

Testimony by

Peter G. Peterson*

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Executive Summary

Mr. Chairman and members of the Committee, thank you for inviting me to comment on the administration's tax plan. While I am not here representing The Concord Coalition, many of that organization's leading members—including Bob Kerrey, Warren B. Rudman, Robert E. Rubin, Sam Nunn, Chuck Bowsher, Lloyd Cutler and Paul A. Volcker—have joined me in recent and similar public messages on fiscal policy.

On the question of tax cuts, we perhaps best expressed our views at a Concord Coalition press conference on March 8, 2001. We said at that time that, if a fiscal stimulus is enacted, its main purpose should be demand-side stimulus. As such, it should (1) be temporary; (2) be targeted to taxpayers and/or businesses most likely to spend it; and (3) do nothing to aggravate our already unsustainable long-term fiscal outlook. Looking at the administration's current tax plan, I'm sure our group would all still agree with this formulation—and would express even more urgency than before over the fiscal long-term implications. Indeed, a group of us did so in the recent attached op-ed piece in the New York Times.

In my complete testimony I review the grave deterioration in the budget outlook over the past two years and the long-term injury resurgent deficits threaten to inflict on the economy and on future generations. I then turn to the arguments the administration has made in favor of its tax plan and why I don't find many of them particularly persuasive. Allow me to summarize the highlights.

The Worsening Fiscal Outlook

Mr. Chairman, two years ago, the ten-year budget balance was projected by the CBO to be a mountainous surplus of \$5.6 trillion. A large tax cut and unexpected spending growth, combined with the bursting of the stock market bubble and the 2001 recession, slashed that surplus to a mere \$0.9 trillion by March of 2003. The CBO says enactment of the administration's 2004 budget proposals would pull the projected ten-year balance down to a *deficit* of \$1.8 trillion. I believe a more realistic estimate is a deficit of \$4.0 trillion. In just two years, America has thus witnessed a \$10 trillion projected deficit swing—undoubtedly the biggest swing in fiscal expectations in U.S. history other than during years of total war.

There are times, to be sure, when deficits today can be justified by surpluses tomorrow. But right now the long-term deficit outlook is even worse than the 10-year outlook. Let's keep in mind that we face an unfunded obligation for Social Security, Medicare and federal pensions of \$25 trillion. As a share of payroll, the cost of Social Security and, Medicare's Hospital Insurance program alone will rise from 14 percent today to between 24 and 34 percent by 2040. If senior entitlements are simply left on

autopilot, both the CBO and GAO conclude that deficits will eventually rise to economy-shattering levels. We've grown used to thinking about entitlements as a "long term" problem, but in fact it's beginning to overlap with our near-term projections. The first Boomer will be eligible for early retirement on Social Security (at age 62) in 2008; this generation will be retiring on full benefits by 2011.

Why Deficits Matter

A future of mounting deficits is a cause for grave concern. Mounting deficits can slow and even halt the steady growth in material living standards that has always nourished the American Dream. When such deficits are incurred in order to fund a rising transfer from young to old, they also constitute an injustice against future generations.

Economically, the problem with deficits is that they soak up national savings and crowd out productive investment. Since America's savings pool is shallow, the impact of large deficits is especially harmful. From 10.9 percent of GDP in the 1960s, America's net national savings rate slid to 4.8 percent in the 1990s—and to two consecutive postwar lows of 3.3 percent of GDP in 2001 and 1.7 percent in 2002.

With real interest rates now so low, some defenders of deficit spending say there's little reason to fear that today's growing deficits are about to crowd out productive investment. I believe, however, that today's low rates are a cyclical phenomenon and unlikely to last. Moreover, as economists William Gale and Peter Orszag have recently pointed out, the strength of the relationship between interest rates and deficits is "at least partially a red herring." Regardless of the effect of deficits on interest rates, increased budget deficits reduce future income. What really matters is the amount of national savings consumed by deficits and whether it is offset by private savings.

Others argue that, even if deficits undermine America's national savings rate, they need not undermine investment and living standards because foreign savers are taking up the slack. Let's remember that our foreign friends in Europe and Japan have even more daunting future entitlement deficits than we do. The problem with capital imports, however, is that they can't last forever. In any case, whatever America borrows it will have to pay back—or else fork over a permanent debt service charge to foreigners. Either way, future American living standards will suffer.

Are we meeting our generational obligations? One has to worry when we embrace a policy of endlessly rising deficits. This policy, after all, constitutes an explicit decision by today's adults to collectively shift the current cost of government from themselves to their children and grandchildren.

What's Wrong with the Arguments for the Tax Plan

Keeping in mind the clear and present danger deficits pose to our future, let me now turn to the advisability of the administration's current tax plan. It seems to me that the case boils down to five basic arguments.

Tax Plan Argument One. The American people want and deserve a tax cut. A democratic government should respond to their wish.

The administration has described a vision of America in which government takes and spends less of our money and leaves more of it the pockets of those who earned it. Overall, it is a vision of a dynamic and entrepreneurial society in which government is smaller and less intrusive. It is a vision that resonates with many citizens.

I want to be very clear on this point. Neither I nor The Concord Coalition is opposed to smaller government or lower taxes. We simply require that, at the end of the day, revenues are sufficient to cover outlays. Washington policymakers must not pretend that we can have it all — guns and butter AND tax cuts.

In short, I insist on the bottom line logic of public finance—that the long-term tax burden is determined by the long-term spending burden, and that unless you reduce the long-term spending burden you do not really cut taxes, but only shift the burden of taxes from the present to the future. As the CBO points out, “at some point in the future under the President’s proposals, either taxes would have to be higher than they otherwise would have been, or spending would have to be lower.”

There is no public finance textbook that teaches that you can ease the long-term tax burden simply by cutting the tax. Instead of pretending it can accomplish the impossible, the administration should be educating the public that, when you face a future of endless deficits, you have to cut spending long term before you cut taxes long term.

Tax Plan Argument Two: OK, let’s forget the long-term tax burden. The tax package still makes sense as near-term fiscal stimulus to bring the economy back to full capacity.

I believe there is some merit in this argument. Today’s economy remains fragile, largely because business and consumer confidence remain fragile. Under these circumstances, stimulus could have a beneficial impact. As Federal Reserve Board Chairman Alan Greenspan puts it, it would help the economy get through a “soft patch.”

The problem with the stimulus justification is not that it’s wrong. The problem is that it doesn’t apply to the plan under consideration. For fiscal stimulus to be effective, it has to put money into consumers’ pockets as quickly as possible. Yet just 5 percent of President’s “economic growth” provisions, those explicitly advertised as stimulus, would end up in consumers’ pockets this fiscal year. Over the entire ten-year projection period, just 17 percent of the full \$1.5 trillion tax-cut package would end up in taxpayers’ pockets over the *first* three years. Fifty-four percent would be distributed in the *last* three years.

Tax Plan Argument Three: Even if it doesn't deliver much near-term stimulus, the tax plan does make the tax code more efficient—which translates into less economic waste and a higher standard of living all around.

Many supporters of the administration's tax plan argue that its provision to eliminate the double taxation of corporate earnings would make our tax system more efficient by reducing the tax penalty on the return to saving generally and on the return to corporate equity (versus corporate debt) in particular. As a sort of representative of "Wall Street," I have to confess I'm sympathetic to this argument.

Personally, as a matter of tax design, I wouldn't do it the same way. A better plan would be to introduce relief on earnings at the corporate level. My biggest problem with this provision, however, is not its complex design and implementation challenges. My biggest problem is that it is deficit-financed. Reducing the taxation on corporate earnings may marginally improve savings behavior—but not nearly enough to compensate for the loss in federal revenue, which adds directly to the federal debt and, in the long run, subtracts dollar-for-dollar from national savings. Far better to have made any proposal revenue neutral, for example by genuine tax reform that eliminates many of the inefficient corporate tax subsidies.

Tax Plan Argument Four: The critics just don't get it. What this tax package is really about is improving "supply side" incentives to work, save, and invest.

We should all be able to acknowledge that "supply-side" reductions in punitive tax rates — as indeed they once were — have sometimes been very successful. And, if supply-side advocates were less theological in their interpretation of the data, we should also be able to acknowledge that in other instances tax-rate reductions have had indifferent results.

In fact, there's plenty of evidence that, when marginal tax rates are not high the efficiency gains from cutting them may be modest. (The average marginal tax rate on federal income and payroll taxes is now 30.0 percent, among the lowest in the developed world.) And the impact on economic activity may be ambiguous—in other words, while some people may react to more after-tax income by working more, others may react by working less. Even if the supply-side response to the administration's marginal rate cut is both positive and sizeable, moreover, the gains would be cancelled out—perhaps even overwhelmed—by the sizeable inefficiencies of the deficits the administration plans to run in order to pay for it.

That's the conclusion reached by CBO's examination of the new tax plan. According to some of the dynamic models reviewed by CBO and indeed several others that I, as Chairman of the Federal Reserve Bank of New York, have had the opportunity to observe, the tax plan would actually result in significant GDP losses relative to baseline and further revenue losses relative to the official "static" projection of the plan. Such losses, needless to say, would constitute a sad outcome for a tax reform purchased at the cost of \$1.5 trillion in extra public indebtedness.

Tax Plan Argument Five: Let's be honest. The ultimate purpose of the Administration's tax cut plan has nothing to do with economics. It's about politics or political philosophy. The purpose is to starve the government of revenue so that, in the long run, Congress will have no choice but to cut back spending and, with that, diminish the size of government.

This is a seductive apologia. But I have three objections to it: It is unfair, it is cynical, and it is hypocritical.

It is unfair because no end, however legitimate, can justify such means. Nothing excuses holding the next generation hostage—any more than your own children—on the dubious bet that another party will have the good will to relent.

It is cynical because it assumes that our democratic process is broken and that we can no longer directly advocate a policy for the common good, but must instead rely on subterfuge to achieve our purpose.

And it is hypocritical. One could take the ostensible goal of the tax cutters—smaller government—more seriously if we saw that the party pushing the tax cut were also trying with great energy to cut spending, both short-term and over the longer term with genuine reform of what OMB itself calls our unsustainable entitlement programs. But we see nothing of the sort. Indeed, it's hard to find the small-government argument persuasive when the budget does nothing to reform entitlements, allows debt-service costs to rise along with the debt, and urges greater spending on defense and indispensable homeland security—and when these functions comprise over four-fifths of all federal outlays.

America at a Crossroads

Mr. Chairman, our nation faces at least two history-bending challenges: global terrorism and global aging. Meeting the first may require marshalling new resources far above the extra spending already legislated. We know that meeting the second will test the ability of our society to provide a decent standard of living for the old without imposing a crushing tax burden on the young. It seems obvious to me that America should not approach this fiscal gauntlet encumbered by deficits as far as the eye can see. To do so would be to ignore every principle of public finance, generational equity, and long-term economic stewardship.

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Full Testimony

Mr. Chairman and members of the Committee, thank you for inviting me to comment on the administration's tax plan. While I am not here representing The Concord Coalition, many of that organization's leading members—including Bob Kerrey, Warren B. Rudman, Robert E. Rubin, Sam Nunn, Charles Bowsher, Lloyd Cutler and Paul A. Volcker—have joined me in recent public messages on fiscal policy. I am attaching to my written testimony a copy of a full-page statement in the *New York Times* (February 2, 2003) and an op-ed essay in the same newspaper (April 9, 2003).

On the question of tax cuts, we perhaps best expressed our views at a Concord Coalition press conference on March 8, 2001. We said at that time that, if a stimulus is enacted, its main purpose should be demand-side stimulus. As such, it should (1) be temporary; (2) be targeted to taxpayers and/or businesses most likely to spend it; and (3) do nothing to aggravate our already unsustainable long-term fiscal outlook. Looking at the administration's current tax plan, I'm sure our group would all still agree with this formulation—and would express even more urgency than before over the fiscal implications.

I will begin by reviewing the grave deterioration in the budget outlook over the past two years and the long-term injury resurgent deficits threaten to inflict on the economy and on future generations. I will then turn to the arguments the administration has made in favor of its tax plan and why I don't find many of them particularly persuasive.

The Worsening Fiscal Outlook

Mr. Chairman, two years ago, the ten-year budget balance was projected by the CBO to be a mountainous surplus of \$5.6 trillion. Many hoped that this surplus could pay off a substantial portion of the publicly held debt, or even better, fund a reform of Social Security that would shore up its finances without raising anyone's taxes or cutting anyone's benefits. Either way, it would be translated into a vast boon to future generations. But that opportunity quickly passed. A large tax cut and unexpected spending growth, combined with the bursting of the stock market bubble and the 2001 recession, slashed that surplus to a mere \$0.9 trillion by March of 2003.

Unfazed by this turnaround, the administration is proposing a budget that includes a second large tax cut and various new spending items, such as a Medicare prescription drug benefit, that the CBO says would pull the projected ten-year balance down to a *deficit* of \$1.8 trillion. And this may be an underestimate. It doesn't count the cost of war and reconstruction in Iraq. It almost certainly understates the costs of improving homeland security, which in my view is indispensable. It ignores the inevitable reform of the alternative minimum tax, which will apply to some 39 million returns within 10 years (assuming that the 2001 tax cuts do not expire in 2010), up from 2 million today. And it

assumes large and unspecified reductions in discretionary spending that most legislators *of both parties* know will never come to pass. A more prudent projection—one that assumes AMT relief will be extended and that discretionary spending will grow at the rate of the economy—would push the ten-year deficit projection to \$4.0 trillion.

What does this all add up to? In just two years, America has witnessed a \$10 trillion projected deficit swing—undoubtedly the biggest swing in fiscal expectations in U.S. history other than during years of total war.

With total war, of course, large deficit swings may be good policy. The nation may expect the emergency to be over soon and thus be able to pay back the new debt during a subsequent era of peace and prosperity. Yet few experts believe that the major drivers of today's deficit projections are similarly short-term. The Vice President has warned that the "War on Terror" may last "a couple of generations." And the biggest single driver of the projections, the growing cost of senior entitlements like Social Security and Medicare, is certain to become much worse just beyond the ten-year horizon when the huge Baby Boom generation starts retiring in earnest. We've grown used to thinking about entitlements as a "long term" problem, but in fact it's beginning to overlap with our near-term projections. The first Boomer will be eligible for early retirement on Social Security (at age 62) in 2008; this generation will be retiring on full benefits by 2011.

In theory, it is true, we are "prefunding" some small portion of these extra entitlement costs through the build-up of the Social Security and Medicare trust funds. But the deficit numbers cited above *include* these trust-fund surpluses. If we set these surpluses aside and put them truly off-budget, the deficit numbers would be \$2.7 trillion larger. And even accepting this accounting, the prefunding would only pay for a small fraction of the estimated \$25 trillion in unfunded Social Security, Medicare and federal pension benefits payable to today's adults.

As a general matter, the longer time horizon does not justify near-term deficits. If anything, the longer-term demographics are an argument for sizeable near-term surpluses. Over the entire decade of 2003 to 2013, the CBO projects that Social Security, Medicare, and Medicaid will grow by less than 1 percent of GDP. But from 2013 on, they will be growing by 1 percent of GDP every three and one-half years. All told, the total cost of these programs is due to more than double as a share of GDP between 2000 and 2040, from 7.6 percent to 15.5 percent of GDP. The cost of Social Security and Medicare's Hospital Insurance program alone will rise from 13.8 percent of worker payroll today to between 24.2 and 34.3 percent of payroll by 2040. If senior entitlements are simply left on autopilot, the official long-term projections of both the CBO and GAO conclude that deficits will eventually rise to economy-shattering levels.

This is not a partisan issue. Even the OMB, the agency responsible for orchestrating the administration's fiscal strategy, concurs that senior entitlements will grow explosively in the decades ahead. According to the President's *Budget of the U.S. Government for Fiscal Year 2004*, the cost of Social Security, Medicare, and Medicaid together, which amounted to 30 percent of noninterest federal spending in 1980, has

reached 45 percent today and will be shooting past 65 percent by 2040. “These long-run budget projections,” says the OMB, “show clearly that the budget is on an unsustainable path.... As the Baby Boomers reach retirement age in large numbers, the deficit is projected to rise steadily as a share of GDP. Under most scenarios, well before the end of the projection period for this chapter rising deficits would drive debt to several times the size of GDP.”

Some supporters of the administration’s fiscal strategy dismiss these long-term projections as little more than guesswork. We hardly know what the economy will do next year, they say. How can we possibly make projections forty years out? The unanimity among official agencies on the magnitude and severity of entitlement cost growth, however, should give these supporters pause.

The long-term projections are in fact much more reliable than most other predictions economists and demographers make. The aging of America is about as close as social science ever comes to a certain forecast. Absent a Hollywood catastrophe—a colliding comet or an alien invasion—it will surely happen. The reason is simple. Over the next 65 years, the number of elderly is easily projectable since they have already been born and are thus countable. Because the typical mortality assumptions are quite conservative, most of the surprises on the longevity side would make the cost outlook even worse. As for the future number of younger people, even a dramatic turnaround in birthrates would have little impact for the next 30 years.

Although some of the economic variables are harder to forecast, these do not influence the long-term cost projections as much as many would suppose. Higher productivity growth, for example, pushes up revenues, and this helps. But it also pushes up benefit awards (which are linked to wages), so that the net result is largely a wash. This is why—contrary to glib reassurances from the “new economy” advocates—we cannot grow our way out of this challenge.

Why Deficits Matter

A future of mounting deficits is a cause for grave concern. Mounting deficits can slow and even halt the steady growth in material living standards that has always nourished the American Dream. When such deficits are incurred in order to fund a rising transfer from young to old, they also constitute an injustice against future generations.

Economically, the problem with deficits is that they soak up national savings and crowd out productive investment. They do so by raising interest rates, probably by 25 to 50 basis points for each one percent increase in the long-term federal deficit as a share of GDP. The former figure appears in a just-released study by the Federal Reserve Board; the latter figure was cited in a recent report by the Center for Economic Development. Many other studies have confirmed a response of at least this magnitude.

Since America’s savings pool is shallow, the impact of large deficits is especially harmful. The U.S. net national savings rate is already low both relative to other developed nations and to our own history. From 10.9 percent of GDP in the 1960s, it slid

to 4.8 percent in the 1990s—and to two consecutive postwar lows of 3.3 percent of GDP in 2001 and 1.7 percent in 2002. Current fiscal policies are due to push net national savings still lower. It may drop below zero within the next few years. The last time this happened was during the depths of the Great Depression.

This brings us to history's bottom line, as insisted on by one economic luminary after another, from Adam Smith to Karl Marx to Alfred Marshall to John Maynard Keynes: No country can enjoy sustained living standard growth without investing, and no country can sustain high investment for long without saving.

These thinkers all understood that capital formation may not be a sufficient condition for rising living standards, but it is certainly a necessary condition. Moreover, it is the one condition that a society can directly influence. We cannot legislate technological breakthroughs—nor even a higher private savings rate. But we can legislate a budget surplus, and surpluses add to national savings just as surely as deficits subtract from it. It may not matter much to private savers whether they end up purchasing a tractor or a T-bill. But it matters a great deal to the economy.

With real interest rates now so low, some defenders of deficit spending say there's little reason to fear that today's growing deficits are about to crowd out productive investment. I believe, however, that today's low rates are a cyclical phenomenon and unlikely to last. As the economy revives and investment rekindles, real interest rates will surely rise—and the vast majority of economists agree that they will rise faster and farther with large deficits than without.

Moreover, as economists William Gale and Peter Orszag have recently pointed out, the strength of the relationship between interest rates and deficits is “at least partially a red herring.” They explain: “The more fundamental point is that long-term budget deficits reduce national saving and impose substantial long-run costs on the economy, regardless of whether interest rates are affected. As long as an increase in the budget deficit is not fully offset by an increase in private saving—and such a full offset is a theoretical possibility that almost all economists reject in practice—the expanded budget deficit will manifest itself in some combination of reduced domestic investment and an expanded current account deficit. Either way, and regardless of the effect of deficits on interest rates, increased budget deficits reduce future income. That reduction in future income is the true cost of a failure of long-term fiscal discipline.”

Others argue that, even if deficits undermine America's national savings rate, they need not undermine investment and living standards because foreign savers are taking up the slack. And in fact since the late 1990s surging capital imports have helped to prop up U.S. investment. The problem with capital imports, however, is that they can't surge forever. Today, with the U.S. current account deficit hitting 5 percent of GDP, the highest rate in at least a century, an urgent question for many economists is how suddenly, or even catastrophically, this surge will stop. In any case, the potential for financial crisis aside, whatever America borrows it will have to pay back—or else fork over a permanent debt service charge. Either way, future living standards will suffer.

There's a related concern. For decades, deficit apologists excused federal debt by pointing out that "we only owe it to ourselves." This was never true in the figurative sense in which the apologists meant it—namely, that borrowing from ourselves has no economic cost. It does. But today, this is not even literally true. Already, 35 percent of the U.S. public debt is owned by foreigners, a percentage that has doubled over the past ten years. If the trend continues, the United States may find itself increasingly hostage to global financial markets—and perhaps even to the whims of foreign governments.

It's important to keep in mind the global context of American fiscal policy. In recent decades, America could count on large capital imports from other rapidly growing industrial economies like Germany and Japan that were generating large savings surpluses. Over the next two or three decades, all of these nations will be aging more rapidly than America. Many will be in steep demographic decline, experiencing zero GDP growth, and struggling to finance a tidal wave of pension and health-care outlays. In my book *Gray Dawn*, I calculate that the combined pension deficit of the G-7 countries would, by the 2030s, grow large enough to consume the net economic savings of the developed world. In short, our habit of borrowing from abroad will be cut short by the overseas age wave. To maintain even a minimal level of domestic investment, America will have to save more on its own.

When we reflect on the fiscal, financial, and geopolitical challenges our children must confront over the next century, we have reason to pause and ask ourselves: Are we meeting our generational obligations? Are we providing them with the economic resources they need to overcome these challenges? Are we investing as much in them as our own parents invested in us? Or are we not in our public policies taking from them more than we are giving? All of the evidence suggests that our kids are getting a bad deal, whether we look at declining rates of return on Social Security contributions or the disquieting findings of a whole new branch of policy analysis, generational accounting. However we quantify the current deal between old and young, one has to worry that we are greatly worsening the terms of the transaction by embracing a policy of endlessly rising deficits. This policy, after all, constitutes an explicit decision by today's adults to collectively shift the current cost of government from themselves to their children.

What's Wrong with the Arguments for the Tax Plan

Keeping in mind the clear and present danger deficits pose to our future, let me now turn to the advisability of the President's current tax plan. It seems to me that the case boils down to five basic arguments.

Tax Plan Argument One. The American people want and deserve a tax cut. A democratic government should respond to their wish.

The administration has described a vision of America in which government takes and spends less of our money and leaves more of it the pockets of those who earned it. Overall, it is a vision of a dynamic and entrepreneurial society in which government is smaller and less intrusive. It is a vision that resonates with many citizens.

How much it resonates, to be sure, remains a matter of some debate. Relative to other countries, after all, the United States doesn't seem especially overtaxed. And right now, in the wake of 9/11, many surveys indicate that voters are a lot more concerned about whether government has the resources to meet urgent public needs than whether it taxes too much. According to two Gallup polls taken in 2003, the share of Americans who say that the federal income tax is "too high" is lower than in any year since 1962. Nonetheless, I think it's fair to give the President the benefit of the doubt on this point. Americans remain wary of a large and burdensome government. And if they aren't especially concerned about high taxes at this moment, they soon will be given the projected upward trend in public spending. Where spending goes, taxes must sooner or later follow.

I want to be very clear on this point. Neither I nor The Concord Coalition is opposed to smaller government or lower taxes. We simply require that, at the end of the day, revenues are sufficient to cover outlays. If we can manage this without raising taxes, that would be great. And if we can manage it while cutting taxes, that would be even better.

In this, not surprisingly, I part company with those Democrats who are ideologically wed to big government and hate to vote down a dime's worth of outlays. But I also part company with many Republicans who, despite their rhetoric, aren't doing much to cut spending either. Indeed, we seem to have embraced a policy of guns and butter AND tax cuts.

I insist on the bottom line logic of public finance—that the long-term tax burden is determined by the long-term spending burden, and that unless you reduce the long-term spending burden you do not really cut taxes, but only shift the burden of taxes from the present to the future. The administration's budget, however, does not propose anywhere near the level of spending restraint that would be needed to justify its long-term tax cut proposals. As the CBO points out in its *Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, "at some point in the future under the President's proposals, either taxes would have to be higher than they otherwise would have been, or spending would have to be lower."

Public finance textbooks teach us many things—how to finance temporary deficits, how to save temporary surpluses, how to structure a tax system that is stable, efficient, and equitable. But there is no textbook that teaches that you can ease the long-term tax burden simply by cutting the tax. Instead of pretending it can accomplish the impossible, the administration should be educating the public that, when you face a future of endless deficits, you have to cut spending long term before you cut taxes long term.

Tax Plan Argument Two: OK, let's forget the long-term tax burden. The tax package still makes sense as near-term fiscal stimulus. Given the current weakness in employment, investment, and the stock market, we badly need stimulus to bring the economy back to full capacity. A tax cut is the quickest and most effective way to accomplish this.

Thirty years ago, President Nixon famously declared that “We are all Keynesians now.” Since the disastrous stagflation of the 1970s, faith in Keynesianism may have waned, but even today few doubt that when the economy suffers multiple shocks, the best way to avert a severe contraction is to apply an immediate dose of fiscal stimulus. Most economists still believe it. I still believe it. And apparently President Bush still believes it. In describing his tax plan, the President often uses classic Keynesian rhetoric. “That money can cover a lot of bills,” he explains. “That money can help families with purchases they have been delaying. That money will be in circulation, which will be good for our economy.”

Again, I believe there is some merit in this argument. Today's economy remains fragile, largely because business and consumer confidence remain fragile. Under these circumstances, stimulus could have a beneficial impact. As Federal Reserve Board Chairman Alan Greenspan puts it, it would help the economy get through a “soft patch.”

The problem with the stimulus justification is not that it's wrong or that the President doesn't articulate it well. The problem is that it doesn't apply to the plan under consideration. For fiscal stimulus to be effective, it has to put money into consumers' pockets as quickly as possible. Yet just 5 percent of President's “economic growth” provisions, those explicitly advertised as stimulus, would end up in consumers' pockets this fiscal year. Over the entire ten-year projection period, just 17 percent of the full \$1.5 trillion tax-cut package would end up in taxpayers' pockets over the *first* three years. Fifty-four percent would be distributed in the *last* three years.

Indeed, the whole design of the plan is long-term and structural, not near-term and countercyclical. That's why nearly all of its changes are permanent, and that's why many of them do nothing except turn temporary provisions enacted in 2001 into permanent changes. Reportedly, the administration is willing to delay the phasing-in of its new tax cuts so long as the ultimate reductions remain unchanged beyond 2010, when they would otherwise expire. What we need is short-term stimulus and long-term restraint. In the administration's plan, it seems to me we get neither.

Tax Plan Argument Three: Even if it doesn't deliver much near-term stimulus, the tax plan does make the tax code more efficient—which translates into less economic waste and a higher standard of living all around.

An efficient tax system can be defined as a system which raises revenue with minimal distortions in economic behavior and thus with minimal “dead weight” loss of wealth and income. Finance theorists have come up with many complex equations to quantify tax efficiency, but it's fair to say that most of us know it when we see it. The acid test is how much the tax system itself changes people's work, saving, and investment

choices in order to raise a given amount of revenue. Much change means inefficiency. Little change means efficiency. But let me repeat the key clause for reasons that will become clear shortly: *in order to raise a given amount of revenue.*

Many supporters of the administration's tax plan argue that its provision to eliminate the double taxation of corporate earnings would make our tax system more efficient by reducing the tax penalty on the return to saving generally and on the return to corporate equity (versus corporate debt) in particular. As a sort of representative of "Wall Street," I have to confess I'm sympathetic to this argument. For decades, many smart economists have been making a very persuasive case that our tax treatment of corporate earnings is conspicuously inefficient and that—a sore point for me—it discourages capital formation. So put me down as a supporter of this type of efficiency reform.

Personally, as a matter of tax design, I wouldn't do it the same way. A better plan would be to introduce relief on earnings at the corporate level. This would be much simpler, because it would avoid complicated "look back" readjustments to the tax basis of everyone's stock. It would also be fairer, because it would extend relief to the two-thirds of all stockowners (especially to millions of younger, moderate-income workers with retirement plans) whose dividends aren't currently taxable at the personal level and who thus won't benefit from the administration's plan.

My biggest problem with this provision, however, is not its design. Such things can be discussed and resolved. My biggest problem is that it is deficit-financed. As such, it does not deserve to be called an efficiency reform—which, by definition, requires that the reform be revenue neutral since deficits themselves are a new source of economic inefficiency. To ignore the deficit-financing of a tax cut is like trying to ignore the extra \$50,000 you just paid for a car that promises to give you an extra mile-per-gallon in fuel efficiency. Reducing the taxation on corporate earnings may marginally improve savings behavior—but not nearly enough to compensate for the loss in federal revenue, which adds directly to the federal debt and, in the long run, subtracts dollar-for-dollar from national savings.

Far better to have made any proposal revenue neutral by engaging in genuine tax reform. The administration's policy makers could have paid for this revenue loss by combining it with other efficiency-enhancing provisions that add rather than subtract from revenue. Even within the corporate realm alone, they could have targeted any number of inefficient loopholes and subsidies for elimination—or any number of gaps for base-broadening. They chose not to do so.

Tax Plan Argument Four: The critics just don't get it. What this tax package is really about is improving "supply side" incentives to work, save, and invest.

Since the late 1970s, a core proposition of what has come to be known as the "supply side" case for tax reform is that reductions in high marginal tax rates can sometimes have a dramatic and positive impact on both economic activity and revenue. In a sensible world, we would all be able to discuss supply-side tax cuts as a special and

important category of efficiency reform. We would all be able to acknowledge that “supply-side” reductions in punitive tax rates, which we indeed once had in the United States, have sometimes been very successful and also acknowledge that in other instances tax-rate reductions have had indifferent results.

That would be a sensible world. The reality is that the supply-side case has developed into something approaching a theology, ruling out any reasonable discussion of the evidence. Heartened by their success with targeted cuts in marginal rates of 70 percent or higher, supply-side true believers move on to the proposition that vast free-lunch efficiency and revenue gains can be derived by cutting nearly any tax rate whenever and wherever they can take a cross-the-board whack at it.

In fact, there’s plenty of empirical evidence that, when marginal tax rates are not high, the efficiency gains from cutting them may be modest and the impact on economic activity may be ambiguous—in other words, while some people may react to more after-tax income by working more, others may react by working less. With the top marginal federal income tax rate currently at 39.6% and the average marginal rate on federal income and payroll taxes at 30.0%, it’s not clear that the U.S. economy is in the “high” range. Even if it is, the marginal rate impact of the reform hardly seems sufficient to trigger a sizeable response. According to the CBO, the administration’s total two-part tax package, the 2001 enacted plan and the current plan, is expected to cut the average marginal rate by no more than 1.5 percentage points (from 32.0% to 30.5% in 2011). That’s less than a 5 percent reduction.

Even if the supply-side response is both positive and sizeable, moreover, the gains would be cancelled out—perhaps even overwhelmed—by the sizeable inefficiencies of the deficits needed to pay for it. That’s the conclusion reached by CBO’s examination of the new tax plan. The tax-rate induced gains in labor supply, reports the CBO, would be positive but small, and in any case they would be neutralized by the deficit-induced losses in investment and capital. According to some of the dynamic models reviewed by CBO and indeed several others that I, as Chairman of the Federal Reserve Bank of New York, have had the opportunity to observe, the tax plan would actually result in significant GDP losses relative to baseline and further revenue losses relative to the official “static” projection of the plan. Such losses, needless to say, would constitute a sad outcome for a tax reform purchased at the cost of \$1.5 trillion in extra public indebtedness.

Some supporters of the tax plan complain that CBO should have assessed the dynamic supply-side gains independently from the dynamic deficit losses. But this clearly would make no sense. If it did, we may as well propose getting rid of taxes altogether and assessing the wonderful efficiency gains independently of the fact that our government no longer has any revenue. Rather than lodge their complaint with the CBO, these supporters might ask the administration why, here too, it failed to incorporate into its package any efficiency-enhancing provisions that add rather than subtract from revenue. When it doesn’t come at the expense of deficits, the logic of reducing marginal tax rates is persuasive. Historically, some of the most successful tax reforms in history

featured a combination of marginal rate reduction with expansions in the taxable income base. This was, for example, the template for the Tax Reform Act of 1986.

Tax Plan Argument Five: Let's be honest. The ultimate purpose of the Administration's tax cut plan has nothing to do with economics. It's about politics or political philosophy. The purpose is to starve the government of revenue so that, in the long run, Congress will have no choice but to cut back spending and, with that, diminish the size of government.

Some Republicans argue that tax cuts are the only way to reduce government spending in a world in which powerful interest groups, allied with the opposition party, stand ready to punish any attempt to cut off the flow of government largess. A direct approach, they say, is futile. The only practical option is to pursue the indirect but more popular course of revenue reduction, choking off government's resources at the source. True, deficit financing can keep outlays flowing for a time. But as in the famous story of Solomon, these strategists hope that Democrats will agree to cut spending rather than punish our children by smothering them with debt.

This is a seductive apologia. But I have three objections to it: It is unfair, it is cynical, and it is hypocritical.

It is unfair because no end, however legitimate, can justify such means. Nothing excuses holding the next generation hostage—any more than your own children—on the dubious bet that another party will have the good will to relent. What if instead they employ your strategy in reverse? What if they call your bluff, raise your ante, and allow a floodtide of debt to sweep forth? What next step do these partisans suggest?

It is cynical because it assumes that our democratic process is broken and that we can no longer directly advocate a policy for the common good, but must instead rely on subterfuge to achieve our purpose. It assumes a political system in which the two parties are so polarized that they no longer share any common values or aspirations on which open agreement can be reached. I, for one, refuse to accept this dismal view.

And it is hypocritical. One could take the ostensible goal of the tax cutters—smaller government—more seriously if we saw that the party pushing the tax cut were also trying with great energy and diligence to reduce government spending in the near-term and especially in the long term with genuine reform of what OMB itself calls our unsustainable entitlement programs. But we see nothing of the sort.

If you doubt me on this point, listen instead to Urban Institute tax expert Eugene Steuerle, respected by both parties for his long track record of dispassionate objectivity. To date, Steuerle writes, the Bush administration has assiduously tried “to avoid budget choices that might take some tax or benefit expenditure away from anyone. Thus it has not pushed to enact any systematic reform that almost inevitably creates losers as well as winners. Every significant enactment so far has involved losing revenues by more spending or more tax cutting—whether this issue has been domestic discretionary spending, defense spending, or tax cuts. So far, few benefits, however unworthy, have been taken away from interest groups—as reflected in the dearth of base broadening tax proposals. Preferences sought by many groups—farmers, steel workers, and railroads, among others—have often been expanded.”

In other words, it's hard to find the small-government argument persuasive when, on the spending front, the budget does nothing to reform entitlements, allows debt-service costs to rise along with the debt, and urges greater spending on defense and indispensable homeland security—and when these functions comprise over four-fifths of all federal outlays.

America at a Crossroads

Mr. Chairman, the current debate over the President's tax plan needs to be viewed in broader the context of our long-term fiscal challenge. In this respect, America stands at a crossroads. We can demand that our leaders undertake the kinds of reforms, including long-term entitlement reforms, that are needed to put the budget on a sustainable trajectory—and face up to the required sacrifice. Or we can continue to pretend that our choices have no consequences—and let our children pay the price in lost opportunities, lower living standards, and a less safe and secure place in the world.

Social Security, as officially projected, will be able to pay only 74 percent of its now-scheduled benefits by the year 2045. Should we face that fact or bury our head in the sand? Neither party has demonstrated much courage here.

I have often criticized the free-lunch games of many GOP reform plans for Social Security—such as personal accounts that will be “funded” by deficit-financed contributions. But at least the GOP pretends to have reform plans. *Democrats have nothing.* Or, as Bob Kerrey puts it quite nicely, most of his fellow Democrats propose the “do-nothing plan,” a blank sheet of paper that essentially says it is OK to cut benefits by 26 percent across the board when the money runs out. Assuming that Democrats would feel genuine compassion for the lower-income retirees, widows, and disabled parents who would be most affected by such a cut, I have suggested to them that maybe we ought to introduce an “affluence test” that reduces benefits for fat cats like me. To my amazement, Democrats angrily respond with irrelevant clichés like “programs for the poor are poor programs” or “Social Security is a social contract that cannot be broken.”

Apparently, it doesn't matter that the program is already unsustainable. They cling to the mast and are ready to go down with the ship. I have already mentioned how many Republicans regard supply-side tax cuts as a sort of theology. But the Democrats have their own theology--federal entitlements.

Mr. Chairman, our nation faces at least two history-bending challenges: global terrorism and global aging. Meeting the first may require marshalling new resources far above the extra spending already legislated. We know that meeting the second will test the ability of our society to provide a decent standard of living for the old without imposing a crushing tax burden on the young. It seems obvious to me that America should not approach this fiscal gauntlet encumbered by deficits as far as the eye can see. To do so would be to ignore every principle of public finance, generational equity, and long-term economic stewardship.

In his State of the Union Address, President Bush himself has said, “This country has many challenges...we will not pass along our problems to other Congresses, to other Presidents, and other generations.” My colleagues and I firmly believe that's a promise America needs to keep.

ATTACHMENT
New York Times op-ed
April 9, 2003

Bob Kerrey, Sam Nunn and Warren B. Rudman are former senators. Peter G. Peterson and Robert E. Rubin are former cabinet secretaries. Paul A. Volcker is former chairman of the Federal Reserve. All are members of the Concord Coalition, a group that focuses on federal budget policy.
By Bob Kerrey, Sam Nunn, Peter G. Peterson, Robert E. Rubin, Warren B. Rudman and Paul A. Volcker

With a war in Iraq and looming postwar costs, growing pressures for a prescription drug benefit, increased expenses for domestic security and a ballooning budget deficit, Congress must exercise restraint on both revenues and spending to prevent fiscal policy from spiraling out of control. The consensus in favor of long-term budget balance must be re-established. This issue is now directly before Congress as it debates the federal budget.

The fiscal outlook is much worse than official projections indicate. These projections assume that the tax cuts enacted in 2001 will expire at the end of 2010. They also assume that discretionary spending, the part of the budget that pays for national defense, domestic security, education and transportation, will shrink continuously as a share of the economy. Neither of these assumptions is realistic.

Moreover, the official projections do not include the costs of war and reconstruction in Iraq. And they ignore the inevitable need to reform the alternative minimum tax, which is not indexed for inflation and will apply to some 40 million households within 10 years - up from two million today.

Under more realistic assumptions, the deficit projections are cause for

alarm. A recent study by Goldman Sachs includes this forecast: if the president's proposed new tax cuts are enacted, a Medicare prescription drug benefit is approved, the A.M.T. is adjusted and appropriations grow modestly, the deficits over the next 10 years will total \$4.2 trillion - even if the Social Security surplus is included. If it is not included, the deficit would be \$6.7 trillion. Under these circumstances, the ratio of publicly held debt to gross domestic product climbs within 10 years to nearly 50 percent, from 33 percent just two years ago.

And all of this happens before the fiscal going gets tough. Looming at the end of the decade is a demographic transformation that threatens to swamp the budget and the economy with unfunded benefit promises, like Social Security and Medicare, of roughly \$25 trillion in present value. Our children and grandchildren already face unthinkable payroll tax burdens that could go as high as 33 percent to pay for these promised benefits. It is neither fiscally nor morally responsible to give ourselves tax cuts and leave future generations with an even higher tax burden.

And yet tax cuts are the primary focus of this year's budget debate. To speed enactment of tax cuts, Congress is planning to use a special fast-track procedure called "reconciliation" in the budget resolution. While determining the size of the tax cut to be given fast-track protection in the budget is sometimes dismissed as a procedural matter, it is not: whatever its size, a tax cut that receives this protection is almost certain to be enacted in the later tax legislation. Members of Congress should not therefore approach the budget decision with the idea that a tax cut given such status now can be easily scaled back later.

The president has proposed a cut of \$726 billion, which the House has already approved. The Senate has reduced the cut to \$350 billion.

Given the rapidly deteriorating long-term fiscal outlook, neither proposal is fiscally responsible. It is illogical to begin the journey back toward balanced budgets by enacting a tax cut that will only make the long-term outlook worse. Furthermore, the proposed tax cuts are not useful for short-term fiscal stimulus, since only a small portion would take effect this year. Nor would they spur long-term economic growth. In fact, tax cuts financed by perpetual deficits will eventually slow the economy.

The tax cuts now before Congress do not pay for themselves. No plausible array of matching spending cuts or offsetting revenue increases has been, or will be, proposed to close the gap resulting from a large new tax cut.

We believe that there should be no new tax cuts beyond those that are likely to provide immediate fiscal stimulus, and that avoid growing revenue loss over time. If, however, Congress decides it must approve a tax cut, it should pass the Senate's. While a \$350 billion tax cut does not fit our definition of fiscal responsibility, it comes closer than a tax cut of \$726 billion. Moreover, Congress should re-establish the pay-as-you-go rule in which tax cuts and entitlement expansions must be offset. The discipline of this rule greatly contributed to the elimination of budget deficits in the 1990's and is clearly needed again.

Congress cannot simply conclude that deficits don't matter. Over the long term, deficits matter a great deal. They lower future economic growth by reducing the level of national savings that can be devoted to productive investments. They raise interest rates higher than they would be otherwise. They raise interest payments on the national debt. They reduce the fiscal flexibility to deal with unexpected developments. If we forget these economic consequences, we risk creating an insupportable tax burden for the next generation.

