr. Angell. Yes. Alan Greenspan knows, as I know, that if tax rates are lowered, and tax rates on high income individuals being lowered is the most efficient way to increase the savings. You can't increase national savings by lowering the tax rates on individuals that don't have any propensity to save. So he knows that lowering tax rates will provide more national savings.

So, Mr. Stark, I was six and a half years next to Alan Greenspan in the office and what we agree upon is sort of 99.7 percent of the time and I'll allow three-tenths of a percent for disagreement.

Representative Stark. Are tax rates lower now than they were in 1981?

Mr. Angell. Tax rates are lower than they were in 1981 because the folks—

Representative Stark. And personal savings rates have just fallen out of bed. In other words, every year since 1981 personal savings rates have gone down regardless of tax rates or the growth of the economy. I have heard -- maybe it was Modigliani or somebody like that say that tax rates don't have any effect on personal savings. How do you comment on that?

Mr. Angell. But, Mr. Stark, we really know, don't we, all of us know intuitively that if we tax the income from savings we will get this—all of us know intuitively that if we shifted to a consumption tax that's progressive as you and I both want, if you shift to such a tax system, we know that savings will rise dramatically and interest rates will thereby fall. It is in the interest of the working man and woman to have lots of capital that increases labor productivity. We as a nation have to have the savings to keep this marvelous economy going and I am just not willing to risk all that we have achieved—

Representative Stark. I asked—it just hasn't worked. Dr. Gwartney, go ahead.

Dr. Gwartney. Yes, let me speak to the issue about whether or not we need to protect ourselves from ourselves.

Representative Stark No, just the Congress. Not you; you're doing fine.

[Laughter.]

Dr. Gwartney. Well, let me just say this, the next ten years are going to be a valley of temptation from the standpoint of Congress. And the reason why that is true is because of demographics. During next ten years there are going to be very substantial revenues coming in and very substantial growth in income. The reason why is because we are going to

have such a large percentage of our population between the ages of 40 and 60, and those are the prime earning years.

The major reason, at least a major contributing factor about why we have gone from having relatively low growth of revenues and budget deficits to having budget surpluses is because of this vast increase of individuals in their prime earning years. In the next ten years those revenues are going to be very high. What is likely to happen is the Congress is going to choose to spend about the same proportion of them that they have in the past and come the year 2009 or 2010 the government expenditures as a share of GDP will be about the same that they are now. If that happens, then as Mr. Greenstein referred to, when the baby boomers move into their retirement phase, the share of population 65 and older will rise from 12 percent of the total population to 18 percent of the total population. This is going to drive the expenditures targeted toward the elderly as a share of GDP up by 6 to 8 percentage points. That means then that total government expenditures, rather than being 33 percent of GDP as they currently are, are going to rise to 40 percent of GDP in the United States. No country has been able to maintain that and sustain 2.5 percent growth or better over an extended period of time. We will be Euro-ized. What I mean by that is, we will have the same size of government as the European countries, and as a result we'll have the same growth rates as the European countries—that is, 1 to 1.5 percent. That's what I want to avoid.

Mr. Greenstein. I want to avoid that too. And one of the ways I want to avoid it is by reducing as much as possible and nearly eliminating the part of government spending, now $230 billion a year, that is interest payments on the national debt. For that reason, and because we don't even know if surpluses outside of Social Security are going to materialize to any degree, this is not the time to do a big new tax cut like this, and, frankly, it wouldn't be the time to do its equivalent in new spending either.

In addition to that, cutting down more debt is the virtue of being the best way to promote—

Representative Stark. It's just that Chairman Mack is leaving and he is not going to leave town and retire with me having the purse here, and he wants to cut the taxes before he goes home so I don't have the money to spend. He is not going to leave anything to chance.

Mr. Greenstein. Could I say one more thing? People can come down on different sides of the debate, and the debate right now will be different a few years from now, but the debate right now isn't tax cuts versus big new spending. It's really tax cuts versus existing spending. And I happen to think it would be a mistake to do overly large cuts in

education and certain areas. I think Congress will increase defense spending on a bipartisan basis more than I particularly would recommend. But the point I'm simply making is neither party in Congress is going to vote for the kinds of reductions in existing spending that you would need to make room for the tax cut.

I also think that if we are unable to transfer any money from the non-Social Security surplus to Medicare or Social Security, then the choices in Medicare and Social Security will be so stark that Congress —both parties—will avoid them and let more years go by. If you look at—I don't happen to be in agreement with Chairman Archer's Social Security proposal, it's an interesting proposal, it's worthy of study, I would go a different route, but his proposal—which is a partial privatization proposal—entails taking large amounts of the non-Social Security surplus and transferring them into the retirement system to help with the transition costs to a privatized system. If you use it all up in a tax cut, you don't have money for transition costs for privatization.

So these are the kinds of issues—I agree with Mr. Gwartney that in the long run we have to deal with Social Security and Medicare, I actually think we need some lubrication money now in order to do the plan to get to those reforms and we are not going to do the kinds of cuts in discretionary that the budget resolution assumes.

Senator Mack. I think Jim Miller wanted to respond to your question.

Dr. Miller. I want—

Senator Mack. But before you do that, let me just say, I am more concerned than you are, Mr. Greenstein. I would hope the debate was just a question about present spending programs versus tax cuts, but the President has already proposed, I think, something like $1.3—1.4 trillion in new spending programs. Every day we hear him speak around the country he is telling one group after the other what additional Federal spending he is going to provide for them. So I think it's much more serious than just the debate between those two points.

Jim.

Dr. Miller. Yes. I wanted to respond to Congressman Stark. We ought to keep things in perspective about the tax fairness issue and redistributional issues. A Steve Moore piece in the August 6th Washington Times points out that the top 1 percent of income earners earn 17 percent of national income but they pay 32 percent of income taxes. The top 5 percent earn 31 percent but pay 51 percent of the taxes. So it is a very progressive income tax rate that we have.

Your own Joint Committee on Taxation did this table on distributional effects of the conference agreement which indicates there is actually very little change in tax rates. It is true that the tax rate reductions affect the upper levels, but they are not very significant.

On Mr. Greenstein's presentation, it seems to me his major argument is that there are all these dramatic cuts in discretionary spending that would have to take place in order for the money to be there to have a tax cut.

Now, let me ask a question. Do you think Congress will be more inclined to make those cuts if you plan a tax cut or if you don't? My argument is that Congress would be far less likely to restrain spending if it had the money coming in no plans to put a tax cut into effect.

Secondly, let's bear in mind that we're talking about current services spending. Most people beyond the beltway understand a cut in spending to mean that you spend less in nominal terms next year than you spent this year. That's not what Mr. Greenstein is talking about. He's talking about current service budgeting.

Finally, I haven't read Mr. Greenstein's analysis, but if I heard you correctly I would bet you, Bob, that if you freeze spending for 2000 and 2001 and then meet the budget caps and contrast that with adjusting for inflation after 2000 you won't get anything like $5 billion, you'll only get about 40 percent of that, 50 percent of that.

Mr. Greenstein. May I respond?

Senator Mack. Yes, after I make a comment.

Mr. Greenstein. Thank you.

Senator Mack. Because that's exactly one of the points that I was going to make. It appears that the $969 billion on-budget surplus number assumes discretionary spending increases for inflationary year after 2002. It appears that there is double counting going on and there's about $420 billion in that green pie slice. So I just don't accept your numbers.

Mr. Greenstein. My numbers are not mine, they are the Congressional Budget Office's. I would be happy to provide you their official tables. There is not a dime of double counting in there. Again the $595 billion is CBO's number. CBO says that its forecast of the trillion dollar surplus rests on an assumption that entails $595 billion less in discretionary spending than the 1999 level adjusted for inflation. No double counting, not my numbers, these are Dan Crippen's numbers.

Now, let me continue.

Dr. Miller. Can you give us a cite?

Mr. Greenstein. I would be happy to give you five cites. I don't happen to have them with me. Or, Jim, if you call Dan on the phone, he will tell you these are right.

There was some testimony, I'll give you a cite, there is testimony that Dan Crippen submitted for the record in July to the Senate Budget Committee, if you look at the tables in the back and you simply subtract the baseline number that is the $996 billion surplus from what happens if discretionary stays even with inflation the $595 billion is there.

In that testimony, in the text, Dan Crippen also said that if discretionary spending simply grew at the nominal rate of 3 percent per year a little bit, but not much faster than the inflation rate, that the entire non-Social Security surplus for the next ten years would disappear. These are Dan Crippen's statements.

Dr. Miller. Well, you could make it 5 percent and have a big deficit. I mean—

Mr. Greenstein. The point that I am making is that Congress isn't going to do that. Just add up the numbers in the appropriations bills that your party is passing. Again, I'm not trying to make a partisan statement—I am just trying to make a factual statement about what is in these bills. There is extra for defense, there is extra for veterans' health care, above last year plus inflation. There is extra for NIH research, additional funding was agreed to last year in the highway bill. When you add these up plus what is very likely to happen in the Labor-HHS bill, this Congress is on track to be spending more than I'm assuming. When Bob Reischauer, who I think is one of the straightest shooters on numbers in town, looked at my analysis, he called me up and he said, "Greenstein, the problem with your analysis is you assume discretionary will only keep even with inflation and there's too much pent up demand and it's going to go up faster than that."

Senator Mack. Jim.

Dr. Miller. Could I make the point, and Bob surely will agree with this, that even though Congress—and I'm not trying to defend Congress's appropriating more than the caps—busts the caps, under current law there would be a sequester.

Mr. Greenstein. Not true.

Dr. Miller. So the spending level will not exceed the caps.

Mr. Greenstein. Not true, because what I—

Senator Mack. Okay. We've carried this discussion, as far as I'm concerned, far enough. I've got a couple of other points I want to make.

The first thing is this issue of whether the tax cuts should go to people who make lots of money. It's a very simple thing. The reason tax

cuts have this result is because taxpayers with high incomes make most of the tax payments. There has been a general acceptance of the idea, and I'm not sure I embrace it, of the progressive Tax Code—that is, if you make more money, you pay the government a greater percentage of your income in taxes. I don't embrace the idea, and clearly reject the notion of a so-called progressive tax cut. That is, that you have to give up more of the tax cut because you make more money. It's just fundamentally unfair and fundamentally wrong.

Are there other points you wanted to pursue? If not, I have a couple of others.

Representative Stark No, I don't, go ahead.

Senator Mack. This goes back now to the economic aspect of this issue. The Keynesian economists have lectured for decades that large budget surpluses could act as a fiscal drag on the economy. Now that the CBO is projecting a unified budget surplus in the neighborhood of three trillion dollars over the next ten years, why aren't the Keynesians warning us of a risk to the economy? Does anybody want to approach that?

Mr. Angell. Because they're—

Senator Mack. Maybe I've misstated it.

Mr. Angell. —because their model is wrong, wrong, wrong, and it doesn't work.

[Laughter.]

Mr. Greenstein. I think there is a disagreement among Keynesians and there are some who have raised concerns about that. A former staff director of this Committee, Jim Galbraith, Professor of Economics, University of Texas, I think has raised some concerns in articles he's written about overly-contractionary fiscal policy. It's not the point of view I have.

I think the point of view a number of people have, and I don't know what we all term ourselves these days, partial Kenseyians, pure Kenseyians, whatever, is that it will be very important to stimulate the economy when the economy is weak. I don't think given how strong the economy is now with a 4.2 percent unemployment rate the FED is concerned enough that it has raised interest rates twice in the last, what, ten weeks or so. I think the view is clearly the kind of surpluses we have now are not a drag on the economy. Our big problem now is not that the economy is sluggish, but a point of view I share with most on the panel, that the savings rate is too low. And one of the things that helps increase the savings rate is national saving through budget surpluses.

So I think a number of people, who years ago in periods when the economy was sluggish and wasn't growing that fast, unemployment which

seemed stuck, remember, we had seven straight years from 1980 through 1986 where the average unemployment was rate was about, what, 7 percent a year for seven straight years. We are in a different era now. Given the marvelous performance of the economy, that was clear instances of the—

Senator Mack. I want to pick up on that point and then I'll turn to you, Wayne.

Clearly we're in a different economy. Nobody knows exactly how this is all going to play out over a period of time, but we're hearing that kind of a statement from everyone who has been pursuing economics either as a profession or as an interest. People have recognized that there is something that's changed in our economy. I'm going to get back to Dr. Gwartney for a minute after Wayne, but I think that's the point he's making with respect to what we're seeing as far as Federal Government revenue growth. The CBO and the OMB have been underestimating revenues to the Federal Government for quite some time now.

Wayne.

Mr. Angell. Yes. There have been statements made that suggest that taking the national debt to zero eliminated interest payments and I believe that is incorrect reasoning. Our economy is a credit-based economy. We do not want to contract credit by thereby having private debt not grow as government debt shrinks. So our nation will see if credit is to expand, which is essential for economic growth, our nation will see a big shift to private borrowing. And so private borrowing will take place at much higher interest rates. Foreigners who are lending us their money buying Treasury Bills today at 5 percent are going to end up lending their money buying corporates at 7 percent. So we cannot operate under the assumption that somehow or other interest payers have a reduced burden.

The fact of the matter is that the interest burden will rise, not fall.

Senator Mack. Dr. Gwartney.

Dr. Gwartney. Well, as I was just sort of reflecting on our discussion here, including the exchange between Congressman Stark and Senator Mack. It seems to me the difference is whether or not there are going to be surpluses off out into the future and whether or not it would be more likely or less likely to have surpluses if in fact we cut taxes. But let me remind you that the President has essentially proposed over a trillion dollars additional increases in expenditures. The Republicans have proposed a $792 billion reduction in taxes and that essentially works out as about a wash.

One of the things I've learned rapidly in the couple of months that I've been here is that 10, 15, 20 billion dollars doesn't mean much up here,

it's an adjustment for me to think like that. But what my position is, is that these revenue figures are grossly understated and that we are going to see very large budget surpluses in the future, both in the Social Security system as well as in the on-budget side of the budget. And I would like to propose a compromise position here, if we want to pay down the debt, whether or not these funds belong to the taxpayers and should be returned, why doesn't Congress pass legislation that essentially says that all of the on-budget surpluses that occur will be rebated back to the taxpayer in proportion to the amount of funds that they paid in taxes. If we overcharged them, let's rebate these funds back to them. If the surpluses do not occur, there will be no reduction in taxes; but if they do occur, and if they occur at a very sizeable level, these funds will go back to the American taxpayer where they belong.

And on the Social Security side, my own view is, I think much the same thing should take place. Rather than allow that $1.9 trillion to accumulate, I think, again, we could come up with a rather creative plan, allocate that $1.9 trillion into, or at least largely into private savings, personal savings accounts with which individuals would be saving for their own retirement. Rather than have the government manage those funds, we would again have individuals managing the funds and have a more secure future than otherwise should be the case.

So wouldn't that be a compromise position? If in fact these surpluses materialize as I'm saying that they will materialize, let's rebate the funds back to the taxpayer who paid in the first place.

Senator Mack. On that compromised spirit, the hearing is adjourned.

[Laughter.]

[Whereupon, at 11:20 a.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

There has been a lot of loose talk in the past few months concerning this Congress's tax relief package, with adjectives like "reckless" and "risky" being tossed about by opponents of tax relief. I am confident that the distinguished panel we have assembled can substitute some light for the heat that has been generated in this debate.

One thing that has gone unnoticed in the budget debate is that both ends of Pennsylvania Avenue agree on the size of the surpluses over the next decade. The nonpartisan Congressional Budget Office, and the President's Office of Management and Budget, this summer released surplus calculations that are only $20 billion apart. When the budget baselines are adjusted to freeze discretionary spending at the 2002 caps, these surpluses total roughly $3.4 trillion over the next ten years.

So, all parties agree that the Federal Government will be overcharging the taxpayers by $3.4 trillion. The only real debate concerns what the government should do with these overpayments. This summer, the Congress passed a tax bill that would provide $792 billion in tax relief for the American people. This is less than 25% of the tax overpayments, a relatively modest portion. But despite the modest size of this tax cut, the President and his supporters have criticized the tax relief as "too big," and have argued that the government cannot part with that much money.

But if you stop to think about it, every single argument being made against the tax cut is just plain wrong.

Some argue, from a Keynesian demand-side perspective, that tax cuts will overstimulate the economy. But even after a $792 billion tax cut, the Federal Government will run up over $2 trillion in surpluses over the next ten years — from a Keynesian viewpoint, $2 trillion in surpluses is not considered a stimulus, it is considered a drag on the economy. And with all of the lags, the delays, and the phase-ins, the bulk of the tax cuts will not arrive until years 2007, 2008, and 2009.

Can anyone seriously think that, in a $9 trillion economy, a $5.3 billion net tax cut for fiscal year 2000 will overstimulate consumer demand? This is just six hundredths of one percent of GDP. The net tax cut for fiscal 2001 is barely noticeable — just $1.1 billion. How can that possibly overheat the economy? Clearly, the facts do not support the argument that our tax relief will overheat the economy. In any event, from the demand-side perspective, the tax cut should be irrelevant. If we do not cut taxes by $792 billion, it is safe to say that spending will

increase by $792 billion over the next decade — spending by the government, that is. That is what President Clinton means when he says we cannot afford a tax cut — his bureaucrats are working overtime to dream up new ways to spend the money. Indeed, including his Medicare proposal, the President has proposed an increase in spending of $1.3 trillion over the next decade — all but $54 billion of the on-budget surpluses, according to the CBO.

Furthermore, a tax cut that removes government barriers to savings and investment is not an "artificial stimulus" that the Federal Reserve Board would seek to offset with tighter money. Inflation, after all, is caused by too many dollars chasing too few goods, not by too many investors creating wealth and opportunity. An even stronger economy, fueled by the freedom and enthusiasm of our entrepreneurs, is not something to fear.

The argument is also raised that a $792 billion tax cut leaves no money to meet some other important government goals. But we still have about $2 trillion in social security surpluses that will be in a "lock-box" to retire debt and shore up our citizens' retirement security, and another $505 billion in non-social security surpluses that can be used for Medicare, national defense, and our other priorities. There appear to be no good economic arguments against the tax relief package. The opposition to tax relief is based not on economics, but on philosophy. This all boils down to one basic, fundamental question: who has the first claim on the income of Americans — does it belong to the government or to the individual families who create the income through the sweat of their brows and the genius of their intellect?

The current Administration acts like the money belongs to the government. It rejects our tax relief bill as "too big," as is taxpayers earn income at the sufferance of the government. Under this view, Uncle Sam does not live under a budget, he sets the budget for every American family, which must be content with the table scraps after the enormous appetite for spending in D.C. has been satiated.

This President and his supporters just don't get it. The tax burden on our citizens is at an all-time, peacetime high — 20.6% of the economy. At the same time, we will be overcharging the taxpayers by more than $3 trillion. A nation that trusted its people, that protected their liberty, would not flinch from the right thing to do: cut taxes so that our families can enjoy the fruits of their labor, instead of the greedy Federal Government.

We cannot forget that tax cuts are not about numbers, they are about people. The true measure of the merit of tax relief is the gain in freedom and the enhancement of opportunity for our people. There can

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be no denying that the American people would be helped tremendously by the tax relief that we have passed.

Consider some of the ways in which our tax relief bill would make a difference in the lives of Americans. We make health and long-term insurance fully deductible, and allow a dependent deduction for elderly family members. Education is more affordable through enhanced savings vehicles — savings accounts and pre-paid tuition plans. Tax rates are lowered across-the-board. We eliminate the marriage penalty for taxpayers in the lowest bracket and repeal the Alternative Minimum Tax for individuals. According to analysis by the Heritage Foundation, once the tax relief is fully phased-in, a blue-collar family of four earning in the low $50,000s would save $381 on their tax bill, and a typical unmarried teacher earning under $40,000 would see her tax bill shrink by $782. These are not trivial amounts. We cut taxes because of the 67-year old owner of a family business in Florida's panhandle, who is discouraged from reinvesting his hard-earned profits because the specter of the death tax is hovering, waiting to swoop down and scoop up 55% of the increased value of his business. We cut taxes because of the two-earner family, struggling to make ends meet, that has to pay over $1000 extra in taxes just because they are married.

We cut taxes so that waitresses, truck drivers, teachers and carpenters can put an extra $1000 in their IRAs each year, to build a better nest egg for retirement. We cut taxes to enable a biomedical company to budget that one additional research project that just might lead to a breakthrough in the treatment of glaucoma or a cure for cancer. And we cut taxes to reduce government barriers to saving and investment, so the capital is available for the American entrepreneurs of the 21st Century to develop markets in technologies we cannot even imagine today.

High taxes are an infringement on the liberty of our families, who should not be struggling to make ends meet while their Federal servants hoard the wealth our families have created. When the question comes down to whether we trust the Federal Government or the family to use money wisely, I choose the family every time.

PREPARED STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

I would like to thank the Chairman for calling this hearing this morning and I would like to welcome all of the witnesses to the Committee.

The US economy is at an important crossroad.

For the past seven years, we have watched as the Federal Government moved from deficits "for as far as the eye can see" into surplus. We may disagree on which administration was responsible for the build-up in the deficit and the elimination of the deficit. But o one thing we should agree — it was hard-working Americans and their families who made the sacrifices which were necessary to bring the budget into surplus.

At the same time the budget moved into surplus, the US economy was experiencing its longest peace-time expansion. The economy's performance under the Clinton Administration is so remarkable it deserves being repeated.

- The unemployment rate fell from 7.5 percent in 1992 to an historic low of 4.2 percent last month. In fact, the unemployment rate has been below 5 percent for more than 2 years.
- Despite all the doomsday warnings, the drop in the unemployment rate has not been accompanied by any significant increase in inflation. On the contrary, inflation as measured by changes in the Consumer Price Index, has been growing at an annual rate of a little more than 2 percent this year. Inflation has averaged 2.4 percent since President Clinton took office in 1992.
- Most importantly, after 20 years of declines and stagnation, American workers are once again enjoying improvements in their standards of living. In 1979, real average wages for private nonagricultural workers were approximately $290.00 per week. By 1992-93, average weekly earnings fell to their lowest level — approximately $255.00. A 12 percent drop over 14 years. Only recently have real average weekly earnings begun to recover, increasing by 6 percent over the last 6 years to $270.00. Good economic performance has helped raise living standards for many, but average workers' wages are still not back to where they were 20 years ago. Real average weekly wages are still $20.00 below their 1979 level.

Overall, the economy is performing very well for many Americans, but we are not out of the woods yet when it comes to the average working family.

With this sound economy as a backdrop, we need to begin addressing some of the hard economic choices before us. Projected surpluses make this job a little easier.

I believe three principles should guide us as we confront these choices.

First and foremost, we must secure our long-term obligations to the most vulnerable people in our society — the elderly, the sick and the poor. Our first priority must be to make Social Security and Medicare financially sound and prepared to meet the needs of their beneficiaries.

Second, we need to focus on ways to share more of the benefits of the current economic expansion with more people. For example, as I have already mentioned above, average working people have benefitted somewhat from the current expansion. Yet, at $5.15, the minimum wage remains 22 percent below its inflation-adjusted level in 1979. In other words, minimum wage workers will earn $3,000 less this year than they would have earned 20 years ago. I don't think any of the tax cut proposals being discussed would give enough relief to the low income workers to offset this kind of real earnings loss. If you really want to help US workers, let's raise the minimum wage.

Third, what policies are most likely to insure the long-term health of the economy? And here, the policy choices are clear. Is now the time for a large tax cut, or should we begin paying down the large debt which the government has been accumulating over the last several decades? I applaud my colleagues on te other side of the aisle for their willingness to take this question to the American people. Over the last month the American people have had a chance to consider both options, and they have spoken loud and clear. The American people believe we should postpone any major tax cuts now, in order to follow the more fiscally prudent step of paying down the national debt. This view is supported by no other than Federal Reserve Chairman Greenspan and by dozens of reputable economists, including several Nobel Laureates, who have signed a letter which I would like to have entered into the record.

So I would ask the 4 distinguished witnesses before us today to address these 3 questions in their remarks:

1. How does the current tax proposal improve the long-term security of Social Security and Medicare?
2. Does the current tax proposal extend the benefits of the robust economy to more people? And

3. How does the current tax proposal improve the long-term health of the US economy?

I look forward to your comments and the ensuing discussion. Thank you.

FORTNEY PETE STARK (CA)
RANKING MEMBER

JEFF BINGAMAN (NM)
PAUL S. SARBANES (MD)
EDWARD M. KENNEDY (MA)
CHARLES S. ROBB (VA)
CAROLYN B. MALONEY (NY)
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Congress of the United States

JOINT ECONOMIC COMMITTEE — MINORITY

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HOWARD ROSEN
STAFF DIRECTOR

August 2, 1999

Dear Colleague:

As we debate an $800 billion tax cut, I would like to bring this very important letter (printed on the opposite side) to your attention. Fifty leading economists, including six Nobel laureates have joined together to denounce any large tax cuts at the current time.

This distinguished group claims that a massive tax cut would not be good economic policy. They argue that a large tax cut would **"drain government resources just when the aging population starts to put substantial stress on Social Security and Medicare."** Their letter goes on to suggest that a large tax cut at this time would stimulate more consumption, thereby causing the economy to overheat.

In sum, these economists agree that a large tax cut is the wrong policy at the wrong time.

On the other hand, this group of noted economists state that the Administration's proposal sets the correct road to take. Under the President's plan, we would begin paying down the national debt, enabling interest rates to fall, and freeing up more capital for productive investment. This in turn will allow us to extend the recent increases in wages and incomes that we have been experiencing.

Sincerely,

Pete Stark
Ranking Member

Letter from Fifty Economists

The federal budget is projected to show substantial surpluses over the next 15 years. These surpluses offer an exceptional opportunity to pay down government debt and thereby strengthen Social Security and Medicare in order to prepare for the retirement of the baby boomers.

President Clinton's budget proposal makes the correct decision, to save most of these surpluses. The Administration estimates that its plan would entirely pay off the publicly held debt by saving over $4 trillion in projected surpluses by 2015. This dramatic contribution to national saving would reduce interest rates, boost business investment in plant and equipment, lead to a more productive workforces, and raise the standard of living.

In contrast, a massive tax cut that encourages consumption would not be good economic policy. With the unemployment rate at its lowest point in a generation, now is the wrong time to stimulate the economy through tax cuts. Moreover, an ever growing tax cut would drain government resources just when the aging of the population starts to put substantial stress on Social Security and Medicare. Further, the projections assume substantial undesirable reductions in real spending for non-entitlement programs, including important public investments. Given the uncertainty of long-term budget projections, committing to a large tax cut would create significant risks to the budget and the economy.

Nobel Laureates:

Kenneth Arrow, Stanford University
Lawrence R. Klein, U of P
Franco Modigliani, MIT
Paul A. Samuelson, MIT
Robert M. Solow, MIT
James Tobin, Yale University

Other Economists:

Henry J. Aaron, Brookings Institution
George A. Akerlof, Brookings and UC - Berkeley
Alan Auerbach, University of California, Berkeley
Robert Barsky, University of Michigan
Susanto Basu, University of Michigan
Olivier Blanchard, MIT
Rebecca Blank, University of Michigan
John Bound, University of Michigan
Christopher Carroll, University of Michigan
Karl E. Case, Wellesley College
J. Bradford De Long, UC - Berkeley
William F. Dickens, Brookings Institution
Christopher L. Foote, Harvard University
Pierre-Olivier Gourinchas, Princeton University
Donald D. Hester, University of Wisconsin, Madison
E. Philip Howrey, University of Michigan
Shane Hunt, Boston University
Erik Hurst, University of Chicago
Saul Hymans, University of Michigan
Paul L. Joskow, MIT
Phillip B. Levine, Wellesley College
Robert E. Litan, Brookings Institution
Anna Lusardi, Dartmouth and University of Chicago
Louis Maccini, Johns Hopkins University
Alicia H. Munnell, Boston College
Maurice Obstfeld, University of California, Berkeley
Janet Rothenberg Pack, U of P and Brookings
Howard Pack, University of Pennsylvania
Uwe Reinhardt, Princeton University
Susan Rose-Ackerman, Yale University
Robert W. Rosenthal, Boston University
Shinichi Sakata, University of Michigan
Charles L. Schultze, The Brookings Institution
Matthew D. Shapiro, University of Michigan
Robert J. Shiller, Yale University
Robert Shimer, Princeton University
Jonathan Skinner, Dartmouth College
Peter Temin, Massachusetts Institute of Technology
Laura Tyson, University of California, Berkeley
David N. Weil, Brown University
David Weiman, Social Science Research Council
Kenneth D. West, University of Wisconsin, Madison
Barbara L. Wolfe, University of Wisconsin, Madison
H. Peyton Young, John Hopkins Univers y

Citizens for a
Sound Economy

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James C. Miller III
Counselor

Prepared Statement of James C. Miller III before the Joint Economic Committee of the United States Congress September 13, 1999

Since serving as Director of the Office of Management and Budget during most of President Reagan's second term, I have been associated with Citizens for a Sound Economy (CSE), a research, education, and advocacy organization with a quarter-million members and supporters.[1] On their behalf as well as mine, I welcome this opportunity to discuss the desirability of tax cuts in an era of budget surpluses.

Let's start by clarifying certain matters that are often overlooked in discussions of fiscal policy.

First, whether at any time we have a budget surplus or a budget deficit is subject to debate because the federal accounts make only limited provision for changes in liabilities and assets. Yearly swings can amount to tens, if not hundreds, of billions of dollars.

Second, it is usual today for the effects of any major tax or expenditure program to be aggregated over 10 years. For example, Congress has passed a $792 billion tax cut; the President says he is willing to accept only a $300 billion tax cut. This was not always the case. When I was budget director, the time frame was five years. Why not make the time frame 20 years, or 50 years? This would run up the numbers and confuse people even more. Also, these aggregates are not discounted; they fail to distinguish between a tax cut that is $10 billion each of the first nine years and then

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[1]Neither CSE nor CSE Foundation receive any money from the Federal government — nor, to the best of my knowledge, have I during the relvant time period.

$100 billion in the tenth year, and a tax cut that is $100 billion the first year and $10 billion annually in years two through 10.

Third, forecasts are just that. Actual fiscal aggregates may be more or less. However, there is far more reason to place confidence in forecasts of next year's performance or maybe the next two year's performance than in any of the "out years." I certainly wouldn't bet the farm on the forecasts for years six through 10.

Fourth, the deficit or surplus is the difference between two very large numbers, revenues and outlays. If the forecasters are off just a little bit in either or both — especially in ways that don't offset — there can be substantial differences between the deficit/surplus forecasts and actual performance.

Fifth, although some progress has been made, the major federal revenue forecasting agencies — Office of Tax Analysis (OTA) and Joint Committee on Taxation (JCT) — still utilize what may be characterized as basically "static," as opposed to "dynamic," forecasting methodologies. Accordingly, they overestimate the size of any revenue "hit" from a tax rate decrease, and they also overestimate the size of any revenue "bump" from a tax rate increase. Thus, everything else equal, the surplus is likely to be larger with the tax cut than forecast by OTA and JCT.

I make these points to emphasize that we don't know with great precision what the deficit or surplus will be — with or without a tax cut. What we can be more confident about is the following.

First, as I explained in my testimony before this committee last March, government is so large that it constitutes a significant drag on the rate of economic growth. In particular, taxes -- some more than others -- restrict economic activity. By lowering taxes, you encourage (allow) the economy to be more robust.

Second, it reasonably clear that to the extent a tax cut reduces the government's revenue — and for most aggregate tax cuts this is the case in the short run — it also constrains spending. For evidence on this proposition, look within your own hearts. Are you more or less likely to vote for a spending increase if you know there's a deficit looming or a smaller surplus, than if the reverse were true? Q.E.D.

That's why James Carter, of the Senate staff, and I recently wrote a piece in USAToday (see attached) indicating that surpluses can be as problematic as deficits. With deficits, because of "fiscal illusion," people underestimate the cost of government and therefore demand too much of it. With surpluses, elected officials are more eager to increase spending. Either way, government expands beyond the size which is optimal!

So, if you want to see the economy continue to expand, and expand at an even

faster rate,[2] you will opt for a tax cut, the larger the better. In particular, I urge you to stand firm and insist on the tax package that recently passed both Houses and reject the tax program outlined by the President. I make this recommendation not only because your tax cut is larger, but because yours is of a better type. Let me explain.

One view of taxes is that they are necessary to raise the money the government requires to operate. A conflicting view is that taxes should not only raise money, but should be an instrument of social policy: "bads" should be discouraged with higher taxes, and "goods" should be encouraged through tax breaks. This view may work in theory, but experience shows it doesn't work very well in practice. The data show that "tax expenditures" have ballooned way out of control. The tax code is riddled with special-interest breaks and punitive features. Such a tax code slows economic growth and is felt, by the public, to be unfair overall.

Although your tax cut contains an assortment of provisions that benefit special interests, by and large it is a straightforward, "clean" cut in tax rates. In particular, it would cut income tax rates across the board, including the "death tax," and it would remedy the anomaly of taxing two people more if they are married than if they are simply living together. On the other hand, as the President and the Vice President have repeatedly indicated, their preference is for "targeted" tax cuts — in other words, tax cuts designed to achieve certain policy goals.

Finally, it should be stressed that while both tax plans envision "saving" social security by "banking" the social security surplus, the President's budget proposal explicitly envisions a far greater increase in outlays than does your budget, of which the tax cut is a part. Obviously, the President's plan, if adopted, would lead to further increases in the size of government, while your plan poses a lower risk. For these reasons, your tax plan should be enacted, and the President's plan should not.

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[2] The argument that increasing aggregate demand through tax cuts will lead to inflation has little empirical support and contracts common sense in view of how the effects on demand of changes in monetary policy altogether swamp the fiscal effects at issue.

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Citizens for a Sound Economy Foundation

CSE Commentary

http://www.csef.org 1250 H Street Northwest, Suite 700, Washington, DC 20005 202/783-3870

Uncle Sam's got extra money, and that may be bad news

By James Carter
and James Miller

Just when you thought everything about the federal budget was hunky-dory, given its huge expected surpluses, along come some economic party poopers like us to remind you that, in the words of President John F. Kennedy, "deficits are sometimes dangerous — and so are surpluses."

Sadly, even a surfeit of money can be bad news. Economics truly is the dismal science, isn't it?

To understand why budget surpluses are risky, ask:

▶ Why has the budget suddenly shifted into surplus?

Four years ago, the Congressional Budget Office projected a deficit of $1.6 trillion for 1999 through 2003. Now, it says there will be a $1 trillion surplus. Although Congress and the White House both claim credit for this neck-snapping turnaround, less than 9% of the change is due to legislation. Instead, it stems from revised economic assumptions.

Even a tiny change in these assumptions can produce a big budget swing: If CBO is just 10% too optimistic in its revenue growth forecast, it will overstate the surplus by more than $100 billion.

In short, we may indeed get a big surplus. Just don't count on it.

▶ Do we have a budget surplus because the government is spending less or because it is taking more of our money?

The budget is in surplus primarily because the tax burden has ballooned and spending on national defense has been curtailed. Neither is a cause for joy.

Taxes from your pockets

The government has prospered even more than the economy. Last year, taxes were the greatest fraction of gross domestic product since 1944. Why? Partly because taxes were increased during the early 1990s, but mainly because the growing economy pushes people into higher tax brackets.

Recent federal spending has fallen as a portion of total GDP, but most of this cut has come out of the hide of the military, which is already short of critical materials and fielding low-paid soldiers. Adjusted for inflation, federal spending on things other than national security was 11.5% higher last year than in 1993 — and this is a time of overall plenty, when one would expect reduced social safety net costs.

Spending cuts? Ha!

▶ What do our elected officials intend to do with the surplus?

We'll answer that with another question: Does it surprise anyone that few on Capitol Hill are seriously advocating that Congress resume its efforts to pare spending?

Without a deficit to combat, Congress has splintered among those who want to cut taxes, those who want to repay the federal debt and those who want to spend the surplus on new and expanded government programs.

Debt reduction is a noble objective, but if the surplus money is in Washington, trust us: Congress and the White House will spend it. Instead, Congress should use across-the-board tax cuts to return the money. Only cockeyed logic supports the notion that the government should collect more from citizens than it needs to operate. The worst thing we could do is fuel government growth.

The nub of the problem is this: When we had a deficit, it restrained Congress' natural inclination to spend. But the emerging budget surplus threatens to fuel a further expansion of the size and scope of government.

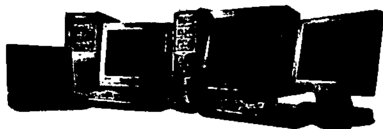
This point was not lost on our Founding Fathers. Believing that surpluses would spur the federal government to grow beyond its limited constitutional powers, America's early political leaders lashed out against the corrupting nature of budget surpluses.

"To secure the republic," writes budget historian James Savage, "both federal deficits and surpluses were to be avoided, for only a truly balanced budget could prevent corruption."

James Carter is an economist with the U.S. Senate. James Miller, a budget director under President Reagan, is the Olin Fellow at Citizens for a Sound Economy Foundation.

Op-Ed by James C. Miller III ** Wednesday, July 14, 1999 ** USA Today

It's our annual "spend-your-budget-before-it's-gone" sale.



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Statement of James Gwartney
Chief Economist, Joint Economic Committee, U.S. Congress
JEC Hearing on Tax Cuts and the Budget Surplus
September 13, 1999

Congress has passed a $792 billion reduction in taxes spread over the next ten years. The bill would reduce marginal tax rates by 1 percentage point, cut the capital gains tax rates from 20% and 10% to 18% and 8%, widen both the standard deduction and tax brackets in order to reduce the marriage penalty, and provide additional incentives for savings, investment, and research. The President has called the legislation "reckless and risky," and promises to veto it. I would like to make four points with regard to this debate.

Point 1: There is a negative relationship between size of government and economic growth.

The debate over the tax bill is primarily about spending rather than taxes. The President wants to use the projected on-budget surpluses to increase spending. Congress wants them returned to taxpayers. Given the nature of the debate, it is important to consider the relationship between size of government and economic growth. Small differences in growth when sustained over a lengthy time period can make a big difference in living standards.

Governments play a key role in establishing an economic environment conducive for individuals to use their skills and knowledge productively and where markets can operate smoothly. The key elements of that environment are: (a) a sound legal structure that enforces contracts and provides for secure property rights, (b) competitive markets, (c) price stability, (d) freedom of international trade, and (e) small government expenditures. The recent policies of the U.S.—particularly those in the areas of monetary and trade policy—have been fairly consistent with long-term growth.

Given the size of government in high-income industrial countries, the level of government spending is inversely related to economic growth. Countries with large government spending as a share of the economy and more rapid growth of government experience lower levels of economic growth. Figures 1 and 2 illustrate this point.[1]

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[1] See James Gwartney, Robert Lawson, and Randall Holcombe, *The Size and Functions of Government and Economic Growth*, (Washington: Joint Economic Committee of the U.S. Congress, 1998); Edgar Peden, "Productivity in the United States and Its Relationship to Government Activity: An Analysis of 57 Years, 1929-1986." *Public Choice* 69 (1991): 153-173; and Gerald Scully, *What Is the Optimal Size of Government in the United States?* Dallas, TX: National Center for Policy Analysis, 1994. While the methodology employed by each of these

Exhibit 1 looks at the relationship between the size of government and the growth of OECD countries during each of the last four decades. Size of government at the beginning of a decade is measured on the x-axis and growth of real GDP *during that decade* is measured on the y-axis. The graph contains four dots for each of the 21 OECD members on which data were available. Thus, the total number of dots is 84. Each dot represents a country's total government spending *at the beginning of the decade* and its accompanying growth of real GDP *during that decade*. As the plot illustrates, there is a clearly observable negative relationship—larger government expenditures are associated with slower growth. The accompanying regression equation also includes dummy variables for the data points in the 1960s and 1970s in order to adjust for the fact that the overall growth rate during these decades was significantly different than during other decades. The size of government variable is highly significant (at the 99 percent level) and it indicates that a 10 percentage point increase in size of government as a share of GDP reduces the long-term annual growth rate of real GDP by seven-tenths of a percent. The R^2 indicates that size of government and the decade dummy variables "explain" 62 percent of the variation in growth across these high-income nations.

During the last four decades, the size of government has expanded in every OECD country. At the same time, the growth rates of these countries—with the exception of Ireland—have fallen. However, there has been considerable variation in the magnitude of government expansion. If big government retards long-term growth, as Figure 1 implies, then there should be a relationship between *increases* in the size of government and *reductions* in economic growth. The countries with the largest *increases* in government should experience the sharpest reductions in growth.

Since 1960, the size of government as a share of GDP has increased 20 percentage points or more in six OECD countries—Denmark, Finland, Greece, Portugal, Spain, and Sweden. On the other hand, the growth of government has been 10 percent or less in four OECD countries—Iceland, Ireland, United Kingdom, and United States. Figure 2 presents data on the growth rates of these two groups, along with the average for OECD countries (bottom line of the table). Among the "rapid expansion in government" group, the growth rate of real GDP fell from 6.4 percent in 1960-1965 to 1.9 percent in the 1990s, a reduction of 4.5 percentage points. In contrast, the average growth rate of the countries with less expansion in the size of government fell from 4.1 percent during 1960-1965 to 3.5 percent in the 1990s, a drop of only 0.6 percent. In every case, the reduction in growth of those countries in the "rapid expansion in government" group was greater than for any of those in the "slower expansion in government" group.

It is interesting to note that in 1960, government expenditures as a share of GDP for every country in the top part of Figure 2 exceeded the OECD average (bottom line of table) of 27.3 percent. At the same time, their average GDP growth rate of 4.1 percent was below the OECD average of 5.6 percent during the 1960s. The situation was exactly the opposite *for this same set of*

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studies was different, each found that the growth maximizing size of government was considerably smaller than the level present in OECD countries.

countries in the 1990s. After their ratios of government expenditures to GDP dropped below the OECD average, their GDP growth rate rose above the average.

Just the reverse happened to the nations in the bottom part of Figure 2. In 1960 their government expenditures as a share of GDP were below the OECD average, and their GDP growth rates were higher than the OECD average. By 1998 their mean size of government had risen above the OECD average and their growth rates had fallen below it. Because these figures are for the same countries (and country groupings), they are particularly revealing.

Point 2: The $792 billion tax cut spread over ten years is small.

The tax cut bill passed by Congress is small compared to the size of the economy, total federal revenues, the surpluses that will remain after the tax cut, or any other sensible measure. Only $156 billion is scheduled to take affect during the first five years. The remaining $636 billion will not be phased in until after 2004. As Figure 3 shows, it is approximately .7 of a percent of GDP—0.4% during the first 5 years and 1.0% during the last five. The tax cut amounts to only 3.5 percent of the projected federal revenue during the ten-year period.

Even with the tax cut, huge surpluses will be present during the next ten years (see Figure 4). To a large degree, these projected surpluses are a reflection of favorable demographics—the large share of the U.S. population currently in their prime-earning years of life. If the tax cut is instituted, the surpluses are projected to average approximately $200 billion per year during the next five years and more than $300 billion per year during the years 2005-2009. This is a highly restrictive fiscal policy. Sizeable tax cuts are needed to smooth the transition of financial markets to large budget surpluses of the next decade.

Both Congress and the Administration are on record as favoring use of the $1.9 billion projected Social Security surplus to retire outstanding debt during the next ten years. Figure 5 shows the path of the net privately-held debt if (a) the Social Security surplus is used for this purpose and (b) the Fed holdings of debt increase at the same rate as during the last decade. If this is the case, the net privately-held debt will fall from the current $3.3 trillion to only $826 billion in 2009. ***This will push it to less than 10 percent of GDP, the lowest level since prior to World War I.***

Point 3: The CBO projections grossly underestimate the size of the future surpluses.

The CBO's methodological assumptions understate federal revenues by at least $1.35 trillion dollars over the next ten years. There are two reasons for this underestimation:

1. The CBO assumes that federal tax revenues will increase less rapidly than nominal income. According to their projections, a 53.1% increase in nominal GDP between 2000 and 2009 will lead to only a 49.6% increase in federal revenue. Thus, their implied tax revenue-income elasticity is 0.94. This is substantially too low. We have a progressive tax structure. While the tax brackets are indexed for inflation, a larger and larger share of income

will be taxed at higher rates as real income grows. In addition, the current system is not fully indexed for inflation. Most notably, as inflation increases nominal capital gains, the rate of taxation on the gains will rise. Clearly, the tax revenue-income elasticity is greater than 1.0.

During the last four years (1995-1998), there have been only minor changes in the tax law. The 1994 revenues would reflect the implementation of the 1993 Clinton tax increase. Even though the tax system was basically unchanged, federal tax revenue rose 8.1% annually during 1995-1998 compared to a 5.2 % annual growth rate of nominal GDP. This would imply a tax revenue-income elasticity of 1.56. Most public finance economists would place the long-term tax revenue-income elasticity of the U.S. tax structure between 1.1 and 1.3. Thus, we re-calculated the CBO revenue projections for the next ten years using these more realistic elasticity figures. As Figure 6 shows, this adjustment indicates that the CBO's projections understate tax revenues and therefore the size of the budget surplus by between $257 billion and $528 billion during the next five years. During the five years after that (2005-2009), the CBO understatement of the tax revenue elasticity results in an understatement of revenue between $709 billion and $1,621 billion. Clearly, these understatements of tax revenues are far greater than the Congressional tax cut.

2. In addition, the CBO assumes a 2.5 percent growth rate during the next decade. During the last ten years, the annual real growth rate was 2.6%; it was 2.7% during the 1980s and 3.2% during the 1970s. During the last five years, real GDP grew at an annual rate of 3.4%. During the last 15 years, real GDP growth has averaged 3.1% annually. During the last 44 years for which it is possible to construct a 10-year moving average with the current GDP series, the 10-year average annual growth rate fell to 2.5% or lower on only 4 occasions. Given the highly favorable demographics—a high percentage of the work force in prime earning years—the 2.5% projected growth rate of the CBO is too low. As Figure 7 shows, even if real GDP growth is only 2.8%, just three-tenths higher than the CBO projection, $89 billion will be added to federal revenues during the next five years and an additional $296 billion would be added during years 2005-2009. A still more realistic annual growth rate of 3.0 percent during the next decade will increase federal revenues by $150 billion during the next five years and $495 billion during 2005-2009.

The tax cut looks puny when compared with the CBO's underestimation of revenue during the next ten years.

Point 4: If we do not reduce government spending as a share of GDP during the next decade, we will become Euro-ized when the baby-boomers retire.

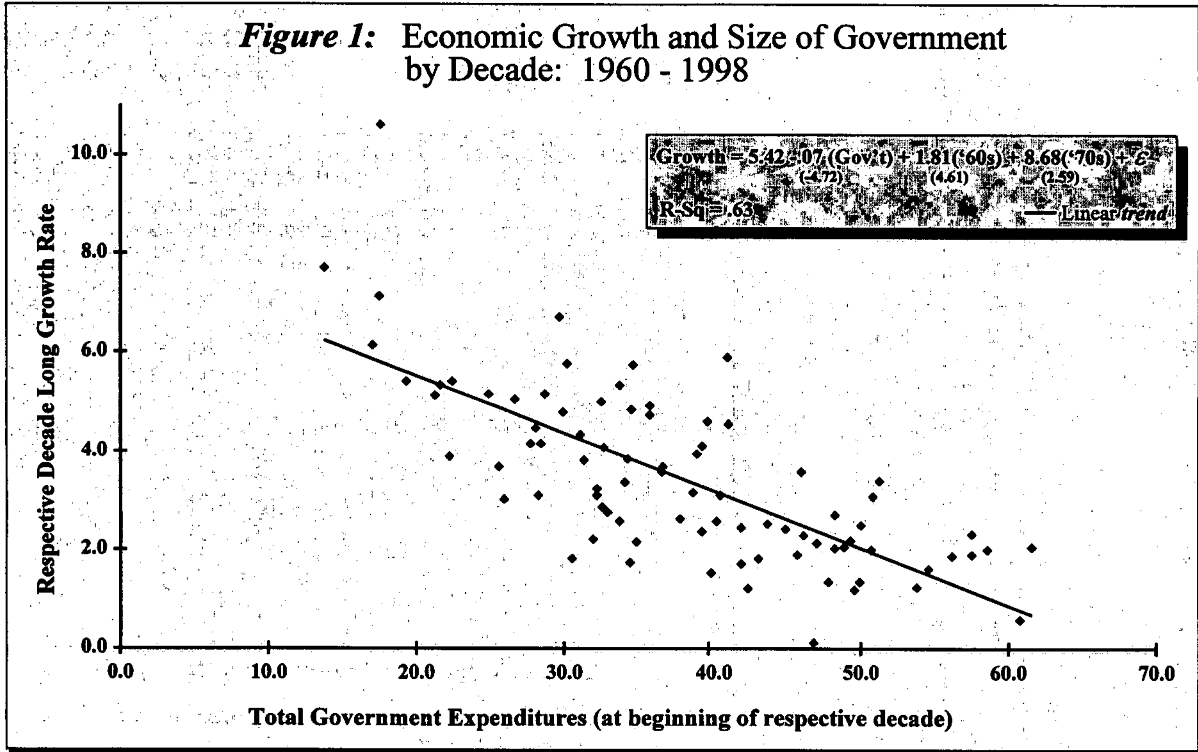
Persons age 65 and over currently account for approximately 12 percent of the U.S. population. Expenditures on health care, social security and other entitlements targeted toward the elderly account for about 12 percent of the total federal budget. When the baby boomers retire between 2010 and 2025, the elderly population will increase to 18 percent of the total. Under current law, this will push federal spending up by 6 to 8 percentage points as a share of GDP during this

period. If new programs are added and government spending is maintained at approximately the current share of GDP during the next decade, the retirement of the baby boomers during the following decade (2010-2020) will push total government spending (including federal, state, and local) up to 40 percent of GDP. No country has been able to sustain real growth above 2 percent with government spending of this magnitude. If we go this route, we can expect European-type growth—one percent to 1.5 percent—when the baby boomers begin to retire.

Conclusion

We are at a crossroads. As a healthy economy provides substantial revenue, it will be tempting to expand spending in the years ahead. This tax legislation will be the first of several conflicts between those who want rapid growth versus those who want more spending, which will retard growth. The tax cut debate is about spending, not taxes. As Figure 8 shows, the President wants to use the on-budget surpluses to increase spending. The funds will be there to do so during the next decade. But such spending will plant the seeds of destruction for the following decade. Clearly, the American people are not under-taxed. As Figure 9 shows, federal taxes as a percent of national income are currently at an all-time high. Furthermore, they are projected to remain at or near this high level during the next decade. Even with the Congressional tax cut, there are only a few prior years with higher taxes as a share of national income than will be the case during the next decade. This suggests that, far from being "reckless," the tax cut is—if anything—too modest. Nonetheless, it is a step in the right direction.

Let me close with this question. Suppose that the non-social security budget was balanced and that Social Security was projected to generate a $1.9 trillion surplus during the next ten years. **Would you vote for a $792 billion tax increase?** If your answer is no, you should support the tax bill. If the bill is vetoed, this will in fact be the result. Under very cautious growth assumptions—ones that are well below what is likely to be achieved—the non-social security portion of the budget will not only be balanced, it will run a surplus. The government does not need more revenue. These funds belong to American taxpayers and they should be returned to them. This is precisely what the tax bill will do.



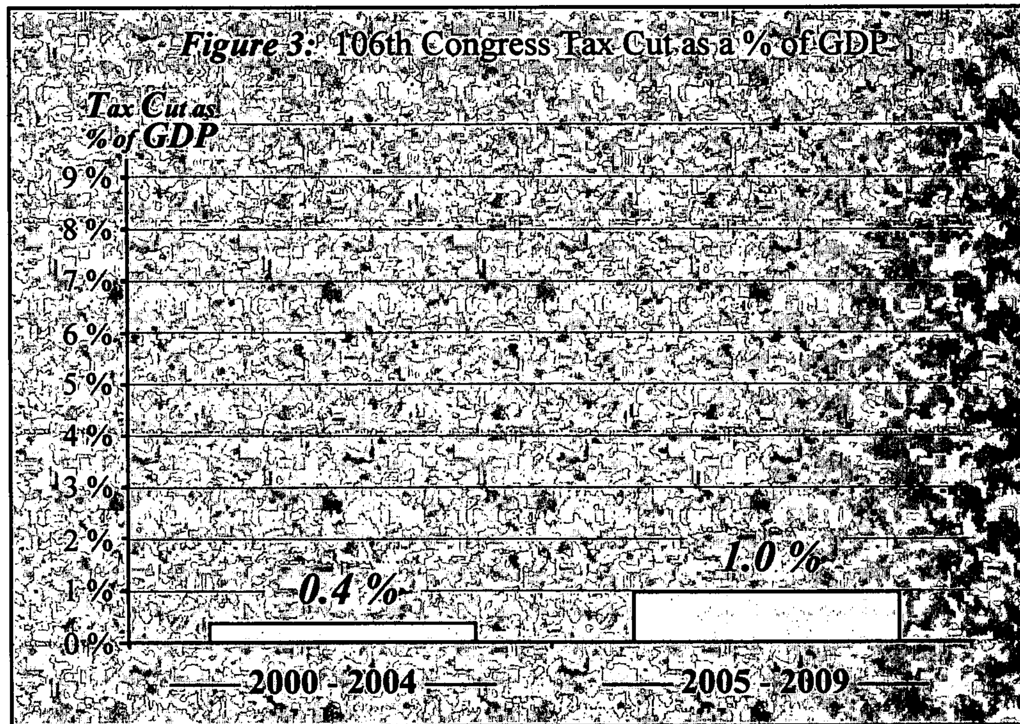
Source: *OECD Historical Statistics: 1960-1994* and *OECD Economic Outlook: June 1999*   ** 21 OECD Countries: OECD omitting Switzerland and Luxembourg*

Figure 2: The Growth Rate of Real GDP in the 1990s Compared to 1960-1965: OECD Countries with the Least and Most Expansion in the Size of Government

	Gov't as a % of GDP			Growth Rate of Real GDP		
OECD Countries with Least (< 10%) Expansion in the Size of Gov't as a Share of GDP	**1960** (1)	**1998** (2)	**Change** (3)	**1960-1965** (4)	**1990-1998** (5)	**Change** (6)
Iceland	28.2	36.2	*8.0*	4.5	2.3	*-2.2*
Ireland	28.0	33.1	*5.1*	4.1	7.1	*3.0*
United Kingdom	32.2	40.2	*8.0*	3.5	1.9	*-1.6*
United States	28.4	32.8	*4.4*	4.4	2.5	*-1.9*
Average	***29.2***	***35.6***	***6.4***	***4.1***	***3.5***	***-0.6***
OECD Countries with Most (> 20%) Expansion in the Size of Gov't as a Share of GDP						
Denmark	24.8	55.1	*30.3*	5.9	2.5	*-3.4*
Finland	26.6	49.1	*22.5*	5.6	1.3	*-4.3*
Greece	17.4	41.8	*24.4*	7.2	1.7	*-5.5*
Portugal	17.0	43.6	*26.6*	6.5	2.7	*-3.8*
Spain	13.7	41.8	*28.1*	8.5	2.2	*-6.3*
Sweden	31.0	60.8	*29.8*	4.9	1.1	*-3.8*
Average	***21.8***	***48.7***	***27.0***	***6.4***	***1.9***	***-4.5***
21 OECD Countries						
Average	***27.3***	***44.3***	***17.0***	***5.6***	***2.4***	***-3.2***

Source: Derived from *OECD Historical Statistics* and *OECD Economic Outlook* (various issues). All Countries for which data were available in the sample period were included.

21 OECD Countries: U.S., Japan, Germany, France, Italy, U.K., Canada, Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Netherlands, New Zealand, Norway, Portugal, Spain, and Sweden



Source: *Congressional Budget Office, Joint Committee on Taxation, and Joint Economic Committee.*

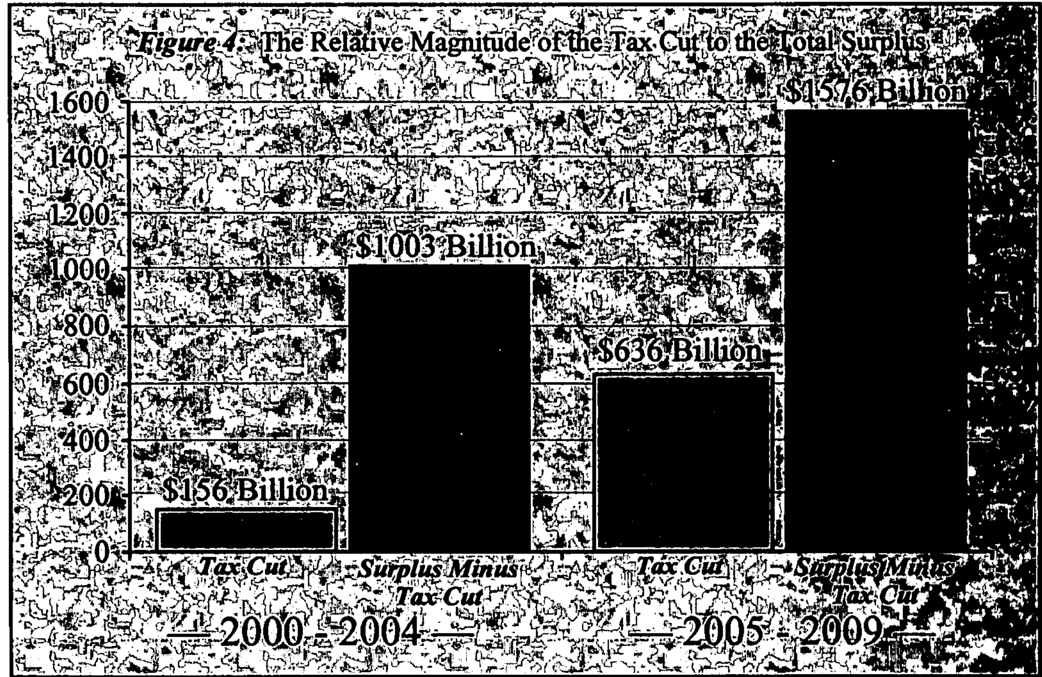
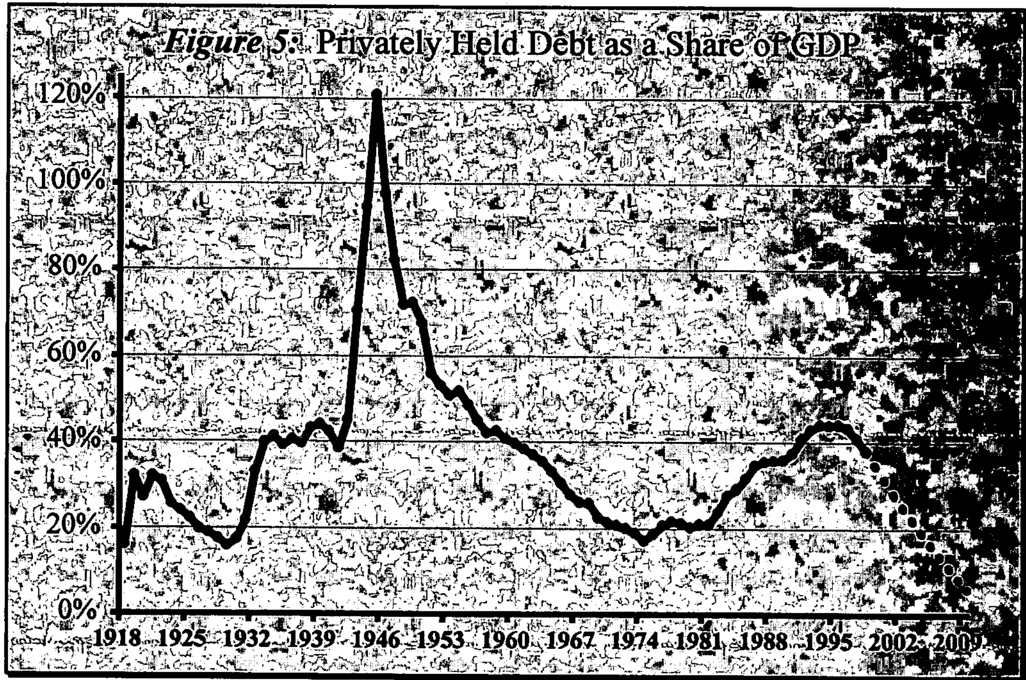


Figure 4: The Relative Magnitude of the Tax Cut to the Total Surplus

Sources: *Senate Budget Committee, Joint Committee on Taxation, and Joint Economic Committee.*



Source: *Statistical History of the United States from Colonial Time, Historical Tables, F.Y. 2000 Budget; Congressional Budget Office.*

Note*: *The data that precedes 1946 is based upon a proxy set of variables that approximate closely the data from 1946 to 1998. The data that spans from 1999 to 2009 is projected using the assumptions that (a) the Fed will continue to increase its holdings of debt at the same rate that it has for the past decade (we use a 6 % measure as a conservative estimate of the actual % 6.4), and (b) that all (and only) the surpluses from within the Social Security "Lock-box" are used to retire Federal Debt (based on CBO projections of such surpluses).*

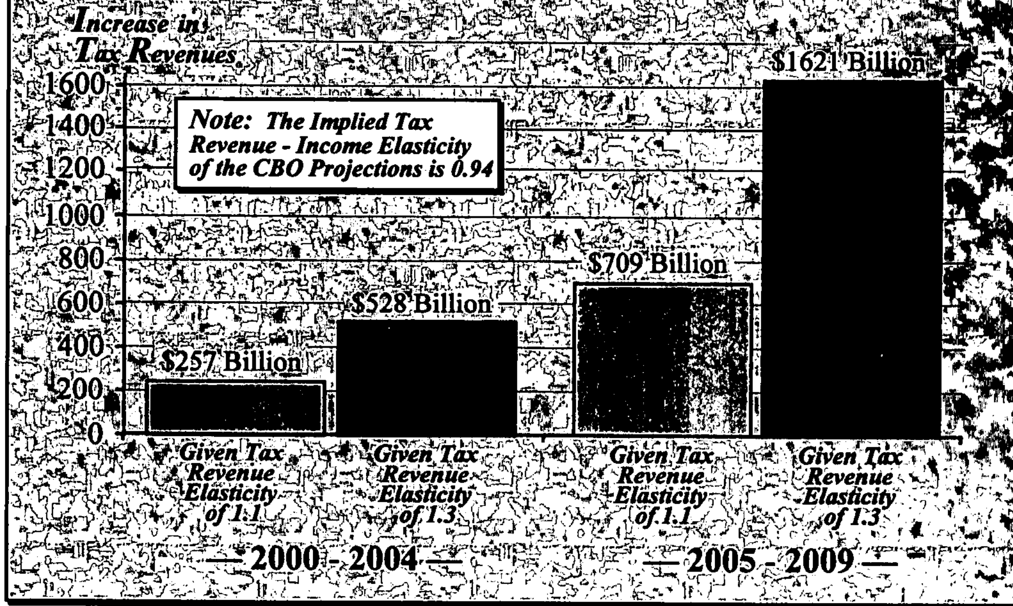
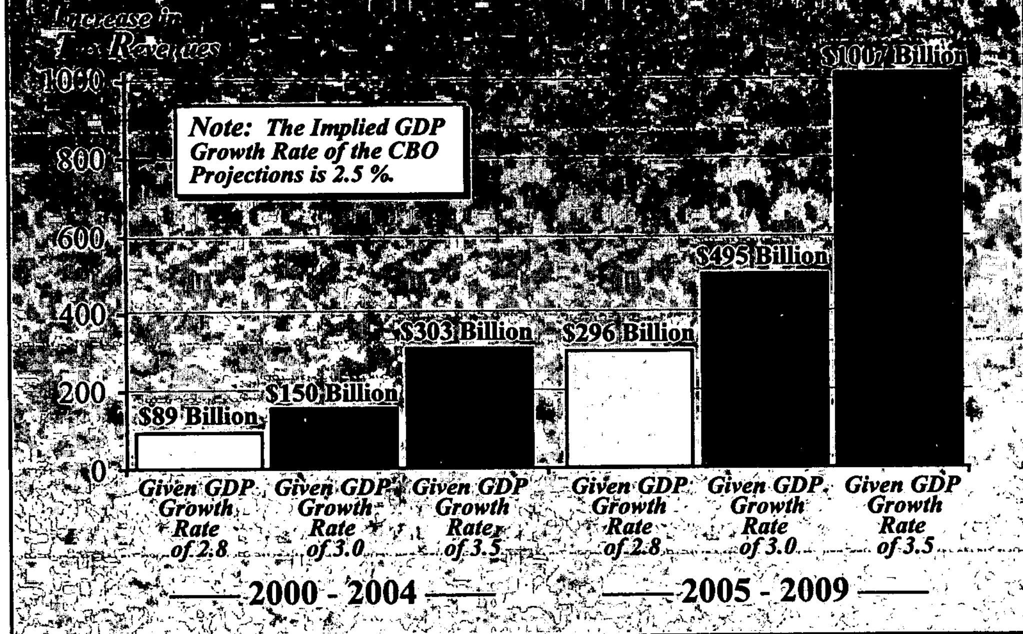
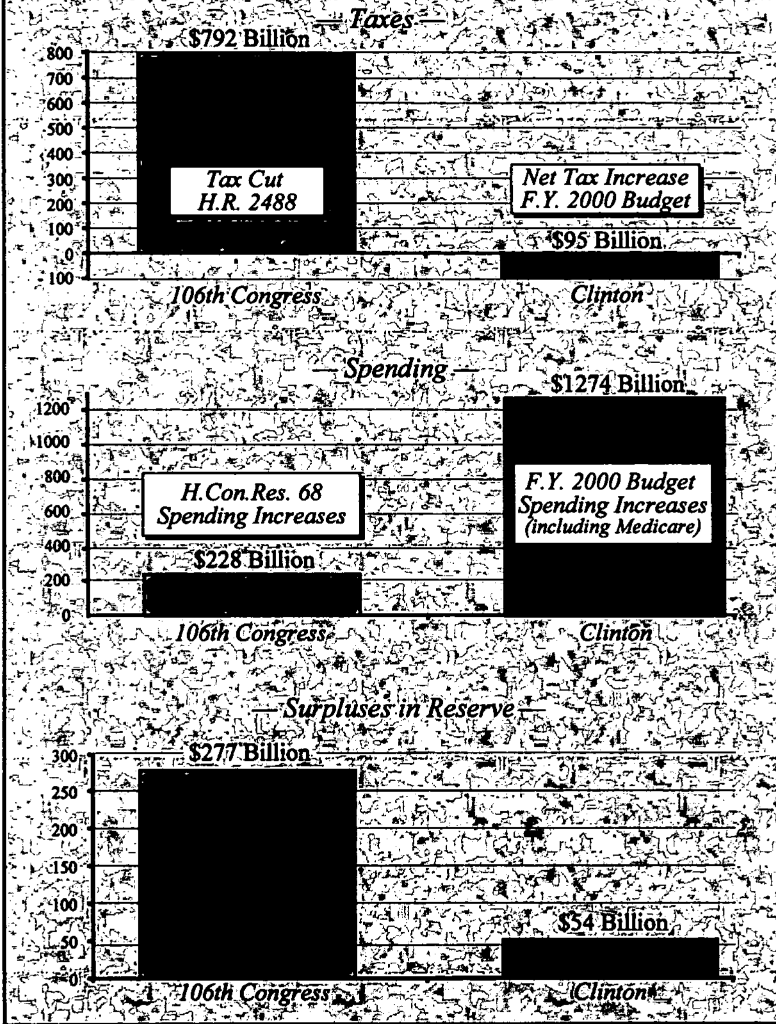


Figure 6: CBO Underestimation of Tax Revenue Due to Unrealistic Assumption of Tax Revenue Elasticity with Respect to Income

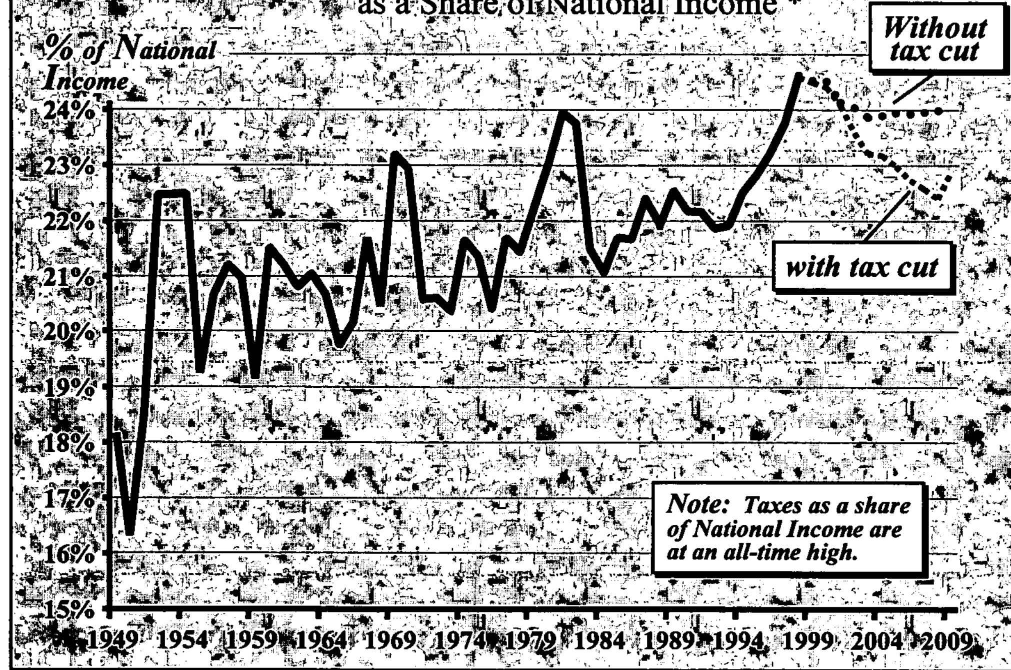
Source: *See Addendum to Fig. 6.*



Source: *See Addendum to Fig. 7.*



Sources: *Congressional Budget Office, Joint Committee on Taxation, and Senate Budget Committee.*



Source: *Haver Analytics, Joint Tax Committee, Congressional Budget Office.*
Note*: *The data beyond 1998 are projected using CBO annual GDP growth estimates for 1999-2009.*

Addendum 6.1

Projected Federal Tax Revenues: CBO Forecasts Corrected For Unrealistic Tax Revenue-Income Elasticity

(By Fiscal Year and In Billions of Dollars)

		0 1999	1 2000	2 2001	3 2002	4 2003	5 2004	6 2005	7 2006	8 2007	9 2008	10 2009	
CBO Projected % Change in Nominal GDP[1]			4.6%	4.2%	4.2%	4.2%	4.2%	4.3%	4.4%	4.5%	4.5%	4.4%	
Multiplier	1.1		5.06%	4.62%	4.62%	4.62%	4.62%	4.73%	4.84%	4.95%	4.95%	4.84%	
Multiplier	1.3		5.98%	5.46%	5.46%	5.46%	5.46%	5.59%	5.72%	5.85%	5.85%	5.72%	
CBO Projected Federal Tax Revenues[1]		*1,821*	*1,905*	*1,970*	*2,045*	*2,116*	*2,198*	*2,296*	*2,396*	*2,501*	*2,609*	*2,725*	Mean
Annual Percentage Increase			4.61%	3.41%	3.81%	3.47%	3.88%	4.46%	4.36%	4.38%	4.32%	4.45%	4.11%
Projected Federal Tax Revenues													
Multiplier	1.1		*1,913*	*2,002*	*2,094*	*2,191*	*2,292*	*2,400*	*2,517*	*2,641*	*2,772*	*2,906*	
Increase From CBO Forecast			*8*	*32*	*49*	*75*	*94*	*104*	*121*	*140*	*163*	*181*	
Multiplier	1.3		*1,930*	*2,035*	*2,146*	*2,264*	*2,387*	*2,521*	*2,665*	*2,821*	*2,986*	*3,156*	
Increase From CBO Forecast			*25*	*65*	*101*	*148*	*189*	*225*	*269*	*320*	*377*	*431*	

	Years 1-5 2000-4	Years 6-10 2005-9	Years 1-10 2000-9
Increase From CBO Forecast (Multiplier 1.1)	*257*	*709*	*966*
Increase From CBO Forecast (Multiplier 1.3)	*528*	*1,621*	*2,150*

[1] July 1999 CBO projections

Addendum 6.2: Calculated Tax Revenue-Income Elasticity for the CBO Projections

Year	**Percent change in *CBO Forecasted* Nominal GDP *(fiscal year)***	**Percent change in *CBO Forecasted* Federal Receipts** (fiscal year)	***Calculated* Tax Revenue - Income Elasticity**
2000	4.61%	4.61%	1.001
2001	4.24%	3.41%	0.804
2002	4.18%	3.81%	0.912
2003	4.19%	3.47%	0.829
2004	4.17%	3.88%	0.929
2005	4.33%	4.46%	1.031
2006	4.41%	4.36%	0.988
2007	4.47%	4.38%	0.981
2008	4.46%	4.32%	0.968
2009	4.43%	4.45%	1.003
2000-2009	53.06%	49.64%	0.936

Source: *CBO, & Joint Economic Committee.*

Addendum 7

Projected Federal Tax Revenues: CBO Forecasts Corrected For Expected Higher GDP Growth Rates

(By Fiscal Year and In Billions of Dollars)

		0 1999	1 2000	2 2001	3 2002	4 2003	5 2004	6 2005	7 2006	8 2007	9 2008	10 2009	Years 1-5 2000-4	Years 6-10 2005-9	Years 1-10 2000-9
CBO Projected Nominal GDP[1]		8,851	9,259	9,652	10,055	10,476	10,913	11,385	11,887	12,418	12,972	13,547			
CBO Projected % Change in Nominal GDP[1]			4.6%	4.2%	4.2%	4.2%	4.2%	4.3%	4.4%	4.5%	4.5%	4.4%			
Additional growth in GDP	0.3%		4.9%	4.5%	4.5%	4.5%	4.5%	4.6%	4.7%	4.8%	4.8%	4.7%			
Resulting Nominal GDP			9,285	9,703	10,139	10,595	11,072	11,581	12,126	12,708	13,318	13,944			
Additional growth in GDP	0.5%		5.1%	4.7%	4.7%	4.7%	4.7%	4.8%	4.9%	5.0%	5.0%	4.9%			
Resulting Nominal GDP			9,302	9,740	10,197	10,677	11,178	11,715	12,289	12,904	13,549	14,213			
Additional growth in GDP	1.0%		5.6%	5.2%	5.2%	5.2%	5.2%	5.3%	5.4%	5.5%	5.5%	5.4%			
Resulting Nominal GDP			9,347	9,833	10,344	10,882	11,448	12,054	12,705	13,404	14,141	14,905			
CBO Projected Federal Tax Revenues[1]		*1,821*	*1,905*	*1,970*	*2,045*	*2,116*	*2,198*	*2,296*	*2,396*	*2,501*	*2,609*	*2,725*			
CBO Projected Federal Tax Revenues as a % of GDP[1]			20.6%	20.4%	20.3%	20.2%	20.1%	20.2%	20.2%	20.1%	20.1%	20.1%			
Projected Federal Tax Revenues Additional growth in GDP	0.3%		*1,910*	*1,980*	*2,062*	*2,140*	*2,230*	*2,336*	*2,444*	*2,559*	*2,679*	*2,805*			
Increase From CBO Forecast			*5*	*10*	*17*	*24*	*32*	*40*	*48*	*58*	*70*	*80*	*89*	*296*	*384*
Additional growth in GDP	0.5%		*1,914*	*1,988*	*2,074*	*2,157*	*2,251*	*2,363*	*2,477*	*2,599*	*2,725*	*2,859*			
Increase From CBO Forecast			*9*	*18*	*29*	*41*	*53*	*67*	*81*	*98*	*116*	*134*	*150*	*495*	*645*
Additional growth in GDP	1.0%		*1,923*	*2,007*	*2,104*	*2,198*	*2,306*	*2,431*	*2,561*	*2,700*	*2,844*	*2,998*			
Increase From CBO Forecast			*18*	*37*	*59*	*82*	*108*	*135*	*165*	*199*	*235*	*273*	*303*	*1,007*	*1,310*

[1] July 1999 CBO projections

August 20, 1999

TAX BILL CONTAINS ONLY MODEST BENEFITS FOR MIDDLE CLASS DESPITE ITS HIGH COST

by Iris J. Lav and Robert Greenstein

The tax bill Congress approved in early August is decidedly not a broad-based middle-class tax cut plan; it is only modestly less favorable to high-income taxpayers than the earlier version of the tax bill the House of Representatives passed. Although the tax plan does provide some tax reduction for those in the middle of the income spectrum, an overwhelming and disproportionate share of the tax cuts in the bill would go to those at higher income levels.

A Treasury Department analysis issued August 5 finds that the 10 percent of households with the highest incomes would receive 59 percent of the bill's tax cuts when the tax cuts are in full effect. The top fifth of households would receive 78.5 percent of the tax cuts — more than three-quarters of the total. By contrast, the bottom 60 percent of the population *combined* would receive just 7.5 percent of the tax cuts, only about one-third as much as the top one percent would get by itself.

The Treasury analysis estimates that the wealthiest one percent of households would each receive an average tax cut of nearly $32,000 a year. The bottom 60 percent of the population would receive a $166 average tax cut.

An analysis conducted by Citizens for Tax Justice similarly finds the bill to be heavily skewed toward high-income households. The CTJ analysis estimates that 81 percent of the tax cuts would go to the top fifth of households, while the bottom 60 percent of households would share just 9 percent of the tax cuts.

The provisions in the package that would do the most for middle-class taxpayers are the proposed increase in the standard deduction for married couples and the proposed reduction of the 15 percent tax rate to 14 percent.

- The increase in the standard deduction for married couples and the reduction in the 15 percent tax rate account for less than one-fifth of the annual tax-cut benefits the bill

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provides. In 2008, when most provisions are largely phased in and before the artificial "sunset" of a number of provisions in the bill, these two provisions would account for only $32 billion of the $168 billion that the Joint Committee on Taxation estimates the package as a whole will cost. (Note that even this reduction in the 15 percent rate would provide a larger dollar tax cut to those at higher-income levels than to much of the middle class. The full benefit of this tax rate reduction would be available only to individuals and families whose incomes place them *above* the 15 percent bracket. Middle-class families in the 15 percent bracket would get only a partial benefit from the rate reduction.)

COST OF VARIOUS PROVISIONS IN 2008
(in billions of dollars)

Provisions Providing Bulk of Their Benefits to Middle-class or Lower-Income Filers	
Reduce 15 percent rate to 14 percent	$26.4
Increase standard deduction for couples	6.0
EITC marriage penalty relief	1.3
Expand dependent care tax credit	1.1
Subtotal	**$34.8**
Provisions Disproportionately Beneficial to Higher-Income Families	
Cut 28, 31, 36, and 39.6 percent rates	$31.0
Repeal individual AMT	30.8
Raise income limit for 14 percent bracket	22.0
Cut capital gains taxes	7.6
Repeal estate and gift taxes	10.9
Raise IRA and pension income and contribution limits	8.2
Corporate and business tax breaks	9.2
Subtotal	**$119.7**
Total cost in 2008	**$167.9**

Source: Joint Committee on Taxation

- There are some other, smaller provisions in the package that would benefit moderate- and middle-income families, such as the increase in the dependent care and adoption credits and marriage penalty reduction for married-couple families that receive the Earned Income Tax Credit. But in total, the provisions that grant a substantial share of their benefits to middle- or low-income taxpayers account for less than one-quarter of the bill's cost when the provisions are fully in effect.

- Most of the remaining tax cuts in the bill would accord a disproportionate share of their benefits to the 20 percent of taxpayers with the highest incomes.

Should the Distribution of Tax Cuts Mirror the Distribution of Tax Burdens?

Some proponents of the tax bill dismiss data showing that the bulk of the bill's tax cuts would go to more affluent households by observing that these households pay the bulk of the taxes and should therefore get the bulk of the tax cut benefits. The tax cuts in the bill are, however, disproportionate to taxes paid. The highest-income 20 percent of the population pays about 59 percent of federal taxes but would get 79 percent of the tax cuts in the legislation.

Moreover, the notion that tax cuts should be apportioned in accordance with the share of taxes that various income groups pay is itself highly problematic. Use of such a standard implies that the more that income disparities widen in the United States and high-income individuals receive the lion's share of the income gains (and thus pay more of the taxes), the more that tax cuts should be directed to the wealthy, making the disparities still greater.

Use of such a standard also overlooks the fact that the wages and living standards of much of the population, with the notable exception of upper-income households, are not much better than they were a decade or two ago. In fact, the hourly wage of the typical (or median) worker is slightly lower today than it was at the end of the 1970s, after adjusting for inflation. By contrast, both executive compensation and capital gains income have risen smartly for those on the upper rungs of the economic ladder.

These developments have multiple causes, including international competition, technological advances, the decline in unionization, other economic factors, and policy changes. Given these trends toward widening wage and income disparities, tax policy ought to compensate at least modestly. At a minimum, tax policy should not magnify these trends.

This is a matter of some importance, since the trend toward increasing income disparities has been quite marked. Congressional Budget Office data show that from 1977 to 1995 (the first and last years for which such data are now available), the average before-tax income of the top one percent of the population jumped 77 percent after adjustment for inflation. The average income of the top fifth of the population also rose substantially, climbing 29 percent. But the average income of the middle fifth barely changed during this period, rising only two percent, and the average income of the bottom two fifths of the population declined. A policy of distributing the lion's share of tax cuts to those on the top rungs of the economic ladder, on the grounds that tax cuts should be conferred in proportion to taxes paid, would exacerbate rather than ameliorate these trends. It would increase further the growing disparities of income and wealth between the most affluent individuals and the rest of society.

Finally, there is the issue of priorities. There is not an economic need for tax cuts geared to the high end of the income spectrum — the economy is running at full tilt with the current tax rates, the stock market is booming at the current capital gains rates, high-income households are already much better off than in the past, and Federal Reserve chairman Alan Greenspan has cautioned that tax cuts in general may be ill-advised at this point. Thus, the question arises as to whether tax cuts of this nature should take precedence over other needs. Should tax cuts that provide the lion's share of their benefits to the most affluent members of society be accorded priority over greater debt reduction, strengthening the long-term financial security of Medicare and Social Security, public investments that hold promise for improving long-term productivity growth (such as investments in education and training, infrastructure, research, and early intervention programs for children), measures to lower the child poverty rate (which remains well above the child poverty rate in Canada and most of western Europe), and tax cuts in which a greater share of the tax reductions go to the middle class and the working poor?

These provisions include the elimination of the estate tax, the capital gains tax cuts, the elimination of the alternative income tax, provisions raising income and contribution limits for Individual Retirement Accounts and employer-sponsored pension plans, the reduction in the tax rates above the 15 percent rate, and the increase in the income level at which the 15 percent tax rate ends for married filers and the 28 percent rate starts.

Rate Reductions

The income tax rate reductions in the bill might seem as though they would provide significant benefits to middle-income taxpayers. In fact, the rate reductions provide only a modest benefit to most moderate- and middle-income families. The bulk of the benefits of the rate cut would go to those at much higher income levels.

The bill gradually reduces each tax rate by one percentage point. Like the Senate bill, the conference agreement gradually lowers the 15 percent rate to 14 percent. But it also lowers each of the other, higher marginal income tax rates, bringing down the 28 percent rate to 27 percent, the 31 percent rate to 30 percent, and so on. Bringing down all of the rates skews the benefits much more in favor of high-income taxpayers than the Senate proposal did.

Even under the Senate bill, the full benefit of reducing the lowest rate from 15 percent to 14 percent would have been secured only by families with income at least as high as the level at which the 15 percent bracket ends and the 28 percent bracket begins. For a family of four, income would have to exceed $61,000 to receive the full benefit — equal to about $450 — from reducing the 15 percent rate to 14 percent. (See box on page 6.) Families below this level would receive a smaller tax cut from this provision.

Three-quarters of taxpayers either are in the 15-percent bracket or owe no income tax. Only the top quarter of taxpayers are in the higher brackets, and only they would receive the full benefit of reducing the 15 percent rate. No one outside the top quarter of taxpayers would benefit even to a small degree from reducing the rates in the higher brackets.

Families with gross incomes at more modest levels would gain little from the rate-cut provisions. Consider a family of four with income of $25,000. Although such a family owes little income tax, it pays sizeable payroll taxes and other federal taxes. This family would receive a tax cut of just $20 from the rate reduction. For a family of four with income of $35,000, the tax from the rate reduction would be $168. By contrast, a family with gross income of $200,000 could receive a $1,500 break from the rate reduction.

The cost of lowering the 15 percent rate to 14 percent while leaving the higher rates unchanged, as the Senate bill would have done, would have been $26 billion in 2008. Adding in the reductions in the higher tax rates more than doubles the cost; the cost of the rate reduction in the conference agreement is $57 billion in 2008. The additional $31 billion in tax cuts would accrue solely to the 25 percent of taxpayers with the highest incomes.

Marriage Penalty Relief

The conference agreement provides three types of marriage penalty relief: an increase in the standard deduction for married couples, a modification of the earned income credit for married couples, and an increase in the income level at which the 15 percent tax rate ends for married couples and the 28 percent rate begins.

The increase in the standard deduction is well-targeted on middle-income families; most higher-income families have sufficient expenses to itemize their deductions and do not use the standard deduction. The bill would set the standard deduction for married couples at a level twice the deduction for single taxpayers. If this provision were effective in 1999, the standard deduction would increase by $1,400 this year. This would generate a tax cut of $210 for most couples in the 15 percent tax bracket. (Applying a 15 percent tax rate to $1,400 less in income yields a tax cut of $210.)

The second type of marriage penalty relief in the tax bill — a modest increase in the amount of earned income credit received by married couples with incomes between $12,000 and $32,000 — also is well-targeted. The standard deduction increase and other marriage penalty relief provisions in the conference agreement will not help most of these low- and moderate-income working families because they have no income tax liability and hence cannot make use of larger income tax deductions. Yet many of these families do face marriage penalties that arise from the structure of the Earned Income Tax Credit. EITC marriage penalties occur when two people with earnings marry and their combined, higher income places them at a point in the EITC "phase-out range" at which they receive either a smaller EITC than one or both of them would have received if still single or no EITC at all.[1]

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[1] Consider a man and woman that each work full time at the minimum wage. If unmarried, the man would file as a single taxpayer, while the woman would file as a head of household and claim an EITC for her two children. Before they are married, the man pays $550 in income tax while the woman qualifies for a $3,816 refund, the maximum EITC for a family with two children in 1999. Their combined refund thus is $3,270. If they marry, the couple's combined income puts them in the phase-out range of (continued...)

Who Is in the 15 Percent Tax Bracket?

The income level at which the 15-percent bracket ends has been widely misreported as being $43,050 for married filers. The $43,050 figure, however, is the level of *taxable income* at which the 15 percent bracket ends for married filers; it is not the level of *adjusted gross income* at which filers move from the 15 percent to the 28 percent bracket. The lowest level of gross income at which the 15 percent bracket ends for a married family of four is $61,250. (This is the level of adjusted gross income at which the standard deduction and the four personal exemptions the family would claim would reduce the family's *taxable income* to $43,050, the break point between the 15 percent and 28 percent brackets.) Married families of four that itemize their deductions can have incomes somewhat higher than $61,250 and remain in the 15 percent bracket.

Three quarters of all individuals and families are in the 15 percent bracket or owe no income tax. Only the top quarter are in higher brackets.

The tax bill would reduce EITC marriage penalties. (The bill would do so by raising by $2,000 both the income level at which the EITC for married families begins to phase down and the income level at which married families cease to qualify for any EITC benefits.) For a husband and wife that each work full time at the minimum wage, this provision would alleviate about one-third of their marriage tax penalty.

In contrast to the standard deduction increase and the EITC provision, the provision in the bill that would raise the income level at which the 15 percent bracket ends and the 28 percent bracket starts for married couples would benefit only those couples with incomes exceeding the level at which the 15 percent bracket currently ends. A couple with two children would need to have income surpassing $61,250 to benefit from this provision. (Couples *without* children would need to have income exceeding $55,750 to benefit.)

The cost of increasing the standard deduction for married couples to an amount that equals twice the standard deduction for single taxpayers would be $6 billion in 2008, while the cost of the EITC marriage penalty relief would be $1.3 billion. By contrast, the provision raising the income level at which the 15 percent bracket ends would cost $22 billion in 2008, three times as much as the other two provisions combined. All of the $22 billion in cost resulting from increasing the income level at

[1] (...continued)
the EITC and reduces their EITC substantially. Their combined refund is reduced to $1,930, yielding a marriage penalty of $1,340.

which the 15 percent bracket ends for married couples reflects tax cuts that would be limited to taxpayers in the top quarter of the income distribution.

Alternative Minimum Tax for Individuals

The bill would scale back the individual Alternative Minimum Tax beginning in 2005 and repeal it fully in 2008. This would allow some very high-income taxpayers to pay taxes at rates well below those that middle-income families pay — or to avoid paying personal income taxes altogether.

The individual AMT was enacted in its current form in the Tax Reform Act of 1986 as a way to prevent high-income taxpayers from using a combination of tax exemptions, deductions, and credits in such a way that they largely or entirely eliminate their income tax liability. The Joint Committee on Taxation projects that 937,000 taxpayers will pay the AMT in tax year 2000 and that approximately three-quarters of these taxpayers will have incomes exceeding $100,000.

In its current form, the AMT is projected to begin imposing additional taxes on some middle-income families in future years, a development that policymakers never intended.[2] The Joint Committee on Taxation projects that by 2008, some 6.9 million taxpayers will pay the AMT under current law, and 44 percent of them would have incomes below $100,000. By that time, a sizeable number of middle-income taxpayers would have various tax credits — such as the child credit, dependent care credit, or education credits — effectively reduced or eliminated as a result of the AMT. It is widely acknowledged that some modification to the AMT must be made to prevent this from occurring.

There are a number of ways the AMT could be modified to exempt most middle-income taxpayers from it while assuring that its original purpose — to prevent tax

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2. This will occur because the AMT utilizes a single deduction of $45,000 (for married couples) in lieu of the exemptions, deductions, and credits allowed for the normal tax calculation. The rate applied to the taxable income computed in this alternative manner is either 26 percent or 28 percent, depending on income. For taxpayers in the 28 percent tax bracket or a higher tax bracket, the alternative minimum tax generally is higher than the tax owed under the regular tax computation only if a taxpayer is using a very large amount of deductions and credits disallowed under the AMT. Unlike the personal exemptions and standard deductions used for the normal tax calculation, however, the single $45,000 deduction allowed under the AMT is not indexed for inflation. As a result, a growing number of middle-income taxpayers in the 15 percent tax bracket will begin to be subject to the AMT unless changes in the AMT are made. But there is no need to repeal the AMT to prevent it from affecting the tax burdens of the middle class.

avoidance by high-income taxpayers — continues in effect. The tax bill that emerged from conference, however, repeals the AMT entirely, which would result in windfalls for some very high-income taxpayers. If the AMT is repealed, some high-income individuals would again be able to escape all federal income tax or to reduce their tax payments very substantially.

The Treasury Department estimates that repeal of the AMT in 2008 would result in 25,000 taxpayers with incomes surpassing $200,000 escaping federal income tax in 2009. The Treasury also estimates that several hundred taxpayers with incomes of *more than $1 million* would avoid paying any income tax.

Estate Tax Repeal

The tax bill would gradually reduce the estate tax and fully repeal it beginning in 2009. The benefits of estate tax repeal would accrue solely to the estates of the nation's wealthiest decedents. Joint Tax Committee estimates show that under current law, only two percent of all deaths result in estate tax liability. Specifically, the Committee's estimates show that only 1.96 percent of decedents in 1999 will have estates large enough to require payment of any estate tax.[3]

Moreover, the bulk of the estate tax is paid by rather large estates. An IRS analysis of the 32,000 taxable estates filing in 1995 showed that the one-sixth of taxable estates with gross value exceeding $2.5 million paid nearly 70 percent of total estate taxes.[4]

Estate tax repeal thus would benefit only the estates of those high on the wealth scale. Claims that family farms and small businesses would be among the principal beneficiaries of this tax cut are inaccurate. Farms and small, family-owned businesses make up only a tiny proportion of taxable estates. The IRS analysis of estates that filed in 1995 found that all farm property, regardless of size, accounted for *less than one-half of one percent* of all assets included in taxable estates. Family-owned business assets, such as closely-held stocks, limited partnerships, and non-corporate businesses, accounted for *less than four percent* of the value of all taxable estates of less than $5 million.

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[3] Joint Committee on Taxation, *Present Law and Background on Federal Tax Provisions Relating to Retirement Savings Incentives, Health and Long-Term Care, and Estate and Gift Taxes* (JCX-29-99), June 15, 1999.

[4] Internal Revenue Service, *SOI Bulletin*, Winter 1996-97.

Cost of Tax Bill Would Reach $2.6 Trillion in Second Ten Years

The tax bill has an official cost of $792 billion over the 10-year period from 2000 through 2009. But its actual cost would likely exceed $792 billion in the first 10 years and reach approximately $2.6 trillion in the second 10 years, from 2010 through 2019.

The bill's official cost is held to $792 billion in the first 10 years through use of a gimmick. The bill "sunsets" many of its principal provisions after 2008 — including the reductions in tax rates, the marriage penalty relief, the capital gains rate cut and capital gains indexing, the increase in IRA contribution limits, and the repeal of the alternative minimum tax. The official cost estimate assumes these provisions will not be in effect in 2009. All remaining provisions of the bill then sunset after 2009.

In fact, canceling some of these provisions would be virtually impossible as a practical matter, while sunsetting others — while technically possible — would be extremely difficult politically. If these provisions really ceased to be effective after 2008, the result would be a $54 billion income tax increase in 2009 — larger than the tax increase that occurred in 1991 following the 1990 deficit reduction deal that President George Bush negotiated with Congress. (These comparisons adjust costs from different years for inflation.)

Furthermore, full sunset of the bill after 2009 would result in an unprecedented — and politically unthinkable — single-year tax income of $180 billion, which would be nearly three times larger than the tax increase that took effect in 1994 following enactment of the 1993 deficit-reduction legislation.

Without the highly unrealistic sunset provisions, the bill's cost — which mushrooms from $62 billion in 2004 to $117 billion by 2006 to $168 billion by 2008 — would rise to $180 billion in 2009. The official estimate, by contrast, shows the cost plummeting from $168 billion in 2008 to $126 billion in 2009.

After the initial 10-year period, the cost of the tax cuts in the bill would explode. Using conservative estimates likely to understate the bill's long-term cost, we find that if the tax bill became law and was in effect after 2009, it would cost approximately $2.6 trillion in the second 10 years, from 2010 through 2019. This is more than triple the $792 billion cost officially shown for the first 10 years. These massive costs in the second 10 years would occur during the same period in which the baby boom generation begins to retire, Social Security and Medicare costs mount, and surpluses both in the Social Security budget and the non-Social Security budget are expected to stop growing each year and begin shrinking.

Additional information concerning the devices the bill uses to mask its long-term costs and the likely cost of the bill in the second 10 years may be found in the Center analysis, *Conference Agreement Tax Cut Would Cost $2.6 Trillion in Second 10 Years*, by Iris J. Lav and Robert Greenstein.

Capital Gains

The legislation contains substantial reductions in capital gains taxes, which are paid on profits from the sale of stocks, bonds, and similar assets. The preferential tax treatment of capital gains income that current law provides would be expanded in two ways — through a rate reduction and an indexing provision.

Under current law, most assets held for more than one year are taxed at a maximum rate of 20 percent. Consider an asset that is purchased for $100,000, grows in value at 7.5 percent per year, and is sold after four years for $133,550. Under current law, the tax would be 20 percent of $33,550, or $6,709.

Current law already provides a major tax break on capital gains income. The affluent individuals who receive the vast bulk of the capital gains income have incomes sufficiently high as to pay income taxes at rates above the 28 percent rate. If capital gains were taxed at the same rate as other types of income, such as salaries, interest, dividends, and self-employment income — as they largely were for a number of years following passage of the 1986 Tax Reform Act — a taxpayer in the 31 percent bracket who secured the $33,550 profit in the example cited above would owe $10,400 in tax on the profit. Instead, because capital gains income is taxed at a preferential rate of 20 percent, this taxpayer owes $6,709, about one-third less.

Preferential capital gains tax rates are worth the most to the wealthiest individuals. The capital gains tax that a very high-income individual in the 39.6 percent tax bracket pays is only half what this individual would pay if capital gains income were taxed like other income.

The tax bill that Congress passed in early August would substantially enlarge the already-generous capital gains tax breaks in current law. First, the rate at which most capital gains income is taxed would be lowered from 20 percent to 18 percent.

Under the 1997 tax law, the tax rate on profits from the sale of assets held more than five years is already scheduled to decrease to 18 percent in 2006. The new tax bill would accelerate the effective date of this rate reduction to January 1999, making it retroactive.

Capital Gains Tax Cut Example

Initial investment	$100,000
Value after four years*	133,547
Profit	33,547
Tax on profit under current law	6,709
Tax at 18 percent with indexing	4,170
Total tax cut	-2,540
Percentage tax cut	-38%
Effective tax rate on profit	*12.4%*

*Assumes 7.5 percent annual growth in the value of the asset (2.5 percent for inflation and five percent real growth).

More important, the bill would eliminate the requirement that assets be held five years to qualify for the lower rate. The 18 percent rate would apply to gains on all assets held more than one year. In the example discussed above, this rate cut would reduce the tax on the $33,550 profit from $6,709 to $6,038, a further reduction of 10 percent in capital gains taxes.

The bill also adds a major additional capital gains tax break not included in either the House or Senate bill — a provision allowing investors to index profits for inflation when figuring their capital gains tax. Under current law, when the capital gains tax is applied to the profit from the sale of an asset, the profit is calculated as the difference between the price for which the asset was sold and the price at which the asset originally was purchased.

Under indexing, a calculation is made that can substantially reduce the amount of profit subject to tax. Assume in the example above that inflation averaged 2.5 percent per year during the four the years investor held the asset. Under the bill, a taxpayer figuring his or her capital gains tax would adjust the $100,000 he or she paid to purchase the asset upward to approximately $110,400 to account for four years of inflation; the capital gain to which the capital gains tax would apply would be considered to be $23,150 rather than $33,550 — $133,550 minus $110,400, rather than $133,550 minus $100,000. With an 18 percent capital gains rate, the tax due on the gain would be reduced to $4,170 as a result of indexing, an additional capital gains tax cut of 28 percent.

When the rate cut and indexing are considered together, the total capital gains tax cut in this example would be $2,540 — a 38 percent reduction in the capital gains tax. Moreover, this tax cut would come on top of the large reduction in capital gains taxes included in Taxpayer Relief Act of 1997. If those tax cuts are enacted, taxes on capital gains would be slashed *more than 50 percent* as a result of the two tax bills.

In the example used here of an asset purchased for $100,000 and sold four years later for $133,550, the effective tax rate on the profit would be reduced to 12.4 percent (that is, the capital gains tax paid would equal 12.4 percent of the profit the investor secured). This illustrates the fact that under the bill, many wealthy investors would pay a lower effective rate of tax on profits from the sale of stocks than moderate- and middle-income families would pay on their wages and on interest they receive on modest savings accounts.

The principal beneficiaries of both of the types of capital gains tax breaks the legislation contains would be wealthy investors. Two-thirds of all capital gains are received by the one percent of taxpayers with incomes exceeding $260,000. These high-

Capital Gains Tax Cuts Would Foster Economic Inefficiency and Tax Sheltering

One effect of the combination of the bill's capital gains rate cut and its indexing provision would be to increase substantially the difference between the top income tax rate on most forms of income and the effective tax rate on capital gains income. The current top rate on ordinary income — including salaries and interest and dividend income — is 39.6 percent. The combination of the proposed 18 percent maximum tax rate on capital gains income and the indexing provision would reduce the effective tax rate on capital gains in many circumstances to approximately 13 percent, or about one-third the rate that very high-income individuals pay on ordinary income.

This differential would create a huge incentive to "convert" ordinary income into capital gains. The large differential could lead investors to avoid investments that yield interest income, forcing some businesses to create equity instruments rather than to borrow needed capital even when borrowing makes more business sense. It also could lead executives to demand compensation in the form of stocks or stock options rather than salary.

More important, it could give new life to the tax shelter industry, which specializes in creating complex, multi-layered transactions that change the character of income for tax purposes. These types of income shifts and tax sheltering are the antithesis of economic efficiency; they skew investment decisions by causing many such decisions to be made on the basis of where the tax advantages are greatest rather than where the economic gain itself is the greatest in the absence of the distorting effect of the tax preferences. It was for precisely this reason — to enhance economic efficiency — that the Tax Reform Act of 1986 equalized the tax rates on ordinary income and capital gains income.

income individuals thus would receive approximately two-thirds of the benefits from the bill's capital gains tax reductions.

Moreover, fully one-third of all capital gains income goes to taxpayers whose annual capital gains income *exceeds $1 million*. These extremely high-income investors would gain the most from these capital gains tax cuts. Most of them would receive average annual capital gains tax cuts greater than the entire income of the typical American family.

Individual Retirement Accounts

The bill includes several types of Individual Retirement Account expansions. It would increase the income limits on the use of Roth IRA tax preferences by individuals with employer-sponsored retirement plans; this would benefit only highly paid individuals with incomes above the limits that current tax law sets. The bill also would more than double the amount a taxpayer and spouse can contribute annually to either a

conventional IRA or a Roth IRA.[5] This, too, would primarily benefit those on the higher rungs of the income scale, since few middle-income families could afford to put this much of their income aside and place it in an IRA each year.

The primary effect of these changes would be to give the 20 percent of taxpayers with the highest incomes substantial new tax breaks. Many of these taxpayers would secure these generous tax breaks by shifting savings from one account to another, rather than by saving more.

- Under current law, a taxpayer covered by an employer-sponsored pension plan may make deposits in a Roth IRA or a conventional IRA if the taxpayer's income is below specified levels. For married filers, the income limit is $160,000 for Roth IRAs. For conventional IRAs, the income limit for married filers will increase under current law to $100,000 by 2007.[6] Taxpayers of *any* income level who are not covered by an employer-sponsored plan may make tax-advantaged deposits to either Roth IRAs or conventional IRAs.

- The bill would raise the income limit on Roth IRAs for married filers to $210,000. This would allow substantial numbers of additional taxpayers with incomes that exceed the current limits to use Roth IRAs regardless of whether they also participate in a tax-favored employer-sponsored plan.

- The current limits exclude only a modest proportion of taxpayers from IRA tax preferences. The Joint Committee on Taxation reports that more than 80 percent of married taxpayers with earnings and more than 85 percent of single taxpayers with earnings are eligible to make deductible contributions to conventional IRAs in 1999. These percentages will rise

[5] Under conventional IRAs, qualified taxpayers and spouses may deduct from their taxable income each year up to $2,000 apiece in contributions to their accounts. Once the contributions are made, earnings of the deposits accumulate free of tax. Income taxes on the principal and interest are deferred until the funds are withdrawn. In contrast, contributions made to Roth IRAs are not deductible from taxable income. But all earnings on Roth IRA deposits are forever free of tax. All qualified withdrawals from Roth IRAs are free of tax because the principal already has been taxed and the earnings are not taxable.

[6] Under current law, married taxpayers who participate in an employer-sponsored pension plan may deduct contributions to a conventional IRA if they have income below $61,000 in 1999; the income limits rise to $100,000 by 2007. Married taxpayers participating in an employer-sponsored plan may contribute to a Roth IRA if they have income below $160,000. (For single individuals participating in an employer-sponsored plan, the income limit for deductible contributions to a *conventional* IRA is $41,000 in 1999, rising to $60,000 in 2005. The income limit for making a contribution to a *Roth* IRA is $110,000 for single taxpayers participating in an employer-sponsored plan.)

under current law, as the income limits for conventional IRAs increase in stages through 2007. Furthermore, the income limits for Roth IRAs are much higher than those that apply to conventional IRAs; the proportion of taxpayers eligible to make Roth IRA contributions under current law consequently is considerably higher than 80 percent to 85 percent.

- Since current law limits the ability of only the 20 percent of taxpayers with the highest incomes to use conventional IRAs — and the ability of a still-smaller percentage of high-income taxpayers to use Roth IRAs — lifting the income limits for Roth IRAs would almost exclusively benefit upper-income taxpayers.

- The bill also would increase the amount that can be contributed each year to either conventional or Roth IRAs. Under current law, a taxpayer and spouse may each contribute $2,000; the bill would raise the maximum contribution to $5,000 each. Thus, the total amount a couple could contribute would rise from $4,000 to $10,000. This, too, would favor higher-income taxpayers. Most of those able to contribute more than $2,000 to an IRA annually would be people who have relatively high incomes or already have substantial assets.

- Many higher-income individuals would be able to shift savings they already possess from taxable investments to tax-advantaged IRAs, thus securing a larger tax break without increasing their savings. On average, people who save through IRAs hold more than three times as much in financial assets as people who do not use IRAs, giving them ample opportunity to transfer assets from other types of savings to IRA accounts.

- While benefiting high-income households, an increase in the IRA contribution limits to $5,000 could work to the detriment of some low- and middle-income workers. It could lead some small businesses not to offer an employer-sponsored pension plan.

  Currently, a small business owner can contribute $2,000 to his or her own IRA and another $2,000 to his or her spouse's IRA, for a total of $4,000. To place more funds in a tax-advantaged retirement account, the business owner would have to establish an employer-sponsored plan that covers the business' employees as well as the owner.

  Under the bill, however, the small business owner and his or her spouse could deposit a total of $10,000 into their IRAs rather than $4,000. With these higher limits, the small business owner may not see a need to provide a company pension plan and may drop such a plan or fail to

institute a plan in the first place. As Donald Lubick, Assistant Secretary of the Treasury for Tax Policy, noted earlier this year in Congressional testimony on this matter, "Currently, a small business owner who wants to save $5,000 or more for retirement on a tax-favored basis generally would choose to adopt an employer plan. However, if the IRA limit were raised to $5,000, the owner could save that amount — or jointly with the owner's spouse, $10,000 — on a tax-preferred basis without adopting a plan for employees. Therefore, higher IRA limits could reduce interest in employer retirement plans, particularly among owners of small businesses. If this happens, higher IRA limits would work at cross purposes with other proposals that attempt to increase coverage among employees of small businesses."[7]

The bill also includes one other upper-income IRA tax break. Under current law, all taxpayers with incomes below $100,000 may choose to convert conventional IRAs they hold to Roth IRAs. The bill would allow joint filers with incomes up to $200,000 to make such conversions. Couples with gross incomes between $100,000 and $200,000 would be able to convert conventional IRAs into Roth IRAs.

Shifting funds from conventional IRAs to Roth IRAs could be highly advantageous to many affluent individuals in this income range. Once they have shifted funds from a conventional IRA to a Roth IRA, all amounts earned on the funds would be forever free of income tax. In addition, Roth IRAs can allow wealthy individuals to bequeath large amounts of funds to their heirs free of any income tax. Conventional IRAs require taxpayers to begin taking distributions of funds from their IRA accounts no later than at age 70½, but no such requirements apply to Roth IRAs. Well-to-do holders of Roth IRAs can leave all of the funds in the accounts, which then can be bequeathed. Furthermore, an heir may be able to keep the bulk of the funds from an inherited Roth IRA on deposit, with the earnings continuing to compound free of tax. (Heirs generally are required to take distributions from the inherited accounts only gradually, spread over the course of their own life expectancies.)

Health Insurance Deductions

Finally, the tax bill includes a new tax deduction for the purchase of health insurance by taxpayers who pay at least 50 percent of the cost of the premium. As first glance, this may seem an attractive idea. Closer examination indicates, however, that

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[7] Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the Subcommittee on Oversight, House Committee on Ways and Means, March 23, 1999.

the proposed deduction would provide little help to most of those lacking insurance and would not significantly reduce the ranks of the uninsured.

At least 93 percent of uninsured individuals either pay no income tax or are in the 15 percent income tax bracket. For them, this deduction would do little or nothing to make insurance more affordable, because it would reduce the cost of insurance by no more than 15 percent. As a result, those who would benefit most from such a tax deduction are, by and large, individuals in higher tax brackets who already purchase individual insurance.

- Some 18 million uninsured individuals — 43 percent of all of the non-elderly uninsured — owe no income tax; their earnings are too low for them to incur an income tax liability.[8] These uninsured individuals would receive no benefit from a tax deduction; a deduction would do nothing to make health insurance more affordable for them.

- Another 20 million uninsured individuals — 50 percent of the non-elderly people without health insurance — pay income tax at a 15 percent marginal tax rate. A deduction would provide these taxpayers with a subsidy equal to 15 percent of the cost of insurance not covered by an employer. For low- and moderate-income families and individuals without employer-sponsored coverage, a 15 percent subsidy that leaves them with the other 85 percent of the premium cost is much too small a subsidy to make insurance affordable.

  For a family earning $35,000 whose employer does not offer insurance, the proposed deduction would reduce the out-of-pocket cost of a typical family health insurance policy that carries a $1,000 deductible from $6,700 to $5,860 — or from 19 percent of income to 17 percent of income.[9] An Urban Institute study shows that more than three-quarters of low- and moderate-income uninsured individuals will not purchase insurance that

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[8] General Accounting Office, Letter to The Honorable Daniel Patrick Moynihan, June 10, 1998, GAO/HEHS-98-190R, Enclosure II. The analysis is based on the 1996 Current Population Survey.

[9] A General Accounting Office study found that in 1996, the middle of the range of premium costs was $5,700 for a family-coverage policy that included a $1,000 deductible. The proposed tax deduction would provide a subsidy of $840 for the purchase of a policy with a $5,700 premium ($840 equals 15 percent of $5,700). This means the family would have to pay the remaining $4,860, or 14 percent of its income, to purchase the health insurance policy. Since this premium is for a policy with a $1,000 deductible, another three percent of income would have to be expended before any benefits would be available. The family's net expenditure for health coverage — the premium plus the deductible — would total $5,860, or 17 percent of the family's income. Without the proposed tax deduction, the full cost of the policy plus the $1,000 deductible is equal to 19 percent of the family's income.

consumes more than *five* percent of their income.[10] Few families that have forgone health coverage because they cannot afford to spend 19 percent of income on it would find coverage affordable because a deduction had lowered its cost to 17 percent of income. (By contrast, the child health block grant established in 1997 set a limit on the premiums and co-payments that can be charged under programs that receive block grant funds, with the limit being *five* percent of income for families above 150 percent of the poverty line and lesser amounts for poorer families.)

- This provision might be of modest help to some moderate-income families whose employer pays half or nearly half of the premium costs since the deduction would be in addition to the employer subsidy. But even families whose employers pay 50 percent of the premium would receive only very modest help from the deduction. The deduction would reduce the proportion of the premium that these families have to pay only from 50 percent of the premium to 42.5 percent.

  While that might help some families afford insurance, the number of such families likely would be small. Moreover, the deduction could induce some employers currently paying more than 50 percent of premium costs to scale back their contribution to 50 percent (or possibly less)

- The group that would appear to benefit most from this deduction would be higher-income taxpayers. A health insurance deduction is worth more than twice as much to affluent individuals in the 31 percent, 36 percent, and 39.6 percent brackets than to moderate- and middle-income families in the 15 percent bracket. Although few higher-income individuals and families are uninsured, a significant number do buy insurance on the individual market. Under this provision, these higher-income taxpayers could deduct the cost of the premiums they pay for health insurance coverage they already have.

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[10] Leighton Ku, Teresa Coughlin, *The Use of Sliding Scale Premiums in Subsidized Insurance Programs*, Urban Institute, March 1997.

Revised July 12, 1999

Much of the Projected Non-Social Security Surplus Is a Mirage:

Vast Majority of Surplus Rests on Assumptions of Deep Cuts in Domestic Programs that Are Unlikely to Occur

by Sam Elkin and Robert Greenstein

Estimate of Available Surplus Lower than in Earlier Center Analyses

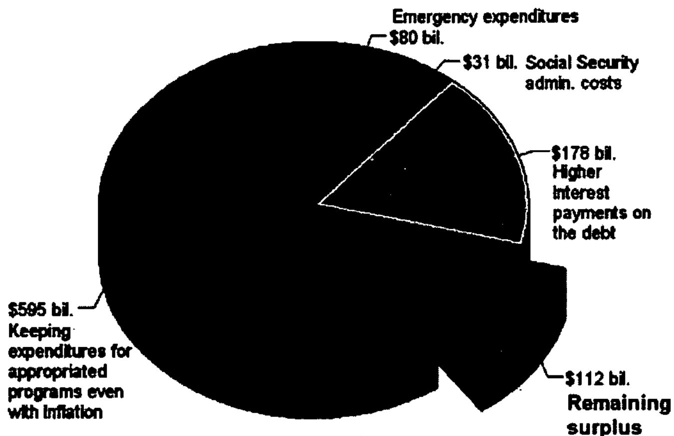
Based on Congressional Budget Office data, this analysis shows that when realistic assumptions are used, the non-Social Security surpluses total only about $112 billion over the next 10 years. Earlier Center versions of this analysis showed modestly larger available surpluses. The revisions in this analysis stem from two factors. First, on July 12, the Congressional Budget Office issued a table that raised CBO's estimate of the portion of the CBO surplus projection that results from the assumption that discretionary spending will be cut. CBO had earlier estimated that $584 billion of the projected surplus was attributable to assuming that non-emergency discretionary spending would be reduced below the FY 1999 level of non-emergency discretionary expenditures, adjusted for inflation. CBO now estimates that $595 billion of the surplus projection is due to this assumption. Second, an earlier Center analysis did not address the assumption in the CBO projections that there would be no emergency expenditures for the next 10 years. This revised Center analysis does address this matter.

Congressional Budget Office figures released July 1 indicate that the large majority of the budget surplus projected outside Social Security is essentially artificial because it depends on unrealistic assumptions that large, unspecified cuts will be made over the next 10 years in appropriated programs and that there will be no emergency expenditures over this period. When the more realistic assumption is made that total non-emergency expenditures for appropriated programs will neither be cut nor increased and will simply stay even with inflation — and that emergency expenditures will continue at their 1991-1998 average level — nearly 90 percent of the projected non-Social Security surplus disappears.(1)

The new CBO projections show that under current law, the federal government will begin running surpluses in the non-Social Security budget in fiscal year 2000 and run cumulative non-Social Security surpluses of $996 billion over the next 10 years. But these projections, like those OMB issued several days earlier, assume that total expenditures for appropriated programs — which include the vast bulk of defense expenditures — will remain within the austere and politically unrealistic "caps" the 1997 budget law set on appropriated programs.(2)

The Available Surplus: Smaller Than You Think

Projected Non-Social Security Surplus: $996 Billion
Available Surplus: $112 Billion



- To remain within the FY 2000 caps will entail cutting appropriated (i.e., discretionary) programs billions of dollars below the FY 1999 level. No one expects this to occur. Leaders of both parties have acknowledged that a number of appropriations bills cannot pass unless the amount of funding provided for the bills is at significantly higher levels than the current caps allow.

- The caps for FY 2001 and 2002 are more unrealistic than the FY 2000 cap; the caps for those years are significantly lower than the FY 2000 cap when inflation is taken into account. Moreover, the CBO and OMB projections assume that for years after 2002, total expenditures for appropriated programs will remain at the level of the severe cap for FY 2002, adjusted only for inflation in years after FY 2002. This means that the surplus projections assume levels of expenditures for appropriated programs for fiscal years 2001 through 2009 that are *lower, when inflation is taken into account, than the highly unrealistic FY 2000 cap that almost certainly will not be met.*

- Also of note, both parties have proposed significant increases in defense spending in coming years. Defense spending constitutes about half of overall expenditures for appropriated programs. In addition, legislation enacted last year requires increases in highway spending in coming years. These factors are further reasons why the caps are unlikely to be sustained.

CBO must base its budget projections on current law. The spending caps on appropriated programs are current law. CBO has acted properly in developing its projections. But policymakers who act as though the $1 trillion in non-Social Security surpluses projected over the next 10 years all represent new funds that can go for tax cuts or program expansions appear to misunderstand the meaning of the projections.

- Because the CBO projections rest on the assumption that expenditures for appropriated programs will be held to the levels of the caps, these projections assume that over the next 10 years, these expenditures will be reduced $595 billion below current (i.e., FY 1999) levels of non-emergency discretionary spending, adjusted for inflation. (The $595 billion figure is found in a CBO table on this matter issued July 12.)

- Since defense spending is widely expected to rise, all of these $595 billion in cuts would have to come from non-defense programs, primarily domestic programs. This would entail reducing overall expenditures for non-defense appropriated programs by 15 percent to 20 percent over the next 10 years, after adjusting for inflation. Since some areas of non-defense spending such as highways are slated to increase, other areas would need to be cut deeper than 15 percent to 20 percent. Achieving cuts of this magnitude in non-defense appropriated programs would be unprecedented.

- Cutting federal expenditures results in lower levels of debt. CBO projects that the $595 billion in reductions in appropriated programs assumed in its baseline would generate $154 billion in additional savings over the next 10 years through lower interest payments on the debt. Consequently, the reductions in appropriated programs that the CBO projections assume result in total savings of $749 billion over the next 10 years.

CBO's Surplus Forecast
How Much is Really Available for Tax Cuts and Program Expansions?
(in billions of dollars)

CBO projection of non-Social Security surplus over 10 years	**$996**
Amount needed to keep non-emergency spending for appropriated programs even with inflation	-595
Likely emergency expenditures (based on average annual emergency expenditures, FY 1991-1998)	-80
Social Security administrative costs (CBO counts as a Social Security expenditure, but Congress counts as a non-Social Security expenditure)	-31
Higher interest payments on debt due to higher levels of spending for appropriated programs than the CBO projections assume	-178
Remaining surplus available for other uses (if some of this is used for tax cuts or program expansions, interest payments will rise further above the CBO projection, requiring some of the $112 billion to be used for interest costs)	**112**

These $749 billion in assumed savings account for 75 percent — or three-fourths — of the non-Social Security surplus projected over the next 10 years. Since most or all of these cuts are unlikely to materialize, a large majority of the surplus projected in the non-Social Security budget is essentially a mirage.

Emergency Spending

Nor does this represent the full extent to which the CBO projections rest on assumptions that lead to an overstatement of the likely non-Social Security surplus. The CBO projections assume no emergency spending for the next 10 years. There will, of course, be emergencies over the next 10 years that result in government expenditures. There have been emergency expenditures outside the spending caps every year since the Budget Enforcement Act of 1990 established the caps. Hurricanes, tornados, floods, and international emergencies will not magically disappear.

Over the 1990's, emergency funding has averaged $8 billion a year, excluding both emergency expenditures for Desert Storm in the early 1990s and the higher level of emergency spending in fiscal year 1999.(3) The most prudent assumption to make is that emergency expenditures will continue to average about $8 billion a year.

This means an additional $80 billion of the projected surplus over the next 10 years is not likely to materialize since it will be used for emergency expenditures. This $80 billion in expenditures will cause interest payments on the debt to be $24 billion higher than the levels the CBO projections assume.

Congressional and Clinton Budgetary Treatment of Spending for Appropriated Programs

The Congressional budget resolution approved earlier this year assumes a very large tax cut of $778 billion over 10 years. The resolution can accommodate a tax cut of this magnitude because it assumes that *none* of the surplus will go to placing spending for appropriated programs at a more realistic level. Moreover, the budget resolution assumes that *additional* cuts in appropriated programs of nearly $200 billion over 10 years will be instituted, *on top of* the already unrealistic reductions assumed in CBO's projections. (These additional reductions would come in years after 2002.) Under the budget resolution, overall expenditures for non-defense appropriated programs would be cut 29 percent between FY 1999 and FY 2009, after adjusting for inflation.

The Clinton budget would add back somewhere in the vicinity of $500 billion over 10 years for appropriated programs, or most of the $595 billion needed to keep non-emergency spending for appropriated programs even with inflation. The Clinton budget only uses $328 billion of the surplus, however, for this purpose. The remaining funds would be raised through a series of offsetting cuts in entitlement programs and tax increases, such as a cigarette tax increase. Many, if not most, of these offsets are given little chance of passage on Capitol Hill. If these offsets are not approved and no funds from the surplus are provided for appropriated programs beyond the $328 billion the Administration has proposed, appropriated programs would have to be cut approximately $270 billion over 10 years below current levels, adjusted for inflation. (To compute the exact amount appropriated programs would have to be reduced under this scenario requires data not yet available on the Administration's new budget plans.) In addition, the Administration's budget does not appear to reserve a portion of the surplus for the emergency expenditures that inevitably will occur.

Another $31 billion also must be subtracted from the projected non-Social Security surplus; it is needed for the administrative costs of operating Social Security. As the Congressional Budget Office explains on page 6 of its new report, CBO counts these $31 billion in costs as a Social Security expenditure, but Congress treats them as part of the non-Social Security budget and counts them against the spending caps on discretionary programs. (The Congressional budget resolutions passed each year include these expenditures as non-Social Security expenditures that affect the size of the non-Social Security surplus. It is the budget resolution, not the CBO projections, that Congressional budget rules enforce.) Counting these costs as part of the non-Social Security budget reduces the non-Social Security surplus.

When this $135 billion — $80 billion for emergency expenditures, $24 billion for related interest payments on the debt, and $31 billion for Social Security administrative costs — is added to the $749 billion described above in expenditures for appropriated programs and related interest payments on the debt, a total of $884 billion — 89 percent of the projected non-Social Security surplus — dries up. Only $112 billion remains. (See table on page 3.) In addition, non-Social Security surpluses of any size do not appear until 2006; the non-Social Security budget either continues to show deficits or is in balance (but without significant surpluses) until that time.

One other caution regarding the surplus projections should be noted. The economic and technical assumptions underlying the forecast could prove too rosy (or not rosy enough). CBO has repeatedly warned that a high degree of uncertainty attaches to budget projections made several years in advance. In a report issued earlier this year, CBO noted that if its projections for fiscal year 2004 prove to miss the mark by the average percentage amount that CBO projections made five years in advance have proved to be off over the past decade, its surplus forecast for 2004 will be off by $250 billion.[(4)] If economic growth is modestly slower than forecast or health care costs rise substantially faster than is currently projected, budget surpluses could be substantially lower than those reflected in the CBO estimates.

Trends in Discretionary Spending

Expenditures for appropriated (i.e., discretionary) programs are already low in historical terms as a percentage of GDP. There is serious question about how much further they can be expected to decline.

- CBO projects that total discretionary spending will equal 6.5 percent of GDP in fiscal year 1999, the lowest level since at least 1962. (Published data on discretionary spending as a share of GDP only go back to 1962.)
- Much of the decline in discretionary spending as a share of GDP has come in defense spending, which fell following the end of the Cold War. But non-defense discretionary spending also has contracted as a share of GDP. At 3.4 percent of GDP this year and last, non-defense discretionary spending is at as low or lower a share of GDP as in any year since 1962.(5)
- Under the new budget projections, discretionary spending would fall much further as a percentage of GDP. The new CBO projections assume discretionary spending will fall from 6.5 percent of GDP today to 5.0 percent in 2009, a much lower level than in any year in decades.

Discretionary spending may be approaching its limits in terms of how much more it can fall as a share of GDP. That may be one of the lessons both of last year's highway bill and of last October's omnibus appropriations bill, which exceeded the budget limits for discretionary spending and designated the overage as emergency spending.

While non-defense discretionary spending has fallen over the past several decades as a share of GDP, it has not declined in inflation-adjusted terms (although it has declined since 1980 if an adjustment reflecting the increase in the size of the U.S. population is made as well). If we have emerged from a period of deficits without expenditures for non-defense discretionary programs having declined in inflation-adjusted terms, there is little reason to believe the political system will exact deep cuts in this part of the budget when the outlook is sunny, surpluses have emerged, and pent-up demands for various types of discretionary spending are coming to the fore (witness the aviation bill the House recently approved). This underscores the unrealistic nature of the assumptions of substantial reductions in discretionary program expenditures that underlie the projections of $1 trillion non-Social Security surpluses.

How Much of the Surplus Is Available for Tax Cuts, Medicare, and Social Security If More Realistic Assumptions Are Used?

In summary, if more realistic assumptions are used — namely, that total non-emergency expenditures for discretionary programs will remain at the fiscal year 1999 level, adjusted for inflation, and emergency spending will remain at its average level for the recent past — a very different picture emerges of how much in surplus funds is available for tax cuts, shoring up Medicare and Social Security, and other initiatives. Under this more plausible scenario, only about $112 billion remains available, and hardly any of it is available in the next five years.(6)

It may be noted that to assume, as we do here, that total non-emergency expenditures for appropriated programs will be no higher in future years than non-emergency expenditures for such programs in fiscal year 1999, adjusted for inflation, is to use a conservative assumption. It is a foregone conclusion that defense spending will rise faster than inflation. Hence, for *overall* non-emergency expenditures for appropriated programs to remain even with inflation, non-defense programs must be cut in real (i.e., inflation-adjusted) dollars. Yet spending for some non-defense program areas such as highways is already slated to rise. The House recently passed legislation to boost aviation spending as well. Thus, the assumption used here for expenditures for appropriated programs may be too low.

These findings have major implications for policymakers. For there to be sufficient surplus funds to finance the large tax cuts some policymakers advocate, Congress would have to make cuts of unprecedented depth in appropriated programs over the next 10 years — cuts substantially deeper than those policymakers are balking at passing this year.

End Notes:

1. We use the average level of emergency spending in fiscal years 1991 through 1998, other than expenditures for Desert Storm. This also excludes the high level of emergency spending in fiscal year 1999. The term "appropriated programs," as used here, means discretionary programs.

2. Technically, OMB assumes expenditures for discretionary programs that exceed the caps, but it also assumes offsetting reductions in mandatory programs and tax increases.

3. The $8 billion figure represents average funding for emergencies other than Desert Storm for fiscal years 1991 through 1998, as expressed in 1999 dollars.

4. In computing the average percentage amount by which CBO projections made five years in advance have proven to be off, CBO excluded the effects of legislation on deficits or surpluses. The $250 billion figure is based on the average percentage amount by which the budget projections missed the mark due solely to economic and technical factors. See CBO, *The Economic and Budget Outlook: Fiscal Years 2000-2009*, January 1999, p. xxiii.

5. This level also stood at 3.4 percent of GDP in 1962 and 1989. There is no year since 1962 when it was lower than 3.4 percent of GDP.

6. There would be a small non-Social Security surplus in fiscal year 2002.

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TESTIMONY BEFORE THE JOINT ECONOMIC COMMITTEE

By

Wayne D. Angell

September 13, 1999

Mr. Chairman, members of the committee, thank you for the opportunity to testify today on the subject of tax cuts. It is a very welcome opportunity to discuss some of the important economic analytical principles that, I believe, should be used to cast light on the current debate about tax reduction in the context of the Republican plan to cut taxes by $792 billion over the next 10 years. Let me say at the outset that while the plan is far from perfect, it represents a first step toward addressing our most critical problem—the inadequacy of national saving in financing the burgeoning growth of capital spending on which our new era economy depends. Before turning to the critical risk posed by our undersaving problem, I believe it is important to review the performance of the U.S. economy and the favorable economic outlook.

U.S. economic performance and outlook

U.S. economic growth is very strong, core inflation rates are at their lowest levels in over three decades, job creation is robust, unemployment is at a three-decade low, real wages are rising, and the stock market hits new records with remarkable frequency. The current economic expansion is in its 103rd month and is the longest peacetime expansion in the history of the United States. However, the expansion shows no signs of old age. Over the last three-and-a-half years, annualized real GDP growth has averaged 3.9% as measured by the Commerce Department, and there are good reasons to believe that this growth rate is understated. Inflation, however, has fallen on balance over this period to levels that policymakers thought unlikely to occur. Indeed, during the first seven months of 1999—a period during which inflation anxieties have risen in some quarters—the core rate of CPI inflation has been only 1.7%, which is the lowest rate of core inflation over such a period since 1965. The unemployment rate has fallen to a 29-year low of 4.2%. All socioeconomic groups have increasingly felt the fruits of the expansion, although much progress yet needs to be made. This is why I favor policies that will produce the fastest sustainable rate of economic growth.

I believe that this remarkable economic performance is consistent with the view the U.S. economy has entered a New Era. The font of New-Era economic performance is the focus on shareholder value by U.S. companies that has in turn produced a sharp increase in the growth rate of labor productivity. The Federal Reserve and Congress have made important policy choices

that have helped bring about this economic transformation of U.S. companies. First and foremost has been the Fed's pursuit of gradual disinflation that appears to have removed from CEOs the notion that they have any pricing power. Second, the administration and congress have, for the most part, been supporters of free trade policies, including the passage of NAFTA. Third, budgetary discipline has freed real resources for private employment and has permitted the emergence of federal government fiscal surpluses, which, up to now, may have contributed to lower borrowing costs. Fourth, the reduction in capital gains tax rates combined with the lower effective tax rate on capital that is a product of the decline in inflation has offset the partial reversal of the 1980s' tax rate reductions by the Bush and Clinton administrations and thereby our economic performance has remained on track.

Perhaps the most important contribution that has been made is the restoration of confidence in the dollar that enabled an emergence of a highly competitive entrepreneurial high-tech economy. The emerging digital economy, so well described in a recent Commerce Department study, has provided CEOs, CFOs, COOs, line managers, and workers with the tools to enhance productivity growth, cut costs, and better address the needs of customers. Over the last three-and-a-half years, nonfinancial corporate productivity growth has averaged 2.9% per year, and, over the last year has run at an even higher rate of 3.8%. This compares very favorably to the 1.5% average growth rate of productivity recorded between the mid-1980s and the mid-1990s. This rapid growth of labor productivity has been made possible by a sharp rise in investment as a share of the overall economy. In real dollar terms, the share of nonresidential fixed investment in GDP has risen to a record-high 13.3% in the second quarter of 1999 from a low of 8.8% at the beginning of the current expansion. Spending on computers has grown rapidly, averaging an annualized growth rate of 50% since the end of 1995.

Our undersaving problem

This remarkable economic performance, however, cannot be taken for granted. We face a persistent and growing mismatch between national saving and gross private domestic investment. Quite simply, our after tax rate of return on savings does not provide sufficient motivation to save annually the $1.5 trillion dollars needed for investment in labor productivity enhancing capital goods. Currently, domestic savings of government, business and households of nearly $1.2 trillion falls about $0.25 trillion short of our demand for capital goods necessitating a foreign inflow of money capital. That means that over the next 10 years we are at risk that our net external obligations of net debt and net external equity obligations nearly double as a percent of $GDP from the current 17% to 30% in 2009 as our net external obligations rise from $1.5 to

perhaps $4.3 trillion. In contrast, it is likely that the U. S. debt held by the public to $GDP ratio will decline from the 41% current level to 17% in 2009. And that includes an assumption that the Congress will decrease tax rates sufficiently to hold general government revenues in balance with general government expenditures over the next 10 years.

Social Security trust fund receipts are likely to exceed outlays by about $1.9 trillion over the next ten years. If we were to balance the general government budget on average over the next ten years then U. S. government debt available to be held by the public would be cut in half from $3.8 trillion to $1.9 trillion. That would mean that the debt held by the public to $GDP ratio would have declined from 50% in 1995 to the current 41% and continue to decline to 17% in 2009.

Foreign central bank current holdings of $0.6 trillion and other foreign holdings of U. S. Treasury securities of $0.7 trillion surely would need to rise by at least 50% over the ten year period if we are going to attract capital inflows. And assuming that the Federal Reserve grows its balance sheet of Treasuries at the same 5% growth rate assumed for $GDP there would be no Treasury securities for the private sector. No Treasuries bills, notes and bonds for holding by state and local governments, including pension plans. Likewise there would not be any U. S. savings bonds or Treasuries available for holding by U. S. citizen including all of our private pension plans.

From this perspective it would seem irresponsible to continue to overtax our citizens to pay down the national debt. As the public debt to GDP ratio falls the corporate plus household debt to $GDP ratio will increase, unless we enter a period of credit contraction, and we can expect to continue to see the spread between Treasury securities and corporate securities widen. In principle, there is some level of debt to GDP that is optimal given the preferences of society. Given the high priority use of Treasury securities for the Federal Reserve and for other central banks there is ample reasons to suggest that that optimum ratio should not fall below 25 percent. In addition to central bank functions government debt is demanded by investors and public pension plans managers who require a very safe and highly liquid asset—indeed the concept of a risk-free asset is central to numerous theories of the efficient functioning of financial markets.

Consider, for example, the dollar's central role as the reserve asset of the world. Clearly, such a role has imparted tremendous benefits on the U.S., not the least of which is the seniorage gain from the $487 billion of U.S. currency that circulates, with perhaps at least two-thirds of these greenbacks circulating overseas. In addition, overseas monetary authorities as the major asset in their foreign currency reserves hold $603 billion of U.S. government securities. It is unlikely, in

my judgment that foreign monetary authorities would hold anywhere near the amount of dollars that they currently do if there were no safe, liquid asset for them to hold. And as the Federal Reserve succeeds in making the dollar synonymous with price stability and the economy of the United States creates high rates of returns on capital, more countries are likely to consider dollarization, currency boards, or to maintain even higher dollar reserves in floating currency systems.

The Federal Reserve also needs a safe, liquid asset in order to conduct their open market operations. The Fed alters the level of overnight interest rates by buying or selling U.S. Treasury securities. The Fed would face considerable operating difficulties if there were not a liquid Treasury market. Think of the credit assessment signal that could occur if the FOMC were forced to substitute corporate debt for Treasury bills and notes in doing open market operations. Corporate securities in Federal Reserve banks portfolios would necessitate an FOMC credit rating and credit approval. Imagine the banking community and Wall Street ramification of word that X Corporation securities have been removed from the FOMC approval list. Clearly risk free Treasury securities have a decided advantage. Furthermore, the Treasury securities in the Fed's portfolio provide the asset that is used to back the U.S. currency. The Federal Reserve currently owns $486 billion of U.S. Treasury debt. Immediately we see, therefore, that the Federal Reserve and other central banks hold $1.1 trillion of federal debt.

The private sector also has a need for the safety and liquidity of U.S. Treasuries. Private pension companies, state and local pension plans, and insurance companies hold $683 billion of U.S. Treasuries, despite the fact that higher yielding assets, such as corporate bonds and mortgages, are available. It is because of the demand for the perceived safety of Treasuries that the government is able to borrow at lower rates than the private sector. If the private sector views holding some Treasury debt in its portfolio as desirable, it is likely that optimal debt-to-GDP ratio is somewhere between 25% and 40%.

On the other hand, the appetite for government debt is not unlimited. One of the major causes of financial instability and consequent inflation in other parts of the world and at other times has been an unsustainable large government debt, which has ultimately ended in some form of monetization of the debt. In recent experience, the examples of Russia at the present time and Brazil earlier in the decade should serve to illustrate the point. It is possible that Japan is heading in that direction since the debt-to-GDP ratio in Japan moved above 100% at the end of last year.

By international standards, the U.S. debt to GDP ratio is relatively low. The ratio of federal debt held by the public has fallen to 41.1% in the second quarter, which is down sharply from a ratio

of 50.1% in 1995. With the federal government projected to run significant surpluses, this ratio is likely to fall sharply over the next decade. Note that at present levels of growth (I assume 5% nominal GDP growth) and federal debt, the debt will decline as a share of GDP as long as the deficit is below 2% of GDP. Note also that if the federal budget is just kept in balance, the debt to GDP ratio will fall to 17% by the end of the next decade, which is lower than the debt to GDP ratio has reached in the post was period. If, in addition to a $1.9 trillion buy down by the social security trust funds, a general government surplus were to run at 1% of GDP, federal debt would fall to less than 10% of GDP by the end of the next decade.

Compare this level of debt to European debt levels. In Germany, the debt to GDP ratio was about 63% last year. In France, the ratio was about 59%. In Italy, about 119%. And in the UK, the ratio was about 53%. By G-7 standards, therefore, US debt is low in relation to GDP. Why should we postpone reducing taxes to push the federal debt to levels that we have seen in the post war period or across other G-7 countries?

Tax policy and the saving rate

Some prefer to keep marginal tax rates high in order to pay down the national debt in order to foster a low interest rate environment. Surely, it is not hard to understand that with a continued shortfall in national saving as compared to our investment demand it is likely that interest rates will remain high enough to continue to attract money capital inflows from abroad. Consequently, there is little likelihood that interest rates can come down and some risk that rates will increase. Until we alter our tax disincentives to saving, interest rates will necessarily be high enough to offset the tax rate or to attract additional money capital from abroad.

The only way to get our economy back onto a path to lower interest rates is to alter the after tax rate of returns on savings. That is why I have supported a radical switch from an income tax to a consumer spending tax. But, that is not the choice that we have today. Our choice today is to take the first step toward a reduction in marginal tax rates that will improve expectations for lower taxes on saving in the future.

The proposed $792 billion tax cut over 10 years amounts to less than $80 billion per year. Assuming 5% nominal GDP growth, the average annual level of GDP over the next decade would be almost $12 trillion per year. The GOP tax cut proposal represents, therefore, a very modest two-thirds of a percent of GDP.

From one perspective it may seem too low to make much difference. Yet, we should know that failure to take this small step would likely lead us to a legislative atmosphere of spending the

money and thereby losing momentum for economic growth. In order to continue the surge in non-residential capital spending which is essential in order to continue to increase labor productivity, we have to be very Spartan in our use of our labor and capital to produce public services. And this tax cut proposal that includes marginal tax rate reductions, a reduction in the capital gains tax rate, and reductions in death taxes does go several small steps in the direction of increasing our saving rate.

Once again, I want to reiterate that our fabulous new era economy is essentially driven by the surge in non-residential capital spending from 9% of real GDP in 1990 to 13.3% in the second quarter of 1999. High technology capital spending is the source of the growth of non-financial corporate productivity to 2.9%. Yet national saving lags far behind and is growing at the same rate as $GDP—just over 5%. Meanwhile capital investment is growing at a 9% annual rate. The shortfall in saving is large as a percent of $GDP and getting larger. That means that the annual deficit in our external sector is getting larger and that our net external obligations as a percent of $GDP are likely to rise from the current ratio of 17% to 30% in 2009 or in dollars from $1.5 to $4.3 trillion. At some point we run the risk that foreign investors and central banks will want higher interest rates to compensate them for the risk of dollar devaluation.

Up to now in its conduct of monetary policy the Federal Reserve has been free to focus almost exclusively on price stability conditions in our domestic economy. If we fail to make savings more attractive by reducing the tax disincentive to saving then Federal Reserve monetary policy considerations may increasingly be at risk as to the willingness of foreign investors and central banks to hold dollars in either Treasury or corporate securities. Think of the ramifications of a downturn in bond prices and a downturn in equity prices generated by a declining dollar or vice versa. Our economy is not immune from changes in foreign assessment if we continue a tax system that damages our incentive to save. It is time to begin. Let's not risk waiting until we have a crisis.

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