**"Long-term Growth, Government Debt, and Family Incomes"**

Testimony before the Senate Finance Committee
Subcommittee on Long-term Growth and Debt Reduction
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Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today. To summarize my testimony, we are neither paying our way nor investing sufficiently in our workers. The nation's low saving rate and the combination of real income stagnation and increased income risk for most families represent the most pressing economic problems facing the country:

- The low saving rate, which is closely tied to the Federal budget deficit, generates massive borrowing from abroad and mortgages the future incomes of Americans.

- Stagnant income and increased income risks for middle- and low-income families threaten a backlash that could significantly reduce growth.

The 2001 and 2003 tax cuts substantially exacerbate both problems. The tax cuts increase government borrowing and reduce national saving. In addition, they widen income inequality and will ultimately reduce incomes for most middle- and low-income families, while diminishing the effectiveness of the tax system in cushioning fluctuations in after-tax income.

Proponents of the tax cuts argue that these costs are worth bearing because the tax cuts generate economic growth. The tax cuts, however, have had at best a modest positive effect on short-term economic growth—and any such positive effect could have been accomplished at lower cost through other means. Furthermore, the tax cuts will likely *reduce* economic growth over the long run. The tax cuts thus increase government debt, reduce national saving, increase income volatility, reduce incomes for most families in the long run, and impair long-term economic growth.

A much better approach to promoting economic growth involves increasing national saving and making investments in education, research, and economic security. This approach is likely to be both more effective at generating growth and more likely to

[1] The views expressed in this testimony are those of the author alone and do not necessarily represent those of the staff, officers, or trustees of the Brookings Institution or the members of the Advisory Council of The Hamilton Project. This testimony draws upon joint work with Lily Batchelder, Michael Deich, Bill Gale, Jon Gruber, and Tim Taylor, among others.

result in broad-based participation in that growth. It is the basis of a new project, The Hamilton Project, at Brookings.[2]

## I. Economic background

The background for my testimony is provided through two sets of charts about the United States economy. The first set explores the nation's low national saving rate, its connection to the budget deficit, and its consequences. The second set examines income stagnation and volatility.

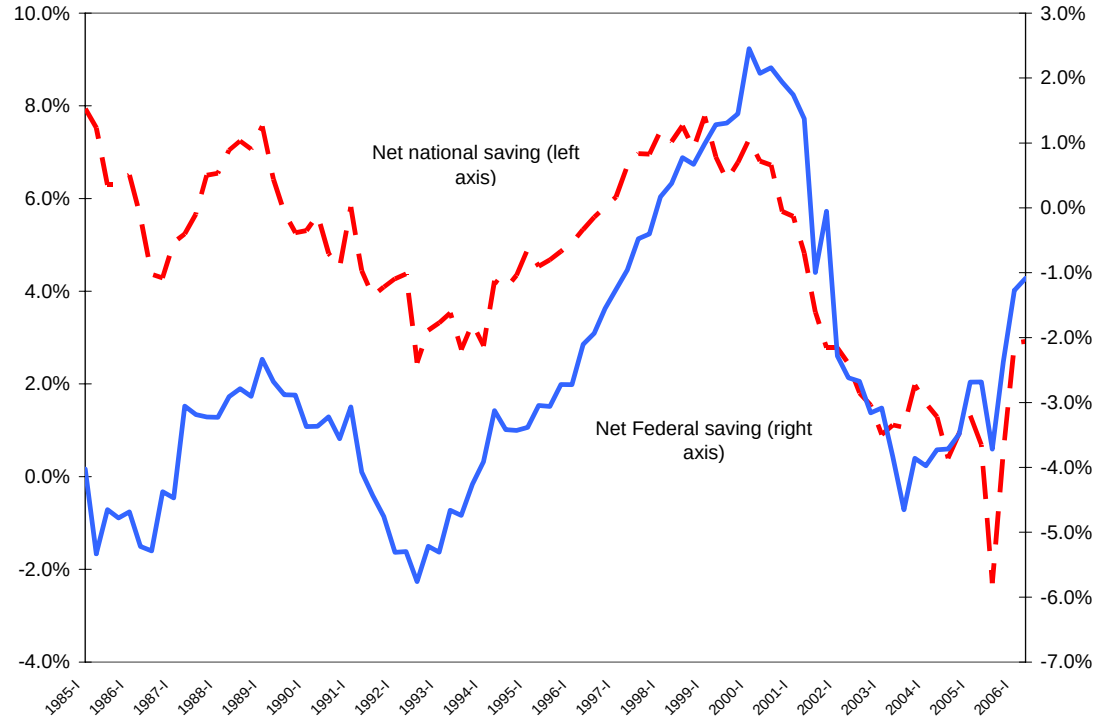
*National saving and the budget deficit*

The first chart shows that net national saving has declined markedly over the past five years. Although it has rebounded slightly since the beginning of this year, net national saving remains less than 3 percent of national income, roughly half the rate of the 1990s. The chart also shows the close connection between how much the Federal government saves or dissaves—that is, the surplus or deficit in the Federal budget -- and how much the nation as a whole saves. Put simply, the more the Federal government borrows, the less the nation as a whole saves. More rigorous econometric work suggests that an increase in the Federal budget deficit of 1 percent of Gross Domestic Product (GDP) reduces national saving by between 0.5 percent and 0.8 percent of GDP.[3] In other words, the deterioration in the Federal budget since 2000 can explain perhaps as much as two-thirds of the decline in net national saving over the same period.

The decline in national saving, driven mostly by the increase in the budget deficit, is triggering a massive increase in borrowing from abroad. The second figure shows net national saving and net domestic investment—that is, saving and investment minus depreciation—as a share of national income over the past two decades. As the figure indicates, net domestic investment, after climbing steadily during the late 1990s and then declining sharply in 2001 and 2002, now appears to have stabilized at approximately 8 percent of national income, roughly its level in the mid-1990s. This net domestic investment must be financed either by net national saving or borrowing from abroad. Over the past few years, it has increasingly been financed by borrowing from abroad, as net national saving has declined. The increase in borrowing from abroad is reflected in the growing current account deficit, which has increased from under 2.5 percent of national income in 1998 to more than 7 percent in 2005.

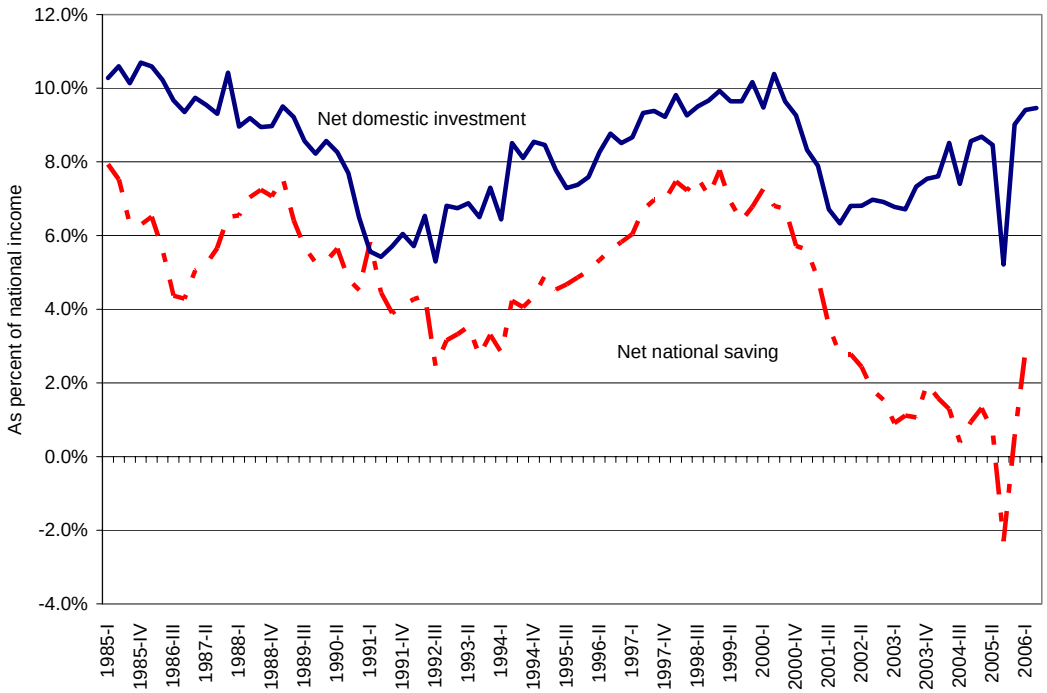
[2] For more information on The Hamilton Project, see www.hamiltonproject.org.
[3] William G. Gale and Peter R. Orszag, "Budget Deficits, National Saving, and Interest Rates" *Brookings Papers on Economic Activity*, no. 2 (Fall 2004), pp. 101-87.

**Figure 1: The federal budget and net national saving**




Source: Author's calculations based on data from the Bureau of Economic Analysis.

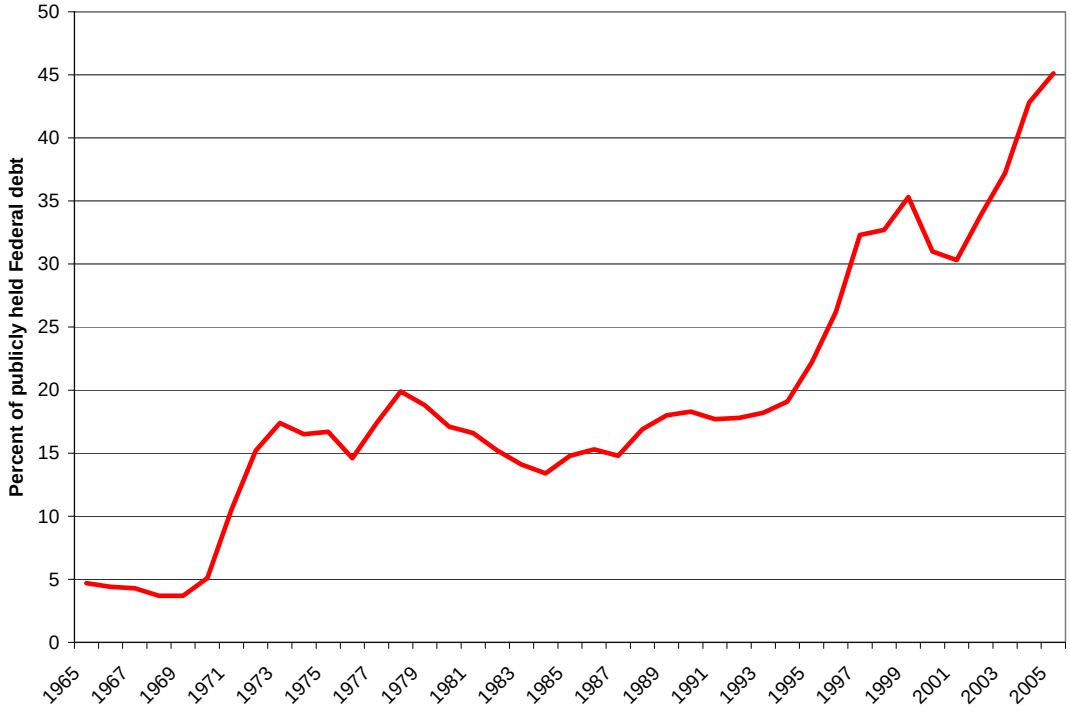
**Figure 2: Net national saving and investment**




Source: Author's calculations based on data from the Bureau of Economic Analysis.

The increase in borrowing from abroad is manifesting itself most prominently in foreign ownership of Federal government debt. Figure 3 shows the share of publicly held debt that is owned by foreigners. Almost half of the nation's publicly held debt is now owned by foreigners, up sharply from roughly a quarter a decade ago. The increase in the foreign share has been particularly rapid over the past few years.

**Figure 3: Foreign ownership of Federal debt**




Source: Department of the Treasury

Under the conventional view of deficits, which is consistent with the story told by Figures 1 through 3, ongoing budget deficits decrease national saving, which then manifests in reduced domestic investment, increased borrowing from abroad, or some combination thereof. Over the past few years, the main adjustment channel appears to have been increased borrowing from abroad. The external borrowing requires that more of the returns from the domestic capital stock accrue to foreigners over time, thereby reducing future national income, with the loss in income steadily growing. Under this mainstream view, the costs imposed by sustained deficits tend to build gradually, rather than occur suddenly. Federal Reserve Chairman Ben Bernanke recently expressed precisely this worry: "I am quite concerned about the intermediate-to-long-term federal budget outlook . . . . By holding down the growth of national saving and real capital accumulation, the prospective increase in the budget deficit will place at risk future living standards of our country."[4]

[4] Greg Ip, "Bernanke Wants Lower Deficits, Doesn't Rule Out Tax Increases," *Wall Street Journal*, sec. A, March 15, 2006, 2.

The adverse consequences of sustained large budget deficits may well be far larger and occur more suddenly than the conventional analysis suggests, however. Substantial deficits projected far into the future can cause a fundamental shift in market expectations and a related loss of business and consumer confidence both at home and abroad. The unfavorable dynamic effects that could ensue are largely if not entirely excluded from the conventional analysis of budget deficits. This omission is understandable and appropriate in the context of deficits that are small and temporary; it is increasingly untenable, however, in an environment where deficits are large and permanent. Substantial ongoing deficits may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing negative cycle among the fiscal deficit, financial markets, and the real economy.

*Income stagnation and volatility*

The next two figures document the second challenge facing policy-makers: that income growth has been stagnant at the same time that income volatility has increased significantly.

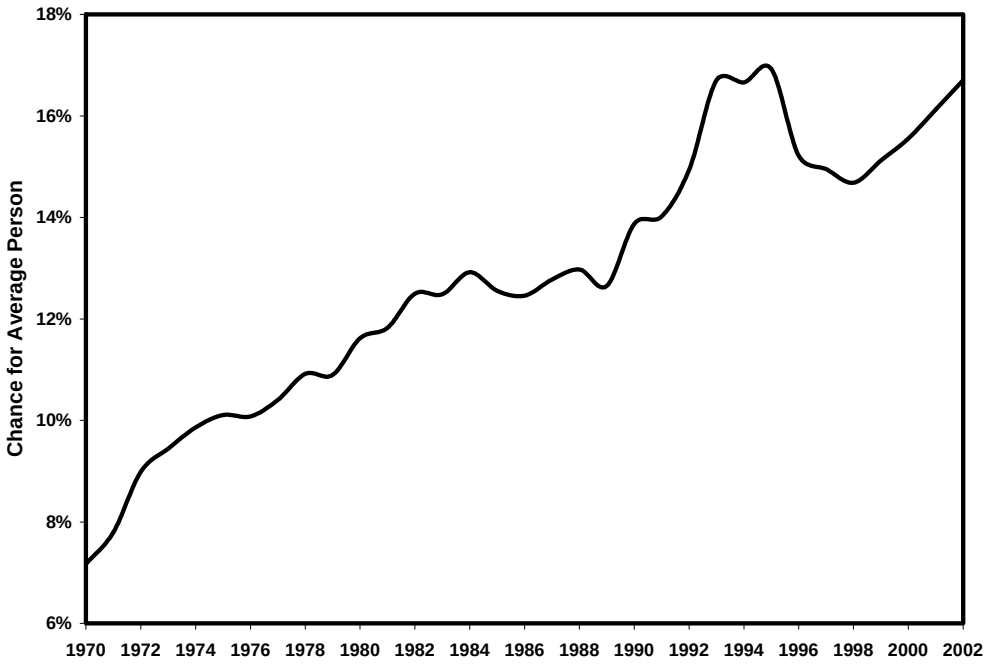
Figure 4 shows the pattern of growth in productivity and real median family income. Although the two series tracked each other closely between 1947 and 1973, they appear to have gotten a divorce since then. The primary reason is a substantial increase in wage inequality, with stunning increases especially at the very top of the wage distribution. According to data compiled by Emmanuel Saez and Thomas Piketty, the top 1 percent of wage earners accounted for 5.6 percent of total wages in 1975. By 2004, their share had risen to 11.2 percent. The top 0.1 percent—that is, one out of a thousand workers—accounted for 1.3 percent of aggregate wages in 1975 and 4.4 percent in 2004.[5]

The final figure shows that over the past two decades, even as macroeconomic fluctuations in GDP and unemployment have declined relative to previous decades, the volatility of family incomes has grown markedly. As Jacob Hacker of Yale University has shown, the probability that an American family will experience a drop in family income of 50 percent or more in any two-year period has doubled from 7 percent in the early 1970s to 17 percent today (see Figure 5).

[5] Table B2, http://elsa.berkeley.edu/~saez/TabFig2004prel.xls.

**Figure 4: Productivity and family income**


**Figure 5: Predicted probability of family income decline of 50 percent or greater**




Source: Calculations by Jacob Hacker based on PSID, University of Michigan; CNEF, Cornell University.

## II. The role of the tax cuts

The tax cuts have exacerbated both of these problems. The revenue loss associated with the tax cuts amounts to roughly 2 percent of GDP. In 2006 alone, the tax cuts entail a budgetary cost (including additional interest on the government debt from the tax cuts since 2001) of $258 billion. It is noteworthy that the budget deficit projected by the Congressional Budget Office for this year is $260 billion. The tax cuts have clearly played a substantial role in expanding the budget deficit, which in turn (see Figure 1) has reduced national saving.

The tax cuts explain much of the deterioration in the budget outlook since the start of 2001. Roughly 70 percent of that deterioration comes from the tax cuts and spending increases, rather than from economic and technical factors outside policymakers' control. Of those policy changes, the tax cuts account for almost half the cost (Table 1). Increases in domestic spending (excluding homeland security) account for only about 6 percent of the cost of legislation enacted since the beginning of 2001.

**Table 1: Deficit impact of legislation enacted since 2001**

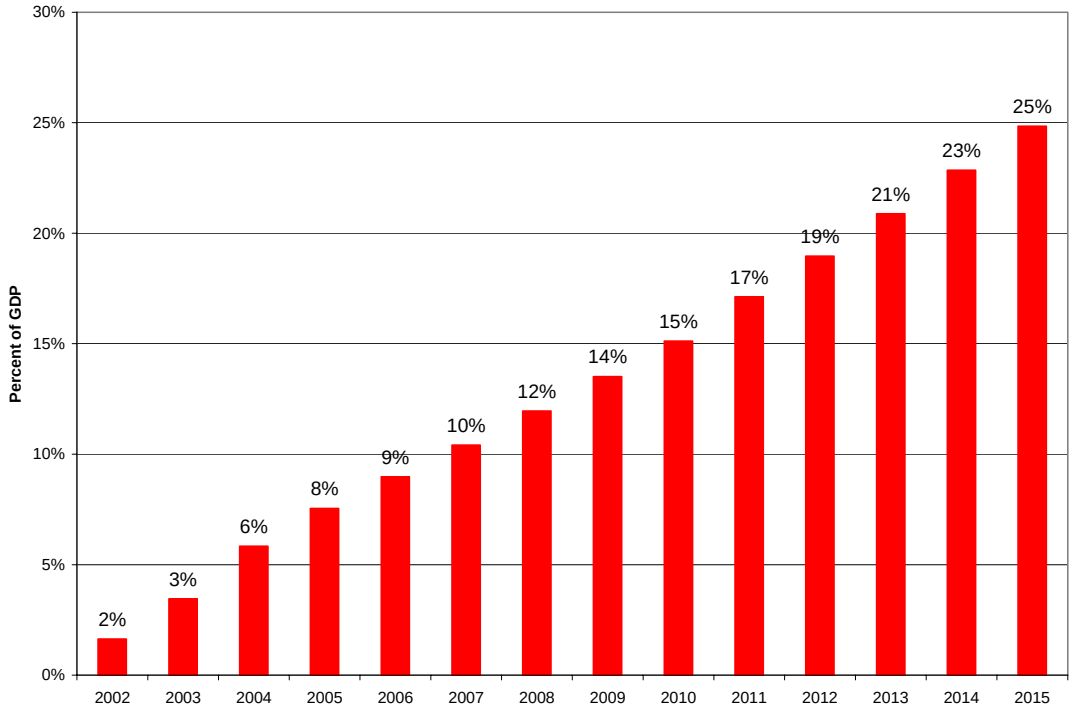
| *Type of legislation* | *Share of legislation cost 2002-2011* |
|---|---|
| Tax cuts | 49% |
| Defense, homeland security, international | 35% |
| Entitlements | 10% |
| Domestic discretionary (excluding homeland security) | 6 % |

Source: CBPP calculations based on Congressional Budget Office data. Assumes extension of the President's tax cuts, continuation of Alternative Minimum Tax relief, a gradual phase-down of operations in Iraq and Afghanistan, and funding of the defense requests in the President's FY 2007 budget.

If the tax cuts are extended without being offset, and are not erased over time by the Alternative Minimum Tax, they will increase the federal debt by $5 trillion in 2015, or by 25 percent of GDP in that year (see Figure 6). This additional debt reduces the capital stock owned by Americans and imposes a drag on future economic performance.

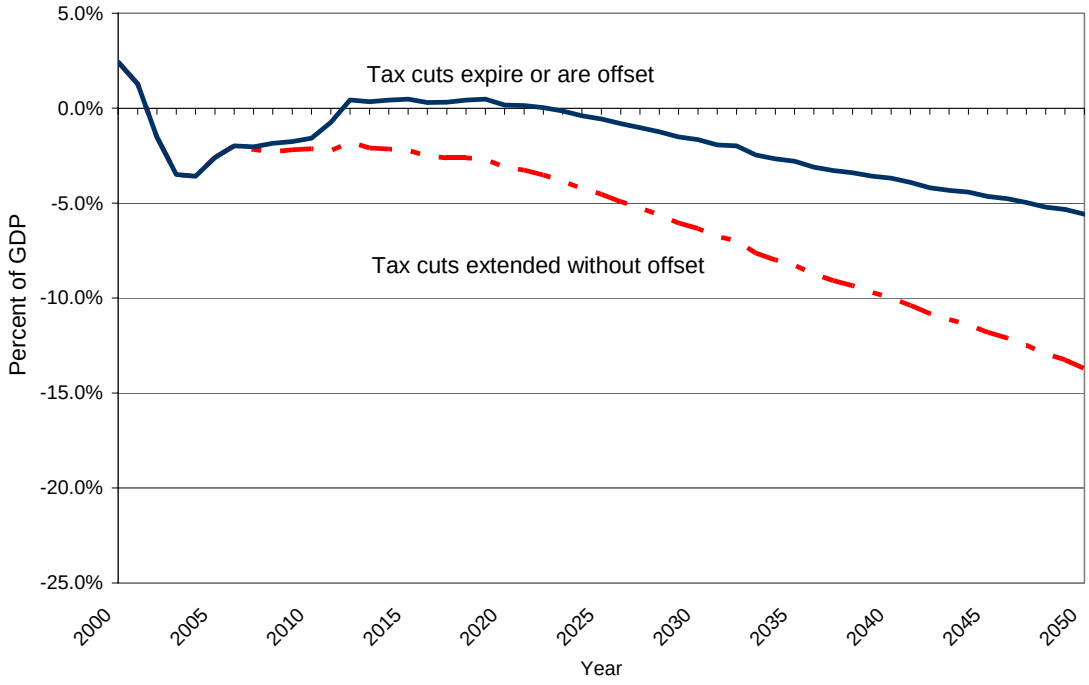
Figure 7, which is based on projections from the Center on Budget and Policy Priorities, provides further insight into the impact of extending the tax cuts (without offsetting their cost) on the budget outlook. As the figure suggests, despite the fact that the long-term problem facing the Federal budget is primarily the cost of health care, extending the tax cuts without offsetting their cost would have a material adverse effect on the budget through 2050 and beyond.

**Figure 6: Additional public debt, as share of GDP, attributable to tax cuts**




Source: Author's calculations based on data from CBO and Tax Policy Center.

**Figure 7: Budget balance through 2050**




Source: Center on Budget and Policy Priorities

The tax cuts also exacerbate the problems facing middle-class families. To measure the effects of the tax cuts across the distribution of income, I use the micro-simulation model developed at the Tax Policy Center and examine the percentage change in after-tax income. If everyone's after-tax income changes by the same percentage, the distribution of after-tax income would remain the same before and after the tax cuts.

Table 2 reports the results, using estimated figures for 2010. After-tax income rises by 0.2 percent in the bottom quintile and by 4.1 percent in the top quintile. It rises even further within the top quintile, with a 6.1 percent increase for the top 1 percent. Thus, the tax cuts raise after-tax income by a greater percentage for high-income households than for all others. Table 2 is a misleading guide to the effects of the tax cuts on most families, however. It assumes that the tax cuts need never be offset by spending reductions or other revenue increases; it can thus create the misleading impression that everyone must be better off, because the direct tax-cut benefits are included but the requisite costs in terms of spending cuts or other tax increases are ignored.

**Table 2: Distributional effect of tax cuts in 2010[1]**

| *Cash Income Percentile[2]* | *Change in After-Tax Income (Percent)[3]* |
|---|---|
| Lowest Quintile | 0.2 |
| Second Quintile | 1.7 |
| Middle Quintile | 2.4 |
| Fourth Quintile | 2.4 |
| Top Quintile | 4.1 |
| All | 3.4 |
| | |
| *Addendum* | |
| 80-99 Percentile | 3.3 |
| Top 1 Percent | 6.1 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
(1) Baseline is pre-EGTRRA law, evaluated in 2010. The AMT exemption is raised (to $54,000 for married couples filing jointly, $38,250 for single filers) to keep the number of AMT taxpayers equal to the number who would have been on the AMT under pre-EGTRRA law.
(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

**Table 3: Distributional effect of tax cuts in 2010 with equal dollar financing[1]**

| *Cash Income Percentile[2]* | *Change in After-Tax Income (Percent)[3]* |
|---|---|
| Lowest Quintile | -26.6 |
| Second Quintile | -9.1 |
| Middle Quintile | -4.2 |
| Fourth Quintile | -1.6 |
| Top Quintile | 2.7 |
| All | 0.0 |
| | |
| *Addendum* | |
| 80-99 Percentile | 1.4 |
| Top 1 Percent | 5.9 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
(1) Baseline is pre-EGTRRA law, evaluated in 2010. The AMT exemption is raised (to $54,000 for married couples filing jointly, $38,250 for single filers) to keep the number of AMT taxpayers equal to the number who would have been on the AMT under pre-EGTRRA law. Financing equals $1922 per tax unit.
(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

The tax cuts must be financed in the future by some combination of tax increases and spending cuts, but at this point, it is impossible to say what specific changes will occur if the tax cuts are extended. As a result, I examine two hypothetical scenarios, which were developed in previous work with Bill Gale and others. In both scenarios, for ease of comparison, the financing is set so that the annual costs of the tax cuts would be fully paid in that same year. The first scenario assumes that each household pays the same dollar amount to finance the tax cuts. Under this scenario, each household receives a direct tax cut based on the tax cuts, but it also "pays" $1,922 per tax unit (in 2010 dollars) in some combination of reductions in benefits from government spending or increases in other taxes. Something close to this scenario could occur if the tax cuts were financed largely or entirely through spending cuts. I refer to this as "lump-sum" or "equal-dollar" financing, with results presented in Table 3.[6]

The second scenario assumes each household pays the same percentage of income to finance the tax cuts. In this case, each household receives a direct tax cut based on the Bush tax cuts, but also pays 2.6 percent of its income each year. Something close to this scenario could occur if the tax cuts were financed through a combination of spending cuts and progressive tax increases. I refer to this as "proportional financing," with results presented in Table 4.

[6] This is the equivalent of the hypothetical lump-sum tax that is used in differential incidence analysis in standard academic research, applied to tax units rather than individuals.

**Table 4: Distributional effect of tax cuts in 2010 with proportional financing[1]**

| *Cash Income Percentile[2]* | *Change in After-Tax Income (Percent)[3]* |
|---|---|
| Lowest Quintile | -2.5 |
| Second Quintile | -1.2 |
| Middle Quintile | -0.7 |
| Fourth Quintile | -0.9 |
| Top Quintile | 0.5 |
| All | 0.0 |
| | |
| *Addendum* | |
| 80-99 Percentile | -0.2 |
| Top 1 Percent | 2.3 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
(1) Baseline is pre-EGTRRA law, evaluated in 2010. The AMT exemption is raised (to $54,000 for married couples filing jointly, $38,250 for single filers) to keep the number of AMT taxpayers equal to the number who would have been on the AMT under pre-EGTRRA law. Financing equals 2.6 percent of cash income.
(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

The results under both financing scenarios are similar: More than three-quarters of taxpayers are made worse off by the tax cuts. For example, under equal dollar financing, those made worse off include almost every household in the bottom 40 percent of the income distribution, 94 percent in the middle quintile, and even 80 percent in the fourth quintile. As with the results ignoring financing, the tax cuts are highly regressive; the difference is that after-tax income now actually declines for most families, rather than increasing by a smaller percentage than for high-income families.

To be sure, this analysis assumes no effect on economic growth from the tax cuts. As discussed below, however, the long-term effect of the tax cuts is unlikely to be a large positive impact on economic growth, and if anything is likely to be negative. Nonetheless, as a rough illustration, consider the effects if the tax cuts raised each component of pre-tax household income by 1 percent. This assumption is generous, since a 1 percent increase in income exceeds the potential growth effects from the tax cuts in almost all recent studies. Even the Treasury Department's central estimate, assuming that the tax cuts are offset by spending reductions, involves an increase of 0.7 percent.[7] When the offsetting spending reductions or revenue increases are properly included, most households would be worse off, even with a 1 percent increase in pre-tax cash income, than they would have been without the tax cuts.[8] *In other words, even an economic growth effect larger than the optimistic estimate projected by the Treasury*

[7] Office of Tax Analysis, U.S. Department of the Treasury, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," July 25, 2006.
[8] For equal-dollar financing, more than two-thirds of households are worse off, including almost everyone in the bottom 40 percent of the income distribution, almost 90 percent of those in the middle quintile, and a majority of those in the fourth quintile.

*Department itself is not sufficient to rescue most households from being worse off if the tax cuts were made permanent, once the financing of the tax cuts is included.*

**The tax cuts as an example of "YOYO economics"**

The tax cuts represent what Jared Bernstein has called the YOYO approach to economics—you're on your own.[9] YOYO economics emphasizes the paramount importance of individual incentives almost to the detriment of all else, while paying little attention to market failures, the reality of individual decision-making as highlighted by the growing field of behavioral economics, or even the fact that government sets the rules under which markets operate. Thus under the YOYO view of economics, the most auspicious way to boost private saving is to remove income and contribution limits on tax-preferred saving, the best way of boosting productivity is to cut taxes, and so on. Improving economic performance is simply a matter of "getting government out of the way."

In my view, YOYO economics is not only misleading and historically inaccurate. The obsession with tax cuts has led to significant budget deficits that depress national saving and expand the current account deficit. And instead of a deep respect for market forces tempered by knowledge of their limitations, the assumption that unfettered markets always produce the best of all possible outcomes in all possible situations has meant that policy has not leaned against the wind of inequality and insecurity, for to do so under the YOYO view would mean increased distortions and less growth.

The tax cuts also exacerbate the volatility of family incomes. A progressive tax system helps to smooth fluctuations in household income, because they mean that households pay a smaller portion of their income in lower-income years and a larger portion in higher-income years. Because the tax cuts make the tax code less progressive, they reduce its effectiveness as a household income stabilizer and thereby worsen the volatility highlighted in Figure 5 above.

*The tax cuts and economic performance*

Some defenders of the tax cuts argue that despite the increase in government debt, reduction in national saving, ultimate reduction in income for middle-class families, and reduction in income smoothing associated with the tax cuts, one should focus on the effects of the tax cuts in promoting economic growth. The tax cuts are not and have not been a particularly effective growth strategy, however. Over the long term, they are likely to *reduce* economic growth rather than increase it.

The tax cuts did provide *some* short-run economic stimulus, but that is a minimalist goal: almost any tax or spending package would have stimulated a recessionary economy to some extent. The more relevant question is whether the policies offered a good anti-recessionary bang for the tax cut buck. Although the tax cuts from

[9] Jared Bernstein, *All Together Now: Common Sense for a Fair Economy* (Economic Policy Institute: Washington, 2005).

2001 to 2003 were well-timed to provide a short-run economic stimulus, they were poorly designed for this task. Studies consistently show that the bang for the buck of the tax cuts was relatively low, while the effect of alternative policies would have been significantly higher. In particular, a tax cut or spending increase that was aimed more at those with middle and low incomes would have provided a much larger "bang for the buck" in terms of stimulating the economy in the short-run than the Bush tax cuts did.[10]

Some proponents of the tax cuts argue that the current economic recovery shows that the tax cuts are "working." There are three flaws in this argument. The first is that much if not most of the recovery is tied to other forces, not the result of the tax cuts. The second is that there were more cost-effective mechanisms available to boost the economy in the short run. The final point is that the current recovery is actually not particularly strong, compared to previous recoveries. If the tax cuts have been so effective at spurring economic activity, and if the tax cuts are primarily responsible for the path of economic performance, one wonders why investment, labor supply, and other key indicators have not performed better. As just two examples, Figures 7 and 8 show the performance of private-sector payroll employment and of real business fixed investment during this recovery compared to previous business cycles. Both indicate that, if anything, this recovery lags behind the historical norm. Other indicators similar suggest a weak recovery.[11]

Several studies, using different methods and models, have sought to quantify the effect of the tax cuts on *long-term* economic growth. These studies have generally reached the same conclusion: Making the tax cuts permanent is likely to reduce, not increase, national income in the long term.[12] If the tax cuts are to raise economic growth over the long term, they must have a powerful enough direct effect on incentives for work, saving, and investment to overcome the drag on growth caused by higher budget deficits. The tax cuts, however, are not well-designed to provide strong incentives for additional saving, investing, and work.[13] As a result, after taking the drag from the higher budget deficits into account, the net effect from the tax cuts is likely to be a reduction in long-term growth.

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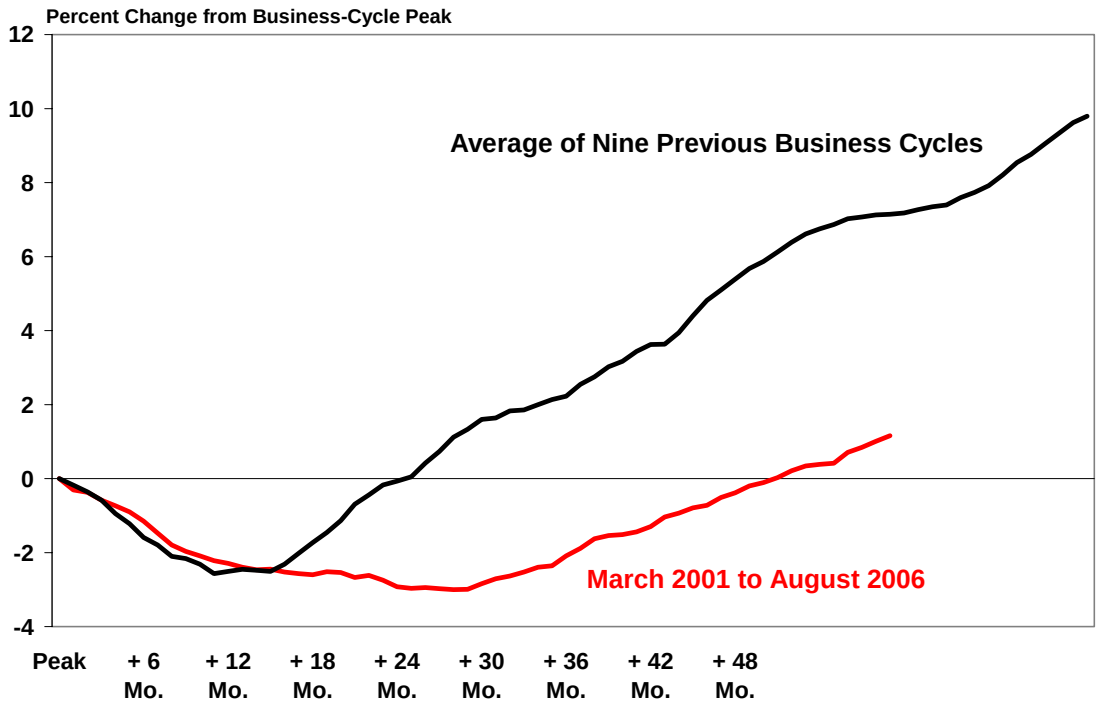
[10] See, for example, William G. Gale and Peter R. Orszag, "Bush Administration Tax Policy: Short-term Stimulus," *Tax Notes*, November 1, 2004.

[11] For further discussion, see Isaac Shapiro, Richard Kogan, and Aviva Aron-Dine, "How Does This Recovery Measure Up?" Center on Budget and Policy Priorities, August 2005.

[12] For a recent review, see Marc Labonte, "What Effects Have the Recent Tax Cuts Had on the Economy?" CRS Report for Congress, April 2006.

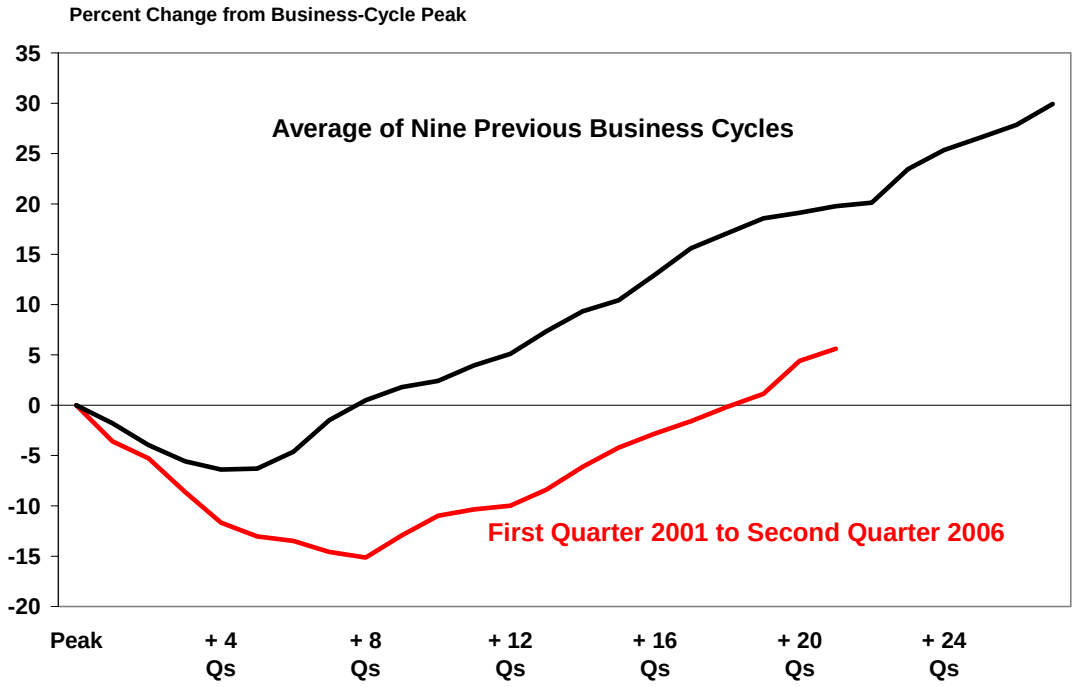
[13] Many households in the bottom half of the income distribution owe little or nothing in federal income taxes. Others higher up in the income distribution are subject to the Alternative Minimum Tax, which was only temporarily reduced by the tax cuts. As a result, a study using the tax model at the U.S. Department of the Treasury showed that the 2001 tax cut, when fully phased-in, would provide *no* reduction in marginal tax rates for 76 percent of households. Similarly, calculations using the Tax Policy Center microsimulation model indicate that, if both the 2001 and 2003 tax cuts were made permanent, 60 percent of filers, who collectively represent more than 40 percent of taxpayers and report 30 percent of all taxable income, would not see a reduction in marginal tax rates, relative to pre-2001 tax law.

**Figure 7: Private-sector payroll employment for current and previous business cycles**




Source: Calculations based on data from the Bureau of Economic Analysis.

**Figure 8: Real business fixed investment for current and previous business cycles**




Source: Calculations based on data from the Bureau of Economic Analysis.

## III. An alternative growth strategy

The tax cuts increase government debt, reduce national saving, impair long-term economic growth, ultimately reduce incomes for most families, and increase income volatility. The Hamilton Project is dedicated to an alternative economic vision, one that promotes growth, broad-based participation in growth, and economic security, all of which can be mutually reinforcing.

Economic growth will ultimately be stronger and more sustainable if all individuals have the opportunity to contribute to and benefit from it. When public policy excessively favors relatively few, growth suffers because the nation misses out on much of our people's potential for innovation and productivity. For example, without a quality public education, the middle-income child is less likely to become the highly productive worker of the future; without adequate access to capital, the potentially successful moderate-income businesswoman is less likely to get her business off the ground. Furthermore, in political economy terms, excluding significant parts of the population from the fruits of economic growth also risks a backlash that can threaten prosperity.

In addition, economic security can increase economic growth. Many policymakers and analysts have been trained to believe that providing more security to families must come at the expense of economic performance and that these two goals are thus contradictory objectives. Especially over the long term, however, the traditional view misses three key points. First, a basic level of security frees people to take the

risks—for example, starting a business, investing in their own education, or trying an unconventional career—that lead to economic growth. Second, if hardship does occur, some degree of assistance can provide the resources to help a family thrive again. For families experiencing short-term difficulties, a safety net can thus be a springboard to a better future. Finally, a basic level of economic security can lessen political demands for protectionism and other growth-diminishing policies. To be sure, providing too much security can harm economic growth by excessively blunting incentives to work, innovate, and invest, and some developed nations have gotten the balance wrong in this way. Policymakers must thus seek the right balance, recognizing that both the form and amount of economic security can affect economic growth and individual well-being.

Given this alternative framework, what policy changes would be beneficial? In this section, I discuss some specific steps to boost growth by increasing national saving, improving education, and strengthening economic security. The Hamilton Project will be releasing additional proposals on topics ranging from technology to health care and tax reform in the coming months.

*Increase national saving*

Higher national saving would reduce the current account deficit, raise future economic growth, and increase future living standards. Since national saving is equal to private saving minus the budget deficit, the key to raising it is to increase private saving and reduce the budget deficit.

The options for tackling the nation's fiscal imbalance, at least over the next decade or so, are well-known. The only real solution to the nation's fiscal imbalance is some combination of reduced spending and increased revenue. Restoring fiscal discipline will require painful adjustments, and it is unrealistic to think that the required adjustments can be undertaken entirely on one side of the budget or the other. The principal problem at this point is one of political choice and will. The combination of serious and intermediate-term deficits and longer term entitlement imbalances is so large that the regular political process seems unlikely to produce a solution. Any specific proposal is apt to be immediately and sharply attacked. Moreover, these attacks taint the proposals put forward and tend as a consequence to take them off the table. Instead, the president and the leaders of both parties in both houses need to come together in a special process.

With regard to private saving, the most important change is to make saving easier.[14] The current system is too complicated. Faced with difficult choices presented by 401(k)s and IRAs, many people simply procrastinate, which often means they don't save. You shouldn't need a Ph.D. in finance to figure out how to navigate a savings account.

[14] For more information, see www.retirementsecurityproject.org. See also William Gale, Jonathan Gruber, and Peter Orszag, "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households" (The Hamilton Project, Washington, DC, April 2006).

How could we make saving easier? The most promising approaches involve an automatic 401(k) for workers at firms offering pensions and an automatic IRA for other workers. The 401(k) and IRA were originally designed for retirement saving, but today both accounts can be used for a variety of purposes. They are the best saving vehicles we have, and we can make them better by automating them:

- Automatic 401(k). Under the automatic 401(k), workers would be automatically enrolled unless they chose not to participate. Their contribution rate would automatically rise over time, and their funds would be invested in a diversified, low-cost portfolio. That is, at each stage of the process, workers would enjoy pro-saving defaults, and they could always make different choices, such as opting out entirely or picking different portfolios. These changes matter. Participation rates among new low-wage workers have jumped from less than 15 percent to 80 percent when automatic enrollment is put in place. No other imaginable change boosts participation as much. The automatic 401(k) is becoming more common among employers, and Congress recently cleared away the legal issues that had been discouraging other firms from joining. So it's time for the rest of corporate America to help workers save.

- Automatic IRA. Not all employers sponsor retirement plans: In 2004, more than 71 million people worked for an employer without one. An automatic IRA would help these workers save.[15] Under this system, companies not offering a pension would have to set up direct payroll deposits to IRAs for their workers. Costs would be minimized through a no-frills design that would take advantage of payroll systems that are already in place. Again, the defaults would set workers in a "pro-saving" direction unless they opted out.

In addition to making it easier to save, it would be beneficial to replace the existing "upside down" set of tax incentives for retirement saving, which mostly subsidize asset shifting by higher-income households rather than new saving by middle- and lower-income households, with a simple 30 percent match for everyone. The result would be a stronger incentive to save for 80 percent of households.[16] New randomized evidence also suggests that transforming the incentive from a *credit* (that is, money returned to the tax filer in the form of a reduction in tax liability or a refund) into a *match* (that is, money deposited directly into the retirement account) would be more effective at inducing retirement contributions.

This approach to saving differs dramatically from the approach implied by you're-on-your-own economics. Rather than focusing saving efforts on the middle-class and on lower-wage earners, the you're-on-your-own approach would direct the bulk of new incentives toward those who already save significant amounts. One common proposal, for example, would increase the maximum amount that can be saved on a tax-

[15] J. Mark Iwry and David John, "Pursuing Universal Retirement Security Through Automatic IRAs," (Retirement Security Project, Washington, DC, February 2006).
[16] William Gale, Jonathan Gruber, and Peter Orszag, "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households" (The Hamilton Project, Washington, DC, April 2006).

preferred basis, such as by raising the amount that can be contributed to an IRA or a 401(k). Yet fewer than 10 percent of 401(k) participants, and about 5 percent of those eligible to contribute to IRAs, make the maximum contribution allowed by law. Simply increasing the maximum contribution amounts would have no effect on the vast majority of families and individuals who currently face no bar against making further tax-preferred contributions. Instead, raising the contribution limits would largely provide windfall gains to households that already make the maximum contributions to tax-preferred accounts and save additional amounts in other accounts. Most of the response to higher contribution limits likely would be a shifting of assets from ordinary accounts to tax-preferred accounts. The expanded tax preference thus would mostly subsidize saving that would have occurred anyway, rather than encourage new saving. As a result, if the expanded tax preferences were deficit financed (i.e., through government borrowing), the subsidies might well lead to a reduction rather than an increase in net national saving. Thus, these policies would fail to improve either household preparation for adverse economic shocks or social equity, and could even reduce net national saving.

*Education*

Education is an essential ingredient in broad-based growth, since it promotes both opportunity and productivity. And just as investments in physical capital carry a rate of return, investments in human capital do also. Indeed, studies suggest that the real rate of return on investments in education and training programs—in terms of the payoff to lifetime earnings relative to the up-front costs—is between 7 and 10 percent per year.

The Hamilton Project has already released two discussion papers to improve education; it will release more in the future.[17] One paper argues that teacher quality could be improved significantly by placing less emphasis on teacher credentials at the time of hiring and more emphasis on teacher effectiveness while on the job. This proposal is supported by research suggesting that qualifications such as teacher certifications provide almost no information about which applicants will prove to be the most effective teachers. Adopting the proposal would result in a larger number of teachers being hired each year—some with and some without certification—but a more rigorous filter—involving performance on the job—for those teachers to receive tenure. The other discussion paper calls for Summer Opportunity Scholarships so that economically disadvantaged children can attend summer school or a summer enrichment program. This proposal is supported by research documenting summer learning loss, in which children from disadvantaged families, who have fewer opportunities for summer enrichment, experience greater losses in skills during summer vacations than do their more advantaged counterparts; these effects tend to cumulate over many summers.

[17] Robert Gordon, Thomas J. Kane, and Douglas O. Staiger, "Identifying Effective Teachers Using Performance on the Job," (The Hamilton Project, Washington, DC, April 2006); Molly E. Fifer and Alan B. Krueger, "Summer Opportunity Scholarships: A Proposal to Narrow the Skills Gap," (The Hamilton Project, Washington, DC, April 2006).

*Economic security*

Higher private saving and quality education not only bolster economic growth; they also better prepare families for periods of economic difficulty. Although greater saving and more education can improve economic security, though, they are not a panacea. It is therefore critical to devise market-friendly ways to help families and workers deal with economic difficulties. Effective programs must strike a difficult balance. As noted above, providing too little assistance not only can directly inhibit risk-taking and productivity, but also can trigger a backlash against policies that are broadly beneficial yet impose concentrated costs on specific firms or industries; at the same time, assistance must be designed to avoid creating harmfully distorting incentives that impair overall growth.

The harder cases, in which the need for balance is most critical, involve programs that provide crucial insurance but also may have significant incentive effects, such as in affecting decisions to work and save. An example is the nation's unemployment insurance (UI) system. The innovation, competition, and shifts in business practices that fuel the dynamism of the American economy also create a turbulent labor market with substantial turnover. On an average day in 2005, for example, about 3.7 million people who had lost their jobs through no fault of their own were unemployed and actively looking for work. The current unemployment insurance system helps cushion the shock of job loss and facilitate reemployment by providing limited income support for up to six months to workers who become unemployed through no fault of their own. Yet that system has not been fundamentally altered since its inception in the 1930s, and the time has come to consider changes.

The Hamilton Project has released two discussion papers that take rather different approaches to restructuring UI. Jeffrey Kling of the Brookings Institution notes that the current system offers no assistance to workers who become reemployed at a lower wage and face significantly lower lifetime earnings—which occurs for about one-third of people who take new jobs after being laid off.[18] Kling proposes a fundamental restructuring of the unemployment insurance system: Wage-loss insurance would provide long-term assistance to laid-off workers who are subsequently reemployed at lower salaries; a newly created borrowing mechanism and system of self-funded accounts would assist workers during periods of unemployment. This proposal, Kling argues, would better protect workers against the long-term effects of involuntary unemployment, better target benefits toward those who most need assistance, and encourage reemployment. Kling's budget-neutral reform would provide help to workers coping with the longer-term hardships against which they are least able to protect themselves. If adopted, the new system would cut in half—from 14 percent to 7 percent—the share of

[18] Jeffrey R. Kling, "Fundamental Restructuring of Unemployment Insurance: Wage-Loss Insurance and Temporary Earnings Replacement Accounts" (The Hamilton Project, Washington, DC, September 2006).

laid-off workers with wage declines who experience very large drops in earnings at their new jobs.

An alternative approach to reforming the unemployment insurance system is described in a discussion paper by Lori Kletzer of the University of California at Santa Cruz and the Institute for International Economics and Howard Rosen of the Institute for International Economics and the Trade Adjustment Assistance Coalition.[19] Kletzer and Rosen believe that UI should remain focused on providing assistance during short-term periods of unemployment. To make UI more responsive to a labor market that has changed substantially since the program was created in 1935, Kletzer and Rosen propose three broad changes to UI. First, they would establish national standards regarding the level and duration of UI benefits, program eligibility (expanding eligibility to include part-time and seasonal workers and reentrants to the labor force), and program financing (raising the maximum federal taxable wage base). Second, they would allow self-employed workers, and perhaps others, to make a limited amount of tax-favored contributions to newly created personal unemployment accounts. Contributions would be matched by the federal government. Funds could be withdrawn later to cushion severe economic loss or to pay for training or a job search. Finally, Kletzer and Rosen propose supplementing UI with a wage-loss insurance program that would offset some of the earnings lost by those who are laid off and then reemployed at lower wages.

Both papers recognize the need to reform UI and to add a wage insurance component. A significant difference between them, though, is the relative emphasis on long-term protection against reduced wages. Kling believes that this should be the focus of a system to help displaced workers, whereas Kletzer and Rosen hold that short-term income support during the period between termination and reemployment should continue to be the mainstay of a comprehensive unemployment system. In addition, the Kling proposal would be revenue neutral, while the Kletzer-Rosen proposal would increase funding for UI and related programs.

A third discussion paper released by The Hamilton Project considers broader changes in how the nation could address economic security. Jacob S. Hacker of Yale University proposes the creation of Universal Insurance focused on providing temporary and partial relief from severe economic shocks.[20] This Universal Insurance program would be available to nearly all American families. To limit potential incentive problems and to target relief effectively, Hacker's proposal would provide only fractional and temporary insurance and would only be triggered if certain qualifying conditions were met, and if family income suddenly declined by more than 20 percent or out-of-pocket health costs exceeded 20 percent of income. Although most families would be eligible, the program would be most generous for lower-income families, which have the fewest resources of their own. Hacker estimates that his proposal would reduce by half the risk of a family income decline of 50 percent or more. He argues that this type of insurance—

[19] Lori Kletzer and Howard Rosen, "Reforming Unemployment Insurance for the Twenty-First Century Workforce," (The Hamilton Project, Washington, DC, September 2006).
[20] Jacob S. Hacker, "Universal Insurance: Enhancing Economic Security to Promote Opportunity," *(*The Hamilton Project, Washington, DC, September 2006).

covering a range of risks but limited to particularly dramatic cases to minimize incentive problems—is likely to provide a stronger platform for enhancing economic security in a world of rapidly changing risks than the current fragmented collection of categorical programs. As the nation struggles with the consequences of increased income volatility, this proposal should be actively debated along with other potential policy responses.

A final idea I'd like to highlight was developed by Lily Batchelder of NYU, Fred Goldberg of Skadden Arps, and me.[21] As noted above, a progressive tax system can help to smooth after-tax income volatility. We could make the tax code both more progressive and more efficient at the same time by reforming the way we provide incentives for many activities. The nation devotes roughly $500 billion a year in tax incentives to subsidizing socially beneficial activities (such as retirement saving, health care, education, and home ownership). The vast majority of these incentives take the form of deductions or exclusions, which link the size of the tax break to a household's marginal tax bracket. In the absence of evidence that high-income households are more responsive to the incentives or generate larger social benefits than low-income households, though, the subsidies should instead be delivered in the form of uniform, refundable credits, so that they do not vary by income—which would be both more efficient and more equitable than the current system. It would make the tax code more progressive, which would help to cushion fluctuations in after-tax income, at the same time as making the system more efficient.

**Conclusion**

The United States has many great strengths—entrepreneurship, flexibility, education, and openness to new people and new ideas—which are qualities that the world economy rewards. Without a change in course, however, the lifetime prospects of today's younger Americans will be unnecessarily and unfairly inhibited—undermining the traditional vision of ever-increasing opportunity for succeeding generations. Regardless of whether a substantial focus on marginal tax rates may have been appropriate when such rates were 70 percent or higher, that day has long passed, and therefore such a focus is no longer relevant. The time is overdue for an alternative economic growth strategy, one that is more attuned to the situation in which the nation now finds itself and that is dedicated to promoting broad-based participation in growth along with economic security. Increasing national saving, improving education, and revamping the nation's approach to economic security would all represent steps in the right direction.

[21] Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," 59 *Stanford Law Review* (forthcoming). See also Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Reforming Tax Incentives into Uniform Refundable Tax Credits," Brookings Institution Policy Brief #156, August 2006.