

# PERSPECTIVES ON DEFICIT REDUCTION

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## HEARING

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

APRIL 13, 2011



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## PERSPECTIVES ON DEFICIT REDUCTION

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WEDNESDAY, APRIL 13, 2011

U.S. SENATE,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Rockefeller, Bingaman, Wyden, Schumer, Nelson, Carper, Cardin, Hatch, Grassley, Snowe, Ensign, Coburn, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; Alan Cohen, Senior Budget Analyst; Tom Klouda, Professional Staff Member, Social Security; and John Angell, Senior Advisor. Republican Staff: Chris Campbell, Staff Director; Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Stephanie Carlton, Health Policy Advisor.

### **OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The hearing will come to order.

Henry Ford II once said, "What's right about America is that, although we have a mess of problems, we have a great capacity, intellect, and resources to do something about them."

Enormous Federal budget deficits and the debt our country faces can certainly be called a mess. Identifying ways to reduce these deficits and eliminate the debt is the topic of our discussion. Addressing our deficits and debt is an economic issue, it is a national security issue, and it is a moral issue.

Our deficits and debt threaten our future and the future of our children and grandchildren. I have long said that we have a moral obligation, when we leave this place, to leave it in as good a shape or better shape than we found it, but today our fiscal challenges prevent us from meeting that responsibility.

And there are other concerns. U.S. debt could be recalled by foreign entities in times of economic or military conflict. This presents a significant national security problem. The nonpartisan, independent Congressional Budget Office estimates that this year the deficit will reach 9.8 percent of our entire economy. That is the second-largest deficit on record since World War II.

One of the most significant factors behind our deficits is the recession. As our economy continues to recover, we will see improvements. By 2015, our deficits are expected to drop to approximately 4.7 percent of GDP. But over the longer term, our deficits are pro-

jected to continue increasing. They will likely reach more than 5 percent by 2021, and debt held by the public will increase to about 91 percent of our entire economy.

We have to do better. Families in Montana and across the country expect us to do better, because that is what they have to do when their budgets are tight in their own lives. Whether it is saving for college or making payroll for their small business, Americans know they have to balance their books, and they know you can only put so much on the charge card.

It is time for us to take a lesson from the family that has not taken a vacation in far too long, from the small business where everyone took a pay cut to prevent layoffs. It is time for us to get serious. Economists agree that we have to get the debt held by the public under control. That means deficits in the near term should be reduced to no more than 3 percent of GDP. To meet that goal, we must act.

While we must be cautious during the present recovery, we should enact the legislation soon with a plan to reduce deficits as our economy grows stronger. That plan should not over-shoot deficit reduction targets, harm critical programs, or risk economic growth, but it also must be a plan we are committed to enact.

As we consider our deficit reduction plans, we must keep several things in mind. First, everything must be on the table. Our deficit challenges are simply that significant. Second, we should not scapegoat Social Security. Social Security benefits are self-financed through the payroll taxes and the trust fund, and Social Security is not responsible for the deficits in the general fund. Third, any deficit reduction package should be balanced. In general, the package should not be tilted too much towards spending cuts or too much toward revenue increases. And fourth, spending cuts do not necessarily mean benefit cuts. We have to stretch our administrative dollars further and make our programs more efficient.

The new health care law has already made some notable progress toward deficit reduction by addressing one of the largest drivers of our deficits, that is, rapidly rising health care costs. The law increases focus on prevention, it makes our system more efficient, and it cuts fraud, waste, and abuse significantly. These improvements—and there must be more—resulted in the most significant deficit reduction in more than a decade. According to CBO, the law will reduce the deficit by more than \$230 billion in the first 10 years of enactment, and by more than a trillion dollars in the decade that follows, that is, compared to what otherwise the law would be, and we must give this law time to work.

The Finance Committee has jurisdiction over many of these programs that will figure prominently in this discussion. We oversee Social Security, Medicare, Medicaid, taxes, and many other programs. That is about 45 percent of total spending. Following today's hearing, I intend to hold more hearings to give us the facts we will need as we move forward to address these paramount concerns. I look forward very much to hearing from our witnesses. They are very highly regarded experts in their field, and their guidance is going to mean a lot as we try to find a solution to this difficult problem.

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

The CHAIRMAN. Senator Hatch?

**OPENING STATEMENT OF HON. ORRIN G. HATCH,  
A U.S. SENATOR FROM UTAH**

Senator HATCH. Well, thank you, Mr. Chairman. I appreciate you, and I want to thank you for kicking off the Finance Committee's deficit reduction efforts this morning.

As I prepared for this hearing, I thought of those two Chicago-savvy musicians, Joliet Jake and Elwood Blues. They were known as the Blues Brothers. Now, I have a chart depicting Jake and Elwood right over here. You can see, very handsome young men. Jake and Elwood would often challenge folks to state their blues. If they asked us here today to state our blues, I think every member of this panel would say we have those big deficit and debt blues. We would also say that those blues will not leave us any time soon.

In recent months, President Obama has frequently discussed our Nation's disturbing fiscal situation. He is right to do so. I am sure the President would say he has the big deficit and debt blues. Who would not have the blues?

Our yearly deficits and accumulated debt hover like thunder clouds over the futures of our children and our grandchildren, and in Elaine's and my case, even great-grandchildren. Although he is late to the table on this issue, President Obama has indicated once again that he seems to have finally recognized the frustration and anger of the American people over our loose fiscal policy.

The President's Fiscal Commission came out with a long-term deficit reduction plan, but the President made no commitment. It was a swing and a miss. Strike one. Then we all waited for the President's budget to show some path to long-term deficit reduction and entitlement reform, but no commitment. It was a swing and a miss. Strike two. Then the White House lit up the Sunday show circuit with an expectation that the President will come to the plate and take another swing at a plan.

Jake and Elwood captured the importance of bottom-line substance with the "sandwich" joke. A sandwich, by their definition, consisted of two slices of bread with no meat. The consumer of the sandwich was supposed to wish he or she had meat between the slices of bread. As we anticipate the President's third swing at the deficit reduction plate, we hope it will not be a strike. Three strikes and you are out. We hope he will be delivering a sandwich and not a sandwich. A sandwich is a joke and not a meal.

Some will say the only real deficit reduction game in town is one where we significantly raise taxes. The nonpartisan Congressional Budget Office tells us that the current tax system will yield ever-rising revenues. I have a second chart that illustrates this point. These are projected revenues from individual income taxes.\* If you look at this chart, you will see that the individual income taxes grow as a share of Gross Domestic Product. The top line is the current law baseline. You can see that it springs upward. Revenues

\*Please see Appendix, p. 51.

grow dramatically under the President's basic policy baseline. It is the center line.

My friends on this side of the aisle probably will not be surprised by that data. What may shock my friends on the Democratic side is that current policy with this year's rates and the AMT patch will yield a growing tax base as well. That is the bottom line. Those are the projected revenues from individual income taxes.

That is right. If current tax policy stays in place, the nonpartisan CBO tells us the tax base individual income tax grows as a portion of the American economy. A shrinking revenue base is not driving the out-of-control deficits of the future. How could it? It is not shrinking. It is actually growing. For those who want to ignore the clear data showing that the individual income tax take grows, let us take a look at some numbers that also grow significantly. In this case, I am talking about Federal spending.

Now, let me just point to Federal taxes and spending as a percentage of GDP. This is this particular chart now.\* Looking from the bottom up, you can see that revenues come back. It is the bottom line in this chart. The top line shows the President's budget spending line. As you can see, it stays very high. As a share of GDP, it is over 15 percent above the historic average. Spending is historically high, and it keeps growing. Someone used the word "hysterically" high, but we will stick with historically high. Now, that is not restraint. It is not discipline. It is beside me how, when looking at this data, folks on the other side can argue that out-of-control spending is not the problem.

That, Mr. Chairman, is why we are here. We need to look at the origins and continuous causes of the unsustainable deficits and debt. This great old committee, the Senate Finance Committee, is where over half of spending originates. It is where almost all revenue policy rests. It is only proper that this committee air these issues out, so I am very grateful to you, Mr. Chairman, for being willing to do so.

It is, however, all for naught if the President misses this opportunity and does not make a bold commitment to entitlement reform and deficit reduction. Hopefully it will not be a third strike, where we are left with the status quo. Hopefully the President will not deliver a sandwich. We have to hunker down, do the work, and rid ourselves of these spending-driven deficit and debt blues. I look forward to hearing these especially learned witnesses this morning.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

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

The CHAIRMAN. I would like to introduce our panel. The first witness is Dr. Alan Blinder, professor of economics and public affairs at Princeton University, and formerly Vice Chairman of the Board of Governors of the Federal Reserve system. Thank you for coming here, Professor.

Second, the Honorable David Walker, founder and CEO of the Comeback America Initiative, and former U.S. Comptroller General.

\*Please see Appendix, p. 52.

And finally, Dr. J.D. Foster, senior fellow in the Economics of Fiscal Policy at The Heritage Foundation, and former Associate Director for Economic Policy at the Office of Management and Budget.

Thank you all very much. Your statements will be in the record. Summarize for about 5, 6 minutes. I encourage you not to pull any punches. This debt limit is fast approaching, and we have to find some solutions here.

Professor Blinder?

**STATEMENT OF DR. ALAN S. BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS AND CO-DIRECTOR OF THE CENTER FOR ECONOMIC POLICY STUDIES, PRINCETON UNIVERSITY, AND VICE CHAIRMAN FOR PROMONTORY INTERFINANCIAL NETWORK, PRINCETON, NJ**

Dr. BLINDER. Mr. Chairman, Ranking Member Hatch, members of the committee, I would like to thank you for the opportunity to come here this morning and share my views with you about the budget deficit and the national debt. I really have only three points to make, and I am going to state them up front—and clearly, I hope—and then elaborate just a very little bit on each and hold to my 6-minute time limit.

The CHAIRMAN. If you want to take a minute or two more—

Dr. BLINDER. I could have 7? Thank you, sir, very much.

The CHAIRMAN. You are welcome.

Senator HATCH. You can even have more.

Dr. BLINDER. Look at this!

The CHAIRMAN. Yes. Well, I am trying to figure out some way to say this. We have to exercise some restraint in this country, so there are limits.

Dr. BLINDER. We have not put mandatory caps on, I see.

The CHAIRMAN. Right. [Laughter.]

Dr. BLINDER. So here are my three points. First, the short-term budget deficit, the very large number that Senator Hatch showed before, large as it is, is really not much of a problem. Indeed, I would say it is probably quite desirable, given the pallid state of our economy still.

What gives me the deficit and debt blues is the government's long-run deficit problem, which is huge and horrendous. It was entirely predictable, and indeed predicted 30 years ago, as Dave Walker reminds us, and really demands congressional action. As both of you Senators said, sooner would be much better than later.

The third point is that no one—no one—should seriously consider letting the government hit the national debt limit.

So let me take those three points up in turn. CBO now estimates that the fiscal 2011 deficit will be in the neighborhood of \$1.4 trillion; the OMB estimate is higher. That is about 9.5 percent of GDP, which looks huge compared to the 40-year average of about 3 percent of GDP, which, as I think you were sort of obliquely suggesting, Senator Baucus, is a reasonable target. I want to make three very quick points about that 6.5-point gap. Why are we at 9.5 instead of at 3 now? First, it is inherently temporary. In round numbers, the recession has added about 2 percent of GDP to the

deficit, and that part is going to naturally fade away as the economy gets better.

About 1 percent of GDP comes from the Recovery Act, and that will certainly disappear on a schedule that you all know. Another 1 percent comes from the wars we are fighting, and I certainly hope that will disappear, although who knows? Finally, another 2.5 percent of GDP comes from the tax cut, et cetera package that Congress enacted last December. That one, as you all know, is scheduled to lapse at the end of 2012, but frankly, as a citizen and an economist, I am a little worried about that, 2012 being divisible by four.

If you add up all of these temporary components, you get 6.5 percent of GDP. So in principle, Congress should be able to get the deficit back down to 3 percent of GDP pretty much without breaking a sweat. Yet as we saw last week, the House and the Senate almost closed the government over just a few billion dollars in discrepancy between the two parties.

The second point. The economic recovery is mediocre at best, and unemployment remains very high. To me, those conditions describe a very bad time to put the economy on a diet, either with large spending cuts or with tax increases.

Third, if we are facing any near-term financing problems—near term, I emphasize—they are invisible now. The capital markets now charge the U.S. Treasury a real interest rate of about 1 percent for 10-year money and strongly negative real interest rates for short-term money. That is extremely cheap financing. So there is no deficit crisis today, but of course we could create one by letting the government crash headlong into the national debt ceiling.

I come now to the second point. Each year, Congress passes a budget. Well, most years Congress passes a budget that implies certain amounts of spending and receipts. The difference between those two numbers is the implied increase in the national debt over that fiscal year. Given the budget, it makes no sense whatsoever to place an additional lower limit on the amount of debt that the Treasury can issue, since Congress has just given instructions to go higher than that.

Letting the debt limit bind is at one level comical because it simply defies the laws of arithmetic, but in a much more important level it is potentially dangerous if it robs the Treasury of the borrowing authority it needs to finance the government. We have enough problems right now and should not be shooting ourselves in the foot.

So now let me turn to the most important point, which is the long-term budget problem. I am sure every member of this committee knows the U.S. Government is now on an unsustainable budget path that will drive the ratio of debt-to-GDP ever higher, just higher, higher, higher, without limit on the current path. That, of course, cannot happen.

I want to emphasize that in my view the next 10 years are not where the problem really is. There is a problem in the next 10 years, but it is puny compared to what comes after that. The CBO's latest long-term projections show the deficit—as a share of GDP under their more realistic alternative scenario, they call it—falling from about 9.5 percent now to about 6.5 percent in 2020—which is

part of why I say it is not such a big problem for the next decade—but then soaring to 16 percent by 2035, after which it just keeps on growing. So it is not like it stops at 16 percent. That is not just unconscionable, it is actually impossible. That cannot possibly happen.

So what is driving those numbers? Other than the inexorable logic of rising debt and rising interest payments, it is Social Security and health care, mostly the latter, exactly as you said, Mr. Chairman. For example, if you look at the primary deficit, excluding interest payments, Medicare and Medicaid account for about 85 percent of the increase in the debt-to-GDP ratio between 2020 and 2035, according to the CBO's estimates. As Rabbi Hillel once said about the Golden Rule, "All the rest is commentary." If we can get the 85 percent right, the 15 percent will take care of itself.

The explosion of medical costs is, in turn, driven by two factors, and you know what they are: increasing longevity and rising relative prices for health care services. I do not think Congress wants people living shorter lives, so it is approximately true that if we can figure out how to bend the health care cost curve, as it is called here, enough we can fix the long-run deficit problem. If we cannot, we cannot. That is the 85 percent.

Unfortunately, no one really knows how to do that. Some people believe that last year's health care reform has the potential to do the job. After all, it does try, as you suggested, Mr. Chairman, just about every cost-control idea that anyone has ever suggested—almost all of them. Others are skeptical, however, that this will work. I do not pretend to know the answer. The most intelligent course of action, it seems to me, is to watch how the various cost-containment efforts play out over the next few years and then do more of whatever seems to work, and certainly not to repeal these cost-containment efforts before they have even had a chance to start.

As I say this, I am painfully aware that cutting losers and riding winners is one of the hardest things for any government anywhere in the world to do, certainly including ours. Nonetheless, I think that you Senators should try to do that, and I wish you good luck. Thank you for listening.

The CHAIRMAN. Very good. Thank you, Dr. Blinder.

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

The CHAIRMAN. Mr. Walker?

**STATEMENT OF HON. DAVID M. WALKER, FORMER U.S. COMPTROLLER GENERAL, AND FOUNDER AND CEO, COMEBACK AMERICA INITIATIVE, BRIDGEPORT, CT**

Mr. WALKER. Chairman Baucus, Senator Hatch, members of the Senate Finance Committee, thank you again for the opportunity to appear before you today.

While the United States is an exceptional and great Nation, we have strayed from many of our founding principles and values that made us great. We must now restore our belief in, and commitment to, these principles and values in order to ensure that America remains great and that our future will be better than our past.

Today's public debt is about 65 percent of the economy and growing rapidly. In addition, if you add the debt that we owe Social Se-

curity and Medicare, which I believe you should, it is 95 percent and growing rapidly. Another way to look at debt is debt per capita, adjusted for inflation. When you do it on that basis you will see that our current level of debt per capita, adjusted for inflation, is double—over double—what it was at the end of World War II. In fact, if you look at our spending and revenues adjusted for inflation, we are actually spending at a 50-percent higher level per capita than at the height of World War II, and our deficits are actually higher than they were at the peak of World War II.

Now, we got something for World War II. I am not so sure what we are getting for today's deficits and debt. Today's deficits and debt levels are a matter of growing public concern. However, as Dr. Blinder mentioned, they are driven largely by temporary factors. Therefore, the real risk is not today's deficits and debt, it is what lies ahead. Clearly, we are talking about unsustainable deficits and debt going into the future. There is already evidence that market forces are beginning to show concern regarding future interest rates.

For example, the Federal Reserve has been buying a majority of our new debt in recent months and is now the largest single holder of Federal debt. China and other foreign investors are buying short-term U.S. debt in order to hedge against future increases in interest rates and declines in the value of the dollar. In addition, PEMCO, the largest domestic holder of U.S. public debt for its investors, recently divested its holdings in U.S. Treasury securities. They did so not because of concern of default, they did so because they believe that current interest rates do not adequately compensate their investors for interest rate risk.

The truth is, the Federal Reserve's buying of our debt amounts to self-dealing, which would be prohibited in connection with pension and employee benefit plans. Importantly, the U.S. has the lowest average debt maturity of any major sovereign nation. In addition, we have very low interest rates by historical standards. Therefore, when—not if, when—interest rates rise, interest costs will rise dramatically. And what do we get? As we say in the South: "Shinola." Nothing. Absolutely nothing.

To help put things in perspective, for every 1 percent increase in interest rates, the U.S. incurs about \$150 billion in interest costs based upon today's gross debt levels. That is over 10 times what the United States spends in international affairs, which, rightly or wrongly, many Americans question. As I said, what do we get for that \$150 billion? Nothing.

Just last month, the Comeback America Initiative, which I founded and lead, and Stanford University's Masters in Public Policy program, issued a Fiscal Responsibility Index. Australia is ranked number one, Greece is ranked 34, and the United States, embarrassingly, is ranked 28. We are not in a good neighborhood. We need to move on up.

The fact is, if you look at that listing, though, you will see that number 2 New Zealand, number 4 Sweden, had their own problems in the 1990s. They made tough choices, and now they are number 2 and number 4. And we ran a separate listing that, if the Congress and the President were able to agree on a set of fiscal reforms that have the same bottom line impact as the National Fiscal

Responsibility and Reform Commission—it does not have to be the same reforms, but the same bottom line impact—we would move from number 28 to number 8. We would have fiscal sustainability for 40-plus years, and we would be number 3 in the world in fiscal governance.

Effectively addressing our structural deficits will require major transformational reforms in a range of areas, including Medicare, Medicaid, Social Security, health care programs, defense and other spending cuts that do not compromise national security, and comprehensive tax reform that achieves numerous objectives, including raising additional revenues as compared to historical levels as a percentage of GDP. In order to be able to be successful, I lay out several tests in my testimony, and I believe it is essential that they be met.

If I can, let me transition and then close with the debt ceiling limit. We must raise the debt ceiling limit. It is a tactical nuclear weapon. Unlike the continuing resolution—if you do not have a continuing resolution, essential operations of government continue, Social Security checks continue to be paid—if you hit the debt ceiling limit, such is not the case. Let me remind you that Social Security is now in a negative cash flow position. It cannot stand on its own. So not only are essential operations threatened, Social Security benefits would not go out on time the first of the month following the month that you hit that. In addition to that, the confidence of the American people and the credibility of the United States in capital markets would be really threatened.

So the question is not if we should raise the debt ceiling limit, but how much, and in exchange for what? In my testimony, I lay out a suggestion. It is time to learn from history and learn from others, and to bring back tough statutory budget controls beginning in 2013; give us time to recover, give us time to get unemployment down, with specific debt as a percentage of the economy targets, with automatic enforcement mechanisms.

This would give Congress time to figure out what to do, to engage the American people with the facts, the truth, and the tough choices that have to be made, and, importantly, if it failed to act, things would happen. There would be transparent and facilitated accountability.

In summary, we are a great Nation, arguably the greatest in the history of mankind. But we are not as great as we think we are, and we are not exempt from the laws of prudent finance. We will have a debt crisis in this country if we do not change course, and it could come within 2 to 3 years. I am hoping that we can do something soon to avoid that.

Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Walker.

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

The CHAIRMAN. Dr. Foster?

**STATEMENT OF DR. J.D. FOSTER, NORMAN B. TURE SENIOR FELLOW IN THE ECONOMICS OF FISCAL POLICY, THE HERITAGE FOUNDATION, WASHINGTON, DC**

Dr. FOSTER. Thank you, Mr. Chairman, Ranking Member Hatch, members of the committee. Thank you for the opportunity to testify

today. My name is J.D. Foster. I am the Norman B. Ture senior fellow in the economics of fiscal policy at The Heritage Foundation, and also, as a former staffer for two former members of this committee, it is a distinct honor and pleasure to be here before you.

Senator HATCH. Which ones?

Dr. FOSTER. Senator Bill Armstrong and Senator Steve Simms—Westerners, naturally.

In 2007, the country was essentially at full employment. The Federal budget deficit ran to \$162 billion; spending on the wars in Iraq, Afghanistan, and related activities totaled \$174 billion. In short, but for the worst spending, the Nation ran a balanced budget in 2007 while collecting a normal share of revenue. Ten years later in 2017, under the budget President Obama submitted this past February, the country is again assumed to be at full employment, yet the projected budget deficit for 2017 is nearly \$1 trillion, despite assuming a substantial reduction in war outlays and a substantial tax increase. From there, the deficit balloons as the entitlement wave crashes upon us.

Above-normal revenues and high and rising deficits can only mean one thing: spending is the problem. The President's budget released last February contained \$2.2 trillion in magic asterisks and precious little else by way of detailed spending restraint.

Last week, House Budget Committee chairman, Paul Ryan, revealed a path to prosperity, an expansive scope calling for sweeping change with real policies and CBO scoring. The Ryan plan has generated both heat and light in abundance, but what this committee, the Congress, the Nation, must realize is that the Ryan plan suggests the magnitude of the changes necessary to stabilize Federal finances. Critique parts or all if you will. In terms of magnitude, nothing less than the changes the Ryan plan proposes must and, however painful, will be enacted.

The President is now coming forward with more substantive views on deficit reduction. One would have expected the budget to reflect his proposals 2 months ago. Clearly, in light of the credibility and sweep of the Ryan proposal, the President is now compelled to say something more. As Senator Hatch notes, we are hoping for a big, healthy, robust sandwich, not a sandwich.

The recent budget deal is a start. It is, however, the other card, as they say in boxing, to the bigger events later this year: the budget resolution, debt limit, and funding for 2012. All those in and out of Congress who worry about budget deficits will have ample opportunity to meet the challenge and advance their own alternatives. We will see who walks the walk and who just talks the talk.

The three key aspects to deficit reduction are growth, taxes, and spending. It is pretty simple. Growth is the necessary, but not sufficient, condition for deficit reduction. As to taxation, we have all heard that higher taxes must be part of the solution. Higher taxes, however, are inimical to the growth we need. Further, simply as a statement of arithmetic, it is not true that higher taxes must be part of the solution. As a statement of budget policy, it is not true.

Taxes need not go higher and may go lower. When scientists describe the operation of established physical laws, these are statements of fact, that our fiscal policy is dangerous and unsustainable,

as the IMF reminds us once again, and can be demonstrated rigorously as factual to the extent any projection can be. The President's own Deficit Commission achieved that, at least.

However, asserting that taxes must go up to address the deficit is expressing a personal opinion, judgment, or policy preference; in my view, taxes should not be raised. On the contrary, we should be so successful at cutting spending that taxes may be reduced. This is my opinion, not the product of analysis.

When any highly respected economist or budget expert tells you that taxes must be part of the deficit reduction or entitlement reform solution, their statement is not based on analysis. It cannot be. They are making a personal judgment about what ought to be. Being an economist does not make one's opinion less valid, nor does it make it any more so. It is a fact: taxes need not go up. It is an opinion to argue the contrary.

The only way a tax hike becomes inevitable is if we believe that higher taxes are inevitable. Understand, it is neither necessary nor sufficient. Understand that a tax increase is a policy choice. If you understand this, then higher taxes should—and I believe likely will—remain the choice not taken. Spending is the source of the deficit and the debt problem. Cutting spending should be the sole solution to the problem.

Some have suggested these problems can only be addressed in a crisis, the presumption being that a crisis—and I agree with David Walker, one is coming—will allow radical changes to go forward, including unnecessarily and unwise tax hikes that could never survive normal public scrutiny.

To this I say, *semper paratus, semper vigilans*: ever ready, ever vigilant. That which cannot prevail in the light and the calm will not pass under cover of darkness or crisis. The problem is too much spending, not a paucity of revenues. Taxpayers should not bear the punishment for Washington's reluctance to cut spending. Senators, I urge you to focus on the problem and leave the taxpayers alone. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

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

The CHAIRMAN. I would like to just ask you, Mr. Walker, to kind of flesh out some of the thoughts you had, some mechanisms that might be put in place in exchange for a debt limit increase. You mentioned, I think, maybe some tough controls and so forth.

Mr. WALKER. Yes.

The CHAIRMAN. What did you have in mind? I ask the question because, frankly, I am quite concerned about brinkmanship when we get close to the current debt limit. As you mention, I think it is a tactical nuclear bomb as opposed to problems we had in the CR. I am trying to figure out a way to give credibility to people around here. They are actually going to tackle the debt deficits. But in exchange for it, let us not play games with the debt limit ceiling. Some mechanism, something. Maybe it is a mechanism, maybe it is an over-arching limit on spending, maybe it is to achieve a certain percentage of GDP or something. But just your thoughts on how we kind of move ahead.

Mr. WALKER. Sure. Thank you for the question, Senator. It is critically important that we raise the debt ceiling limit. At the

same point in time, I think it is also an opportunity to do something meaningful before the 2012 elections, and it may be the only opportunity that we have. Realistically, you are not going to have a congressional budget agreement this year between the House and the Senate based on where we are starting, so you are going to have to go through some type of process to determine top-line 2012 spending. Hopefully it will happen a lot quicker and be less acrimonious than the last one. So the real key is the debt ceiling limit.

In my view, Mr. Chairman, it is very, very clear that we are going to have to reform Medicare, Medicaid, another round of health care reform, Social Security reform, defense and other spending cuts and constraints that do not compromise security, and comprehensive tax reform that will accomplish a number of objectives, including raising additional revenues.

Now, this committee has jurisdiction over most of the things that I just mentioned, and you are going to be critically important. While all those things have to be done, there is no way they can be done all at once. There is no way they could be done before the debt ceiling limit comes up, or even, frankly, I think, before the 2012 election.

Therefore, let us learn from history. If you look at the charts that are in my exhibits, you will see we lost our way about 30 years ago. About 30 years ago, we lost our way with regard to thrift, savings, limited debt, stewardship, investing in the future, for a variety of reasons.

We regained our senses in the early 1990s through 2002, when President George Herbert Walker Bush, along with the Congress, and President William Jefferson Clinton, along with the Congress, did three things in common. (1) They supported tough statutory budget controls that restricted the ability to make new promises when we already made more promises than we could afford to keep; they had tough but realistic discretionary spending caps. (2) They did not expand entitlement programs. That is the most imprudent thing that you can do. And (3) they broke campaign promises when they saw they were imprudent. Three and zero, battling a thousand, they both deserve credit, one Republican, one Democrat.

Fast forward. George W. Bush, a Republican, and President Obama, a Democrat: 0 for 3. It is a strike-out. But President Obama has a chance to change course, and you can help him. My view is, let us bring back tough statutory budget controls, not just pay-go rules, because pay-gos just keep you from making more promises. Not just tough, but realistic, discretionary spending caps that do not exempt defense. Because I can tell you, I was on the Defense Business Board as an ex officio member for 8 years. There is huge waste in defense that can be cut without compromising national security. The same thing for Homeland Security.

What we really need to do is recognize the real threat: it is debt burdens. That means debt as a percentage of the economy. So let us impose some annual "debt as a percentage of the economy" targets starting September 30, 2013, which gives us time to engage the American people, to figure out what reforms we need to do, and to make installments. If you hit that target, great. You do not have to do anything.

But, if you do not, then there are automatic spending cuts, certain automatic freezes, and other actions on the mandatory side, and possibly temporary tax surcharges that would be a separate line item on a tax return, a deficit reduction surcharge, and an agreed-upon ratio. You could think possibly about the National Commission on Fiscal Responsibility and Reform's work. They had roughly a 70/30 ratio, with 70 percent spending cuts, 30 percent revenue.

My view is, we need to do something that is credible. Just having a goal without an enforcement mechanism will not be credible. In addition, while I agree with Dr. Foster that mathematically you can make something work, it is just spending cuts, you cannot make something work that will pass the House, the Senate, and get the President's signature just with spending cuts. If you do not accomplish those three things, you have accomplished nothing.

The CHAIRMAN. An alternative might be something like the Andrews Air Force Base model. What if that were a part of increasing the debt ceiling? We are going to do Andrews.

Mr. WALKER. Here is my concern. Mr. Chairman, we have to make very dramatic and fundamental reforms. In order to be able to do that in a way that is acceptable to the American people, that will not involve significant political retribution for incumbents, we have to end up engaging in a meaningful citizen education engagement effort outside Washington's Beltway. The Commission did great work, but it did nothing outside of Washington's Beltway. Nobody has done more than I have on that—47 States. We have only three left. I am very in touch with where the American people are on this, and we need to do more.

The CHAIRMAN. I have not seen you in Montana yet. Yes, you were in Montana.

Mr. WALKER. I have been to Montana at your request. I have North Dakota, South Dakota, and Alaska to go. You do not go to those in the winter. I am in the process of working that out.

The CHAIRMAN. Thank you very much. My time has expired. But I raised Andrews, in part, because I think there has to be buy-in by the President, and the leadership of both parties at the table, or else it is going to be very difficult to do.

Mr. WALKER. I agree.

The CHAIRMAN. My time is expired. Dr. Blinder, we will get to you. Thank you very much.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman. I really appreciate this panel. I think you have all done a very, very good job of expressing your particular viewpoints.

Let me ask this question for all three of you, and maybe each of you can answer. On January 1, 2013, a combination of the expiring tax rates and Obamacare will mean a significant hike in the top marginal rates on ordinary and capital income. On the ordinary income side, it will mean a hike somewhere between 17 and 24 percent. A lot of small businesses will be hit. In addition, self-employed small business owners will face almost 1 extra percentage point because of the Obamacare and Medicare HI tax hike.

Now, it is worse on capital gains and dividend income. In that case, the marginal rate hike would be almost 59 percent, if I have

it right. Now, Dr. Foster, I would just mention to you, I take it from your testimony you do not agree that this is a good short-term or long-term fiscal policy, and it would be interesting to see what you other folks think as well.

The House liberal group, the Progressive Caucus, is proposing to basically subject all salary or small business income to the Social Security tax. This dramatic tax hike has been euphemistically described by many in the press as a change in the “earnings limit.” Some press reports are that the President is looking at this tax hike for his deficit reduction package. He proposed a version of it in the 2008 campaign.

Now, I would like the panel to comment on the possibility of all these marginal rate hikes and the potential new tax hike advanced by House liberals. We hear my friends on the other side robotically describing Chairman Ryan’s budget as extreme.

For folks who own small businesses, is a marginal tax rate hike of 52 percent on the ordinary income side not extreme? For folks who invest their money, is a marginal rate hike of almost 59 percent not extreme? Does it help to create an environment of growth? So, these are a bunch of questions, a bunch of thoughts that I would like you to discuss, if you will.

Dr. Blinder, we will take you first. How is that?

Dr. BLINDER. Thank you, Senator. I guess the starting point, to answer your question, is large, abrupt changes in the tax code are rarely good things. That is a general principle. In terms of moving the basic tax structure—I will come to some of those other things that you mentioned in a second—moving the basic tax structure back up to—this is the personal income tax structure—the rates that prevailed in the Clinton years, it is hard for me to make a case, looking at the history of those years, that those were ruinous tax rates.

So I think that I am not worried at all about moving back to those kind of rates. Now, given what we have done to capital gains rates since then, there may be a case for more gradualism. The more you make a cliff—if the cliff stays, there is going to be a titanic increase in realizations before you jump off the cliff. You cannot avoid that entirely, but you could make it smaller than it would be if we did what you were just suggesting, Senator, on January 1, 2013.

On the need for more revenue, you mentioned in particular the Social Security earnings limit. I think there is a quite powerful argument on equity grounds—and of course it is all fundamentally based on the need for revenue—to raising the earnings ceiling so that it catches, again, the same share of earnings that it used to. Because of the tremendous disequalization of earnings, we are now capturing a smaller share of total earnings in the economy under the Social Security limit.

I have not favored personally raising that limit to infinity, which I think is what you were alluding to. As you say, that would be an extremely large increase in marginal tax rates on a very large number of people.

A last thought. My own favored way to raise revenue, and I will just state it without going into any elaboration—it seems inappropriate here—is carbon taxes, which can raise a lot of revenue and

I think, arguably, will stimulate the economy rather than depress it. But I will leave it at that.

Mr. WALKER. Senator, you properly point out that small business is the engine of innovation, of economic growth, and of job production, and that most small businesses are not taxed in chapter C form. They are taxed through pass-through entities, they are taxed as individuals, either the partnership form or subchapter S corporation, or whatever. So you have to be concerned with what the impact will be on that.

Look, in my view, the problems that we have are overwhelmingly spending problems, three to one. You might have solved this problem solely on the spending side 10 years ago; you cannot now. We are going to have to have revenues as a higher percentage of GDP than historically has been the case, which is 18.3. The question is, how do you get there? In my view, the tax system—and I am a certified public accountant, so I know more than most people about it—is an abomination. We need comprehensive, fundamental tax reform that focuses more on consumption-related approaches rather than income-related approaches.

As far as the issue of Social Security, having been a trustee of Social Security and Medicare, one can make a compelling case to raise the taxable wage-based cap to address the issue that Dr. Blinder mentioned. I think it would make no sense whatsoever to eliminate the taxable wage-based cap. This is a social insurance program. It is not supposed to be a general revenue support program. It is already a progressive program. The people who end up making less get higher replacement rates. That would be a 12.4-percent tax increase, including on a lot of small business owners and upper middle income individuals.

Dr. FOSTER. Senator, any or all of the tax hikes you suggest—

The CHAIRMAN. I am sorry. We are going to have to move on here. Your time has expired.

Senator HATCH. If he could answer quickly, I would appreciate it.

The CHAIRMAN. If you can keep it very short.

Dr. FOSTER. I will, sir.

The CHAIRMAN. There are a lot of Senators here who want to ask questions.

Dr. FOSTER. Any or all of the tax hikes you suggest would be harmful to the economy, and it would not wait until 2013. Small businesses investing for next year would take it into account. We would see the economic effects next year. The higher tax rates would not be ruinous, as Alan Blinder suggests; however, they would be harmful, and growth is the key to deficit reduction. Thank you, sir.

The CHAIRMAN. Thank you very much.

Next, Senator Bingaman.

Senator CARPER. Mr. Chairman, can I ask a unanimous consent request? I arrived at 9:55, and I have asked—

Senator BINGAMAN. No. I am glad to have Senator Carper go instead of me.

Senator CARPER. If I could. Senator Wyden and Senator Ensign are very gracious to say that I could do that.

The CHAIRMAN. They are both gracious.

Senator CARPER. Yes. I appreciate that, thanks. We have a mark-up in Homeland Security in about 5 minutes, and I need to be there. I appreciate it.

The CHAIRMAN. Senator Carper?

Senator CARPER. Thank you so much.

I just want to comment to you, Dr. Blinder. I thought you said a great truth with respect to health care. You were talking about the health care legislation we passed. I will quote you. You said, "The most intelligent course of action, it seems to me, is to watch how the various cost-containment efforts play out over the coming years and do more of whatever seems to work." I think that is a great truth, and I am going to steal that, but initially I will quote you.

One of the health economists looked at our legislation after we finished it and the President signed it into law. He said we took a whole bunch of different ideas for health care cost containment and threw them up against the wall. The idea is to see what sticks.

There is plenty that we threw up against the wall: large purchasing pools, the ability for States to enter into interstate compacts to have multi-State purchasing pools to sell insurance across State lines, the stuff that Senator Ensign and I worked on to incentivize people to take personal responsibility for their own health care, menu labeling, starting later this year.

Some of the major cost drivers for us are really weight and tobacco. Those are really the major cost drivers, and we tried to address those. To use and to harness information technology, to foster more electronic health registers where we can actually do coordinated care, creating these Accountable Care Organizations, and trying to focus on different approaches to literally let the States be laboratories of democracy, to reduce the incidence of defensive medicine, to reduce the incidents of medical malpractice lawsuits, and to get better health care outcomes—there is a lot in there, and I think your advice is actually very well taken.

I want to thank Dave Walker for the great work that he did when he was our Comptroller General. One of the things that the GAO does for us is they provide for us, each year, a high-risk list, a high-risk list of parts of our government, whether it happens to be the Census or major weapon systems cost overruns—major weapon systems cost overruns last year: \$402 billion. The cost of the Census between 2000 and 2010 more than doubled.

Improper payments have climbed to \$125 billion, not counting DoD or Homeland Security, or Medicare Part D. The post office is on track to run up a tally of about \$230 billion in debt over the next 10 years if we leave them on auto-pilot, billions of dollars that we can save by unloading surplus properties that we do not need.

IT projects are costing about \$80 billion; about a quarter of that, a lot of people say, is largely wasted. Medicare and Medicaid—Medicare fraud alone, Attorney General Eric Holder says, is \$60 billion a year. I mean, there are all kinds of things that we can do, and we pull them right off the high-risk list that you helped to create all those years ago.

One of the things we are doing in our Homeland Security and Government Affairs Subcommittee that I am privileged to chair is literally going down that list and looking at each one of these and

asking this question: how can we get better results for less money, or how can we get better results for not a whole lot more money? I thank you for giving us that list to shop.

My hope is, when the President speaks this afternoon, that one of the things he will do is talk about the need to actually focus on getting better results for less money and trying to change the culture around here so that we can be less accused of having a culture of spend thrift and say we operate on a culture of thrift. So I want to thank you for helping us get on that path.

I am a big fan of Erskine Bowles, a big fan of Alan Simpson, and a bunch of the people who worked on your commission, the Fiscal Commission. They gave us an approach that says, let us try to cut the deficit by about \$4 trillion over 10 years, two-thirds on the spending side, about a third on the revenue side. They broaden the base, they lower the rates, and they put everything on the table: domestic discretionary, defense discretionary, entitlements, tax expenditures. That is their approach.

Let me just ask each of you, and just start with you, Dr. Blinder. You have talked a little bit about this. Just speak specifically to the approach that they took in the Bowles-Simpson Commission.

Dr. BLINDER. I would not want to take a quiz on every detail, but in broad swipes, I think the kind of two-thirds/one-third, or 30/70, or something is a reasonable number to shoot for. I think to get to a number like that, it is absolutely—well, as Dr. Foster said, it is not quite arithmetic, but with a little realism on top of the arithmetic it means you have to put everything on the table, including Social Security, including defense, including revenues to get to that. I think the kind of magnitude of total deficit reduction over the decade that Bowles and Simpson pointed to is a sensible target, and probably the kind of target the Congress will eventually set—and I would not like to guess how long eventually is.

But the thing I want to emphasize is what I said in my testimony, that the really important part is the follow-on. Believe it or not, the big problem is not between now and 2021, it is what happens after 2021. That is the crucial thing. If Congress can be thinking about and actually doing something about that now structurally, that would be great.

Senator CARPER. Thank you. You had just a quick response?

Mr. WALKER. Very quickly. I think they did a very good job. I think that they recognized the difference between the short term and the structural. They recognized that everything has to be on the table. They weighted it more towards spending cuts, which I believe it should be. Then the question is, what is Congress going to do now?

Senator CARPER. All right. Thank you.

Dr. Foster?

Dr. FOSTER. The important thing, in my view, is they are moving the conversation forward. We have a near-term problem, a medium-term problem, and an enormous long-term problem. They are keeping the conversation moving, and if nothing else, that was helpful.

Senator CARPER. Good. Thank you so much.

And to my colleagues who were very kind to yield, thank you so much.

The CHAIRMAN. Thank you, Senator.

Senator Ensign, you are next.

Senator ENSIGN. Thank you, Mr. Chairman.

There are two different questions that I want to ask. One is on taxes. I want to start with Dr. Foster. Taxes, tax rates, obviously affect growth. You have made that point, I think, very effectively. But are all tax rates the same?

Dr. FOSTER. Some tax rates are much more harmful to the economy than others. Top marginal tax rates are very harmful. Taxes on capital are especially harmful because they are effectively layered onto the taxes on labor that were charged in the first place. So some taxes are certainly more harmful than others. Those that choose between industries are particularly harmful versus the aggregate tax rate.

Senator ENSIGN. If I could maybe get in writing from you kind of an analysis, and if any of you want to comment on that in writing afterward, because we do not have time to really go into it, I would really appreciate what you think the more harmful taxes are to growth in the economy and which ones would be more beneficial. If you believe in raising taxes, which would be more beneficial to cutting the deficit?

Mr. Walker, I want to ask you about—you mentioned, we need to raise the debt ceiling, but you also said in 2 to 3 years we could be facing a debt crisis, which I think, if we do not do anything, is inevitable. It is almost a guarantee. I think, just looking at the numbers, there is almost no way to avoid that.

Having said that, the debt crisis that we could face by not raising the debt ceiling, if we do not do anything with it, in other words, if we are not able to get anything for the debt ceiling raising, are we not just putting off the debt crisis for a couple of years? I realize how dangerous it is to potentially do that, but at the same time it is incredibly dangerous not to have these spending reforms put into place that you talked about.

Mr. WALKER. Well, first, the debt ceiling limit is an arbitrary number. I mean, I do not know how people come up with these numbers each time, presumably to give enough room for a certain number of months. But you have to keep in mind, you are on a path where you are going to need to continue to raise it, even if you end up dramatically cutting spending. So you are going to have to raise the debt ceiling limit.

Frankly, intellectually, I would say you ought to be going more towards debt-to-GDP targets with automatic enforcement mechanisms and get rid of the debt ceiling limit. I mean, that is a more intelligent approach, because the real issue is, how much debt as a percentage of the economy do you have? I firmly believe, Senator—

Senator ENSIGN. The only reason I would disagree with you on that is because there are—you talked about certain concepts. When you are in bad economic times, if you have had a normal debt-to-GDP ratio, now you go down like we are going down now, now you have ended up in a crisis situation. It is just like businesses. Businesses for so long have been encouraged to take on debt. It is a way to grow, and things like that.

But you do have to have sound financial capital structures. By 3 percent or whatever, I think you should strive for as low of a debt-to-GDP ratio as you possibly can and not just say, well, this is an acceptable limit. Because, if you just set that as an acceptable limit, we will shoot right up to that number all the time.

Mr. WALKER. Well, to make it clear, Senator, I agree with you. What I am talking about—and as the National Fiscal Responsibility and Reform Commission suggested, as well as the Peterson-Pew Commission which I was on, and others—we are talking about getting to 70 percent of GDP by 2020, going down to 50 percent of GDP by 2035, and declining. All right?

Senator ENSIGN. Right.

Mr. WALKER. So I agree. But the point is, look, there will be a crisis if we have a stalemate on the debt ceiling limit. I believe it is possible to do something—you can get bipartisan support—that would increase the debt ceiling limit and yet do something meaningful that would send a signal to the markets and to the American people that we know we have been living beyond our means, we have to start making tough choices, and very, very importantly, this committee has jurisdiction over a significant majority of the issues that have to be addressed. You need to cover the normal legislative process, you need to engage the American people, and then we need to engage the American people beyond the Beltway. It is not just an inside Washington thing.

Senator ENSIGN. The last point I would make on this, the debt ceiling—and you and I talked about this. This really is about saving the Republic. I mean, we literally have a chance of losing our Republic due to this debt. That is how big of an issue it is here. So the debt ceiling, all the debt ceiling debate is about, is about using it to make sure we put ourselves on a sustainable path, because everybody agrees that the path that we are currently on is unsustainable.

You have been around the Congress long enough—we have all been around. If we do not have something as a kind of hammer almost to use, we will not get things done. That is why I think some have said that the debt ceiling is the thing to focus on right now to make sure we get some of these spending cuts under control.

Dr. BLINDER. What you said about the unsustainability is exactly correct, Senator. The quickest and surest way that we could have a crisis in financing the U.S. debt is to hit the debt ceiling and throw doubts into the minds of investors that the U.S. Treasury will not make its debt service payment. That would bring it on really fast.

The CHAIRMAN. Senator Bingaman?

Senator BINGAMAN. Thank you all very much. One of the ideas that has been proposed by some of our colleagues to solve this problem, to deal with this problem, is to legislate spending limits, to essentially put in a limit which would be a certain percent of GDP as a spending limit going forward for the indefinite future. I think one of the proposals is that we would be at 20.6 percent.

I think the Simpson-Bowles Commission also had a spending limit in there, maybe at 21 percent or something like that. They enforce that by saying that, if you want to exceed that, you have

to get two-thirds of the House and two-thirds of the Senate to agree to anything above that.

These proposals, of course, do not address the issue of revenues at all, it is just spending. I would be interested in Dr. Blinder's view first, and then the rest of you, as to whether you think this makes sense as a fix to our current problems.

Dr. BLINDER. Well, I think it makes sense only as a last resort. You know the famous Churchill remark, "The Americans always do the right thing after they try everything else." Hopefully we are not going to do that. I get very worried about anything that is indefinite. The world just changes a lot.

I mean, just to take the example we are now living through, the pig and the python phenomenon, which was probably not predictable 70 years ago. We have this big cohort of people my age and a bit under who are going to start making huge claims on the Social Security system and, even more importantly, on the Medicare system. People in 1900 did not know about that. A rational government is going to make an allowance for that.

There are also business cycle aspects. You have a big slump, spending goes up. So I am very wary of any mechanical formula such as that. I think we can do better. I think some of the things that David was just speaking about in terms of targets for the debt-to-GDP ratio that are not going to be immutable—we are not going to set it now for the next century—are a more sensible way if you need a mechanical restraint. If I had to choose between those two, I would not hesitate.

Senator BINGAMAN. Yes, David. Go right ahead.

Mr. WALKER. Sure. Senator, I think the question is, how reasonable and sustainable is the target? We have to keep in mind that 10,000 people a day are eligible to retire under Social Security. Ten thousand a day. They will eventually be eligible to retire under Medicare. We budget on a cash flow basis, so that means we are just now starting to feel that. We will not feel the real tsunami of spending for several years into the future.

So the question is, to what extent does the limit adequately consider demographic trends? Then secondly, to what extent does it adequately consider health care costs? Frankly, the Medicare Chief Actuary—and I used to be a trustee of Medicare—gave an adverse opinion on the Medicare trustees' report—the first time in the history of the United States—and came up with a separate calculation of the estimated costs of the recent health care reform on Medicare, which was \$12.3 trillion higher than CBO.

Dr. FOSTER. Senator, spending caps and deficit targets are no way to budget. But unfortunately, we do not seem to be able to do it the proper way, so we have to fall back on these mechanisms. They do work on occasion. Ultimately what we have seen is that the discipline of budgeting has broken down, and has broken down for quite some time, so we obviously need something that enforces a budget discipline, whether it is a spending cap or deficit target. Those are both good solutions.

I prefer the spending cap because it focuses the attention on where the problem is, on the spending. But the devil is in the details. How do you get there; how do you enforce it? The immutability of the targets is very important, so is what it takes to waive

them. These are not constitutional amendments. They traditionally now require 60 or 67 votes. That is a key issue.

How hard is it to waive these targets? You do want them to be waivable because you may have another recession or some event, and it turns out the decision you made sometime a year or two or three past is no longer appropriate. On the other hand, you need something to guide the process, something more than just deciding what is right. So these sorts of targets turn out to be quite necessary.

Senator BINGAMAN. Well, I would say requiring a two-thirds vote in both the House and the Senate to waive something makes it pretty unwaivable in this current circumstance, so I would just point that out.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Dr. BLINDER. Could I put in one more sentence on that?

The CHAIRMAN. Yes. Sure. Go ahead.

Dr. BLINDER. I wanted to say, before, Mr. Chairman, you mentioned the Andrews Air Force Base agreement.

The CHAIRMAN. Yes. I was going to get back to that to give you a chance, but go ahead now.

Dr. BLINDER. We put in—not we, you—quite sensible budget control measures at Andrews Air Force Base. They worked very well. I think they probably worked better than anyone in Congress actually thought they would work. Then around 2001—it was 2001, was it not—we took them off.

Mr. WALKER. The end of 2002. If you look at the data, things have been totally out of control since 2002.

Dr. BLINDER. It was a gigantic mistake, and I think we should go back to that.

The CHAIRMAN. Thank you.

Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman.

Mr. Walker, one of the reasons you are respected on both sides of the aisle is your independence and your willingness to make calls on the merits. Given that, I was struck by your comment on the debt issue, that you thought you had to have a long-term approach that is socially equitable. The House of Representatives is working on a proposal that does not touch the military and does not touch corporate tax havens, and yet at the same time makes significant reductions for seniors and kids and education. Does that strike you as meeting your test of social equity, the kind of independent approach that is going to bring people together?

Mr. WALKER. No. My view is, our problem is primarily a spending problem, three to one, if I had to give you something. My view is, to do something that makes sense, it needs to make economic sense, be socially equitable, be culturally acceptable, number one. Second, it must pass the math test. If we are trying to stabilize debt-to-GDP, if we are trying to balance the budget over a business cycle, then the math has to work. That is the new four-letter word in Washington.

Third, you have to get a majority in the House, potentially 60 votes in the Senate, and a presidential signature. What I would say

is, whatever you do, it needs to meet those three tests. If it does not meet those three tests, then we are hanging over a cliff.

Senator WYDEN. I appreciate your answer. I think your response is going to carry a lot of weight because people around here know that you are independent. I asked the question for a specific reason. I want to see Democrats and Republicans come together. I think you have laid out some good principles, and you have made it clear now that you do not think what the House is working around is socially equitable by cutting programs for vulnerable folks and leaving alone corporate tax havens and the like.

So let me ask you a question about growth as well. I think that we agree that, right at the heart of this, is making major changes in cutting spending, but I also think, as Erskine Bowles and Alan Simpson have said, you cannot cut your way out of this, you have to also have significant growth.

Now, in 1986, when Democrats and Ronald Reagan got together, we created 6.3 million new jobs. Senator Coats and I have introduced a bipartisan bill that goes right to that same kind of model. As you know, the Bowles-Simpson Commission said they used that legislation as a model for their work.

Is there any reason why we would not have, with that kind of 1986 model—cleaning out the preferences, using that money to hold down rates for everybody and keep progressivity—that we would not have significant job growth again? Not enough to deal with the entire problem, but significant job growth again so that it could be one of the legs of this triangle that you described.

Mr. WALKER. I think the type of reform approach that you are talking about for the income tax is clearly one of the essential elements of comprehensive tax reform. Second, one of the other reasons that I also talk about, let us focus on debt-to-GDP, is because that way you get credit if you grow the economy.

Keep in mind, after World War II we had the highest debt-to-GDP in the history of the country. The reason the debt-to-GDP came down was primarily due to economic growth. We did not pay off a dime of debt. Not a dime. But we had fiscal discipline, and we had economic growth. So by going debt-to-GDP, you also get credit for pro-growth policies if they actually manifest themselves.

Senator WYDEN. I like the idea very much. I want to talk to colleagues who were involved in the tax reform effort. It is a way to factor in growth that is real. As you know, we have had this debate around here about dynamic scoring, static scoring, and the like. You are giving us a chance to do it in a way that is real. I very much appreciate your independence. I think, particularly when you look at that bill in the House, it does not meet the Walker test of being socially equitable. We have to also go to growth. As usual, you have given us some valuable ideas.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Cardin, you are next.

Senator CARDIN. Thank you, Mr. Chairman. I really do appreciate the testimony of all of our witnesses.

Mr. Walker, you refer back to the 1990s and the formula used by President George Herbert Walker Bush and President Clinton. And you are right, back then we were able to reduce spending, put

enforcement in, and raise revenues. But let me remind you, at the end of the day, the last chapter of that was passed only by Democrats. We do not have that luxury today. We need to come up with a proposal which Democrats and Republicans are going to be able to agree on.

Here is the real issue I have. When you are talking about enforcement including revenues, you have my attention, because I think you need to have a fair way to get the budget into balance. I am very much with you as far as the danger this Nation faces.

But the challenge we have, when you look at the Ryan budget, they make certain economic assumptions with tax cuts about the growth of our economy and the growth of our revenues, and I could make the exact same argument. If we could invest more in education, we could grow our economy and bring in more revenue.

But the problem is, we have to be realistic as to a budget that is credible in reducing the deficit, and the only way we are going to get there is if we have credible plans to reduce spending, and also bring in the revenues that we need in order to balance the budget. We need a credible plan that gets us from where we are today in the short term and in the long term.

We have talked about fundamental changes. I think the point that has been raised here today, I just really want to underscore. The debt limit debate makes no sense at all. For those who are trying to use it as leverage, we are going to have to be dealing with the debt ceiling for a long time to come. It makes no sense to what we are trying to achieve.

So it seems to me you raise a very good point of why we do not look at a fundamental change right now in this part of the history of America and look at a limit of debt-to-GDP rather than a debt limit, understanding that it will take time to get to the level that we believe is appropriate. In the absence of reaching that limit, you have the enforcement mechanisms that you refer to, which include, I would very much argue—it is going to have to be balanced between spending and revenues.

But that, it seems to me, would be serving our Nation by getting rid of an arcane limit that really has no economic purpose that I can see at all, that is being used strictly now for political purposes. Does that make sense if we look at those types of reforms? Does that meet your standard? Would that help us in dealing with those who are watching what is happening in America?

Mr. WALKER. I think what matters is debt-to-GDP. That is what matters, and that we get it to a reasonable and sustainable level over a period of time. I think you need to have, as has been said by Dr. Foster and Dr. Blinder, a mechanism where, if we are at war, if you have a serious recession, you can waive it temporarily, if you will. You have to keep in mind, though, that we have not declared war since World War II. That is another issue, but we will not go there now.

Senator CARDIN. And the second fundamental change—and I heard you say this, and I want to make sure it is understood—you basically do not believe we can save our current income tax in its current form, I take it. We need some fundamental changes. The political reality is, when we dealt with it last in 1986, it lasted

about 1 year before Congress added back special provisions and complexity.

I heard you mention consumption taxes. I want to give you a chance to sort of talk a little bit more about that.

Mr. WALKER. Sure. Look, I mean, I prefer that we move to some type of progressive consumption tax in lieu of our current tax system, if we could get there politically. Realistically, I do not think it is possible to get there in one fell swoop. But let me tell you the problems with our current tax system. I am a certified public accountant. Many years I prepared my own taxes. The top 1 percent of Americans have over \$500,000 in taxable income. They pay an average tax rate of 18.8 percent. I do not make \$500,000 a year, but all of mine is in wages. I pay a lot higher than 18.8 percent.

In addition, I pay a 30-percent surtax because of the Alternative Minimum Tax. All right. The fact is, we need to dramatically reform our entire tax system. We have 47 percent of Americans who pay no income tax at all, and yet every express and enumerated responsibility envisioned by the Founding Fathers in the Constitution is funded solely or overwhelmingly by income taxes. Plus, wealthy people consume out of their wealth, not just their income. So I think we need to recognize those realities to engage in comprehensive reform, and that includes consumption taxes.

Senator CARDIN. Let me just underscore, a progressive consumption tax. People do not think it can be done. It can be done.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Nelson?

Senator NELSON. Thank you. This has been most illuminating. May I ask you, Mr. Walker, in your suggestion of debt-to-GDP ratio, that is what we target in on now. Do you have a particular number in mind?

Mr. WALKER. Senator Nelson, what I would suggest is, you could look to the National Commission on Fiscal Responsibility and Reform, you could look to the Peterson-Pew Commission. There are several that are out there. Most of them basically try to get to about 70 percent of public debt-to-GDP by 2020, declining to about 50 percent of debt-to-GDP by around 2035. Obviously, as has been said by Dr. Foster and Dr. Blinder, you need to have an out with the high bar in certain extraordinary circumstances, but I think those are reasonable targets.

Senator NELSON. Would you trace for the committee what would be the result on the average American if we did not raise the debt ceiling?

Mr. WALKER. Well first, unlike a continuing resolution where, if you hit that, all essential operations of the Federal Government continue; you lay off people temporarily, they may or may not get paid, but essential operations continue. Furthermore, Social Security benefits continue to be paid. Medicare payments continue to be paid, et cetera. All right. If you hit the debt ceiling limit, to my knowledge—and I have not researched this—you do not have that same exception. You have to keep in mind, we are spending \$1.40 for every dollar we are taking in, so in theory you would have to end up dramatically cutting expenses.

You have to figure out how you are going to do that, how you are going to cut that much that quickly. If you fail to do that, then even Social Security benefits, the timely payment of Social Security benefits, would be threatened because Social Security is now in negative cash flow. Not by much, but it is, and it is adding to the deficit. So, therefore, that means that the first of the month following the month that you hit the debt ceiling limit, Social Security benefits do not go out on time. Now, if you have 35 to 40-plus million Americans not getting their checks on time, I think that would be a problem.

Senator NELSON. What does it mean to the functions of government, as you said—what we experienced last week, if we had to shut down the government, the emergency functions of government would continue. What does hitting the debt ceiling and not being able to continue borrowing to keep the functions of government mean to the national security apparatus?

Mr. WALKER. Well, I have not studied, Senator, whether or not there is an exception as there is under the continuing resolution. I do not believe there is. That is something you may want to ask the Congressional Research Service to take a look at; they are very good at that stuff.

As you know, under the CR, the military continues, FAA continues, a number of the essential things continue. You do not want to play chicken with the debt ceiling limit. On the other hand, I agree with what Senator Ensign said before. Something ought to be done that is substantive with regard to the structural deficits. That is why you need to negotiate it out now. You do not want to be in the situation like you were for the CR because that could have a serious adverse effect on confidence in the markets and credibility, as Dr. Blinder mentioned.

Senator NELSON. If you were advising the President, what would be the best remarks for him to make today? What would you say, Mr. Walker, given everything that you have already testified here today about the practical politics?

Mr. WALKER. Well, I would reiterate the difference between the short-term challenge and the structural challenge so the American people understand that. I would have him talk about the need to do something credible with regard to our structural deficits. Frankly, I think the approach that I have outlined here, that, let us move to some type of debt-to-GDP targets, let us engage the American people with the facts, the truth, the tough choices, are things that make sense. By the way, citizen education engagement is a page out of the 1998 Clinton effort on Social Security, which was the right way forward on that, which we ought to do.

I would also have a lot more specific comments about his National Fiscal Responsibility and Reform Commission than he has made to date. I would note that everything has to be on the table and everybody has to be at the table in order to solve this problem, and I would reinforce that we may have conditions on raising the debt ceiling. We must raise the debt ceiling. We cannot play with a tactical nuclear weapon.

The CHAIRMAN. Thank you, Senator.  
Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Dr. Blinder, I will just pick on you. Chairman Ryan came out with a budget for 2012. He proposed cutting corporate and individual tax rates from 35 to 25 percent, at a cost of more than \$4 trillion. Now, we have sort of been through that. I was stunned by that. You yourself wrote last July that the Recovery Act, which is castigated by so many Senators and in so many newspapers, that the Recovery Act held unemployment 1.5 percent lower than it would have been otherwise and added 2.7 million jobs to the economy. Yet, the infrastructure and low-income assistance programs that made the Recovery Act such a success, in this Senator's view, and in your nationwide view, are the same programs that are on the chopping block now.

So my first question to you is, do our current debt and deficit levels allow us the luxury of spending \$4 trillion on tax cuts?

Dr. BLINDER. I do not think so, Senator. I did not think so in the year 2001 when we enacted these. I mean, the tragedy of 2001 is that the budget picture looked very bright in the near term, but it was clear as can be—because after all we knew how many people were turning 65, more or less, and every year going forward from that—that we were in a very perilous fiscal position in the long term.

Indeed, as David has emphasized, we have known this for 30 years, so it was not a big secret. So we could not afford them then, and we certainly cannot afford them now. With every decade that passes, we can afford them less and less and less. So, while \$4 trillion would not be enough to solve the entire long-run problem, it is a nice first step, I would have thought, and very substantially more progressive than the kinds of things that are in Chairman Ryan's budget proposal.

Senator ROCKEFELLER. Let me pursue that. Moody's, as I believe is in your testimony, has sort of a list here of bang for the buck on fiscal stimulus.

Dr. BLINDER. Yes.

Senator ROCKEFELLER. There are, what, about 15 issues here, all of them important. The cut in corporate tax rate is 0.32 return on the dollar, making dividend capital gains tax cuts permanent is 0.37, and making the Bush income tax cuts permanent is 0.32. Now, what I am really sort of leading up to here is, Mr. Walker has talked about, you cannot do what is not politically possible. What I am suggesting is that maybe we cannot solve this problem without changing the politically impossible. I do not know how that is done. I cannot, in my mind, get past that \$4 trillion. It happened under Reagan, and deficits soared, jobs went down, jobs were not created. It does not work. Tax cuts for the wealthy do not create jobs. It does not do it. That is amply shown.

But then you use the argument where you could only do what is politically possible. I am positing for the moment that we will not solve our problem unless we can change reactions, in this case on the Republican side, and some Democrats, about tax cuts for the wealthy, tax cuts—35 percent, 25 percent estate tax, all the rest of it. The estate tax, we fixed that to where it was, and it was \$65 billion more.

The mind-set is that we can only do what is politically possible. The Republicans have set about—and quite successfully so far—to

create a situation where you cannot touch the tax cuts. You saw that with Obama's behavior and the tax cut deal. We have to accept the tax cut because the Republicans will not do anything. As a result of that, yes, you can argue \$900 billion, where about \$600 billion of that went to the middle-income and the poor, so we got something for it.

But in the situation we are talking about here, debt/deficit, I do not think you can do this without behavioral change, and it has to come on behalf of the people who are successfully wedded and supportive to the proposition of not doing that.

Mr. Walker?

Mr. WALKER. First, I think by using the debt-to-GDP approach and coupling it with the increase in the debt ceiling limit, it will preserve the debate about, how do you achieve balance. You can end up engaging the American people with the facts, the truth, and the tough choices. You can go to the committees of jurisdiction with regard to tax reform, Medicare reform, Medicaid reform, Social Security reform, et cetera. You are not going to change their minds by the debt ceiling limit going up.

And frankly, the American people need to be engaged to a much greater extent. So that is why I am saying, go with the default mechanism. The whole purpose of a default mechanism is to avoid the default, to make choices through the normal political process and the normal committee process to decide how to hit the targets.

Only if you fail to do that does the default come in, but I think the default has to be equitable, too. That means more heavily weighted towards spending cuts, which is what the National Fiscal Responsibility and Reform Commission did, but some revenue element, in part because it has to be socially equitable, and in part because you want both sides to have a motivation to do something.

Dr. BLINDER. If I could just answer the question very briefly. I mean, you raised a lot of things in the question. It is true that, other things being equal, a lower tax rate is better for the economy, on everything. Well, except on bad things that we want to get rid of. On anything good, if you lower the tax rate on it, that is better for the economy, other things being equal. But that kind of attitude completely ignores the fact that we have to finance the government somehow.

So the notion that we can just cut and cut and cut and cut and that is going to be good for the economy because we are going to get a growth miracle, as you said, has been proven false many times. That does not falsify the idea that the economy is more efficient and better at lower taxes. It is, but there is the other side of the ledger.

Now, on the enforcement mechanism, I think, first of all, 100 Senators are going to be a lot better at figuring out what a sensible enforcement mechanism is than I am. But the one thing that I would urge on you is, if there is going to be an enforcement mechanism, it has to be something, when the bell rings, that both the Democrats and the Republicans hate, presumably for different reasons. So it has to have something that is totally unpalatable to Republicans and totally unpalatable to Democrats, and then you have the setting for Andrews Air Force Base.

Senator ROCKEFELLER. Thank you.

The CHAIRMAN. Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. I am going to engage Dr. Foster, since Mr. Walker and Dr. Blinder have been most engaged. And here is what I would like to just talk about a little bit. I am not talking about ideology, where obviously one side is more adverse to revenue enhancement than another. But I think two issues have been confused: one is reducing the deficit, and one is shrinking the government. I am sure you believe in both.

But my question is a very simple one, something that has been lost here, and that is that, if you are focused only on the deficit—and I like to say we are a blindfolded person and we are walking towards a cliff, and at some point we fall over the cliff. We may be 300 steps away or we may be 30 steps away, but no one wants to fall over the cliff. That deals with the deficit, not with the size of the government.

So a whole lot of moderates and conservatives have said we need revenues. I have quotes here, which I will not read, from Bruce Bartlett, Alan Greenspan, McCain's advisors in the campaign, and you name it, Hoagland, and all of these folks who are Republicans of one stripe or another.

Do you disagree with the fundamental notion that, if our only goal is deficit—let us just leave aside our predilection for what size we want the government to be—that revenues can contribute equally to reducing that deficit as cuts?

Now, Barack Obama would say, if you cut transportation, you are going to lose jobs, and the economy will shrink. You would say, if you are going to raise taxes—I do not agree with this on certain things—that the economy will shrink. But I am not talking about that. I am just talking, let us say we are close to the cliff and we have to deal with the deficit, because the credit markets look at the size of the deficit, not so much where it comes from.

Do you disagree in any way with the proposition that, in terms of purely reducing the deficit, not related to how the government grows in reaction to it, that one dollar of revenue cuts is the same as a dollar of spending reduction? A dollar of revenue enhancement is the same as a dollar of spending reduction?

Dr. FOSTER. The fact that we have to call them revenue enhancements tells us a lot about what is really going on.

Senator SCHUMER. Taxes.

Dr. FOSTER. But the way you expressed it at first was really excellent. You asked, can tax cuts contribute to deficit reduction? The key here is the verb "can." Of course they can.

Senator SCHUMER. I meant taxes. Yes.

Dr. FOSTER. The question is, should they?

Senator SCHUMER. No. I am talking about revenue increases.

Dr. FOSTER. Did I say tax reductions? I am sorry.

Senator SCHUMER. Yes. Tax increases.

Dr. FOSTER. Tax increases can contribute to deficit reduction. Arithmetically, that is almost a fact unless you find such a terrible—

Senator SCHUMER. And equally, right? A dollar of tax increase and a dollar of spending cut, mathematically, do the same for deficit reduction.

Dr. FOSTER. Except for the economic effects of the tax increase.

Senator SCHUMER. I understand that. That is where you and Dr. Blinder would argue, that is where this side and that side would argue. But what has happened here is that we have forgotten the fact that they are equal in terms of deficit reduction. In a sense, the argument of deficit reduction and shrinking governments have sort of merged, and they are not the same.

Dr. FOSTER. They are not the same, but they are sure close.

Senator SCHUMER. Why?

Dr. FOSTER. Why? Because the reason we have a major deficit, as Senator Hatch's earlier remarks pointed out, is we spend too much. We spend far more than we ever have.

Senator SCHUMER. Part of the reason we have a deficit—

Dr. FOSTER. My colleagues have made the same point.

Senator SCHUMER. Excuse me. Isn't part of the reason we have the deficit we do because of the Bush tax cuts?

Dr. FOSTER. Arithmetically, yes.

Senator SCHUMER. All right. That is my point. I do not want to get into—

Dr. FOSTER. Another way to say that is, isn't our failure to raise taxes on the American people the reason we have larger deficits? Yes. If you raised taxes you would have smaller deficits.

Senator SCHUMER. All right.

Dr. FOSTER. That does not make it the right policy, though.

Senator SCHUMER. And if you cut spending, you would have smaller deficits.

Dr. FOSTER. Yes, sir.

Senator SCHUMER. And the two contribute equally.

Dr. FOSTER. Arithmetically, they do.

Senator SCHUMER. That is the only point I wanted you to make. Thank you.

The CHAIRMAN. Thank you.

Senator Grassley? He is gone.

I would like to first congratulate you, Mr. Walker. Apparently the President, at 1:30 today, is going to suggest a debt-to-GDP trigger to get the deficits down, which you have been talking about. I think all of you have been talking about it. I think you, Dr. Blinder, said basically the same thing.

But I just wanted to focus on what you think the most effective mechanism will be. Again, I am trying to find a way to separate the debt limit increase from getting our work done here. Mr. Walker talked about maybe a glide path of 1 percent every year or two, or something like that.

I guess the enforcer would be—I have forgotten what the enforcer would be. He said, if we do not reach the target—then tell me again what the enforcer would be. I would also like Dr. Blinder to comment on that and try to figure out and see where you agree on what mechanism makes sense and where we can kind of bridge the gap, to the degree that you disagree.

Mr. WALKER. Mr. Chairman, there are at least three elements: the first element is discretionary spending; the second element is mandatory spending; and the third element is revenues. On the discretionary spending, in my view, security should not be exempted. So whatever the default mechanism is should apply to all discretionary spending, in part because you want to avoid that. I

know that there are certain players who do not want to cut defense or security spending. Well, if we do our job, you can solve the problem. So I would not exempt defense and other security spending, and I know there is a huge amount of waste there.

Second, mandatory spending. That is where the problem is. Sixty-eight percent of spending is mandatory spending. So I think you need to think about whether or not you want to do some things on the mandatory side. For example, do you want to have a temporary suspension of indexing, cost of living indexing, or some adjustment of that? Do you want to have a temporary change in subsidies for the well-off?

We provide huge subsidies for middle-, upper-income, and even very wealthy people under Medicare who voluntarily sign up for Medicare Part B and Medicare Part D. That is not a tax. A tax is when you have no choice. We are providing huge subsidies there, so do you want to do something about that?

Third, on the tax side, there are different ways you can get there. Again, I said if you look at the National Fiscal Responsibility and Reform Commission, there are roughly 2:1 spending cuts to revenues. My personal view, I would like to have it more on the spending side. But if you piggyback on that, then you have to think how you are going to make the revenue side work.

One idea is, let us have a separate line item on the tax return: "deficit reduction surcharge." It should be temporary, so we could say "temporary deficit reduction surcharge," pending making decisions on comprehensive tax reform, entitlement reform, other spending cuts and constraint. That would be transparent. That would be visible and facilitate accountability. But again, everybody should seek to avoid having—and by the way, you would have annual debt-to-GDP targets, so this would be something that would happen every year.

Let me give you one last example. Let us say the target was 70 percent of GDP. If you are 70 or less, no problem. If you are over 70, then you monetize the difference, so you calculate what the difference is. It is that difference that would have to be subject to the default mechanism.

The CHAIRMAN. I got you. I want to give Dr. Blinder at least equal time to you, Dr. Foster.

Go ahead, Dr. Blinder.

Dr. BLINDER. Well, I will be brief. I do not have a magic formula, but I want to reiterate—and just let me give you some examples. I am just thinking about this in real time.

The CHAIRMAN. Sure. Right.

Dr. BLINDER. You want something that is anathema to Republicans and anathema to Democrats.

The CHAIRMAN. Right.

Dr. BLINDER. And they are presumably going to be different things that kick in if you do not hit the target. Now, before I go further, all of you are better at thinking about that than I am. What it looks like to me as a citizen is the thing that is most anathema to the Republican Party now is raising the top bracket income tax rate, so that could be one piece, only if you fail. This is the Armageddon scenario.

Something about, you could cut Social Security benefits for all but the poor, or you could raise the payroll tax rate. Every Democrat would hate that idea. The principle is, you are trying to induce inter-party agreement by having everybody say, no, no, we cannot go there. Those are just two examples. There are probably better ones. As I say, you will be better at thinking about this than I am.

The CHAIRMAN. All right.

Dr. FOSTER, do you have some mechanisms here?

Dr. FOSTER. There are a lot of different mechanisms, I think.

The CHAIRMAN. Well, what do you recommend?

Dr. FOSTER. My preference is spending caps that are very specific, that are enforced with clear rules for cutting spending. My preference would be to cut out national defense from that, but I am willing to accept the proposition that that would be part of the overall exercise because, as Mr. Walker pointed out, the point is not to trigger the caps. The point is not to trigger the enforcement mechanism.

The point is to compel the Congress to budget and say, this is the amount we are allowed to spend, and we are going to make decisions to get us there. Leave that up to the American people and the American people's reaction as to whether they like the result. That is what elections are for.

The CHAIRMAN. Everybody talks about tax reform around here, whether it is corporate, individual, or what. Should that be revenue-neutral, or as we go down that road should we have in mind the possibility that the business sector would like to cut taxes, a lot of others would like to increase revenue? Thoughts?

Mr. WALKER. In the aggregate, when you do comprehensive tax reform—which is individual income tax reform, corporate income tax reform, whatever you are going to do on Social Security and whatever you are going to do on the consumption side, in the aggregate—my view is—and part of this, you will get through. If you get great tax policies, you will get better economic growth, which will generate more revenue. I think we need to close about three-quarters of the gap through spending cuts and constraint, and about one-quarter through additional revenues.

The CHAIRMAN. That is what the President is going to recommend at 1:30.

Mr. WALKER. Well, then somebody has been listening.

The CHAIRMAN. Yes.

Dr. BLINDER. If I could say something about that, Senator. I think, given the perilous state of the budget, getting some new revenue from tax reform would be a very good way to do it. The tax code is a mess, as everybody said, both on the corporate and the individual side.

On the other hand, when you think about the politics of this—and this is certainly the way the 1986 tax reform went—if you do not have some sweeteners to give back for the people who have to eat the things that do not taste very well, and you do that by either having it revenue-neutral or actually a revenue loser, it is very hard to get tax reform through.

So, when I hear about comprehensive tax reform being part of the deficit reduction package, as someone who has always favored comprehensive tax reform—my favorite law that the Congress has

passed in the last 40 years is the 1986 tax reform, so do not get me wrong. I am completely, 100 percent in favor of it. But I think it is a distraction in the context of deficit reduction because I do not see how you get revenue out of it.

The CHAIRMAN. Thank you.

Senator Hatch?

Senator HATCH. Mr. Walker, let me just make a note for the record. You have described the Debt Commission mix of deficit reduction of 70 percent spending restraint and 30 percent new revenues. Now, that ratio assumes the revenue baseline is an alternative to current policy. In other words, it assumes some tax increases from the sunset of the 2001 and 2003 tax relief plans in 2013. Now, that is \$1.6 trillion in revenue. That is a lot of new revenue.

Let me just finish my comment. Now, my staff tells me that, when you substitute in the current policy baseline, the ratio of tax hikes and spending restraints is very roughly 50 percent apiece. I think it is actually 54 percent to 46 percent. I raise this matter simply to clarify how ambitious the Debt Commission report is on the revenue side, and I just wondered if you had a comment about that.

Mr. WALKER. Senator, it depends upon what period of time as to what numbers you get. Let me just reiterate my personal view: it ought to be 3:1, spending to revenues. That is my personal view. I only point to the National Fiscal Responsibility and Reform Commission as one possible thing that you could go to. If you ask my personal recommendation, I would make it 3:1.

Senator HATCH. I am not trying to find fault with you. I just wanted to mention that it is pretty optimistic on the revenue side.

Let me just say this. This has been a terrific hearing. The three of you have done an excellent job, and you have had different points of view that have been very helpful to me, and I am sure to other members of the committee as well. So we appreciate the time that you have given to this, and I just want you to know that your time is not wasted, in my opinion.

The CHAIRMAN. Senator Rockefeller? Thank you, Senator.

Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman.

I am intrigued also. Like Senator Hatch, I think this has been really good. I missed the first part of it, and I apologize, but these are really thoughtful, good people here, and willing to go after the untouchable: only what will work is what everybody hates. It is a terrific concept, and it is really true in marriage, in life, and in budgeting.

The CHAIRMAN. And in many ways, all three are the same. [Laughter.]

Senator ROCKEFELLER. So that leads me on to something which has always bothered me, but which is really bad to talk about in States like my rural State, where the military is a way out to get a job. I totally believe you, Mr. Walker, when you talk about waste, fraud, and abuse, but let us say waste in the military. We will not touch it. We do not pay for any of our wars, cannot do it, it is unpatriotic to think about it. But let us just forget that last statement

for a moment and talk about the waste and the abuse. The total size of the military budget is about what?

Mr. WALKER. Seven hundred billion dollars.

Senator ROCKEFELLER. Seven hundred billion. Of that, would you think that as much as \$50, \$60 billion—

Mr. WALKER. Oh, easily you can deal with that. Well, first you have to realize you would have the conflicts that we have going on right now, you have Iraq, you have Afghanistan, whatever you want to call Libya. Those are going to be temporary, so ultimately they are going to come down at different time frames.

But, even if you look at the base of the budget, believe it or not, Congress, by law tells the Pentagon that, when it is doing its quadrennial defense review and when it is trying to figure out what its "requirements" are, it cannot consider cost. It is precluded from considering cost. That alone means that we end up starting a bunch of things that we cannot afford, we cannot sustain.

Senator ROCKEFELLER. All right. That is very helpful. So for me, that puts defense on the table.

Mr. WALKER. It should be.

Senator ROCKEFELLER. It has to be on the table. Second, just a question, just because I want to hear it said more than once: we cannot do this and make it work, especially for the long term, without raising new revenues. Now, you can raise new revenues by thinking up new things, or you can do it by reducing existing exemptions, oil depletion, all that kind of stuff. Would the three of you agree that we cannot make this work without, obviously, the spending cuts, but also raising revenue, raising new revenue that we do not now have?

Dr. BLINDER. I first want to agree with that, with the proviso that Dr. Foster's statement about arithmetic at the beginning of his testimony is true. It is not mathematically impossible. I think it is socially and politically impossible, and highly undesirable, to try to do this with no additional revenue, and the Ryan budget is the example. That takes no revenue.

Senator ROCKEFELLER. And especially at a time like now.

Dr. BLINDER. And especially at a time like now.

Senator ROCKEFELLER. But still there is the proposition that it has to happen, or rather the proposition that it cannot possibly happen, starting with Reagan and going on right through Bush and continuing, making things permanent. Either positively or negatively, you cannot continue that proposition.

Dr. BLINDER. I think that is clear. I hear what you are saying. Continuing the proposition that we can just keep lowering taxes and lowering taxes and lowering taxes—we cannot just keep on doing that.

Senator ROCKEFELLER. I thank you all.

The CHAIRMAN. Senator, do you want to jump in some more?

Senator THUNE. Thank you, Mr. Chairman. Thank you, gentlemen. Great to have you here.

Let me just, if I might, ask a couple of questions regarding—I think there is some attention that has been already given this morning to the Ryan budget, but I guess I would ask General Walker, take away the feelings about the political feasibility and sort of the 3-step test that you set up in terms of something that

might work: do you believe that it addresses the long-term debt crisis and really gets us where we need to be going in terms of sustainability?

Mr. WALKER. I think it is politically courageous. I think that it involves a number of transformational type of changes, some of which are meritorious. I know there have been some concerns that have been expressed about some of the assumptions underlying it that I think have to be looked at, but those would be my preliminary thoughts.

Senator THUNE. Let me ask you all about the CLASS Act. The CLASS Act was a provision that was a part of the health care reform bill that passed last year. Even Secretary Sebelius has appeared in front of this committee and said it is totally unsustainable. That is what CBO has concluded, that it will add significantly to deficits.

The Fiscal Commission actually recommended abolishing it or repealing it. I have a bill that would do the very same thing. It strikes me, at least, that when you are in a hole you should quit digging, and we are in a pretty deep hole. This is something that complicates, I think, the fiscal picture even more dramatically going forward. So tell me what your reaction is with regard to that legislation that passed as part of the health care reform bill and what we ought to be doing now to get it off the books.

Mr. WALKER. It is fiscally irresponsible, fundamentally unsustainable, and I think you ought to consider repealing it.

Senator THUNE. Does anybody have a different reaction to that? Oh, I am sorry. It was a long-term care piece of legislation, an entitlement program that was added to the health care bill.

Dr. BLINDER. Yes. Well, I think that is the kind of mistake that was made with Medicare Part D. I mean, you need to have funding mechanisms for things like that. We should have done that with Medicare Part D, and I would say the same thing about this.

Senator THUNE. As I was leaving—I had to go do something else—something Dr. Foster was mentioning in reaction to a response to a question from Senator Schumer had to do with sort of the moral equivalence of a dollar generated from revenue increases versus a dollar from spending cuts.

I would ask you, just maybe if you could, to elaborate on that, because it strikes me, at least, that revenue increases—and if you look historically throughout the 40 or 50 years, we always were somewhere in that 18 to 19 percent of GDP, irrespective of what tax rates are. People find ways, they adjust their behavior and reaction to whatever the tax rates are at the time.

I also believe that tax increases, of course, affect, I think, economic growth. So the question about how that bears on revenues, I would like you to elaborate a little bit on that because I am not so sure—when you were answering that question, you were saying a dollar of revenue increases or tax increases would be equivalent to a dollar of spending cuts, arithmetically. But could you provide some context or a little texture to that that would get more at the issue of how tax increases would bear on economic growth, and therefore long-term revenue?

Dr. FOSTER. Thank you, Senator. I appreciate that opportunity. Arithmetically, one dollar of tax increase does equal one dollar of

spending reduction, but the comparison breaks down from that point forward. It is a lot more than just math: there is the economics; there is the politics, the concept of what is fair politically between conservatives, liberals, Republicans, Democrats; and then there is the question that Senator Schumer was trying to sort of set aside, I think, which is the size of government.

The problem that we have before us is that government has grown dramatically, and it is expected to do so far more dramatically in the long run, as Dr. Blinder has pointed out. The problem is, in fact, the spending side. So, if that is where the problem is—not on the revenue side, because revenues will get back to their historical norm very quickly as the economy recovers, and in fact rise above the historical norm in the years that follow under current policy—the issue is not a shortfall of revenues, the issue is an excess of spending. If that is where the problem is, it strikes me as unfair to taxpayers—who are the real issue where it should be fair or not—it is unfair to taxpayers to ask them to pay more to solve a spending problem that Congress would otherwise have not solved.

Senator THUNE. Just a quick reaction, if I might. Admiral Mike Mullen, Chairman of the Joint Chiefs of Staff, has said in testimony in front of the Senate that the greatest threat to America's national security is our national debt. You have probably heard that, which I think is a pretty stunning statement coming from your top military leader. But the former Chairman of the Federal Reserve Board, Alan Greenspan, has said that he believes there is a 50-percent probability of a debt crisis in the next 2 to 3 years. Do you agree with that assessment?

Mr. WALKER. I agree with both, and I have said it in 2007.

Dr. BLINDER. I do not agree with either, actually. I think there is some probability of a crisis in the near term. The signs are not that it is happening. We are in some sense protected by the “you cannot beat something with nothing” principle. The people who would flee the dollar have to go somewhere else. So it could be, but I would certainly not handicap it at 50 percent.

I do not think it is the biggest threat to our national security. I would not even attempt to decide which one was. If it got number two on Admiral Mullen's list, I would probably just shake my head yes that that is right. I do not think it is the national debt.

Dr. FOSTER. I think we are momentarily seduced by a variety of conditions in the global system. They are driving down interest rates and signaling to us that everything is all right, and we are being seduced by that. That is not going to last for long. When the crisis comes, no one knows. That it will come if we stay on our current path is a certainty.

Mr. WALKER. Let me clarify if I can, Senator. I do not believe that the current national debt—I believe that our fiscal irresponsibility is the greatest threat to America's future, which is the deficits and debt that lie ahead. That, I believe, is the number-one national security threat, not the current level of debt.

Senator THUNE. All right. Very good.

Thank you, Mr. Chairman. Thank you all very much.

The CHAIRMAN. That concludes our hearing. I want to really thank you. This has been one of our better hearings, just because

you bring intelligence and common sense and urgency to this debate. Thank you so much. I have a hunch that we are going to be talking again. We have a lot more ahead of us before we solve this. Thank you, all three, very, very much.

The hearing is adjourned.

[Whereupon, at 12:03 p.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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### **Hearing Statement of Senator Max Baucus Regarding Perspectives on Deficit Reduction**

Henry Ford II once said:

“What's right about America is that although we have a mess of problems, we have great capacity, intellect and resources to do something about them.”

The enormous Federal budget deficits and the debt our country faces can certainly be called a mess. Identifying ways to reduce these deficits and eliminate the debt is the topic of our discussion today. Addressing our deficits and debt is an economic issue, it is a national security issue, and it is a moral issue.

Our deficits and debt threaten our future and the future of our children and grandchildren. I've long said we have a moral obligation to leave this place better than we found it, but today, our fiscal challenges prevent us from meeting that responsibility.

And there are other concerns. U.S. debt could be recalled by foreign entities in times of economic or military conflict. This presents a significant national security concern.

The non-partisan, independent Congressional Budget Office, or CBO, estimates that this year the deficit will reach 9.8 percent of our entire economy. This is the second-largest deficit on record since World War II.

One of the most significant factors behind our deficits is the recession. As our economy continues to recover, we will see improvements. By fiscal year 2015, our deficits are expected to drop to approximately 4.7 percent of GDP.

But over the longer term, our deficits are projected to continue increasing. They will likely reach more than five percent of GDP by 2021, and debt held by the public will increase to about 91 percent of our entire economy.

We have to do better. Families in Montana and across the country expect us to do better because that's what they have to do when budgets are tight in their own lives.

Whether it's saving for college or making payroll for their small business, Americans know they have to balance their books. And they know you can only put so much on the charge card.

It's time for us to take a lesson from the family that hasn't taken a vacation in far too long and from the small business where everyone took a pay cut to prevent layoffs. It's time for us to get serious about our deficits and debt.

Economists agree we have to get the debt held by the public under control. That means deficits in the near term should be reduced to no more than three percent of GDP.

To meet that goal, we must act. While we must be cautious during the present recovery, we should enact legislation soon with a plan to reduce deficits as our economy grows stronger.

That plan should not overshoot deficit reduction targets, harm critical programs or risk our economic growth, but it also must be a plan we are committed to enact.

As we consider our deficit reduction plans, we must keep several things in mind.

First, everything must be on the table. Our deficit challenges are simply that significant.

Second, we should not scapegoat Social Security. Social Security benefits are self-financed through payroll taxes and the Trust Fund. Social Security is not responsible for the deficits in the general fund.

Third, any deficit reduction package should be balanced. In general, the package should not be tilted too much toward spending cuts or too much toward revenue increases.

Fourth, spending cuts do not necessarily mean benefit cuts. We have to stretch our administrative dollars further and make our programs more efficient.

The new health care law has already made some notable progress toward deficit reduction by addressing one of the largest drivers of our deficits, rapidly rising health care costs.

The law increases focus on prevention, it makes our system more efficient, and it cuts fraud, waste and abuse significantly.

These improvements resulted in the most significant deficit reduction in more than a decade. According to CBO, the law will reduce the deficit by more than \$230 billion in the first ten years of enactment and by more than a trillion dollars in the decade that follows. We must give this law time to work.

The Finance Committee has jurisdiction over many of the programs that will figure prominently in this discussion. We oversee Social Security, Medicare, Medicaid, taxes and many other programs. That's 45 percent of total spending.

Following today's hearing, I intend to hold more hearings to give us the facts we will need as we move forward to address these paramount issues, and I look forward to hearing the ideas the President will put forward later today.

So let us tackle this mess of problems head on, and let us capitalize on the capacity, intellect and resources this great nation has to solve them.

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Testimony of  
Alan S. Blinder  
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs  
And Vice-Chairman, Promontory Interfinancial Network  
Princeton University  
to the  
Committee on Finance  
United States Senate  
April 13, 2011

Chairman Baucus, Ranking Member Hatch, members of the Committee, I'd like to thank you for the opportunity to share my views on the budget deficit and the national debt with you today. I really have only three points to make. I'll state them up front and then elaborate just a bit on each.

1. The short-term federal budget deficit, large as it is, is really not much of a problem. Indeed, it's probably desirable.
2. By contrast, the government's long-run deficit problem is huge, horrendous, and demands Congressional action. Sooner would be better than later.
3. No one should seriously consider letting the government hit the national debt limit.

The Short-Run Budget Picture

CBO now estimates that the FY11 deficit will be about \$1.4 trillion, roughly 9½% of GDP. That looks huge compared to the 40-year average of about 3% of GDP—and it is. But let me make three quick points about the 6½ point gap.

First, it's inherently temporary. In round numbers, the recession has added about 2% of GDP to the deficit. That part will naturally fade away as the economy improves. About 1% of GDP comes from the Recovery Act, and that will certainly disappear. Another 1% comes from the wars we are fighting, and I certainly hope that will disappear. Finally, roughly another 2½%

comes from the tax-cut package that Congress enacted last December. That is scheduled to lapse in 2012, but I worry because that's an election year. If you add up all these "temporary" components, you get about 6½% of GDP. So, in principle, Congress should be able to get the deficit back down to 3% of GDP without breaking a sweat. Yet the House and Senate are tying themselves up in knots over about \$30 billion.

Second point: The economic recovery is mediocre at best and unemployment remains high. To me, those conditions describe a bad time to put the economy on a diet of either spending cuts or tax increases.

And third, if we are facing any near-term financing problems, they are invisible. The capital markets are now charging the U.S. Treasury a real interest rate of about 1% for 10-year money, and strongly *negative* real interest rates for short-term money. That is very cheap financing.

So there is no deficit crisis today. But we could create one by letting the government crash headlong into the national debt ceiling.

#### The Dysfunctional National Debt Limit

Each year—well, except for this one—Congress passes a budget that implies certain amounts of spending and receipts. The difference between those two numbers is the implied increase in the national debt over that fiscal year. Given the budget, it makes no sense whatsoever to place an *additional*, lower limit on the amount of debt the Treasury can issue. How can we bar the Treasury from borrowing the money that the budget dictates?

Letting the debt limit bind is, at one level, comical—because it purports to defy the laws of arithmetic. But at a more important level, it's potentially dangerous if it robs Treasury of the

borrowing authority it needs. We have enough problems and should not shoot ourselves in the foot.

#### The Long-Term Budget Problem

Let me now turn to the long-term budget problem. As I'm sure every member of this Committee knows, the U. S. government is on an unsustainable budget path that will drive the ratio of debt to GDP ever higher. The next 10 years are not where the problem really is; it's what comes after that.

CBOs latest long-term projection showed the deficit as a share of GDP, under the more realistic "alternative scenario," falling from about 9½% now to about 6½% in 2020, but then soaring to 16% by 2035—after which it continues ever upward. That's not only unconscionable, it's impossible.

What's driving these numbers? Other than the inexorable logic of rising debt and interest payments, it's Social Security and health care, mostly the latter. For example, if you look at the *primary* deficit, which excludes interest payments, Medicare and Medicaid account for roughly 85% of the increase between 2020 and 2035. As Rabbi Hillel said about the Golden Rule, "All the rest is commentary."

The explosion of medical costs is, in turn, driven by two factors: increasing longevity and rising *relative* prices for health care. I don't think Congress wants people living shorter lives. So it is approximately true that, if we figure out how to "bend" the healthcare "cost curve" enough, we can fix the long-run deficit problem. And if we can't, we can't.

Unfortunately, nobody really knows how to do that. Some people believe that last year's healthcare reform has the potential to do the job. After all, it tries almost every cost-control

idea that's been suggested. But others are skeptical. I don't pretend to know the answer. The most intelligent course of action, it seems to me, is to watch how the various cost-containment efforts play out over the coming years and then do more of whatever seems to work.

As I say this, I'm painfully aware that cutting losers and riding winners is one of the hardest things for any government to do. Nonetheless, I think you senators should try—and I wish you good luck.

Thank you for listening.



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*CONGRESSIONAL TESTIMONY*

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**Testimony before**

**The Committee on Finance  
United States Senate**

**April 13, 2011**

**J.D. Foster, Ph.D.**

**Norman B. Ture Senior Fellow in the Economics of  
Fiscal Policy  
The Heritage Foundation**

Chairman Baucus, Ranking Member Hatch, Members of the Senate Finance Committee, thank for the opportunity to testify today. My name is J.D. Foster. I am the Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at the Roe Institute of the Heritage Foundation.

In 2007, as the country was essentially at full employment just prior to the Great Recession, the federal government ran a budget deficit of \$162 billion. In 2007, spending on the wars in Iraq and Afghanistan and related activities totaled \$174 billion. In short, but for the war spending, the nation ran a balanced budget while collecting a normal share of tax revenues relative to the size of the economy.

Ten years later, under the budget President Obama submitted this past February, the country is once again assumed to be at full employment, yet the federal government is projected to run a budget deficit of nearly a trillion dollars despite an assumed substantial reduction in war outlays and a substantial tax increase pushing revenues well above historical norms. And from there, the deficit balloons as the long-awaited entitlement wave crashes upon us.

Above normal revenues and high and rising deficits can only mean one thing: Spending is the problem. Congress will take a good first step at restraining spending in the legislation finally funding the government for the balance of 2011. It certainly was not easy; nor was it enough. It is also likely we have now harvested most of the low-hanging deficit reduction fruit.

The President's budget released last February offered an exceptional garden of magic asterisks totaling some \$2.2 trillion in savings. The budget is usually where the President puts forward his programmatic agenda, with details sufficient to inform the public and guide legislative action. Magic asterisks indicate an area of desired programmatic change and the expected budgetary effect, but no policy. Beyond the asterisks, the President's plan was notably silent on how we would address the near-term or the long-term deficit.

Last week, Congressman Paul Ryan, Chairman of the House Budget Committee revealed a Path to Prosperity program of expansive scope calling for sweeping change -- with real policy proposals and Congressional Budget Office scoring. To date, not one magic asterisk has been identified.

The Ryan plan is bold, and has generated both heat and light in abundance. Stepping back, what this Committee, the Congress, the nation must realize is that the changes proposed in the Ryan plan suggest the magnitude of the changes necessary to stabilize federal finances. Critique parts or all if you will, in terms of magnitude nothing less than the Ryan plan must and, however painful, will be enacted.

It is no coincidence the President only now is willing to come forward with some of his own ideas on these matters. One would have expected the budget to reflect his

proposals two months ago. Clearly, in light of the credibility and sweep of the Ryan proposal the President is now compelled to say something.

I sincerely hope he engages in earnest; far better late than never. The President should present a clear direction of reform for major programs, with enough specificity to see the end product. He need not address every area of government spending, every entitlement. But he must address some of them, and especially those most pressing, such as Medicaid and Medicare. If, instead, he offers exhortation, targets, and the like, then he will have merely planted another field of asterisks alongside those he planted in the budget released two months ago.

The invigoration of spending excesses is not unique to the current or immediate past Congress. Spending discipline substantially evaporated on a bi-partisan basis at the end of the last millennium, though the degree of the inspiration along with the spending certainly grew dramatically in the past Congress. The recent budget deal cutting non-defense discretionary spending some \$37.8 billion is the painful reality that follows from such inspiration. With a projected deficit for 2011 of about one and a half trillion dollars, marking the third year of extraordinary profligacy, these cuts mark an important, initial effort.

It is, however, only the undercard as they say in boxing, to the bigger events yet to come later this year. The House of Representatives will soon take up a budget for 2012, a relatively novel event in recent memory. We will then see if the Senate can do likewise. It would encourage the nation and the markets greatly for Congress to succeed.

In a very few months a fight over the debt limit will build to a crescendo. This may be the main event for deficit reduction this year. Reaching the debt limit provides a unique opportunity to restrain spending and thereby cut the deficit. Between the budget resolution and the debt limit all those in and out of Congress who decry budget deficits will have every opportunity to meet the challenge implicit in the Ryan plan and, hopefully, in the President's belated response, to put forward their own substantive alternatives. We will see who walks the walk, and who just talks the talk.

The news for the near term is not all grim. As the economy recovers, receipts will recover, as well. As many have noted including President Obama's former chief economist Larry Summers, growth is the necessary but not sufficient condition for deficit reduction. This provides all the more reason for Congress and the President to declare a cease fire in their war on prosperity. Stop threatening higher taxes and more regulations. Abandon the folly of thinking that deficit spending is somehow propping up the economy when in fact it is distorting the allocation of saving and driving up the trade deficit.

There are three key aspects to near-term deficit reduction. The first is economic growth. A stronger economy means more options, so every time Congress passes legislation that nicks the economy keep in mind the costs may be far greater than appear in a Congressional Budget Office table.

The second is the level of taxation. We have heard, and will continue to hear, that higher taxes must be part of the solution. Simply as a statement of arithmetic, this is not true. As a statement of budget policy, it is not true. Taxes need not go higher, and could go lower.

When scientists describe established, physical laws, these are statements of fact. When politicians and others assert that our fiscal policy is dangerous and unsustainable, that statement can be demonstrated rigorously as factual to the extent any projection can be.

However, when anyone asserts that taxes must go up to address the deficit, they are expressing a personal opinion, judgment, or policy preference. This is what budget making is all about – making choices based in part on personal views. In my view, taxes should not be raised. On the contrary, we should be so successful at restraining spending that taxes may be reduced.

This is my personal opinion, not the product of economic or budgetary analysis. Even when a highly respected economist or budget expert tells you taxes must be part of the deficit reduction or entitlement reform solution, their statement is not based on economic analysis. It cannot be. They are making a personal judgment about what ought to be. Economic training should not front for personal judgment. Being an economist does not make one's opinion less valid, but nor does it make it any more so.

It is a fact that taxes need not go up. It is an opinion to argue the contrary. It may be a judgment about what is necessary to achieve a political outcome, but it should not be confused with a statement of fact, however forcefully or artfully presented.

Spending, of course, is the third aspect of the deficit problem, especially the big three entitlements. It may surprise you to learn there's a fairly strong consensus on how to reform Social Security and Medicare to make these programs affordable while strengthening their core missions. A similar consensus is emerging in Medicaid. The problem, the hindrance, is the political environment. We should all hope the President now intends to improve that environment.

Medicaid, of course, is uniquely structured and so poses unique issues to resolve. The essential feature of Medicaid is that it demonstrates a distinct federal paternalism. Its structure suggests the federal government, that is the Congress, believes it is the only true defender of the health care for poor families and seniors. It is a statutory insult to the competence and humanity of every state government.

Medicaid imposes unaffordable burdens on the states and an increasingly unaffordable burden on the federal government. It should be turned into a block grant program combined with an appropriate minimum performance standard applicable to all states. States could then fashion programs that best fit their unique circumstances. A Medicaid program that works well for Montana is likely to look quite different that works well in New Jersey.

The basic outlines of how to reform Social Security to make it sustainable and more effective in protecting seniors from poverty are by now well-known. Changes relating to the eligibility age, indexation of benefits, cost of living adjustments, and so forth are all well-understood and would have dramatic consequences for the program, saving more than enough to ensure a more robust benefit to low-income seniors.

Some have argued that for both Social Security and Medicare, changes should not affect current retirees or those nearing normal retirement age. I agree that low- and middle-income Americans above some age nearing retirement should not be affected, nor need they be. They simply do not have enough working years left to adjust their lifestyles and finances. However, this does not apply to seniors with substantial resources. There is no reason, for example, not to apply an income-relating mechanism to Social Security benefits similar to what applies today to Medicare Parts B and D premiums. There are other approaches, as well. I am not proposing a specific approach, but rather a direction of change.

Medicare is a far more complex program, but poses only a slightly more complex problem. Some aspects of reform will follow the changes to Social Security, such as a higher eligibility age. The best solution is to pursue a premium support model similar to that in the Ryan plan or the less frugal Rivlin-Ryan proposal. Some find this a radical proposal. It is nothing of the sort. In important respects, this approach simply acknowledges that Medicare Part D offers a successful model of providing seniors financial support and allowing them to make their own health insurance decisions.

This can be further extended to achieve the necessary savings to reduce the budget deficit in the near term and assure Medicare's long-run viability by setting the premium support levels to reflect both need and available resources. Low- and middle-income seniors need more assistance than those of greater means, and wealthy seniors should carry the costs of their own health insurance.

In the premium support model one can and should continue with the traditional Medicare fee for service program as an option seniors may choose to buy with their premium support. Many current seniors for any of a number of reasons would choose to continue buying their health insurance from Medicare, with the same level of premium support they would receive if they were to choose a private plan, and they should be allowed this option.

Alternatively, if one believes it really does make sense for the federal government to run the world's largest health insurance company, then Medicare's finances can be improved immediately and adequately without fundamental changes to the program. This can be achieved by further tightening the income-relating mechanism current at work for Parts B and D, and then applying a premium for Part A along the same lines. This is a minimalist approach to Medicare reform. It leaves seniors with fewer options than the premium support model and would have relatively little effect in strengthening the market processes necessary to restrain health care costs overall. But it would be

sufficient to generate the near-term savings needed to address the near-term deficit while simultaneously establishing long-run program viability.

Many seniors will counter that they paid into these programs and they are entitled to the benefits they were promised. Very true, and it should be acknowledged unequivocally at the outset.

But there are other truths that must be acknowledged. As is now well and broadly understood, benefits were promised that the nation cannot afford. This may warrant an apology to some seniors, but it does demand a fundamental change.

Another competing truth is that the longer we go making good on all these promises made in the past, the more extensive will the promise be broken for future generations. How much tax and how much government debt must our children and grandchildren and generations beyond bear to maintain our fidelity to all seniors for just a few years longer? Someone must pay more for others to get more. It is moral corruption to continue to support seniors who can support themselves at the expense of today's working families and generations to come.

Some have suggested these problems can only be addressed in a crisis. Maybe so. But if so, it is quite an indictment of our political leaders and our political system. Many politicians retort that it is easy for analysts to say these things. Analysts don't have to stand before the voters. True enough, but then why does every politician campaign on their leadership abilities and willingness to make the tough choices? Ducking is not leadership, and orating is not choosing.

The presumption by some is that a crisis will allow radical changes to be pushed through the Congress, including unnecessary and unwise tax hikes that could never survive normal public scrutiny. Thus we see intensive efforts plumbing the inner workings of a Value-Added Tax, or new taxes on financial services, or carbon taxes. Generally fearful of advancing a proposal in advance, instead proponents prepare for the day when they may be able to foist a new tax system onto the American people.

To this I say "semper paratus, semper vigilis" – ever ready, ever vigilant. That which cannot prevail in the light or the calm will not pass under cover of darkness or crisis.

**STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER  
U.S. SENATE COMMITTEE ON FINANCE HEARING OF APRIL 13, 2011  
PERSPECTIVES ON DEFICIT REDUCTION**

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, released his opening statement from a committee hearing today examining the current federal fiscal crisis and approaches to deficit reduction. Today's hearing is the first in a series by the Finance Committee this Congress examining deficit reduction and the soaring national debt.

A full copy of Hatch's remarks, as prepared for delivery, follows:

As I prepared for this hearing, I thought of those two Chicago-savvy musicians, Joliet Jake and Elwood Blues. They were known as the "Blues Brothers." I have a chart depicting Jake and Elwood.

Jake and Elwood would often challenge folks to state their blues. If they asked us here today to state our blues, I think every member of this panel would say we've got those big deficit and debt blues. We'd also say that those blues won't leave us anytime soon.

In recent months President Obama has frequently discussed our nation's disturbing fiscal situation. He is right to do so. I'm sure the President would say he has big deficit and debt blues. Who wouldn't have the blues?

Our yearly deficits and accumulated debt hover like thunderclouds over the futures of our children and grandchildren. Though he is late to the table on this issue, President Obama has indicated, once again, that he seems to have finally recognized the frustration and anger of the American people over our Federal fiscal policy.

The President's fiscal commission came out with a long-term deficit reduction plan, but the President made no commitment. It was a swing and a miss. Strike one. Then we all waited for the President's budget to show some a path to long-term deficit reduction and entitlement reform, but no commitment. It was a swing and a miss. Strike two.

Then, the White House lit up the Sunday show circuit with an expectation that the President will come to the plate and take another swing at a plan.

Jake and Elwood captured the importance of bottom-line substance with the "sandwich" joke. A sandwich, by their definition consisted of two slices of bread with no meat. The consumer of a sandwich was supposed to wish he or she had meat between the slices of bread.

As we anticipate the President's third swing at the deficit reduction plate, we hope that it will not be a strike. Three strikes and you're out. We hope he'll be delivering a sandwich and not a sandwich. A sandwich is a joke and not a meal.

Some will say the only real deficit reduction game in town is one where we significantly raise taxes.

The non-partisan Congressional Budget Office ("CBO") tells us that the current tax system will yield ever rising revenues.

I have a second chart that illustrates this point. If you look at this chart, you'll see that individual income taxes grow as a share of gross domestic product ("GDP"). The red line is the current law baseline. You can see that it springs upward. Revenues grow dramatically under the President's basic policy baseline. It's the blue line. My friends on this side of the aisle probably won't be surprised by that data. What may shock my friends on the Democratic side is that, current policy, with this year's rates and the AMT patched, will yield a growing tax base as well. It's the orange line.

That's right. If current tax policy stays in place, the non-partisan CBO tells us the tax base individual income tax grows as a portion of the American economy. A shrinking revenue base is not driving the out-of-control deficits of the future. How could it? It's not shrinking. It's growing.

For those who want to ignore the clear data showing that the individual income tax take grows, let's take a look at some numbers that also grow significantly. In this case, I'm talking about federal spending. Working from the bottom up, you can see that revenues come back. It's the blue line in this chart. The red line shows the President's budget's spending line. As you can see, it stays very high. As a share of GDP, it's over 15% over the historic average. Spending is historically high and keeps growing. That's not restraint. It's not discipline. It's beside me how, when looking at this data, folks on the other side can argue that out-of-control spending is not the problem.

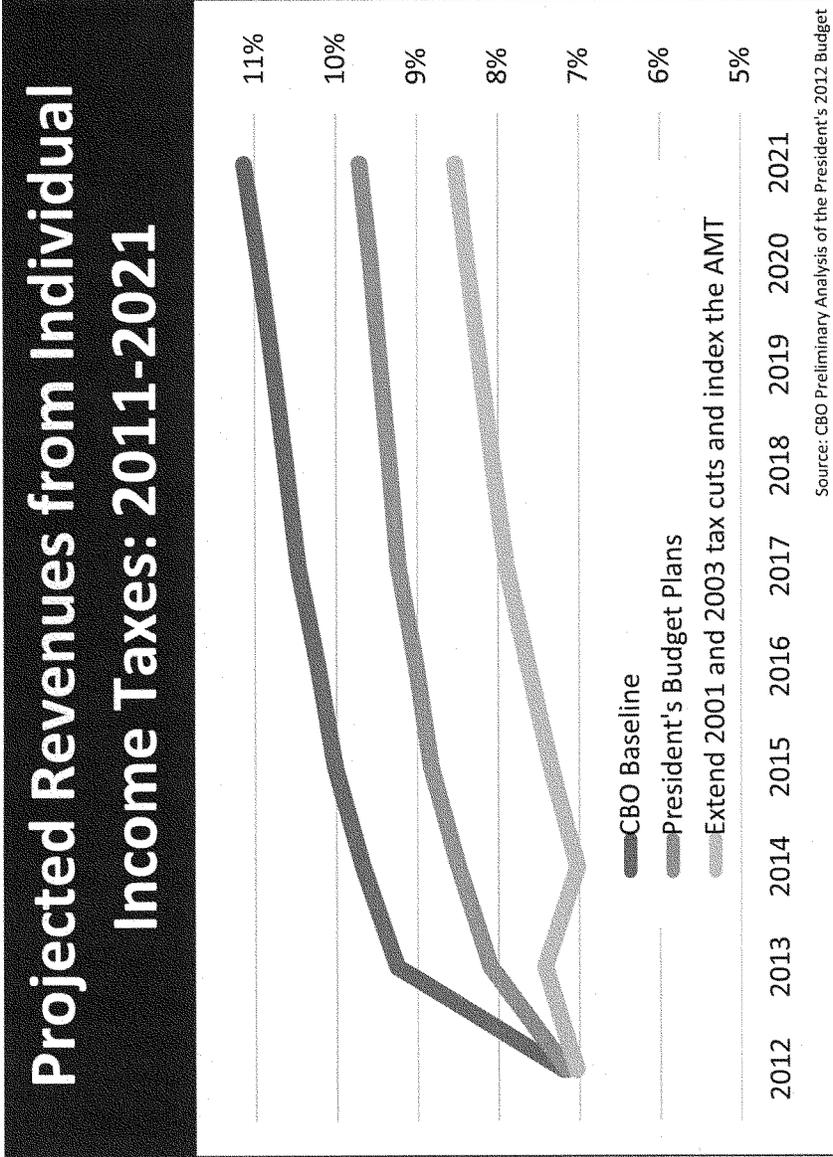
That, Mr. Chairman, is why we are here. We need to look at the origins and continuous causes of the unsustainable deficits and debt. This great old committee, the Senate Finance Committee, is where over half of spending originates. It's where almost all revenue policy rests.

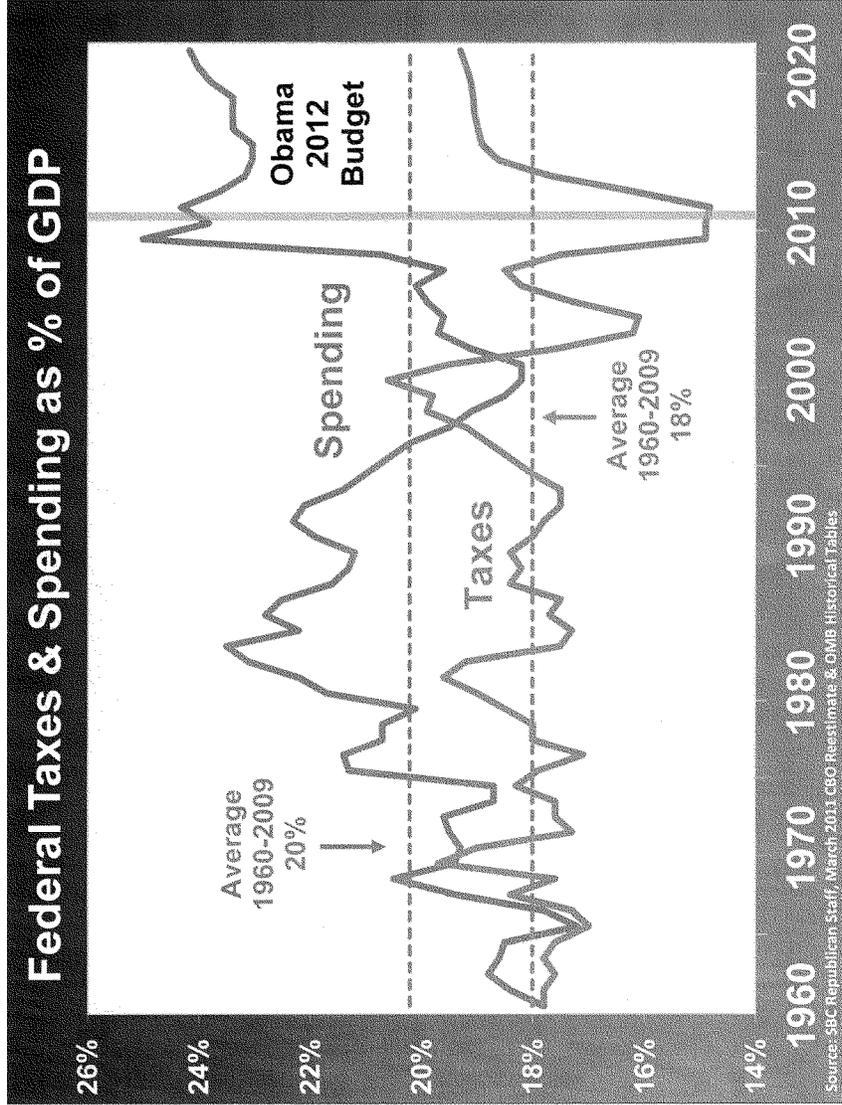
It is only proper that this committee air these issues out. It is, however, all for naught if the President misses this opportunity and does not make a bold commitment to entitlement reform and deficit reduction.

Hopefully, it won't be a third strike where we're left with the status quo. Hopefully, the President will not deliver a sandwich. We've got to hunker down, do the work, and rid ourselves of these spending-driven deficit and debt blues.

I look forward to the witnesses' testimony.

###





**Senator Pat Roberts**  
**Perspectives on Deficit Reduction**  
**April 13, 2011**  
**Statement for the Record**

Thank you, Mr. Chairman, for holding this hearing to get perspectives on reducing the deficit. And thank you to our witnesses for their testimony.

Let's clarify the facts. The national debt is over \$14 trillion, grows daily, and we are fast approaching the debt ceiling. I know the chairman remembers that the last Congress raised the debt ceiling four times in two years, and spent twice as much in two years as was spent in the last four years of the previous administration. If this continues, then by the year 2014 interest payments on the debt alone will be greater than all discretionary spending outside defense. The debate or fuss about which programs must not be cut will cease – they all will be cut, the money will go to pay interest on the debt.

We are not getting out of this fiscal mess until we make a commitment to cut discretionary spending, and follow through on reforms to entitlement spending, which accounts for roughly 60 percent of federal outlays. These objectives cannot be attained without leadership from the president.

There is an old saying by Thomas Paine: "Lead, follow, or get out of way." Someone needs to tell the president that options B and C are not options at all. What's needed from 1600 Pennsylvania Avenue is leadership. Remember, that before the president was *for* raising the debt limit, he was against it while serving as a Member of the Senate.

Come to think of it, Mr. Chairman, why isn't someone from the administration present for this hearing on deficit reduction? When is the administration going to fully engage on this issue?

The president's 2012 budget request was \$3.73 trillion, and it has a projected deficit of over \$1 trillion. This adds to the national debt instead of cutting from it.

And in regards to entitlement reform, the president's budget request is largely silent. It did nothing to address the looming disaster in which the Social Security Trust Fund becomes completely exhausted, and Medicaid and Medicare become broken beyond recognition or repair. The new health care law fails to extend the solvency of Medicare, provide a long-term solution to the broken physician payment formula, and the Part A Trust Fund continues to run deficits – \$39.5 billion deficit for 2011 alone. Meanwhile, Medicaid is projected to cost \$4.39 trillion over ten years, and there is still no relief for states. Why can't the president say, at the very least, what entitlement animals are in the pasture?

On the Agriculture Committee we might ask, "Where's the beef?" Here on the Finance Committee, in regards to entitlement reform and deficit reduction, I ask, "Where's the leadership?"

The clock is ticking, and the time to do anything about entitlements and spending is running out. We are approaching the eve of raising the debt ceiling again, yet again. I would point out that Kansas families do not have the option of arbitrarily raising their debt ceilings should they spend beyond their means.

This is not about party politics. It's about reducing spending and tightening our federal belt. We are borrowing 40 cents of every dollar we spend. It's time to start doing something about this. "Lead, follow, or get out of the way." Mr. President, if you are listening – if not to this committee hearing on deficit reduction, then at least to the American people – it is time to choose option A: it is time to lead. Thank you.

**FINAL:**

April 13, 2011

**Senate Finance Committee – Our Fiscal State of Affairs**

By: Hon. David M. Walker, Founder and CEO of the Comeback America Initiative  
and Former Comptroller General of the United States (1998-2008)

Chairman Baucus, Senator Hatch and other members of the Senate Finance Committee. Thank you for the opportunity to appear today and discuss the critically important question of our nation's serious fiscal challenges.

Before I address some of the relevant key statistics, the related risks, and discuss a possible path forward, I want to briefly address the issue of our broader cultural challenge. It is very relevant to where we are and what we need to do to restore fiscal sanity and sustainability.

While the United States is an exceptional and great nation, we have strayed from many of the founding principles that made us great. These include such principles as limited government, individual liberty and fiscal responsibility. From a fiscal perspective, it includes such values as thrift, savings, investment, limited debt, and stewardship. We believed in and, for the most part, were true to these principles and values for almost 200 years. However, within the past 30 years, we have lost our way both as a country and a society. We must now restore our belief in and commitment to these principles in order to ensure that America remains great and our future will be better than our past.

I do not want to provide a lot of statistics, but a few statistics and charts will be instructive. The high point of federal public debt/GDP was at the end of World War II when it was about 112 percent of GDP. (See Exhibit I). At the end of World War II, the U.S. was over 50 percent of global GDP and demographic trends were working in our favor. In addition, after World War II America took a number of steps to promote economic growth (See Exhibit II) and restore fiscal responsibility. As a result, debt/GDP levels plummeted from an all time high at the end of World War II to less than 40 percent of GDP by 1980.

Today's public debt is about 65 percent of GDP and growing rapidly. In addition, if you add the debt owed to Social Security and Medicare, which I believe you should, federal debt is close to 95 percent of GDP and growing rapidly.

Debt per capita is another informative to look at debt. On a per capita basis, our current federal debt level is over double what it was at the end of World War II and growing rapidly. (See Exhibit III).

How did we get to this level of debt? You will see that federal government spending per capita adjusted for inflation has grown dramatically since the end of World War II, especially in the past 10 years. Real per capita spending is now about 50 percent greater than at the peak of World War II. In addition, our current deficits per capita are larger than during World War II. (See Exhibit IV). While it is clear that we achieved a lot for the deficits that we ran and debt that we accumulated during World War II, there are serious questions regarding what we are getting for today's deficits and mounting debt burdens.

Today's deficits and debt levels are a matter of growing public concern; however they are largely driven by a range of temporary factors. Therefore, the real risk that we face is not today's deficits and our current debt but the ones that lie ahead. These are driven largely by known demographic trends, rising health care costs and outdated tax systems. Based on our current path, we are headed for deficits and debt levels that are clearly irresponsible and unsustainable. (See Exhibits V and VI).

Believe it or not, the projections that are provided by federal government agencies are in actuality optimistic absent fundamental reforms. They do not adequately consider the rise in interest rates that most assuredly will occur with any attempt to fund the projected debt levels, especially considering total expected global sovereign debt financing needs and the likely available capital. Importantly, as was the case in Greece, such a rise in interest rates can come very quickly if we lose the confidence of investors.

There is already evidence that market forces are beginning to show a concern regarding future interest rates. For example, the Federal Reserve has been buying a majority of our new debt in recent months and is now the largest holder of federal debt. China and other foreign investors are buying short-term U.S. debt in order to hedge against future increases in interest rates and declines in the value of the dollar. In addition, PIMCO, the largest domestic holder of U.S. public debt for its investors, recently divested its holdings in Treasury securities. They did so based on their belief that current interest rates do not adequately compensate investors for future interest rate risks.

The truth is that the Federal Reserve's purchases of federal debt amounts to self dealing. It may serve to hold down interest rates in the short-term but it serves to distort the market and increase our longer-term risk. Eventually, the Fed's positions must be unwound. When this occurs, we will see what real interest rates will be.

Importantly, the U.S. has the lowest average debt maturity of any major sovereign nation. In addition, we have very low interest rates by historical standards. Therefore, when interest rates rise, our interest costs will increase rapidly.

To help put things in perspective, for every 1 percent increase in interest rates the U.S. incurs about \$150 billion in additional interest costs based on today's debt levels. That is over 10 times what the U.S. currently spends on international affairs which, rightly or wrongly, many Americans question. And what do we get for interest? Absolutely nothing!!!

While the figures that I have reviewed should be enough to make a clear and compelling case for a change in our current fiscal path, there is one more dimension that I need to address. Namely, how does our debt/GDP level compare to other major nations and how does the U.S. stack up in the area of fiscal responsibility and sustainability?

Based on an IMF study issued in 2010, when you consider total federal, state and local public debt as a percentage of GDP, the U.S. had higher debt/GDP levels than the UK, Spain, Ireland and Portugal. In addition, the U.S. was less than 10-years from Greece's levels. However, when you consider the debt owed to Social Security and Medicare, we were less than three years from the debt/GDP levels that Greece had when it experienced its debt crisis and riots in the streets.

Just last month, the Comeback America Initiative (CAI) and Stanford University Masters in Public Policy program issued the first Sovereign Fiscal Responsibility Index (SFRI). This fiscal fitness index ranked 34 nations on their fiscal responsibility and sustainability. It considered a range of quantitative and qualitative measures and relied on data from respected international organizations like the IMF and OECD.

Australia ranked 1<sup>st</sup> and Greece ranked 34<sup>th</sup>. Where does the U.S. rank? Shockingly we ranked number 28. (See Exhibit VII). We are not in a good neighborhood on this list. Therefore, we must take steps to move up the list soon and before we have our own debt crisis. After all, a U.S. debt crisis would result in a much more severe recession than the last one and it would be felt around the world.

Fortunately, there were two pieces of good news that resulted from the SFRI project. First, several of the highly rated countries, for example New Zealand and Sweden, faced their own crises in the 1990s. They made tough choices and now rank high on the index, 2<sup>nd</sup> and 4<sup>th</sup>, respectively. In addition, a second ranking list was created based on an assumption that the Congress and the President were able to enact a comprehensive reform package that would achieve the same "bottom line" fiscal impact as the package of recommendations made by the National Fiscal Responsibility and Reform Commission. The result was moving the U.S. up from the 28<sup>th</sup> position to the 8<sup>th</sup> position. The U.S. would also achieve fiscal sustainability for over 40 years and move up to 3<sup>rd</sup> in fiscal governance. Therefore, why haven't the Congress and the President done more with the Commission's recommendations? Are they waiting for a crisis?

Now that I have provided a foundation of where we are, where we are headed and how we compare to others, it's important to discuss a possible way forward. First, the Congress and the President should be commended for reaching an agreement on spending levels for 2011. At the same time, Washington policymakers took way too long to do so given the fact that the result

only involved about a 1 percent reduction in total federal spending. In essence, they were arguing over the bar tab on the Titanic.

There is a fiscal iceberg floating ahead that threatens to sink our Ship of State, which is why our policy makers must turn their attention to the much bigger fiscal problems. Specifically, the fiscal 2012 budget and, much more importantly, the debt ceiling debate will represent both key challenges and opportunities.

Why do I say that? The recent budget discussions left eighty-eight percent of federal spending and the need for comprehensive tax reform off the table. This is totally inappropriate since the structural deficits that serve to threaten our collective future, are driven primarily by entitlement programs and outdated tax systems. As the National Commission on Fiscal Responsibility and Reform recognized, these areas must be on the table in order to restore fiscal sanity and ensure fiscal sustainability.

Effectively addressing our structural deficits will require major transformational reforms in all major areas of the federal government. This includes reforming Medicare, Medicaid, Social Security, other health care programs, defense and other spending cuts and constraint, and comprehensive tax reform that achieves numerous objectives, including increased revenues as a percentage of the economy over our historical average.

Given the comprehensive nature of the needed reforms, their complexity, and the political difficulties associated therewith, it will take a range of actions over a number of years in order to put the federal government on a more prudent and sustainable path.

Therefore, it is important to have a game plan for attacking this challenge in a manner that meets three key tests of desirability and feasibility of any major reform proposals. They are:

- Does the proposal make economic sense, is it socially equitable, and is it culturally acceptable?
- Does it pass a math test? Namely, if you are attempting to balanced the budget or stabilize debt/GDP at some reasonable and sustainable level, do the numbers associated with the proposed reforms add up and achieve the desired goal.
- Is it politically feasible? Namely, can it achieve majority support in the House, obtain 60 votes in the Senate, and gain the signature of the President?

If proposals do not pass the above three tests, they are likely to fail. And failure is simply not an option in connection with putting the federal government's finances in order. Failure to do so will ultimately result in a crisis that would reduce the U.S. Government's position in the world, our national security, our standard of living at home, and potentially domestic tranquility in our streets.

Given the above, what is a possible path forward? First, the Congress and the President need to agree on spending levels for fiscal 2012. This will take some time and, hopefully, will be achieved on a much timelier basis and constructive manner than for fiscal 2011. Much more importantly, over the next couple of months the Congress and the President need to agree on how much to increase the debt ceiling limit and under what conditions.

In my view, the decisions associated with the debt ceiling limit may represent the most important fiscal decisions that will occur before the 2012 elections. It seems that the Democrats and the Administration's Plan A seems to be to raise the debt ceiling in an unrestricted manner. This is totally unrealistic given today's political environment. On the other hand, the Republican's Plan A seems to be to raise the debt ceiling limit conditioned on passage of a constitutional balanced budget amendment. Irrespective of the merits of such an amendment, the votes are not likely there for its passage based on its current form. Therefore, the country needs a Plan B because doing nothing is simply not a viable option.

A Plan B should be able to achieve bipartisan support in Congress and of the President. One possible approach would be to raise the debt ceiling limit by a considerable amount conditioned on three key provisions. They are:

- Agreement on a top line level of spending for fiscal 2012. This agreed level may not occur for some time and; therefore, there may have to be two authorized levels of increase. One if agreement on fiscal 2012 spending occurs by a date certain and a lower level if it does not.
- Much more importantly, it's time to re-impose statutory budget controls with automatic enforcement mechanisms starting no earlier than 2013. Among other things, these controls would include a new element. Namely, specific annual debt/GDP targets with default mechanisms if such targets are not met. Such targets could be set based on the work of the National Fiscal Responsibility and Reform Commission and/or the Peterson/Pew Commission. The default mechanisms would include automatic discretionary spending cuts, including in the security area, an automatic freeze of indexing and waiver of premium increase limits for mandatory spending programs, and automatic temporary tax surcharges for deficit reduction. The ratio for these could be based on the good work of the National Fiscal Responsibility and Reform Commission. In addition, any temporary tax surcharge should be shown as a separate line item beginning with the 2014 individual tax returns.
- Authorize and fund a meaningful citizen education and engagement effort that draws lessons from the Social Security effort during the Clinton Administration in 1998 and the Peterson/MacArthur/Kellogg effort in the summer of 2010. I took part in both efforts, which involved America.

The above approach would demonstrate to our foreign lenders and the American people that Washington is serious about addressing the structural deficits that lie ahead and putting our nation's finances on order. They would also provide time and a means for the public to be informed and engaged regarding the magnitude of the fiscal challenges that we face and the types of reforms that will be necessary to effectively address them. This will be necessary in order for elected officials to be able to make the necessary decisions without losing their jobs.

Importantly, the default mechanisms are just that. They would not come into effect unless the Congress and the President failed to act in a timely or effective manner. In addition, the Congress and the President could agree on reforms that result in a different ratio and mix of spending cuts and revenues than the default mechanism. There are clearly significant philosophical differences in how best to address our fiscal gap. At the same time, there is a growing consensus that we must act to close it.

Finally, and very importantly, the above approach will ensure that something happens if the Congress and the President fail to act. This is critical since a debt crisis could incur in the U.S. within 2-3 years absent substantive action.

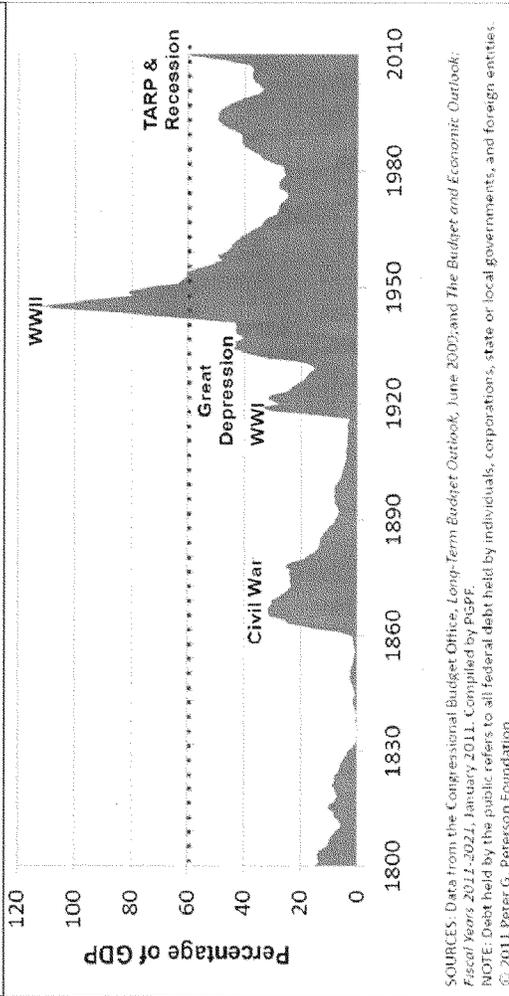
Thank you again for the invitation to testify. In summary, it's time to focus on the future, put the public interest over special interests and progress over partisanship. We must take steps to address our structural deficits and put our finances in order before it's too late. It's time for leadership rather than more laggardship and crisis management from Washington. Our nation's founders and our families deserve it, and our collective future depends on it.

# Exhibit I



## Historical Debt Burdens

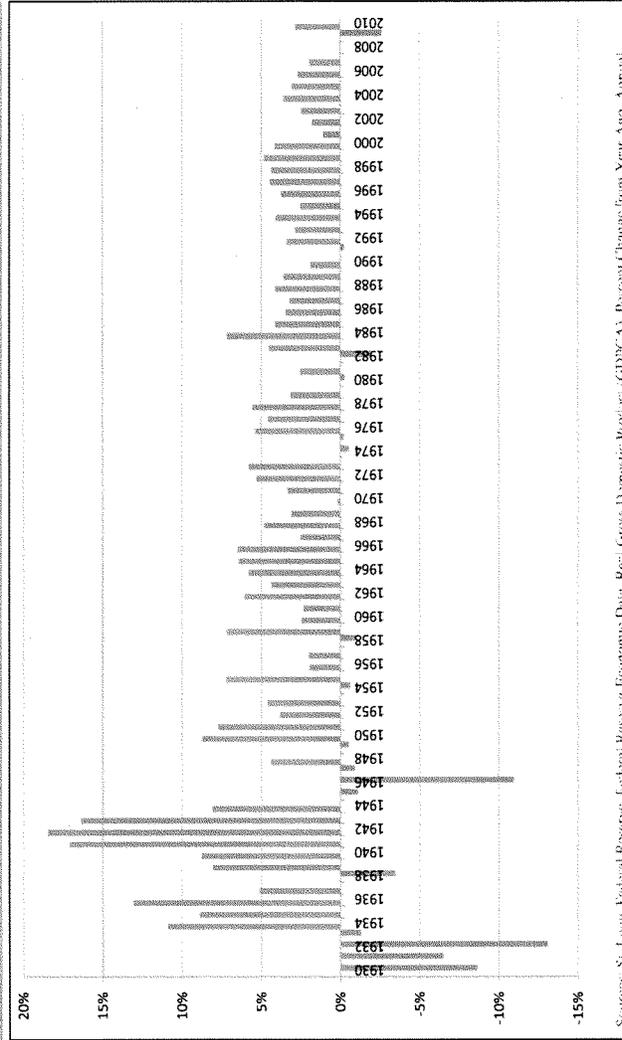
Since 1800, U.S. Debt Held by the Public has exceeded 60 percent of GDP (the maximum debt ceiling used by the European Monetary Union) only during World War II



SOURCES: Data from the Congressional Budget Office, *Long-Term Budget Outlook*, June 2003; and *The Budget and Economic Outlook: Fiscal Years 2011-2021*, January 2011. Compiled by PIGPP.  
NOTE: Debt held by the public refers to all federal debt held by individuals, corporations, state or local governments, and foreign entities.  
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## Exhibit II

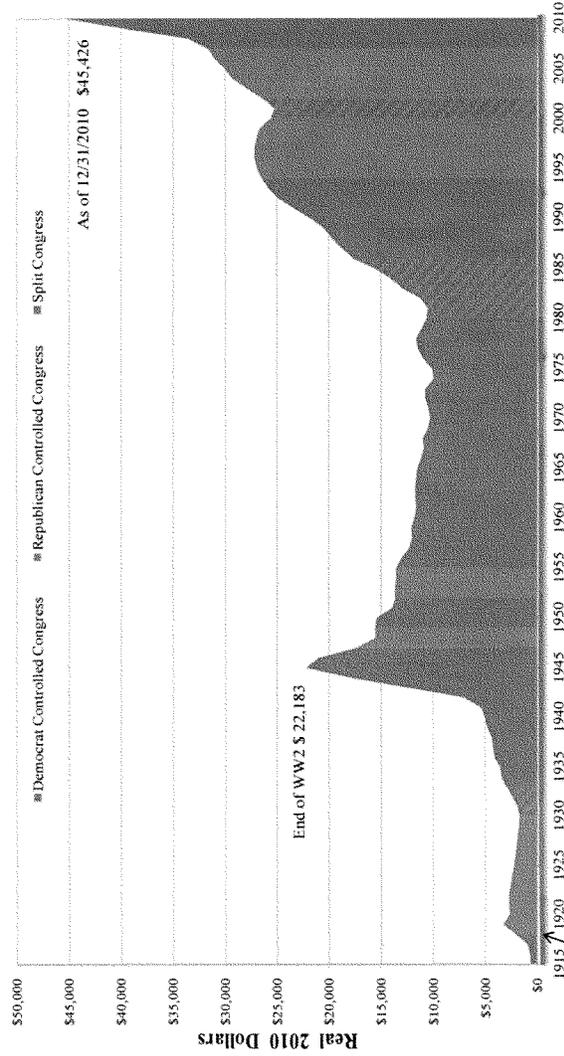
### Historic Annual Economic Growth



Sources: St. Louis Federal Reserve, Economic Data; Real Gross Domestic Product (GDP-C). Percent Change from Year Ago, Annual.

# Exhibit III

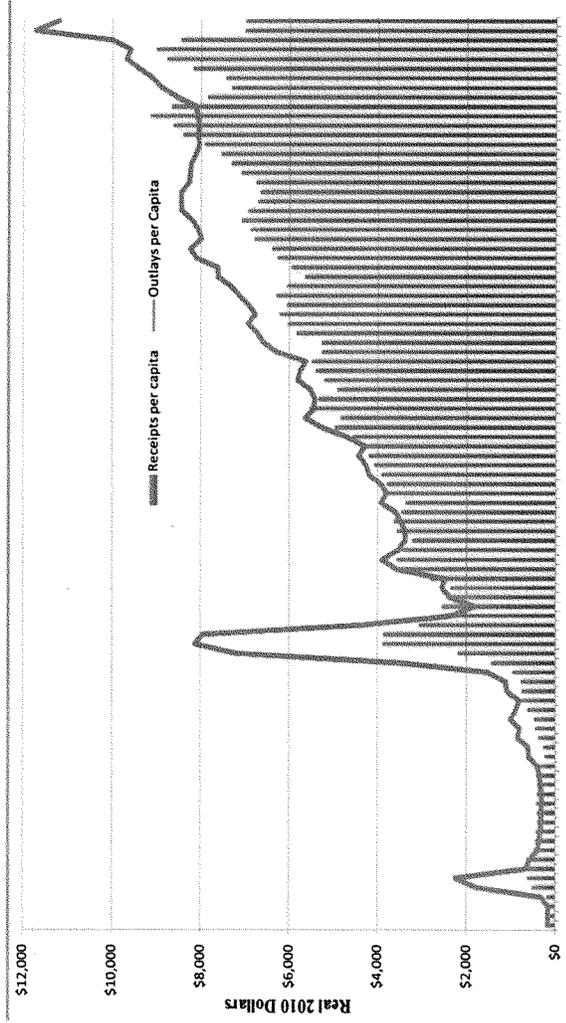
## Federal Debt Per Capita & The Political Party In Power



Source: U.S. Census Bureau, U.S. Department of Treasury, U.S. Bureau of Labor Statistics, U.S. House and U.S. Senate. Compiled by ICAD. NOTE: All amounts are adjusted for inflation and in 2010 Dollars. Federal Debt is the total public debt outstanding and intragovernmental holdings.

# Exhibit IV

## Historical Receipts & Outlays

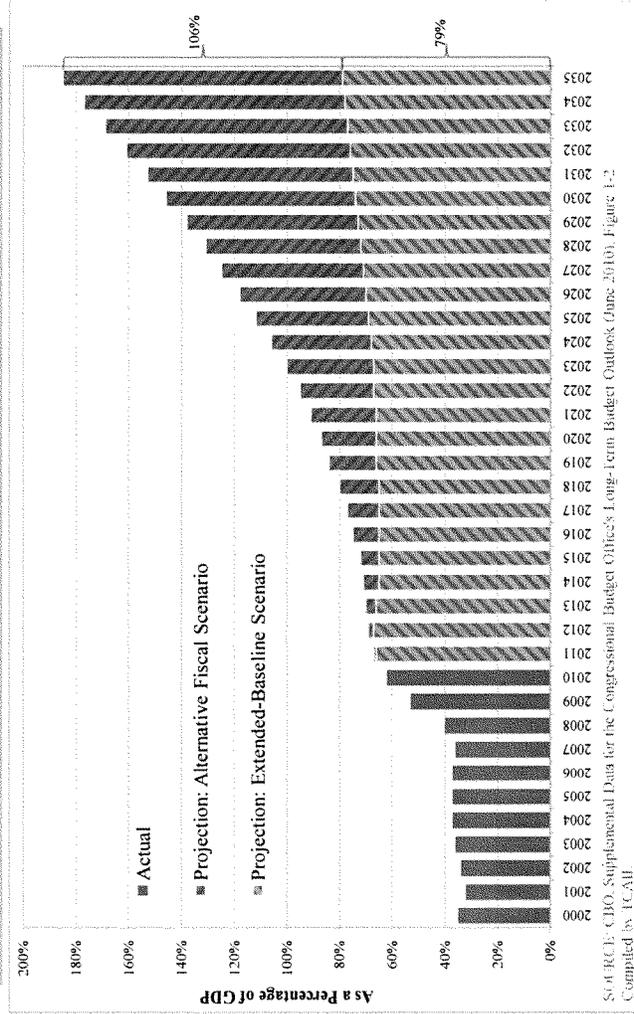


1914 1918 1922 1926 1930 1934 1938 1942 1946 1950 1954 1958 1962 1966 1970 1974 1978 1982 1986 1990 1994 1998 2002 2006 2010

SOURCES: OMB Historical Tables, Table L.3 - Summary Receipts, Outlays, and Surpluses or Deficits (-) in Current Dollars; Bureau of Labor Statistics, and U.S. Census Bureau. Compiled by ICMA.

# Exhibit V

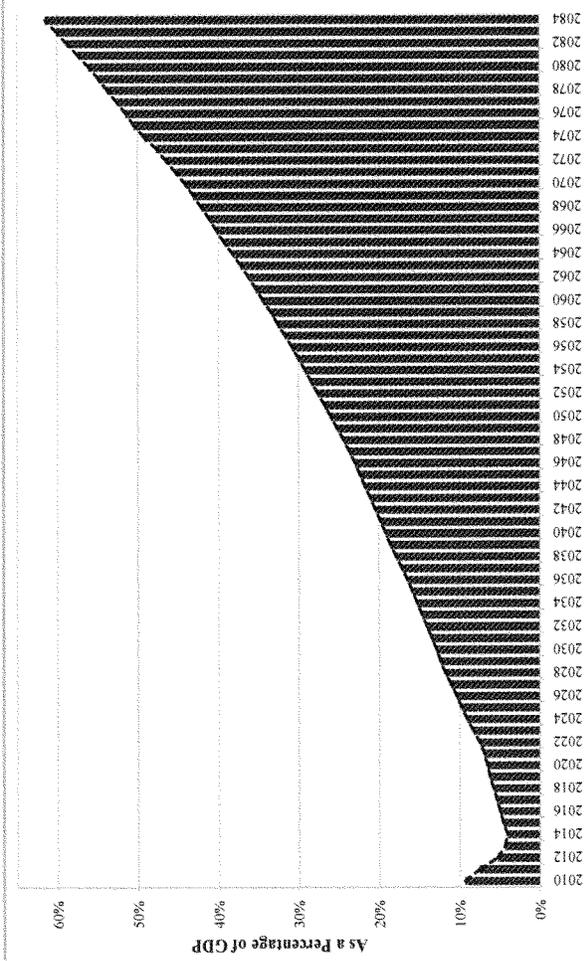
## CBO's Public Debt Projections



Source: CBO. Supplemental Data for the Congressional Budget Office's Long-Term Budget Outlook (June 2010), Figure 1-2. Compiled by ICAM.

# Exhibit VI

## CBO Alternative Estimate of Projected Federal Deficits



SOURCE: CBO Long-Term Budget Outlook June 2010, Data Underlying Scenarios and Figures, Summary, Alternative Fiscal Scenario. Compiled by ICAII

## Exhibit VII



### Fiscal Fitness Index: Overall Results

Rank	Country	Rank	Country
1	Australia	18	Mexico
2	New Zealand	19	Israel
3	Estonia	20	Slovenia
4	Sweden	21	Austria
5	China	22	Finland
6	Luxembourg	23	France
7	Chile	24	Spain
8	Denmark	25	Germany
9	United Kingdom	26	Belgium
10	Brazil	27	Italy
11	Canada	<b>28</b>	<b>United States</b>
12	India	29	Hungary
13	Poland	30	Ireland
14	Netherlands	31	Japan*
15	Norway	32	Iceland**
16	Slovak Republic	33	Portugal
17	Korea	34	Greece

Source: Sovereign Fiscal Responsibility Index.

Note: \*Japan's debt was downgraded by Moody's 1/29/11.

\*\* Iceland has already defaulted and its Sustainable Fiscal path reflects reforms made since default occurred

**United States Senate Committee on Finance Hearing  
Perspectives on Deficit Reduction  
April 13, 2011**

**Responses to Questions for the Record From David Walker**

**Questions from Senator Baucus**

1. The U.S. Government has historically been able to borrow money easily, at relatively low interest rates. Does the study you reference in your testimony, the Sovereign Fiscal Responsibility Index, factor in the ease with which the United States has been able to finance its debt compared to other countries? If so, how? If not, why? Where do you project current investors in U.S. securities will invest their funds if U.S. debt as a percentage of GDP increases? Who would be our main “competitors” for investment in this scenario?

*Answer to Question 1:* While the U.S. has historically been able to borrow the funds that it needs, it has not always been able to do so at low interest rates. In addition, history shows that if investors lose confidence in the willingness and ability of a country to address large, known and growing structural deficits and escalating debt burdens, interest rates can rise both suddenly and dramatically.

The U.S. currently has the lowest average maturity of any major nation for its sovereign debt. In addition, interest rates are near historic lows. Therefore, the U.S. has huge interest rate risk. Furthermore, the Federal Reserve has been buying U.S. debt, which tends to distort true market conditions. The Fed’s positions will have to be unwound at some point.

Importantly, other countries are projected to need to borrow large sums in the future, which will likely drive up overall interest rates. In addition, investors have many investment options other than sovereign debt.

The Sovereign Fiscal Responsibility Index considers a variety of factors that are applicable to all of the countries that were analyzed. Therefore, it does not expressly consider the historical ability of the U.S. to finance its debt. Rather, the index is focused more on the future and factors such as estimated debt/GDP limits, current projected deficits and debt burdens, reliance on foreign lenders, and the nature and strength of the nation’s fiscal governance system and controls.

In summary, the U.S. will be able to finance its debt in the future, but the only real question is at what interest rates. Importantly, additional interest costs will only serve to further increase projected deficit and debt levels, which are already imprudent and unsustainable.

2. The Ryan budget would ask seniors, most on low, fixed incomes, to pay another \$6,000 more than they would pay under current law for their Medicare benefits. On the other side of the ledger, the Ryan budget would provide a \$100,000 tax cut for those making a million dollars a year or more.

The Center on Budget and Policy Priorities estimates that low-income families would pay for two-thirds of the deficit reduction in the Ryan budget. Shouldn’t fairness and balance be part

of any debate over how to reduce the deficit? Shouldn't any deficit reduction plan hold harmless the least-advantaged in society?

I know in the largest deficit reduction agreements in recent times – 1990 and 1993 – fairness was considered the most important test.

Should the standard of fairness once again guide us in finding ways to reduce the deficit this year?

*Answer to Question 2:* Yes. In my view, in order for any fiscal restructuring plan to be viable it should:

- Make economic sense; be socially equitable and culturally acceptable;
- Stabilize debt/GDP at reasonable and sustainable levels within a reasonable and credible time frame; and
- Be politically feasible.

In my view, given the size and nature of our structural imbalance, everything needs to be on the table in order to put our fiscal house in order. This includes budget process reforms and controls, social insurance and health care reforms, defense and other spending cuts and constraints, and comprehensive tax reform that will generate more revenues than the recent historical average as a percentage of GDP. I also believe that we need to maintain a reasonable, secure and sustainable social safety net.

3. In Dr. Blinder's testimony, he talks about two factors that cause growth in health care spending: "increasing longevity" – basically life expectancy – and rising relative prices for health care – what we pay for health care for each person who receives services.
  - Dr. Blinder says that in order to tackle health care costs and our long-term budget challenge, we need to decrease the growth in the relative price of health care.
  - Isn't that exactly what the health reform law does by increasing efficiency in our health care system? The law provides financial rewards to doctors and hospital to provide high quality care, not just the quantity of care.
  - How does dismantling Medicare and making it a voucher program, like the House Budget Committee has proposed, decrease the relative price of health care? How does it improve efficiency in the delivery of our health care system?
  - It is my sense that it will not. Rather it will simply shift costs onto the backs of seniors. What are your thoughts?

*Answer to Question 3:* Conversion to a premium support model will result in capping the government's cost while increasing competition in the marketplace. The resulting increased competition over cost and quality should have a positive, but difficult to determine, impact on overall health care costs and outcomes.

In my view, the federal government needs to engage in comprehensive reform of our health care system to provide a universal level of care that is appropriate, affordable and sustainable. The federal government has over-promised in the area of health care, and current promises need to be rationalized. The federal government also needs to establish a budget for federal health care costs, just as every other major nation has done. Premium support is one way to do this, but not the only way to do it. In addition, the federal government needs to engage in a range of other reforms designed to reduce costs and improve outcomes in the overall health care system.

4. Some economists, and some of my colleagues in the Senate, believe that any deficit reduction package should include a balance of spending cuts and tax increases. With so many expiring provisions in the tax code, though, it's sometimes unclear when a tax change is a tax cut or tax increase.

For example, as I understand it, 30% of the deficit reduction achieved by the Deficit Commission's "illustrative plan" is due to tax increases relative to CBO's "alternative fiscal scenario" baseline. But it actually reduces taxes relative to current law.

And my understanding is that the Ryan plan reduces tax revenues by over \$4 trillion over 10 years relative to current law. So many or most of its proposed spending cuts are be used for tax cuts, especially for high-income taxpayers, and not to reduce deficits.

- What baseline do you think we should use when thinking about the proper balance between spending cuts and tax increases?
- And what do you think is the proper balance between spending cuts and tax increases?

*Answer to Question 4:* I believe that it is appropriate to use the unadjusted current law baseline in determining the proper balance between spending cuts and tax increases, with one big exception. In my view, the current law baseline numbers for projected health costs are unrealistic and unsustainable. My view is consistent with the views of the Office of the Chief Actuary of Medicare which gave an adverse opinion on the Medicare Trustees' cost projections in both 2010 and 2011. Those Trustee projections were based on assumptions that were generally consistent with those used by CBO in preparing the current law baseline.

I also believe that achieving fiscal sustainability will require both spending cuts and revenues as a percentage of GDP in excess of the historical average. Therefore, everything needs to be on the table as part of a fiscal sustainability plan.

I believe that achieving fiscal sustainability should involve much more in spending cuts than revenue increases. As I mentioned during the hearing, I would suggest three parts spending cuts and one part revenue as a way to close our longer-term fiscal gap, and also as a default for any debt/GDP enforcement mechanism. Finally, I believe that any comprehensive fiscal plan should focus on achieving a reasonable and sustainable level debt/GDP over stated time periods (10-25 years).

**Questions from Senator Roberts**

1. In your testimony, you state that “effectively addressing our structural deficits will require major transformational reforms in all major areas of the federal government. This includes reforming Medicare, Medicaid, Social Security, other health care programs, defense and other spending cuts and constraint(s), and comprehensive tax reform that achieves numerous objectives, including increased revenues as a percentage of the economy over our historical average.”

Why should an objective of tax reform be to increase taxes? How high above historical averages would you suggest taxes would have to be increased to address the deficits?

*Answer to Question 1:* Under current law, federal taxes as a percentage of GDP are expected to reach over 23 percent and climbing by 2035, as compared to a historical average of about 18 percent over the past several decades. In my view, this is unacceptable. At the same time, under current law, federal spending levels as a percentage of GDP are expected to reach over 28 percent and climbing by 2035 versus a historical average of about 20.8 percent over the past several decades. This is also unacceptable, yet it is unrealistically low based on the alternative Medicare cost estimates prepared by the Office of Medicare’s Chief Actuary.

In my view, the federal government has grown too big, promised too much and waited too long to restructure in order to achieve fiscal sustainability at historical average tax levels. As I noted at the hearing, I would suggest a ratio of three parts spending cuts and one part revenue increases as a means to achieve fiscal sustainability. Importantly, additional revenues should be achieved through comprehensive tax reform that, among other things, broadens the base of income subject to taxation, while lowering marginal tax rates.

2. In your testimony, you suggest reimposing budget controls with automatic enforcement mechanisms. As I understand it, these budget controls could include specific debt-to-GDP targets with default mechanisms that would kick in if these targets are not met.

One of the default mechanisms you suggest is a temporary tax surcharge targeted to deficit reduction. Can you expand further on how such a surcharge might work, who would pay it, the amount, how much it would raise, and how long it might need to be in effect?

*Answer to Question 2:* The temporary tax surcharge would only come into effect if the Congress and the President failed to achieve the reforms necessary to hit the applicable annual debt/GDP target. If the target was missed, the difference would be quantified in dollar terms, and allocated between spending cuts and additional revenues. I recommended a ratio of 3:1 spending cuts to additional revenues at the hearing.

The additional revenue amount could take the form of a temporary tax surcharge for deficit reduction, which would appear as a separate line item on individual tax returns. The actual amount could then be based on a standard percentage applied to adjusted gross income or taxable income on the individual’s tax return.

**Question from Senator Ensign:**

1. There are currently various proposals in Congress to increase taxes to help alleviate deficit and long-term debt concerns. Judging by the large size of the United States tax code, taxes permeate our economy. Which tax rates are harmful to the economy and which tax rates hamper economic growth more than others?

*Answer to Question 1:* High marginal tax rates can serve to discourage additional economic activity. In addition, high corporate tax rates can serve to undercut our nation's competitiveness, economic growth and job creation ability.

## COMMUNICATION

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### Why the Deficit Commission and Senator Warner are Wrong on Tax Policy and Our Tax Plan is Right

By Tom Pallow of [ThirdWayProgressives.org](http://ThirdWayProgressives.org); contact: 202-902-1133

It is time that we, in regards to tax and fiscal policy, rid ourselves of our ridiculous catch 22.

What is this catch 22? If we raise personal income taxes on the wealthy in order to acquire the federal tax revenue we need, we will be taking money away from private sector job creators at a time when private sector jobs are what we most need. But, if we don't raise taxes on the wealthy, we will go further in debt which could raise interest rates, and we will not have the federal revenue we need to keep consumer demand up either through the tax code or government spending just at a time when a lack of consumer demand is the biggest factor that is keeping our economy weak.

Of course, if there were any Fed funds rate left to lower, the Fed could lower rates to stimulate the economy, and we would not have to worry about this catch 22. But the Fed rate is essentially 0, and even if the rate were quite high, breaking our catch 22 would create a much more economically efficient way to tax.

So how is this catch 22 broken? Raise personal income tax rates on the wealthiest 2% of income earners up to where President Obama wants to raise them or above that. Then, award a tax credit worth \$.15 on the dollar for all W2'd US employee expenses up to the payroll tax cap. Also, set a floor cap on how low a private business can exercise these credits to the point as though the personal income tax bracket rates were 5%, 10%, 20%, 28%, 33%, and 35%. Remember, only 19% of all the income that is generated by the top 2% of US income earners is the profits of any business that is taxed as personal income that has even one employee in the US.

Such a tax plan would raise more federal revenues than President Obama's personal income tax plan while cutting the effective tax rates to below where they are today for the employers of 98% of Americans who work for a private business. You can look on the website, [ThirdWayProgressives.org](http://ThirdWayProgressives.org), for details on how this is done, along with a C Corporation, Capital Gains, and FICA tax plan. Each plan achieves the same basic goal of raising more federal revenues while incentivizing and creating more private sector jobs in the US.

But this paper is about why the Deficit Commission and Senator Mark Warner are wrong on tax policy, and why our policy would work much better. So why is this so?

The primary feature of successful tax policy that the Deficit Commission's tax reform plan leaves out is the promotion of economic growth. That is, successful tax policy needs to achieve three primary goals. Firstly, of course it needs to raise needed government revenues. But secondly and thirdly, it should increase consumer demand, and it should lower the cost of capital for employers in the US. Achieving goals two and three will increase economic growth. The higher the economic growth of the country, the more government revenues will be raised without having to raise tax rates.

Further, even though government tax revenues can be used to increase consumer demand by increasing government spending and/or lowering tax rates for the poor and middle class, it is only profits and increases in wages in the private sector that can provide growth to the economy as a whole over the long run. Increases in wages and salaries will increase government revenues, and private sector profits can be reinvented in the economy. These are the only ways to grow the economy over the long run.

If a government is very inefficient and small relative to GDP, an economy will increase its growth rate over the long run due to increases in efficient government spending. However, our advanced nation economy now has total government spending, federal, state and local, at about 44% of GDP. Today in the US, increases in government spending would not be likely to increase overall economic efficiency, productivity, long term employment careers, or long term economic growth. We need the private sector to do that now.

So how do the Deficit Commission's tax proposals stack up when compared to our plan in regards to raising new federal revenues, increase consumer demand, and lower the cost of capital for US businesses?

The truth is that their plan compares very poorly. Their plan appears to raise about \$925 billion over 10 years, while our plan would raise about \$1.25 trillion over 10 years. However, their plan compares most poorly when it comes to promoting economic growth. It compares poorly when it comes to increasing consumer demand and lowering the cost of capital for businesses in the US.

For example, the commission's first and most favored option is to lower all personal income tax rates in exchange for all tax deductions being eliminated. Today's 33% and 35% rates or next year's 36% and 39.6% rates would go to 23%. Today's 25% and 28% rates would go to 14%, and today's 10% and 15% rates would go to 8%. However, in order to get to these lower rates everyone would have to get rid of all current deductions: the Child Tax Credit, the Earned Income Tax Credit, the Home Mortgage Interest Deduction, and all deductions for retirement savings, among other deductions.

The problem here is that this type of trade off would greatly decrease consumer demand, and therefore slow economic growth. It would decrease consumer demand because those in the top 5% of US income earners would be getting a much better deal as a percentage of their total income than would the bottom 95%. That is, the top 5% of income earners pay about 60% of all federal personal income taxes, however, they are only responsible for about 22% of all tax deductions, and this number is much lower when including the EITC. So this would create a direct shift in income to the top 5% from the bottom 95%. Moreover, since the top 5% has an average savings rate of about 30%, while the bottom 95% only saves about an average of 3% of their income, this would mean that the overall economy would suddenly have a large chunk of consumer demand pulled from it, as well as a shift in income from the poor and middle class to the rich.

As for the ability of the Deficit Commission's tax plan to lower the cost of capital for businesses, it would do the opposite of that. Keep in mind that the Deficit Commission's tax plan would raise about \$80 billion a year in 2015 and about \$925 billion over 10 years, so it is also a net increase in taxes on the top 5% of income earners as well as all others. Most importantly, it is a tax increase in a way that would slow economic growth. This is, unlike our tax plan, it would increase taxes equally on those who run businesses that hire employees in the US with those who do not. Therefore, the Deficit Commission's plan would raise the cost of capital for American businesses that hire in the US, and thus slows down the economy. Our plan of course would do the opposite of both these things.

As for the Senator Mark Warner tax plan, it is a great pleasure to see that the Democratic Party is finally moving tax policy closer towards where it needs to be in the global economy of the 21<sup>st</sup> century. However, there are several ways in which the Warner plan needs to move closer to our plan and in one important way the plan fails miserably.

First of all, the tax cuts in Warner's plan lay primarily in "targeted" capital expenses, and in our plan they rest primarily in W2'd US employee expenses. If, outside of raising government revenues, the primary goal of American tax policy is to help create American private sector jobs, especially good paying US private sector jobs, than nothing does this more directly and efficiently than a tax credit for US employee expenses. Whereas Capital Expenses for a tax credit for creating jobs in the US is a much more amorphous concept to nail down from a tax avoidance perspective. Capital expenses are much more difficult to be traced as to where they are actually being used, whether they are being used in the US or in a foreign country. Yet W2'd US employee expenses are about as definable and enforceable a tax concept as could exist when it comes to determining whether a business expense is being spent in the US or not. This is not to say that tax cuts or credits for "targeted" capital expenses would be a bad thing. They

are great, especially for a few years during a recession, and especially when needing to rebuild an industrial base.

Secondly, our tax credits for US employee expenses would only cost about 22% of the federal revenue that would be raised under President Obama's personal income tax plan. The Warner plan proposes using 100% of these possible new federal revenues towards tax credits for US capital expenses, R&D expenses, and payroll tax cuts. It is unclear what the percentage breakdown for these tax credits and cuts would be. Yet it is easy to argue that US Employee Tax Credits as explained in our personal income and C Corporation portions of our plan would be a great addition to the three Warner tax cuts. In fact, because of the reasons mentioned above, that they are more direct and enforceable, it is easy to argue that they should be the largest single component. It would also be best to increase the payroll or FICA tax cut contribution to the Warner plan, but our plan would create more jobs given that it is larger in size and structure. Also, the best way to merge the Warner plan with the C Corporation portion of our plan would be to install the tax cuts in our C Corporation plan for three years before instituting the tax increases in that portion of our plan.

This brings us to perhaps the important component of our plan and the Warner plan, and that is, how are these plans going to raise any new federal tax revenues? Obviously, neither our plan nor Senator Warner's plan would raise any new federal revenues until 2013. Warner's plan would raise taxes immediately to the personal income tax levels that Obama has proposed, but it would spend 100% of these revenues on tax credits for capital, R&D, and payroll expenses, most of which look to be permanent tax credits. Therefore, Warner's plan would raise little if any new federal revenues. However, our plan features immediate tax cuts for businesses, with increasing tax rates in 2013 that would more than pay for our tax cuts. Our plan would collect in 2013 as much as 80% more federal revenues than President Obama's plans, 35% more than the Deficit Commission's plan, and apparently about \$1.25 trillion over 10 years more than Senator Warner's plan!

Moreover, in order to improve our economy it is important not to raise taxes on anyone while our economy is still weak. The Warner plan would raise taxes on the top 2% of income earners immediately. While the top 2% of US income earners save about 35% of their income on average, this still means that they spend 65% of it. Such an immediate tax increase would pull consumer spending out of the economy, and therefore slow down the economy. However, our plan would work best in that it would not increase any taxes until three years out. It would give the economy three years to grow, and therefore three years to shift the spending in the economy from the top 2% to the poor, middle class, and businesses that are hiring in the US.

Also, because our plan would raise 80% more federal revenues than President Obama's plan, 35% more than the Deficit Commission's plan, and apparently about \$1.25 trillion over 10 years

more than Senator Warner's plan, our plan would immediately signal to the bond market that we are serious about our national debt. This alone would probably be enough to keep interest rates low enough to no longer need any more QE2, and certainly in three years there would be no need.

So how do our, the Deficit Commission's, and Senator Warner's tax plans grade when it comes to the three primary goals of tax policy, raising government revenues, increasing consumer demand, and lowering the cost of capital for businesses in America?

The Deficit Commission's tax plan does raise revenue, but it fails by lowering consumer demand and raising the cost of capital for American businesses. Warner's plan certainly lowers the cost of capital for businesses in the US. But it is a mixed picture on increasing consumer demand, and it fails miserably when it comes to raising government revenues. Only our plan accomplishes all three primary goals, and it surpasses the other two plans in all three areas!

