CBO'S BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2004–2013

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

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CONTENTS

CBO'S BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2004–2013

THURSDAY, SEPTEMBER 4, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:07 a.m. in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Shays, Thornberry, Hastings, Portman, Brown, Putnam, Garrett, McCotter, Diaz-Balart, Hensarling, Spratt, Moran, Hooley, Baldwin, Moore, Lewis, DeLauro, Edwards, Scott, Capps, Baird, Cooper, Emanuel, and Davis.

Chairman NUSSLE. Good morning. This is a full committee hearing in which we will hear from the Congressional Budget Office and the very distinguished director of that office about the budget and the economic outlook for fiscal years 2004–13, which was released last Tuesday.

Before I begin, I would like to acknowledge Rich Meade and his new arrival. His daughter was born just before the August recess. We welcome Rich back and congratulations on your new addition.

Today our witness is Dr. Doug Holtz-Eakin, the Director of the Congressional Budget Office.

Dr. Holtz-Eakin, once again, welcome back to the committee. We look forward to your testimony here today. And welcome back to the rest of the committee members. I hope everyone has had an enjoyable and productive August. I know I did.

And today we will pick off—we will pick up where we left off in July—and maybe even pick off, not the director though. But we will pick up where we left off in July, looking at the Federal budget.

As you may recall, we talked to the OMB Director just before we left. And really, since our last hearing some things have changed and some things have not. What has not changed is that we still have substantial—and, in fact, slightly larger than previously forecasted short-term deficits—$401 billion for this year, $480 billion for next year as predicted by the Congressional Budget Office. What has not changed is that these deficits do matter. I believe that, I have always believed that, and that is in part why we continue to address them in the hearings we have today.

There are maybe some who don't think that deficits matter, but I will leave that to their opinion. I believe deficits do matter.

What has not changed is that this report generated the usual round of finger-pointing. And if you didn't hear it, I did, but that may be because I come from Iowa, and these days there is always somebody else to blame for just about everything. And what has not changed is that many of these same people who are pointing fingers really don't have any answers. There are a few brave souls that have come out and suggested—I am not sure if it is bravery or lunacy, depending on your point of view—but have decided that raising taxes at this point in time, with the economy just barely getting moving again, would be the thing to do.

I don't believe raising taxes at this time would or should be an option.

So now let us talk about what has changed since we have met. Since OMB released its report in July and since CBO closed its books on its report over 2 months ago, our economy has for the first time in a long time shown some signs of turning the corner to sustained economic growth. We have had higher than expected real GDP growth in the second quarter, stronger tax relief-induced retail sales and manufactured durable good shipments and orders in July, surging manufacturing activity in August, and an outlook for higher than previously expected real GDP growth in the second half of the year. And even without the most encouraging recent economic news, CBO does project the economy, quote, "poised for a more sustained recovery." That is the good news.

Of course, if you don't have a job yet from this recovery, the economy has not yet turned the corner. And so there is more work that must be done. So with that in mind, let us go over a few things that I think most of us can agree on.

First, we share a concern over these deficits. Second, we should be able to agree at this point that the tax cuts did not cause these deficits. And according to CBO, had we not passed the tax cuts, we would still have substantial deficits, about $200 billion, and there would be many more Americans out of work. And, finally, the recent economic news makes it clear that the tax relief measures are doing precisely what they intended to do, albeit at a slower rate than we would have liked, and that is to help stem the job loss and get the economy moving in the right direction.

So now that the economy is moving forward, we all need to shift our focus to the other side of the ledger, which is spending. CBO has done several models of the baseline, and every one showed even greater problems ahead if we continue at our current rate of spending. And as Director Holtz-Eakin has testified to this committee before, we cannot simply grow our way out of this problem. It must be a combination of economic growth and spending restraint.

We have been very, I think, generous in our spending over the past few years. I enjoyed sending out the news releases to my constituents as much as anyone in the Congress and anyone on this committee. But, my friends, the times have changed. Just like the families and businesses we represent, we must adjust our spending to reflect the current circumstances. And let me just be clear. I am not saying and never have said that we have to cut programs, benefits, or services. This is not about cuts. What this is about is getting our spending down to a level that is sustainable, which at present it is not.

For the past several years, government spending has well exceeded the rate of inflation. This committee has spent a great deal of time and effort this year discussing how best to reduce waste, fraud, and abuse within our Federal Government's mandatory programs. That effort is well under way in the committees of this Congress, and I have no doubt that our efforts will pay off in more efficient, reliable, well-executed programs and in tax dollars better spent. Even if it is one of those dollars better spent, that is better than we were the day before.

But while the bulk of our Federal dollars are spent on the mandatory side, we cannot pretend that our discretionary spending does not count. Many of you have claimed dire concern at the size of the current deficits. Trust me, I share that concern.

So what I would suggest to you is this: Let us not add to it. I think that sounds pretty reasonable. Let us not on the one hand bemoan the deficits, then on the other hand demand more spending. Let us all try and control ourselves. Let us all acknowledge that we are not going to have any extra money for a while, and actually stick to the budget. Let us try that for a change as well.

At present, we have passed 11 of the 13 appropriation bills, and I think we have done a pretty good job so far. But the challenge for the remainder of the session of Congress is to hold the line on the budget resolution level for discretionary spending.

Let us not lose the lessons of the past few years or of this report. CBO's report shows that it is incumbent on lawmakers to control spending if they truly care about achieving a balanced budget. We have to control what we can control.

Let us use our time today with Director Holtz-Eakin to discuss to what extent we must curb our spending to get these deficits under control. And let us use this hearing to commit, all of us, to doing what we know we need to do to get our budget back in balance, keep the economy growing, and rein in this body's out-of-control spending.

I want to thank the Director for his report and for the many options that CBO has put in here. It is, I think, a detailed report and one that I know we can use and will be useful as we march ahead toward controlling this problem.

And now I would like to turn to Mr. Spratt for any comments he would like to make.

[The prepared statement of Mr. Nussle follows:]

PREPARED STATEMENT OF HON. JIM NUSSLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Good Morning. Today the Budget Committee will hear from the Congressional Budget Office on its economic and budget update The Budget and Economic Outlook: Fiscal Years 2004–13 which was released last Tuesday.

Our witness today is Dr. Douglas Holtz-Eakin, the Director of the Congressional Budget Office. Dr. Holtz-Eakin, once again, welcome back.

Also, to this committee, I welcome of you back. I hope everyone had a productive August recess, and an enjoyable Labor Day.

Today, we will pick up just where we left off in July the outlook of our Federal budget. Since our last hearing, some things have changed, and some things have not. What has not changed is that we still have substantial, and, in fact, larger than previously-forecasted short-term deficits $401 billion this year, and $480 billion next year as predicted by CBO. What has not changed is that I still believe these deficits are a problem and that they must be addressed. What has not changed is that this report generated the usual round of finger-pointing about the cause of these deficits. And what has also not changed is that those same people who are more than willing to point fingers when our fiscal situation gets tough once again failed to offer any sort of solution to get these deficits under control, or even extend themselves to join with the efforts already under way.

Unfortunately, that too has not changed.

Now, let's talk about what has changed since we last met. Since OMB released its report in July, and since CBO closed the books on its report over 2 months ago, our economy has, for the first time in a long time shown signs of turning the corner to sustained economic growth. We've had higher than expected real GDP growth in the second quarter, stronger tax-relief-induced retail sales and manufacturers' durable goods shipments and orders in July; surging manufacturing activity in August; and an outlook for higher than previously expected real GDP growth in the second half of the year. And, even without the most encouraging, recent economic news, CBO does project an economy quote "poised for a more sustained recovery."

So, with this in mind, let's go over some things I think most of us can agree on: First, we all share a concern over these deficits. Second, we should be able to agree, at this point, that the tax cuts did not cause these deficits.According to CBO, had we not passed the tax cuts, we would still have a substantial deficits—about $200 billion but there would be many more Americans out of work. And finally, the recent economic news makes it clear that the tax relief measures are doing precisely what they were intended to do albeit at a slower rate than we would have liked and that is to help stem the job loss, and get the economy moving in the right direction.

So, now that the economy is moving forward, we all need to shift our focus to the other side of the ledger and that is spending. CBO has done several models of the baseline and every one showed even greater problems ahead if we continue at our current rate of spending. As Director Holtz-Eakin has testified to this committee before, we cannot simply grow our way out of this problem it must be a combination of economic growth and spending restraint. We have been very, very generous with our spending in the past few years.

I enjoyed sending out the good news press releases to my constituents in Iowa as much as everyone else in this Congress. But my friends, times have changed. Just like the families and businesses we represent we must adjust our spending to reflect the current circumstances. Let me be clear: I am not saying and never have said that we need to "cut" programs, benefits or services. This is not about cuts. What this is about is getting our spending down to a level that is sustainable, which at present, it is not. For the past several years, government spending has well exceeded the rate of inflation.

This committee has spent a great deal of time and effort this year discussing how we best reduce waste, fraud and abuse in the Federal Government's mandatory programs. That effort is well under way in the committees of this Congress, and I have no doubt that our efforts will pay off in more efficient, reliable, and well-executed programs, and in taxpayer dollars better spent. But while the bulk of our Federal dollars are spent on the mandatory side, we cannot pretend that our discretionary spending doesn't count.

Many of you have claimed dire concern at the size of the current deficits. Trust me, I share your concern. So what I would suggest to you is, let's not add to it.

Sound reasonable?

Let's not, on one hand, bemoan the deficits, then on the other, demand more spending. Let's all try that. Let's all acknowledge that we're not going to have any "extra" money for awhile, and actually stick to our budget. Let's try that, too.

At present, we have passed 11 of the 13 appropriations bills, and we've done a pretty good job. But the challenge for the remainder of this session of Congress is to hold the line on the budget resolution level for discretionary spending.

Let's not lose the lessons of the past few years or of this report. CBO's report shows that it is incumbent on lawmakers to control spending if they truly care about achieving a balanced budget. Let's use our time with Director Holtz-Eakin to discuss to what extent we must curb our spending to get these deficits under control. And let's use this hearing to commit all of us to doing what we KNOW we need to do to get our budget back to balance. Keep the economy growing, and reign in this body's out of control spending.

Thank you, and I now turn to Mr. Spratt for any opening comments he may have.

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

And Dr. Holtz-Eakin, welcome to our hearing, and thank you for the good work that underlies the August update.

Since May of 2001, every CBO report on the budget has been worse than the one before it, and this update is no exception. It shows that when the books are closed on fiscal 2003—less than 30 days—the deficit will hit an all-time high, $401 billion. This exceeds the largest deficit heretofore recorded, $290 billion, which was incurred in the last fiscal year of the first President Bush.

The deficit CBO forecasts today is $156 billion more than the deficit CBO forecasted for this year, 2003, as recently as last March. And get this: the deficit for this year, forecasted today, $401 billion, is $760 billion worse than the deficit predicted for this year in 2001—$760 billion worse in one fiscal year.

This record, bad as it is, will last for just one year because next year the deficit will be even worse. Next year, the deficit, as forecast here, is $480 billion. If you back out the surplus in Social Security, and I think you should, the surplus next—the deficit next year will be $644 billion.

Six months ago CBO came here and they projected a surplus over the next 10 years of $891 billion, deficits in the near-term, surpluses in the long-term, netting out to a surplus of $891 billion cumulative. Of course, that depended on a critical assumption, and that is that all of the expirations in the tax cuts passed in 2001 and 2003 will actually be allowed to expire as scheduled. But in 6 months' time that estimate of the surplus has moved $2.287 trillion in the wrong direction to a deficit of $1.397 trillion.

The worst news of all is that these deficits are here to stay. In budget parlance, that is structural, not cyclical. They are rooted in the budget, they are not going to go away, fade away as the economy picks up. On the contrary, CBO assumes growth that averages more than 3 percent a year for the next 10 years, as this chart indicates, more than 3 percent for the next 10 years. And these deficits don't decline. They hover around $300 [billion] to $400 billion a year as we pile on, as a result, $3 trillion in additional debt over the next 10 years.

Now, it may seem to some who read this report superficially that the deficits do diminish over time. But, if so, you should read on and read carefully.

In the first sentence of the first chapter, CBO starts out by saying, quote: If current laws and current policies do not change, deficits will be $401 billion this year and $480 billion next year." The problem is, we all know that current laws and current policies will change.

Nevertheless, by the laws we pass, budget rules and budget procedures, CBO cannot assume that the billions of dollars in tax cuts enacted in 2001 and 2003 and stipulated to expire will be renewed and extended. CBO has to assume that these tax cuts will expire as scheduled, even though the Bush administration says that all of these tax cuts will be renewed and will be extended. CBO's assumption that they will be allowed to expire as scheduled as $1.564 trillion back to revenues. It is an assumption that the alternative minimum tax won't be altered, and we know politically will have to be fixed, or it will capture more than 30 million taxpayers within 10 years. That adds $400 billion more to revenues.

And since CBO cannot presume what Congress is about to pass, it also can't presume that there is any cost for prescription drug coverage under Medicare, which takes $400 billion out of spending. They also assume that discretionary spending, which has grown, as the chairman has noted, 7 to 8 percent, will be reined in and held to the rate of growth of inflation only, at current services expectation.

Given the fact—as you can see from the chart we are about to put up, this bar chart—that 95 percent of the growth and discretionary spending over and above current services for all of discretionary spending—95 percent of the excess over and above current services—has gone to homeland defense, national defense, New York City relief, and airline relief, it is hard to believe that we can hold it, rein it in to the level that—at least to a level of inflation only.

When you just seize assumptions for political reality, what is likely to happen in law and in policy, easily, you add $2 [trillion] to $3 trillion to CBO's 10-year surplus—10-year deficit, which is already $1.4 trillion. And there is the bottom-line result. Instead of having a surplus of $211 billion in 2013, we have a deficit of $363 billion. The resulting public debt over this period of time is about a $3 trillion addition from $4.4 trillion at the end of fiscal year 2004, to $7.4 trillion at the end of 2013. Resulting deficits total $3.429 trillion.

Now, you can argue with the assumptions we have inserted in order to make the CBO baseline forecast a realistic political document, but for the most part we have tried to be not contentious, and practical and farsighted in putting those numbers in there. It is clear to me, we are looking at least in the range of $3 trillion in additional deficits.

When OMB brought its mid-session review here in July, I read it from cover to cover. And when I got through, I said, what disappoints me most is there is no shock, no shame, and no solution. OMB responded to these massive deficits by simply saying, they are manageable, and by saying as to solutions that if we continue to pursue our progrowth policies. We can grow out of this problem, at least holding out that hope; and then pointing to the possibility, the prospect by their reckoning that in 5 years the problem will be cut at least in half, even though they excluded from that 5-year projection the enormous costs we are now incurring for the deployment of troops in Iraq and Afghanistan.

Well, I don't think, Mr. Chairman, that these deficits are manageable for that period of time. I think this is a looming disaster. And, frankly, I think it is a moral outrage, mortgaging our children's future so that we can have it all, and mortgaging also—undermining two programs which the people of this country look to as bedrock: Social Security and Medicare. Because these deficits, if they are allowed to occur as projected here, will do nothing more than put a ticking time bomb under Social Security and Medicare for years to come. There is a day of reckoning coming.

I am glad to see that the Director has acknowledged that long-term deficits, particularly when they are perceived to be permanent or intractable, can indeed be a detriment to the economy, because I fervently believe that; and I think what you have put before us is a call to action. We need to act now before these deficits become so intractable, so difficult to deal with that we simply can't turn this problem around.

Thank you again for coming. We look forward to your testimony.

Chairman NUSSLE. Director, welcome. And we are pleased to put your entire testimony into the record, and you may proceed as you feel necessary.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Mr. Chairman, thank you. Congressman Spratt, members of the committee, thank you for the chance to be here today.

What I thought I would do is briefly summarize what I think are some of the key features of our summer update. The entire report has been available for a little over a week, and I submitted for my written testimony a summary of that report.

I thought I would begin by talking about facts in our baseline projection, highlight three key features of those particular projections, and then close with a short discussion of the economic outlook, after which I would be happy to answer your questions.

Let me begin with facts, which are summarized on the first slide and which are available in front of you.

Our baseline projection anticipates a deficit of $401 billion in fiscal 2003, $480 billion in fiscal year 2004, $341 billion in fiscal year 2005, and total deficits of $1.4 trillion between 2004 and 2013. The pattern is that these deficits occur all in the first 5 years; the last 5 years show a very tiny surplus. The pattern throughout the budget window is for sharp near-term deficits, followed by diminishing deficits, and a return to surplus in 2012.

Changes in CBO's Baseline Projections of the Deficit Since March 2003 (In billions of dollars)

	2003	2004	2005
Total Deficit as Projected in March 2003	-246	-200	-123
Changes			
Legislative			
Revenues	-53	-135	-77
Outlays	46	92	101
Subtotal	-99	-227	-178
Economic and Technical			
Revenues	-69	-64	-64
Outlays	-13	-11	-24
Subtotal	-56	-52	-39
Total Impact on the Deficit	-155	-280	-218
Total Deficit as Projected in August 2003	-401	-480	-341

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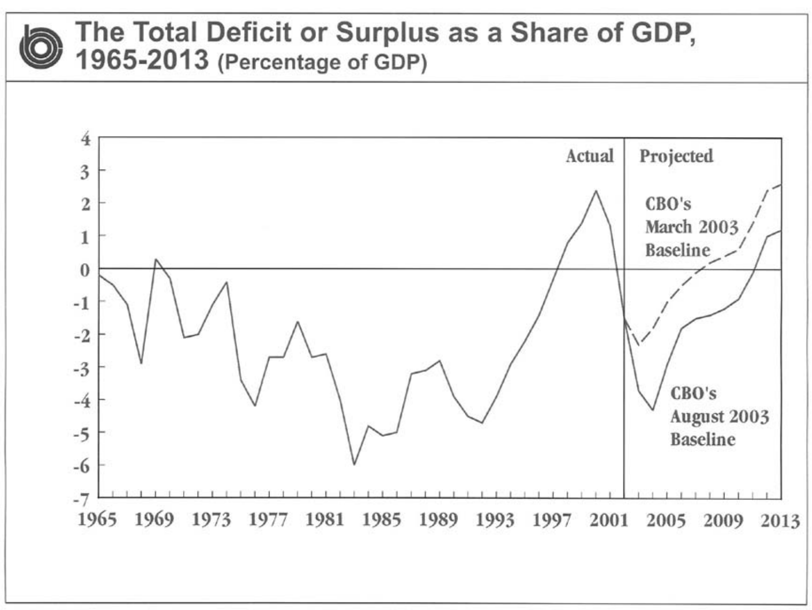
The fiscal year 2004 deficit is the largest in dollar terms; however, relative to GDP, 4.3 percent, it doesn't rival the 6 percent that occurred early in the 1980s, which was the largest number.

The final basic feature of the baseline projections is the debt-GDP ratio, which is about 37 percent at the onset of the budget window, rises to about 40 percent and then diminishes to 30 percent over the course of the budget window.

Now, I think there are three key features of our baseline projections that merit attention in thinking about them. The first and perhaps the one that might not need to be repeated, but I think is worth highlighting for you, is that they are baseline projections and are constructed according to the rules of the baseline projections. In particular, they must follow the implications of current law on both the receipts and the outlay sides.

For these particular projections two features stand out. On the receipts side, they assume the sunset of the tax cuts that were put in place in 2001 and also the ones passed by Congress earlier this year; and on the outlay side, we follow the baseline rules in including the fiscal year 2003 supplemental appropriation in the baseline appropriations and then inflating those appropriations at the rate of inflation. In effect, that supplemental appears in each year of the budget window, properly adjusted for inflation.

The second key feature is that the basic patterns in these projections are very similar to our March baseline projections. They have the feature of having large near-term deficits diminishing over the budget window and ultimately coming to surplus. In this case, the near-term deficits are larger, they reflect the actions taken earlier in the year both to cut taxes and to increase outlays, resulting in higher near-term deficits; and the budget comes to balance later in the budget window than had been anticipated in March.



The mechanics by which we come to balance over the budget window is on the revenues side. Revenues grow at an average rate of 7.5 percent over the budget window, rising from about 16.2 percent of GDP at their low in 2004 by 4.3 percentage points, or 20.5 percent of GDP at the end of the budget window in 2013.

On the outlay side, mandatory spending grows at an average rate of 5.2 percent over the budget window. That can be contrasted with GDP growing at about 5.1 percent over the budget window, so a little bit faster than GDP. Discretionary spending follows the baseline rules and grows at an average rate of 3.2 percent of GDP, or more slowly than the economy as a whole.

The final point that I would highlight about our baseline projections is that they are subject to an unusual amount of uncertainty. Baseline projections always face uncertainty. They face uncertainty from the evolution of the economy in ways that cannot be anticipated; they face uncertainty from the evolution of the relationship between the economy and the budget, technical factors in the lingo of our reports, which shift through time. And we have in our report tried to document these usual sources of uncertainty so that Members of Congress can appreciate that, as we go farther out in the budget window, 5, 6, 7, 10 years, the degree to which these projections would occur, even if we stuck to current law, becomes less and less certain.

However, in this instance, we also felt there is a substantial amount of uncertainty in the budget outlook that derives from policy choices facing the Congress, and we attempted to show the boundaries of the implications of some of the policy choices that were clear and about which we had some guidance.

In particular, on the receipts side, the tax cuts may or may not sunset as a policy choice, and that delivers some uncertainty to our baseline projections. There is uncertainty about whether in fact the alternative minimum tax will evolve on its current path, involving many more taxpayers toward the end of the budget window. To quantify the degree of that uncertainty, we took the most simple approach we could think of, which is, to remove the mechanism by which more people end up on the alternative minimum tax, namely due to inflation alone, and index the AMT for inflation.

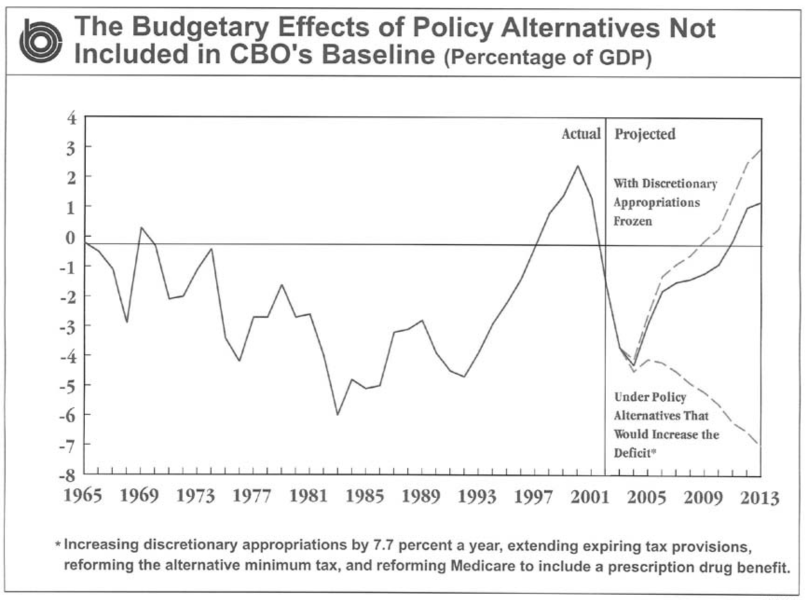
In addition, each House of Congress has passed the Medicare prescription drug bill with a budget total of $400 billion over the budget window. We took as our guidance in that area the year-by-year information on the Medicare prescription drug bill, as passed in the budget resolution earlier this year.

And also, on the outlay side, the path of discretionary spending, as has been mentioned, may not follow the level in the baseline rules of 3.2 percent. One might want to remove from that baseline projection the 2003 supplemental alone, and then follow that baseline projection. We present information about that.

One might imagine either slower discretionary spending growth—and we show the implications of slower growth in our alternatives as well—or one might imagine that discretionary spending will grow at the pace of recent experience. As guidance for that, we took the average rate of discretionary spending growth over the past 5 years, which is 7.7 percent—that excludes the 2003 supplemental—and showed the implications of that through the budget window. That 7.7 percent was representative of both defense discretionary and nondefense discretionary spending over that window, in which they grew at about that rate, at 7.8 and 7.6 percent, respectively.

And within the nondefense discretionary spending, we experienced rapid growth in a wide number of budget areas—health, education, aviation, and housing to name a few. So we felt that was representative of the kinds of things that we could quantify.

What I show in the chart are the implications for the future path of fiscal balance at the extremes of different combinations of those possible policy futures. And I think they highlight the importance of the policy choices that face Congress. To the extent that one were to put together the upper extreme, we would arrive at balance sooner and reach larger surpluses. If one were to put together the bottom end of that band, those deficits would reach, at the end of the budget window, 7 percent of GDP, larger than the historic high as a fraction of GDP, and would involve a level of debt-to-GDP that is more than twice as high as that in the baseline projection.



We also face some uncertainty that we were unable to quantify in our budget projections—in particular, the future path of the budget as it is affected by ongoing operations in Iraq and the global war on terrorism. We have since then done some analysis at the request of Senator Byrd, which I would be happy to discuss if the committee is interested. And there has also been recent interest in the particular costs of addressing energy problems in the aftermath of the blackout in August. Those kinds of uncertainties are not reflected in these numbers in any way.

Looking forward, I think that using debt-to-GDP as a fiscal indicator is a useful thing for the committee. The numerator, the debt, summarizes in a cumulative fashion all differences between receipts and outlays as the policies get put into place. The denominator reflects the performance of the economy, which is also affected by policy choices. And I wanted to spend the closing few minutes of my remarks talking about our outlook for the path of the economy for both the near-term and the long-term.

Our projections have two pieces. The near-term projections are CBO's attempt to forecast to the best of its ability the cyclical recovery of the economy from the recent recession and the dynamics of that recovery. Over the longer term, after 2 years, we make no attempt to anticipate business cycle fluctuations of any type, but instead focus on the long-term growth of potential GDP, the full employment level toward which the economy typically returns, and get the long-run path of the economy in some rough sense.

Our short-term forecast does show that the economy does pick up in the near-term, rising to close to 4 percent real GDP growth in 2004. In the path of that recovery, unemployment comes down somewhat slowly, lingering in the neighborhood of 6 percent over the next 18 months. That reflects the net effect of two opposing forces. As the economy picks up, we do anticipate that job creation will rise and payroll employment numbers would improve.

At the same time, however, our reading of the evidence is that during the recent cyclical downturn, a greater than typical number of individuals chose not to participate in the labor force. As the economy begins to grow more quickly and jobs begin to be created, those individuals will likely return to the labor force. That increase in the labor force participation will slow the decline in the unemployment rate in the absence of other influences.

We expect that inflation will remain modest in the near-term and that, as a result, we will not have any sustained impacts of inflation on our economy.

Now, this particular forecast really hinges on, I think, our reading of the degree to which sustained economic growth is, in fact, about to begin; and the key to that really comes in two pieces. On the up side, the economy will only have sustained economic growth if we have a resumption of robust business investment, and our reading of the evidence is that we have begun to see a firming of business fixed investment. Financial conditions, which we talk about in the report, which include not just the stance of monetary policy as evidenced by the Federal funds rate, but also a broader index of financial conditions, have moved from having a net negative posture in the economy to being roughly neutral and, as a result, will no longer restrain business investment.

Our reading of the degree to which businesses have accumulated a capital overhang and, as a result, had excess capital to work off seems to suggest that the process has largely run its course with some sectoral exceptions. And as a result, on the up side, it does appear that we are about to see a more sustained growth in business fixed investment that will provide economic growth.

The other main ingredient in sustained economic growth would be the absence of a falloff in household spending, particularly in personal consumption expenditures. The risk of that falloff would stem from households' desire to rebuild lost wealth perhaps from the falloff in equity markets over the past several years. We look at the risk of the potential for a sharp rise in the saving rate that would be coincident with such a falloff, and our reading of the evidence is that particularly in the presence of a fiscal policy that will over the next 2 years provide $120 billion to the household sector, and in the third quarter of this year alone $120 billion at an annual rate, the household sector could actually raise its savings rate and maintain its rate of consumption without risk of near-term falloff in the overall rate of economic growth.

Over the longer term, we expect the economy to average about a 3.3 percentage-point growth between 2005–08, and then at the end of the budget window, for the years 2009–13, to grow at an average rate of 2.7 percent.

Now, as this committee is probably aware, the key to long-run economic growth is productivity growth, and it is worth highlighting that the decline in our long-term economic growth rate is not the result of a forecast that we expect productivity growth to decline. On the contrary, our baseline includes a labor productivity growth of about 2.1 percent, which is quite close to the levels reached in the post-1995 acceleration productivity. Instead, that slower rate of economic growth reflects a slowdown in the rate of growth in the labor force that is the first leading edge of the impacts of the retirement of the baby boom population.

As those workers begin to retire, we will see a slowing in the growth in the labor force and the overall hours available to the economy. Our projections reflect that slowdown both on the economic side and also on the budgetary side where we, at the same time as we see this economy slowing down, in those last years we will see growth in the number of Medicare beneficiaries, for example, rise from something like 1.5 percent a year to between 2 and 3 percent a year. So within this budget window on both the budgetary and economic side we will begin to see the initial impacts of the retirement of the baby boom population.

The final point I would make about our baseline projections is that they reflect a good-faith effort for us to incorporate the impacts of current policies on both the path of the economy and on the receipts. In particular, the future path of fiscal policy can have a substantial effect on economic performance.

On the spending side, the degree to which additional spending raises deficits and crowds out investments is incorporated into our projections of the future of both capital accumulation and, thus, productivity growth.

On the receipts side, we are faced with a fairly tricky analytic problem, quite frankly, because the future path of the economy will depend on what individuals and businesses expect about the future of tax cuts. It may be the case that individuals expect tax cuts to be permanent; it may be the case that they expect them to sunset on schedule as provided by the law; and it may be the case that individuals and firms believe something in between.

In constructing our baseline projections, we followed the spirit of baseline projections and assumed that individuals expect the tax cuts to sunset as provided in the law. This affects our underlying economic forecast as the increase in tax rates has incentive effects on labor supply that would diminish the supply of labor toward the end of the projection window and as the increase in deficits in the near-term and decrease in the long-term affects the rate of capital accumulation in the economy.

At the level of receipts, we know that the provision of a sunset in the tax code provides incentives to shift activities across years. We have done our best to accommodate that in our baseline path for receipts, but would acknowledge that the particular structure of these sunsets raises even greater uncertainty about how the private sector will actually behave than might normally be the case.

At any rate, I thank the committee for your patience in this quick overview of our report, and I look forward to answering your questions.

[The prepared statement of Mr. Holtz-Eakin follows:]

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, Congressman Spratt, and Members of the Committee, I am pleased to be here today to discuss the Congressional Budget Office's (CBO's) update of its baseline budget projections for 2003–13. CBO projects that the Federal Government will incur deficits of $401 billion in 2003 and $480 billion in 2004 under the assumption (mandated by statute) that current laws and policies remain the same (see table 1 on page 5). Those deficits reflect the recent economic slowdown as well as legislation enacted over the past few years that has reduced revenues and rapidly increased spending for defense and many other programs. Although such deficits for this year and next year would be smaller than those of the mid-1980s relative to the size of the economy, they would reach record levels in nominal dollar terms.

The economy now seems poised for a more sustained recovery. CBO anticipates that gross domestic product (GDP) will rise by nearly 4 percent in calendar year 2004 after growing by less than 2 percent in the first half of this year. Signs of faster growth in consumer and business spending, rapid growth in Federal purchases, tax cuts for businesses, and a slightly more accommodative monetary policy have improved the economic outlook for the rest of 2003 and for 2004.

Partly because of that economic growth, CBO's baseline projections show deficits that diminish and then give way to surpluses near the end of the 2004–13 period—under the assumption that no policy changes occur. In particular, the baseline assumes that the major tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) will expire as scheduled in 2010. It also assumes (as required by the Balanced Budget and Emergency Deficit Control Act of 1985) that budget authority for discretionary programs will grow at the rate of inflation—which is projected to average 2.7 percent over the next 10 years. Furthermore, the baseline does not include possible policy changes such as the introduction of a prescription drug benefit for Medicare beneficiaries. Various combinations of possible actions could easily lead to a prolonged period of budget deficits, although other scenarios could be more favorable. In addition, economic and other factors that deviate from CBO's assumptions could affect the budget considerably—in either a positive or a negative direction.

Regardless of the precise course of the economy and future policy actions, significant long-term strains on spending will begin to intensify within the next decade as the baby boom generation begins reaching retirement age. Driving those pressures on the budget will be growth in the largest retirement and health programs—Social Security, Medicare, and Medicaid. Federal spending on those three programs will consume a growing proportion of budgetary resources, rising as a share of the economy from 8 percent in 2002 to a projected level of nearly 14 percent in 2030.

THE BUDGET OUTLOOK

CBO projects that if current laws and policies remain unchanged, the recent surge in Federal budget deficits will peak in 2004. In the ensuing years, under CBO's baseline, deficits decline steadily and give way to surpluses near the end of the 10-year projection period. Deficits are projected to total $1.4 trillion between 2004 and 2008; the following 5 years show a small net surplus of less than $50 billion.

Revenues have slid from a peak of 20.8 percent of GDP in 2000 to 16.5 percent this year and are anticipated to drop again next year, to 16.2 percent. From that point on, the trend reverses, as projected economic growth pushes revenues in the baseline up from 17.4 percent of GDP in 2005 to 18.7 percent in 2010. Under current laws and policies, revenues are projected to climb more rapidly thereafter because of the expiration of EGTRRA, reaching 20.5 percent of GDP in 2013.

Whereas revenues are expected to diminish in 2003, CBO anticipates that total outlays will rise—from 19.5 percent of GDP in 2002 to 20.2 percent this year. Under the assumptions of CBO's baseline, outlays are projected to peak at 20.5 percent of GDP in 2004 and then to begin a gradual decline as a share of the economy. By 2013, outlays are projected to account for 19.3 percent of GDP. That decline is mostly attributable to the baseline's treatment of discretionary spending, which is assumed to grow at the rate of inflation over the projection period (or at about half the rate of growth projected for the economy).

Since CBO last issued baseline projections in March, the budget outlook has worsened substantially. Half a year ago, CBO estimated that the deficit for 2003 would total $246 billion, the deficit for 2004 would decline slightly to $200 billion, and the cumulative total for the 2004–13 period would be a surplus of $891 billion. Now, CBO's estimate for this year's deficit has risen by $155 billion and for next year's by $280 billion. For the 10-year period from 2004 through 2013, projected deficits have increased and projected surpluses have decreased by a total of nearly $2.3 trillion (see table 2 on page 6).

Compared with the projections in the March baseline, revenues have declined by $122 billion for 2003 and by $878 billion for the 2004–13 period. Changes resulting from legislation, mostly the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), account for the majority of the decline through 2005. After that, technical estimating changes explain most of the drop in projected revenues relative to those in the March baseline.

Outlays are $33 billion higher for 2003 than previously projected and a total of $1.4 trillion higher over the 10-year period, largely because of legislation enacted since March. Extending supplemental appropriations enacted in April and August over the 2004–13 period, as required for CBO's baseline projections, accounts for $873 billion of that total, and additional debt-service costs resulting from both tax and spending legislation account for most of the rest.

THE ECONOMIC OUTLOOK

CBO's forecast for the next year and a half anticipates that the growth in overall demand for goods, services, and structures will pick up. The growth of consumer spending will remain modest because consumers are likely to save much of the money that they receive from the accelerated tax cuts under JGTRRA to rebuild their wealth. Businesses are likely to begin to restock, rather than draw down, their inventories and to increase their investments in structures and equipment. As a result, real (inflation-adjusted) GDP is expected to grow by 3.8 percent in calendar year 2004, up from 2.2 percent in 2003 (see table 3 on page 7). CBO's forecast assumes that the rapid rise in the Federal Government's spending will contribute to growth for the next few quarters, but thereafter, under the assumptions in CBO's baseline, such growth will slow.

CBO does not anticipate a quick reduction in the unemployment rate from its current level. Typically, the unemployment rate falls when the growth of real GDP exceeds the growth of potential GDP (the highest level of production that can persist for a substantial period without raising inflation). But even though the GDP growth that CBO is forecasting exceeds its estimate of potential GDP, CBO expects that the unemployment rate will average 6.2 percent for calendar years 2003 and 2004. In part, the sustained high rate of unemployment reflects caution on the part of employers, who—if they follow recent patterns—are not likely to resume hiring immediately as demand begins to grow. In part, it also reflects the likelihood that people who have been discouraged in their job searches by the economic weakness of the past few years are now likely to resume them—and be tallied among the unemployed.

The near-term outlook is subject to a number of risks. Foreign economic growth and foreign demand for U.S. goods may deviate from the assumptions in CBO's forecast. The residual effects of certain economic developments in recent years—the large reduction in households' equity wealth, the fall in the personal saving rate, businesses' productive capacity that remains under-used, and the increased dependence on foreign financing—may also continue to dampen growth more than CBO assumes. However, favorable economic fundamentals—such as low inflation and rapid growth of productivity—may set the stage for another long period of robust growth.

Between 2005 and 2008, the growth of real GDP is projected to average 3.3 percent, and between 2009 and 2013, 2.7 percent. In CBO's projections, the growth of real GDP slows as the gap closes between GDP and its potential; once that gap has been eliminated, real GDP grows at the same rate as potential GDP.

CBO expects that inflation, as measured by the consumer price index for all urban consumers, will average 2.5 percent from 2005–13, while the rate of unemployment will average 5.3 percent. The projection for the rate on 3-month Treasury bills averages 4.6 percent during the 2005–13 period and that for 10-year Treasury notes, 5.8 percent. All of those projections are virtually identical to the ones published by CBO last January.

TABLE 1.—PROJECTED DEFICITS AND SURPLUSES IN CBO'S BASELINE

[In billions of dollars]

	Actual 2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004–2008	Total, 2004–2013
On-Budget Deficit (−)	−317	−562	−644	−520	−425	−421	−434	−426	−417	298	−143	−105	−2,444	−3,833
Off-Budget Surplus[1]	−160	−162	−164	−179	−199	−219	−237	−255	−273	−289	−304	−317	−999	−2,436
Total Deficit (−) or Surplus	−158	−401	−480	−341	−225	−203	−197	−170	−145	−9	−161	−211	−1,445	−1,397

Source: Congressional Budget Office.
[1] Off-budget surpluses comprise surpluses in the Social Security trustfunds as well as the net cash flow of the Postal Service.

TABLE 2.—CHANGES IN CBO'S BASELINE PROJECTIONS OF THE DEFICIT OR SURPLUS SINCE MARCH 2003

[In billions of dollars]

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total, 2004–2008	Total, 2004–2013
Total Deficit (−) or Surplus as Projectedin March 2003	−246	−200	−123	−57	−9	27	61	96	231	405	459	−362	891
Changes													
Legislative													
Revenues	−53	−135	−77	−20	−13	−17	−11	−4	4	2	2	−263	−270
Outlays	46	92	101	105	117	129	140	150	162	172	184	544	1,352
Subtotal	−99	−227	−178	−126	−130	−146	−151	−155	−158	−169	−183	−808	−1,622
Economic													
Revenues	−16	−13	−12	−12	−15	−17	−19	−23	−20	−12	−8	−70	−151
Outlays *	−12	−31	−34	−25	−16	−16	−17	−20	−24	−28	−118	−223	
Subtotal	−16	−1	18	21	10	*	−3	−6	*	11	21	48	7
Technical													
Revenues	−53	−51	−51	−51	−55	−50	−45	−41	−39	−40	−34	−258	−457
Outlays	−13	1	6	12	19	27	33	39	44	47	51	66	280
Subtotal	−40	−51	−58	−64	−74	−77	−78	−80	−82	−87	−86	−324	−737
Total Impact on the Deficit or Surplus	−155	−280	−218	−168	−194	−223	−232	−240	−240	−245	−248	−1,083	−2,287
Total Deficit (−) or Surplus as Projected in August 2003	−401	−480	−341	−225	−203	−197	−170	−145	−9	161	211	−1,445	−1,397
Memorandum:													
Legislative Changes to Discretionary Outlays.													
Defense	27	54	62	65	66	68	70	72	74	75	77	315	683

Nondefense	6	14	17	18	19	19	20	20	21	21	22	87	19
Total	33	68	79	83	85	87	90	92	95	96	99	402	873

Source: Congressional Budget Office.
Note: * = between −$500 million and $500 million.

TABLE 3.—CBO'S CURRENT AND PREVIOUS ECONOMIC PROJECTIONS FOR CALENDAR YEARS 2003–2013

	Forecast		Projected Annual Average	
	2003	2004	2005–2008	2009–2013
Nominal GDP (Billions of dollars)				
August	10,836	11,406	[1] 14,098	[2] 17,943
January	10,880	11,465	[1] 14,154	[2] 18,066
Nominal GDP (Percentage change)				
August	3.7	5.3	5.4	4.9
January	4.2	5.4	5.4	5.0
Real GDP (Percentage change)				
August	2.2	3.8	3.3	2.7
January	2.5	3.6	3.2	2.7
GDP Price Index (Percentage change)				
August	1.5	1.4	2.1	2.2
January	1.6	1.7	2.1	2.2
Consumer Price Index[3] (Percentage change)				
August	2.3	1.9	2.5	2.5
January	2.3	2.2	2.5	2.5
Unemployment Rate (Percent)				
August	6.2	6.2	5.4	5.2
January	5.9	5.7	5.3	5.2
Three-Month Treasury Bill Rate (Percent)				
August	1.0	1.7	4.2	4.9
January	1.4	3.5	4.9	4.9
Ten-Year Treasury Note Rate (Percent)				
August	4.0	4.6	5.7	5.8
January	4.4	5.2	5.8	5.8

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

[1] Level in 2008.
[2] Level in 2013.
[3] The consumer price index for all urban consumers.

Chairman NUSSLE. Thank you.

Since there has been some comparison to 2001 and the projections of CBO in May of 2001, let me just for the record make sure that we have this clear.

In May of 2001, was funding for September 11 included in those projections?

Mr. HOLTZ-EAKIN. No.

Chairman NUSSLE. The war with Iraq?

Mr. HOLTZ-EAKIN. No.

Chairman NUSSLE. The war with Afghanistan?

Mr. HOLTZ-EAKIN. No.

Chairman NUSSLE. Global war on terrorism?

Mr. HOLTZ-EAKIN. No.

Chairman NUSSLE. The emergency spending for the Pentagon or New York City and victims?

Mr. HOLTZ-EAKIN. No.

Chairman NUSSLE. How about the economic stimulus package that was voted on in a bipartisan way?

Mr. HOLTZ-EAKIN. No.

Chairman NUSSLE. If we could put up chart No. 1, I would like to move to that.

These are based on the report that you have showing that these are, by and large, spending-driven deficits. Each one of those instances that I am talking about required spending, required spending above and beyond the call of duty, above and beyond what was budgeted for as a result of profound emergency that this country is facing, has faced, and continues to face and will continue to face.

And so I understand that there will be a continuation of comparing this to this huge change prior to 2001, but I am going to continue to remind colleagues and everyone that I can that obviously quite a bit has changed. If people want to continue to think in September 10 thinking, then they are certainly allowed to do that, but we need to think in September 12 and beyond thinking, and it is going to require some new priorities.

Spending-driven deficits not only have a macro impact, but on an individual basis—if you would show me chart No. 2. This is just amazing to me that spending, if you look at it on a per capita basis, what each taxpayer would be footing if in fact the spending continues at this rate, it is going to be astronomical. Spending at this rate is what is contributing to and causing the large deficits that we see, and spending has got to get under control.

You made a comparison of the deficit to the economy. Certainly, in nominal terms, the deficit is as large as it has ever been in history. But compared in terms to the power of our economy, which you were talking about, the GDP, would you cover that one more time? Why is it better or why is it appropriate to talk of these deficits in terms of a comparison to the economy as opposed to comparison to previous total dollar deficits from years before?

Mr. HOLTZ-EAKIN. Well, I think the spirit is the same as the spirit when one applies for a mortgage or any other personal loan. The first question a lender will ask and the question capital markets will ask is, what is your income? What is your ability to repay this loan? And comparing the deficit, the borrowing relative to the income in the economy, the gross domestic product, is the appropriate comparison.

Chairman NUSSLE. And in those terms, and I believe that was the chart you were showing—I don't know which chart that is, but it is the chart that is showing the comparison of CBO's March 2000 versus August 2003 baseline.

Mr. HOLTZ-EAKIN. Chart No. 2.

Chairman NUSSLE. Chart No. 2, OK.

That shows, I believe, the comparison as a share of GDP. And compared to the economy, how does this deficit stack up to previous deficits?

Mr. HOLTZ-EAKIN. Well, as you can see in the chart, the previous largest deficit is 6 percent of GDP in the early 1980s. The fiscal year 2003 baseline deficit is 3.7 percent; the fiscal year 2004 baseline deficit is 4.3 percent of GDP, and it diminishes thereafter.

Chairman NUSSLE. Now, I understand the next chart that you show. Showing the fact that there is uncertainty, demonstrates—if anything—that we should not be complacent as a result of this. But I do think that some perspective is in order.

There seems to be some dispute as to how severely these deficits will impact the economy. Would you cover that? You covered it briefly, but would you cover that one more time as far as the impact, both currently and in the future how these deficits can and will impact the economy?

Mr. HOLTZ-EAKIN. Certainly.

First, with respect to the particular lines on this chart, the CBO does not offer those as forecasts in any sense. We are trying to illustrate the range of possible outcomes under alternative policy choices, simply to highlight the fact that the ultimate path will depend heavily on policy choices.

In terms of the impact on the economy, I think it is important to recognize that the ultimate impact of deficits is to diminish national savings. The mirror image of that is that it increases spending at any point in time. If the Nation decides to save less, it will spend more.

At times when the economy is slack and the private sector is not spending, households and businesses, those actions can support private demand and minimize cyclical impacts. At times when the economy is at full employment, the diminishment of saving and spending places more pressure on the economy's capacity to produce. It can drive up interest rates and diminish capital accumulation, which slows the pace of economic growth going forward.

In our current situation, I think, looking backward, given the cyclical status of the economy, there is no particular evidence that the deficits per se have had striking economic damage. However, looking forward, were we to run sustained sizable deficits, especially a magnitude of 7 percent GDP, then there would be harm to the rate of capital accumulation and the pace of future economic growth.

Chairman NUSSLE. Then let me just close by—what I take away is that deficits do matter. They may not matter—they may not have a dramatic impact today, but they will if they are sustained. And I would agree with that, deficits to do matter. And you can control spending; that is the one thing that we can control, because there is a lot of uncertainty out there.

The uncertainty in March of 2001, looking back, of course, is obvious. Looking forward may be just as obvious.

So getting this under control by controlling spending and getting the economy to grow so that our income can grow, so that the GDP can grow, so that our comparison of these deficits in the future can continue to be as small or as slight as possible is the most important effort that we can put forward.

As far as ticking time bombs, you know, I understand that there will be a complaint that there is a ticking time bomb for Medicare or for Social Security. But I can tell you that the time bomb is currently there if we do nothing. The bomb is already set to go off, No. 1. And No. 2, adding a trillion dollar drug package to it as what was offered on the floor by the minority party without it being paid for or offset even in their own budget, I think sets the bomb off even sooner.

So I think we have to control spending, get the economy moving again. These deficits do matter, and sticking to the plan that we have in order to make sure that we get them under control, I think, is the best thing that we can do at this point.

Mr. Spratt.

Mr. SPRATT. Thank you, Mr. Chairman.

Let me show you once again chart No. 4, our chart No. 4, showing growth, budget projection already assuming growth. This one right here. There you go.

Just a reminder that these are the rates of growth assumed by CBO and by OMB in their forecast for the next 10 years. They have got substantial growth, real growth factored into the forecast all the way, and the deficits don't go away even though the economy is growing for 10 straight years at 3 percent real rate of growth.

Now, let me show you in the battle of the charts, chart No. 5 to contest your chart along the same lines. It is a layered chart just like yours. And I would ask Dr. Holtz-Eakin to comment upon it, but let me first explain it.

A large part of the reason for the disappearance of the surplus is, in a sense, overestimation or misestimation. It is called economic and technical factors, but it means that the surplus, based upon projecting and forecasting conventions being used at the time, was overstated. That is the top layer. Back it out, and you have got a much-less surplus.

The next layer is defense and homeland security. Homeland security is a rubric that didn't even appear in the budget 2 or 3 years ago. Defense has been increased by more than we anticipated in 2001, and that adds substantially. The other is other spending.

But the bottom layer is tax cuts. And the interesting thing about the bottom layer is, if you take it away, if you take the tax cuts away, the budget is back in balance in 2005.

Dr. Holtz-Eakin, I know I am asking you to pass judgment on something you have just seen, but do you see any obvious flaws in this analysis?

Mr. HOLTZ-EAKIN. Indeed, we have attempted to do a similar kind of analysis. I won't pretend to be able to do chart math in my head; but we have done similar decompositions. I would be happy to work with you on it.

Mr. SPRATT. Could you share your chart with us or your background work with us?

Mr. HOLTZ-EAKIN. Yeah.

Mr. SPRATT. Have you got it available?

Mr. HOLTZ-EAKIN. I have it here.

Mr. SPRATT. How do your procedures break down amongst economic and technical adjustments?

Mr. HOLTZ-EAKIN. For the fiscal year 2004, economic and technical changes account for 41 percent of the change from 2001; legislative changes account for 59 percent of the changes. Outlays are 24 percent of those, revenues are 31 percent of those, legislative changes and net interest, I guess, would be the remainder.

Mr. SPRATT. Well, in 2004, is that the changes since March?

Mr. HOLTZ-EAKIN. Yes.

Mr. SPRATT. I was talking about——

Mr. HOLTZ-EAKIN. From January—sorry. From January 2001.

Mr. SPRATT [continuing]. Using the time frame '01 through '11?

Mr. HOLTZ-EAKIN. No. That is from January 2001.

Mr. SPRATT. OK.

Mr. HOLTZ-EAKIN. My apologies.

Mr. SPRATT. We might put a request in the record for you to at least check these numbers and maybe to replicate them using your own similar analysis.

[The information referred to follows:]

[CBO resolved this matter with the Member's office.]

Mr. SPRATT. But that brings up a point with respect to this year. We have seen the budget worsen by $156 billion since your last report in March. And if I read your report correctly, you say that two-thirds of that was within our control. Two-thirds of that was—more than two-thirds was legislative action.

In the past, we have come to find that the economy has taken a greater toll, terrorism has taken its toll, war has taken its toll. But since March, the toll that has been taken has been taken by Congress itself, by legislative action, is that correct, two-thirds of it?

Mr. HOLTZ-EAKIN. Yes, that is correct.

Mr. SPRATT. And a large share of that was in the 2003 tax cut, or the previous—how much of that was due to the tax cut?

Mr. HOLTZ-EAKIN. For fiscal year 2004, $135 billion was in revenues on the legislative side, and $92 [billion] in outlays.

Mr. SPRATT. Of the $5.6 trillion that you forecast in 2001, do you know how much of that, for 2001–11, you would now estimate to be the applicable baseline surplus for 2001?

Mr. HOLTZ-EAKIN. Not off the top of my head, but we could get that.

Mr. SPRATT. Could you get us that for the record?

Mr. HOLTZ-EAKIN. Yes, sir.

[The information referred to follows:]

[CBO resolved this matter with the Member's office.]

Mr. SPRATT. Let me show you one other chart and ask you if this comports with your understanding, and that is chart No. 6, the bar chart showing increases in spending.

What this chart shows is how much of the increment in spending over and above current services for defense and nondefense programs, where it went, where did the increment go after other programs were funded at current service levels.

By our calculation, in each of 3 years 95 percent of it went to the Iraqi war, the response to terrorism, New York City relief, airline relief, things related to defense, war—and the war on terrorism in particular—and recovery from the catastrophe in New York.

Does this square with your understanding of the increments in spending that we have been experiencing?

Mr. HOLTZ-EAKIN. Well, we can certainly check. I am not familiar with the percentages. I would be happy to do so.

Mr. SPRATT. Well, if you could check this, we would appreciate it. Because it shows how difficult it will be to rein in spending if what we are talking about is wartime spending, with 150 troops deployed who have to be supported, with the reconstruction cost about to come to us. CQ says that it could be $65 billion, per Bremer's request. It is going to be awfully hard to rein in that kind of spending and sustain the commitment we have made and the battle against terrorism.

And one final point—two final points. Show me chart No. 16 again. This is a little hard to see. No, it is not as hard as I thought to see. The top line is outlays, and interestingly enough, the outlays this year are still as a percentage of GDP lower than they were in the Reagan administration and lower than they were in the year 2000, when we had a surplus in the budget, a $236 billion surplus in the budget.

But the interesting thing here is, this is an object lesson for how to rectify the problem. As you can see, in 1992, which was the year before Clinton came to office, the budget outlays started downward as a percent of GDP until they got to just over 18 percent of GDP. Every year during the Clinton administration spending as a percent of GDP came down.

By the same token, we passed some tax increases in 1993 as part of Clinton budget, and they tended to tilt the code progressively toward upper bracket taxpayers who made out the best during the halcyon days of the 1990s. As a consequence, revenues as a percentage of GDP went up, and the difference between outlays in revenues there, which is about 3 or 4 percent of GDP, is a surplus that emerged in those years.

Now what we have got are outlays going up and revenues coming down, just the opposite of what we had before. And that is the definition of a deficit and a long-term deficit at that.

We would like for you, if you would, to take these three charts—we will give you copies of them—and let us know if there is anything incorrect, wrong, analysis or facts, because this is the way we see the problem.

[The information referred to follows:]

[CBO resolved this matter with the Member's office.]

Mr. SPRATT. My one final point is, as I look at your projection, baseline projection, your current services projection, if you don't factor in the things that you have got on charts 1–6—Medicare, repeal the tax cuts, in particular—you get to almost no deficit by the year 2011, close to the end of our time frame. The biggest factor there is your assumption that the tax cuts won't be repealed, they will simply repeal themselves, they will be allowed to expire as scheduled, as you put it.

So basically you are telling us there, we should simply leave the code alone and let these tax cuts expire as they were proposed to expire when they were originally passed; we can see daylight by 2011.

Mr. SPRATT. We will be out of the deficit by 2011.

Mr. HOLTZ-EAKIN. And maintain the other projections, assumptions.

Mr. SPRATT. The other projections, too. Thank you very much.

Chairman NUSSLE. Mr. Brown.

Mr. BROWN. Mr. Chairman, thank you for coming and being with us today, Director Holtz-Eakin.

If I could pick that same chart back up that Mr. Spratt had earlier, would that be possible? The last chart that showed the decline I guess of—yeah, this one. That is correct. Right.

It looked to me that the decline in the outlays was starting actually in 1982, and I just wanted to bring that to the attention of the group. I also would like to make a point——

Chairman NUSSLE. Would the gentleman yield?

Mr. BROWN. Yes.

Chairman NUSSLE. Just one other observation. It is kind of interesting that we are now calling the 1995 close-down-the-government budget a Democrat budget. I think that is kind of interesting that we finally come full circle now and that is being claimed as a Democrat budget. That is kind of interesting.

Mr. SPRATT. Let me point out in fiscal 1983 outlays as a percentage of GDP you hit an all-time high of 23.5 percent for peacetime. It may look like 1982 on that chart but, in 1983, the midst of the Reagan years, 23.5 percent. When Bill Clinton left office, it was 18.5 percent, 5 full percentage points of GDP less than what it was in the peak of the Reagan years.

Chairman NUSSLE. Would the gentleman continue to yield?

I am just wondering, too, I don't remember one Reagan budget—boy, maybe my memory is slipping, but I don't remember one Reagan budget that came in that was not claimed to be dead on arrival. In fact, I don't remember a Bush budget that was not claimed to be dead on arrival. So it is kind of interesting how now all of a sudden these Presidents are in charge of spending when the Constitution under article 1 says that Congress is in charge of spending. Just kind of an interesting observation. So you may want to take that into consideration as you are analyzing these very interesting charts.

Thank you for yielding.

Mr. BROWN. Mr. Chairman, one further question. If we had not passed the tax cuts, what impact would this have on receipts? I mean, you would have to take into account the increase in the productivity of the American people by giving them more money to spend. If we had not passed the tax cuts, would we be better off or worse off on that chart?

Mr. HOLTZ-EAKIN. The 2001 tax cuts I think are widely recognized as having provided some support for the household sector for personal consumption housing expenditures and the more recent ones for both consumption expenditure and investment.

The precise numerical impact is, unfortunately, impossible to tell, because in the absence of the tax cuts it is quite likely that monetary policy would have been very different and the future path of the economy is just simply not knowable. So we know that in broad terms the economic impact was to support those sectors of the economy at a time when they are economically weak, but I don't know how much that would have specifically affected the overall performance of the economy and as a result the impact on receipts.

Mr. BROWN. But you would almost have to agree that it would have to have some positive benefit?

Mr. HOLTZ-EAKIN. It had some beneficial impacts in supporting the private demand in the economy.

Mr. BROWN. OK. Thank you.

Chairman NUSSLE. We have two votes on the floor, so we will adjourn and come back after the second vote.

[Recess.]

Mr. SHAYS [presiding]. Sorry for the delay, Mr. Director; and we will commence our questions with Mr. Moran from Virginia.

Mr. MORAN. Thank you, Mr. Chairman.

I wanted to refer to your very, very well done budget and economic outlook. It is nice to have you on board, and I think that the misgivings that some folks had have been put to rest, because it is a very good one and I think an objective report that you have provided us with.

On page 12 you lay out the budgetary effects of policy alternatives that you were not required to include in your baseline but are fairly obvious in terms of their budgetary impact and their likelihood of being enacted.

First place, the chairman and the ranking member and I suspect the leadership of the majority are absolutely determined to extend the expiring—the sunsetted tax provisions, and when that happens—not if, but when that happens—it is going to add another $1.6 trillion to the total deficit.

We also know that the leadership of the House and Senate are going to fix the alternative minimum tax. So that is another $400 billion, as you say in your table on page 12.

We also know that both parties have agreed to a Medicare prescription drug plan. The lowest number is $400 billion. It could be twice that, but we know that it is going to be at least $400 billion over the next 10 years.

Then there is an issue as to discretionary appropriations, and given the fact that the Congress in the White House's same party under the leadership of the majority has increased spending by over 7 percent a year—and, of course, that is spending that has been requested by the White House. And it looks now—even today we read the papers. We are looking at another $60 billion for the war in Iraq, and that is probably just a starting point. If we go by current historical experience, in other words, the last few years, we talked about adding another $2.8 trillion to the deficit over the next decade. Let's be conservative and just add half of that, $1.4 trillion.

So we add all of that up, plus the deficit that you told us about everyone agrees upon is a reasonable but conservative estimate. So we are up to about $6.6 trillion in terms of the accumulated deficits over the next—well, excuse me, $5.2 trillion. I am going to use the lowest number, $5.2 trillion, lowest number for spending. That is scary.

One of the things that has come out that has yet to emerge in these hearings is the reaction on the part of the international community, the fact that we are borrowing all of this money and we are putting the rest of the world in a difficult situation. Because we are going to be taking about half a trillion dollars a year out of the money that would otherwise be available for capital investment.

In fact, there was an article in the Wall Street Journal that quoted people in the International Monetary Fund, the leadership in the International Monetary Fund. The head, of course, of the fund is a Republican, Ken Rogoff, but he is very critical of U.S. economic policy. He delivered a sharp rebuke to the Bush administration's fiscal policy saying that the tax cuts were poorly timed and probably unnecessary. If enacted in full, they would significantly worsen the fiscal position not just of the United States but throughout the world. It is going to have an adverse effect upon developing countries, and it is going to create a gaping trade deficit. So he sees our budget spending from black into red, open-ended security costs and exchange rate, that is going to worsen the fiscal situation for other countries.

You know, it is not the Democrats that are registering some of the most serious concerns. It is the other people that are watching our fiscal situation.

Mr. SHAYS. The gentleman's time has expired.

Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Dr. Holtz-Eakin, except for the fact that everybody in this room I think agrees that we have an untenable deficit and it appears to be getting worse, I am not sure there is a whole lot else we agree on.

My concern isn't just with the deficit, though. My concern is with the amount of money that we are spending. If we could go to chart No. 2 again, please. If I am reading this correctly, in constant 1996 dollars, we have had a spending explosion per capita since 1996, where we have gone from 4,911 to 6,111 on a per capita basis.

Now we hear a lot about mortgaging our children's future, but whether we pay for it with cash or whether we pay for it with a credit card, ultimately somebody is going to have to pay for all this spending.

So my first question is—and please forgive me; I am new around here as a freshman—but has Federal spending ever dropped from one year to the next in recent memory?

Mr. HOLTZ-EAKIN. In terms of nominal dollars, I would have to check. I don't know the answer. My suspicion is it has not dropped recently in total dollars. As a fraction of GDP, as you know, spending has both risen and fallen as a fraction of GDP.

Mr. HENSARLING. So GDP can increase and decrease, family income may increase and decrease, but in nominal dollars it appears that the Federal budget continues to grow, and at least if this chart is accurate, and I assume it is, it has been growing at an alarming rate since 1996.

Earlier you mentioned about the damaging impact on the economy deficit spending can have, but how about total spending by the Federal Government? I mean, if I am reading these reports correct, discretionary spending has grown on an average of 7.7 percent for 5 years, and I think that you are assuming, if I am reading your report correctly, mandatory will grow by 5.2 percent over the course of your budget. So assuming for the moment that was all paid for by cash and it comes out of the pockets of the American family, what are the impacts on family income in GDP growth if these spending trends continue? Do you have an opinion on that matter?

Mr. HOLTZ-EAKIN. Well, I think that those questions all fall in a common theme, and that theme is that should the Federal Government choose to have a program and to spend some money those resources will have to come from the private sector in some way. So the spending measures, the burden of the decision to go ahead and provide a program, which is presumably done on the basis of the merits, but the cost is what is given up in the private sector, it will, as you point out, be financed one way or the other.

It will be financed either by taxes or by borrowing; and the real issue becomes then, for the particular taxes that one might choose to finance that, what would be given up in the private sector? Will it be consumption spending at that point in time or will it be some saving which will provide for future accumulation of capital and labor skills?

And when one borrows, again, what is given up in the private sector? Are you giving up current consumption, higher interest rates? Do people forego buying something on their credit cards or does it crowd out capital investment for the future? In comparing the two ways of financing a given level of spending, that is really what you are trying to decide, which one will have the biggest impact on both the present and the future.

Mr. HENSARLING. We are asking you to engage in a number of 10-year projections, which I am somewhat dubious about our ability to look into a crystal ball and particularly predict economic growth. It does seem like we have a fairly good indication of our ability to predict growth of government, but some on the other side of the aisle consistently point to economic growth tax relief as being the significant contributing factor to deficits. But since we just passed a 10-year budget, if I am doing the numbers right, we passed $350 billion of economic growth tax relief versus a $28.3 trillion worth of spending. If I am doing the math right, the economic growth tax relief, assuming it has zero impact on the economy, is 1.2 percent of $28.3 trillion. Wouldn't that suggest that if you wanted to do something about the deficit maybe you would look at the spending side, which appears to be 99 percent of the equation?

Mr. HOLTZ-EAKIN. Well, I am not sure where you are doing your math, but I will stipulate that it is correct. We can talk about it later.

Going forward, the issue is really one can choose to address the deficit per se on either the receipts or the outlay side. That is a decision to either change the scope of government activities on the spending side or change the way you finance existing government spending on the revenue side, and you have both of those options going forward.

Mr. SHAYS. Thank the gentleman.

Let me just, for the benefit of the members—the list I have, there are no other Republican speakers except for me at the moment, and so what I have is I have Mr. Edwards next followed by Mr. Scott, followed by Mrs. Capps, followed by Mr. Emanuel, followed by Mr. Lewis and then Ms. Baldwin. So we will go with you, Mr. Edwards.

Mr. EDWARDS. Thank you.

Mr. Chairman, the Republican leadership in the House cannot have it both ways. It cannot pass budget resolutions year after year on a totally partisan basis and then deny responsibility for the consequences of those budgets. It seems to me that if you want to preach personal responsibility, you must first practice it. I believe the startling deficit numbers should be a wake-up call for the free lunch bunch, those who have preached the failed philosophy that we can have trillion dollar tax cuts, massive increases in defense spending and still balance the budget.

This jobs growth and balanced budget dream and promise has turned into a looming economic nightmare. As a result of the free lunch fiscal policies, we now have the largest deficit in American history—let me repeat—the largest deficit in American history combined with the largest loss of jobs since Herbert Hoover.

What do massive deficits mean to average Americans? Well, as a result of these deficits, businesses and family farms will be taxed because of higher interest rates on their loans to run their businesses, thus slowing economic growth. In the short run, it will mean more—it will be more expensive for working Americans to build a business, to buy a home, to buy a car or to pay off credit card debts.

In the next decade these deficits will mean Social Security and Medicare benefits will be put at risk as millions of baby boomers start to retire, and in the long run our children and grandchildren will face massive tax increases to pay for the four to five hundred billion dollar annual interest charges on our huge national debt.

Let's look at the consequences already this year. As a member of the House Appropriations Committee, I have witnessed this. The bill has come due this year for an irresponsible fiscal policy implemented by the Republican majority in Congress.

First, military construction funds to improve homes, schools and Medicare clinics for the families of our military servicemen and women serving in Iraq are being cut this year by $1.5 billion, or 14 percent.

Veterans who were promised by Republicans in the House in the budget resolution just a few months ago they get a $1.8 billion increase over the President's request in VA health care spending woke up in August and saw that the leadership in the House had taken away every dime of that promised $1.8 billion increase for veterans' health care. As a result, veterans' health care, according to the Veterans' Administration, will be $1.9 billion less than that necessary to meet 2004 anticipated health care needs of veterans already enrolled in the VA health care system.

So, as a result of all this deficit policy, we are cutting health care benefits to veterans during a time of war. What a terrible message to send to the 20,000 soldiers from my district at Fort Hood that are now in Iraq.

The administration even continues to support cutting military impact aid education for military children's education programs by $173 million. So cut the kids's education funding while Mom and Dad get on the airplane to fly to fight in Iraq.

Unfortunately and unfairly, Mr. Chairman, the people hurt by the Republican's failed economic policies are those who can least afford it, working parents who have lost their jobs, small businesses and families who have to borrow money to build a business or buy a farm. It hurts seniors who depend on Medicare and Social Security, and it hurts servicemen and women and veterans who have already made tremendous sacrifices on behalf of our Nation.

Mr. Chairman, this is an awfully high price for millions of Americans to have to pay for failed economic policies that former President George Bush once called "voodoo economics." To add insult to injury, Americans learned in the 1980s that the promise of massive tax cuts, huge defense increases and balanced budgets is a false promise that leads to huge national deficits. At least David Stockman, the architect of the Reagan tax cut of 1981, had the integrity to admit two decades ago that these numbers were a false promise, but to repeat those false promises 20 years later at the expense of seniors, veterans and children is inexcusable.

The Republican party once took pride of being the party of fiscal responsibility. Now today it must take responsibility for massive deficits, millions of lost jobs and cuts to programs important to veterans and seniors and children.

Despite all of that, Mr. Chairman, I will work on a bipartisan basis with my Republican colleagues to address these challenges, but I will not vote to cut veterans' benefits and children's programs and education programs to pay for a repeal of a dividend tax cut or a regressive tax system that leads to lost jobs and a massive deficit.

Mr. SHAYS. I thank the gentleman.

Mr. Scott, you are next, and my apologies. Mr. Kind, I made him my idol, Mr. Lewis, by mistake; and he——

Mr. KIND. I am still your idol, Mr. Chairman.

Mr. SHAYS. But you are not Mr. Lewis.

Mr. Scott.

Mr. SCOTT. Thank you.

Can we get the Social Security chart up? I don't have that. Well, could you get chart No. 11? OK, this is the Social Security chart.

Mr. Holtz-Eakin, does that accurately depict the Social Security cash flow for the next 30 or 40 years?

Mr. HOLTZ-EAKIN. It looks to be right.

Mr. SCOTT. It shows that right now we are enjoying between Social Security and Medicare about a $150 billion surplus?

Mr. HOLTZ-EAKIN. Well, we can certainly check in the numbers, but——

Mr. SCOTT. Looks about right.

Out of that, the $400 billion deficit that we expect this year, is that before or after we raid the Social Security and Medicare trust funds for about $150 billion?

Mr. HOLTZ-EAKIN. The $400 billion deficit consists of $162 billion in an off-budget surplus and a $562 billion on-budget deficit.

Mr. SCOTT. Which means we raided the Medicare and Social Security trust funds for $162 billion?

Mr. HOLTZ-EAKIN. Yes, $162 [billion].

Mr. SCOTT. So that if we don't count that, because we are going to have to—we are going to need that later on, the on-budget deficit is $562 billion this year?

Mr. HOLTZ-EAKIN. The on-budget estimate is $562 billion in fiscal year 2003.

Mr. SCOTT. And next year?

Mr. HOLTZ-EAKIN. It would be $644 [billion].

Mr. SCOTT. A $644 billion deficit.

Now, on——

Mr. EMANUEL. Would the gentleman yield for one quick question?

Mr. SCOTT. I will yield.

Mr. EMANUEL. Mr. Director, if that is correct, the $640 [billion]—what did you say? $644 billion? What percentage of that is the GDP?

Mr. HOLTZ-EAKIN. I don't——

Mr. EMANUEL. Would 5.8 be close?

Mr. HOLTZ-EAKIN. It is somewhere in that vicinity.

Mr. EMANUEL. So it would be equal to the largest deficit ever run as a percentage of GDP, which has always been used by the chairman as a correction to us that we are not running the largest deficit.

Mr. Scott, I don't mean to take your time because I know you have got 5 minutes, but for the record in fact we are running equal to the largest deficit as we did in 1983, because in 1983 we didn't have a Social Security surplus as we do now, and if you didn't use Social Security surplus to do your math, we would be running at a deficit equal at the largest point in history to GDP—as a percentage of GDP.

Mr. HOLTZ-EAKIN. With all due respect, I don't think the numbers are comparable, because it is the unified surplus that represents the net drain on credit markets and has the economic impact.

Mr. SCOTT. Reclaiming my time, you are talking about a deficit next year of $644 billion if you——

Mr. HOLTZ-EAKIN. That is our projection.

Mr. SCOTT. OK. On page 4, table 1–2 of your report, how much do you project coming in in revenues from the individual income tax?

Mr. HOLTZ-EAKIN. In fiscal year 2004, $765 billion.

Mr. SCOTT. And you are running a on-budget deficit of $644 [billion]?

Mr. HOLTZ-EAKIN. Your projection is $644 [billion].

Mr. SCOTT. Now, does that include the $60 billion that was just requested for the Iraq supplemental?

Mr. HOLTZ-EAKIN. It would include the inflated value of the fiscal year 2003 supplemental which had $60 billion for activities in Iraq and Defense Department.

Mr. SCOTT. We just want the numbers to be in perspective, because we are getting $765 billion from the individual income tax, and we are $644 billion in deficit, just to give an order of magnitude.

Now the chairman put up a chart that showed that we could actually get back in—if we didn't mess up the budget any worse than we are doing now, that we could be in surplus in about 8 to 10 years. Did that chart assume that we are going to let all of the tax cuts expire as they are scheduled to expire?

Mr. HOLTZ-EAKIN. The baseline projection that I presented, the sunset——

Mr. SCOTT. Can we get chart No. 9 and then chart No. 10?

Mr. SHAYS. Let me just say to the gentleman, his time is running short here, but let's go through these, and then we——

Mr. SCOTT. OK. Chart No. 9 and chart No. 10, if you will just put them up real quickly. That is what—if we don't make it any worse, we actually go up into surplus, although you are still raiding Social Security, but if we adopt in chart No. 10 the Republican proposals, it is getting worse, you are at 4-, 5-, $600 billion a year. Does that suggest that it would be dangerous to adopt the Republican proposals?

Mr. HOLTZ-EAKIN. I am not exactly sure that is the—to make the tax cuts permanent, AMT, Medicare prescription drug, are those the proposals?

Mr. SCOTT. Right.

Mr. HOLTZ-EAKIN. And discretionary spending?

Mr. SCOTT. Right.

Mr. HOLTZ-EAKIN. I think the message—if it is the blue line—we were looking at a unified deficit of roughly 7 percent of GDP, the lower boundary of the charts I presented. I can compare numbers later. To run sustained deficits of that size will have consequences for the accumulation of capital——

Mr. SCOTT. When we run out of the Social Security surplus, will we be able to pay Social Security if we adopt those policies?

Mr. HOLTZ-EAKIN. The projections that we present are unified and thus reflect all cash flows into the Treasury for both mandatory and—from all receipts and then outflows for both mandatory and discretionary spending.

Mr. SHAYS. The gentleman's time has expired. He has been going on about 6 plus minutes, and I feel that Mr. Moran may want a second on this.

Are you gentlemen coming back? Because I will be coming back? We have a vote, unfortunately. So we will go to our vote and come right back, and then we can do a second round if there is that pleasure.

[Recess.]

Mr. SHAYS. We will call this hearing to order and say to you, Mr. Director, you have a very difficult task and we in Congress have a difficult task. The numbers don't look good, and in many ways nobody likes these deficits, and many of us got elected to eliminate these deficits. And here then again—so the question is, you know, what do we do about it?

I tend to come on the side of the equation that says when you have annual growth at 7 percent each year in spending or close to it when you look at mandatory and nonmandatory, it stares you in the face. If revenues don't grow at 7 percent a year even if you didn't have a tax cut, you have got a problem.

I would like to know, without tax relief, the economy would have been worse. Is that true or false?

Mr. HOLTZ-EAKIN. Again, it is a difficult question, because we don't know what the other policy would have done in terms of monetary policy. What I think there is a broad consensus about is that over the past several years the tax cuts have supported the household sector, particularly personal consumption and housing expenditure.

Mr. SHAYS. But it has been said that the 2001 recession was much milder than it would have been without the tax cuts that year, and you agree, but it just depends to what level.

In a similar vain, would the current unemployment situation be worse if not for the tax cuts? If so, do you have an estimate of how much worse?

Mr. HOLTZ-EAKIN. I don't have an estimate for exactly the same reason, but cyclical unemployment would be the mirror image of the degree to which the economy is operating below its potential.

Mr. SHAYS. In what ways would the tax cuts of 2001 and 2002 contribute to the economic improvements we have begun to see? And you do agree that the economy is improving, correct?

Mr. HOLTZ-EAKIN. We do see, as our forecast indicates, an economy that will improve over 2003, 2004. Embedded in that improvement is a rise in business investment. In part that is a result of the partial expensing and section 179 investment incentives that were in the 2003 and earlier tax measures. That supportive business investment, we expect to have a modest impact in 2003, but more substantial, as much as a 5-percent increase in business investment, in 2004.

The household sector has continued actually to be relatively resilient to the downturn, but we expect that the fiscal policies in place going forward will support its ability to rebuild its wealth through some saving as well as maintaining a healthy rate of consumption expenditure, and those two pieces are the key to sustained economic growth.

Mr. SHAYS. Do you have any way of evaluating what the impact would be first if the tax cuts were repealed or if they were allowed to be discontinued as they are not renewed? Do you have any way to evaluate the impact of that?

Mr. HOLTZ-EAKIN. Well, as our report discusses in the chapter on the economic outlook, in our baseline projection we try to incorporate to the best of our ability the impacts of the sunset of the tax cuts toward the end of the budget window on the potential GDP of the economy. The net effect is a modest negative in which under the current fiscal policies, while they have some beneficial incentive effects through lower marginal tax rates, the accumulated deficits tend to crowd out capital accumulation enough that productivity growth is lower, other things equal. It is that net effect that we can quantify. Breaking apart the different pieces is not really very tractable.

Mr. SHAYS. So the bottom line, we are seeing some significant deficits.

We have some real question marks about what we need to spend in Iraq. Has the administration presented any document to you as to what they think we need to spend on the military side and then what they think we need to spend on the rebuilding side?

Mr. HOLTZ-EAKIN. No, they have not.

Mr. SHAYS. Have you requested that information?

Mr. HOLTZ-EAKIN. No. We typically respond to requests from Congress and——

Mr. SHAYS. Well, I am certainly going to make that request through you all to have that done. There is no doubt in my mind that when we look at all the things—and I voted for the tax cut. I believe that we were right in doing that, but I think that I would be irresponsible if I don't just put everything into play as to what our future needs are going to be.

With that, I think that, Mrs. Capps, you have the floor. Is that correct? Yeah. You have the floor.

Mrs. CAPPS. Thank you, Mr. Chairman; and thank you, Mr. Holtz-Eakin, for your patience with our back-and-forth schedule today.

To continue the discussion on the effects of the tax cut on the deficit, particularly comments that have been made today and other times that the tax cuts did not cause these deficits, but to turn to page 15 of the budget outlook and quote you—or whoever put it together under your supervision at least—and this is a quote: "Laws enacted in the past 5 months are responsible for nearly two-thirds of the increase in the projected 2003 deficit and for an even larger share, roughly 70 percent, of the increase in the projected 10-year deficit, and one of the most * * *"—this is, I think, significant—"* * * one of the most significant of those laws from a budgetary perspective is the jobs and growth tax relief bill which is estimated to increase the deficit by $62 billion this year and by $288 billion over the 2004–13 period."

Then you do have a table 1–8 to substantiate that.

I will ask you for a comment in a minute, but I'd like to be clear and proceed from that point about what is and is not included in the budget projections before us. These issues have been raised but not with an opportunity I think for you to respond.

CBO is projecting a $480 billion deficit for the next year and a whopping $1.4 trillion deficit to be racked up over the next 10 years. But this understates the case—and this point is being made by several of my colleagues, but I want to talk about two or three of the issues which CBO's figures don't include, like a number of likely expenditures that Congress is poised to make. CBO by law has to assume only what is in the law when it figures the baseline budget, is that correct? But for us to get a realistic budget, I think we need to anticipate some sure markers as well.

For example, today as we are here, my colleagues on the Energy and Commerce Committee are having a hearing on the blackout and the chairman wants to finish the conference report on the energy bill by the end of this month. I think we are going to be voting on conferees today. The energy bill has some $20 billion of subsidies to the energy industry in it, and these new costs to the Federal budget and the taxpayer are not included in your projection. If this bill becomes law by September 30, we would have to add these costs to our deficit projections, is that correct?

Mr. HOLTZ-EAKIN. That would be correct.

Mrs. CAPPS. Then another topic that is of great interest to the Energy and Commerce Committee is the Medicare prescription drug coverage which could also be completed in the next couple of months. Hopefully, we will be coming back from the conference and voting on some kind of package, but it is supposed to cost at least $400 billion over the next 10 years and probably more if we include payments to rural providers that Senator Grassley and others, including me, are very concerned about. So, again, that $400 billion is not included in the projections, but we would have to increase our deficit projections if that becomes law, is that correct?

Mr. HOLTZ-EAKIN. That is correct.

Mrs. CAPPS. If it becomes law, but it is quite—I mean, it is everybody's interest that it would become law.

Again, not to rub this in, but your projections are assuming that the tax cuts will expire, because that is the way the bills were written. But it has been said over and over again by the White House and others that the tax cuts are going to be made permanent, and then that of course would change these potential costs as well, am I correct?

Mr. HOLTZ-EAKIN. Yes.

Mrs. CAPPS. These changes would add $1.5 trillion in our deficit over time.

Just a couple of others. What about any fixes to the AMT?

Mr. HOLTZ-EAKIN. They are not in our baseline.

Mrs. CAPPS. And they are not in the baseline but this is going to begin to affect millions of middle-class taxpayers the next few years, and the President has indicated that he very much wants to fix this, and I think he has substantial support for doing that. That might cost, say, $400 billion in projected additional deficits, maybe closer to $700 billion if the Bush tax cuts don't expire.

Well, this is something of concern to me, and I think it needs to be stated. Then is it correct that you will be coming back if these laws are enacted, if they are, with an additional set of deficit figures?

Mr. HOLTZ-EAKIN. In a typical course of events, anything that is passed between now and our January projection of the economic budget outlook would be incorporated in our baseline in January.

Mrs. CAPPS. Finally, we have not included in my discussion any potential increases in defense spending or the mandatory costs of the extra debt service, am I correct?

Mr. HOLTZ-EAKIN. That is right.

Mrs. CAPPS. Thank you very much Mr. Chairman.

Mr. SHAYS. Thank the gentlelady.

Mr. Baird is next, but he is not here, so I think we go to Ms. Baldwin.

Ms. BALDWIN. Thank you, Mr. Chairman, and thank you, Mr. Holtz-Eakin.

As I read comments from some of my colleagues in the news, it appears that some of our former deficit hawks are becoming deficit doves these days, and I remain deeply concerned about our economic crisis, as I see it right now.

Your August CBO baseline projection showed that just shy of $1.4 trillion will be added to our national debt by the end of a decade's time, and I think we all know that this number will actually be much higher.

If we could have slide No. 3 up there, that would be helpful.

Because of course by law your baseline projections don't include some of the things that have been outlined by previous members through their questioning but things that we feel are relatively confident are going to happen. I think we can all assume that these numbers are going to end up being much higher, and I am concerned about these deficits for many, many reasons, including their impact on Social Security, their impact on the next generations who come through, the impact on vital security, both national and homeland security issues, health issues, education priorities, and also the impact on the budget of average families in the United States. Right now an average family of four is paying, as I understand it, in excess of $2,000 a year just to service the interest on national debt without these additions.

If we look at these additions, we are talking about doubling that over the course of a decade. Our staff puts the figure just over I think $4,500 a year, and for a Congress that is so concerned about providing tax relief, putting money in the pockets of these families, these numbers just have to make you wonder.

Now the projections that you have shared with us assume that we can grow out of these budget deficits. Barring any drastic increases in domestic spending—and of course the chart indicates that, you know, we must assume some that aren't in this baseline—you have assumed rapid economic growth in the year 2004 and thereafter, 3.8 percent real economic growth for the year 2004, 3.5 percent for the year 2005 and at least 3 percent growth through 2008.

At that point, growth slows a bit in large part because of the retirement of the baby boom generation gradually from the labor force.

In addition, when you look at all of the things that just are not currently assumed in the August CBO baseline but we assume will happen, when those costs are factored in, the House Budget Committee Democratic staff project that our debt will outrun the economy indefinitely.

So I guess in terms of questions of you, sort of how big does a deficit have to be to hurt the economy? And the companion issue is, what sort of economic growth do we have to assume to grow our way out of this once these pretty clear items are added to your baseline after Congress acts?

Mr. HOLTZ-EAKIN. With regard to the first question, I would emphasize that there is no clear one-to-one relationship between Federal Government deficits and economic performance. We ran deficits that averaged about a little over 2 percent of GDP in the 1970s. We also ran deficits that averaged 2 percent over GDP in the 1990s, and economic performance differed greatly. Deficits are both the results of deliberate policy decisions but also the result of economic performance and as an outcome they reflect a great many factors. So I think emphasizing a clean relationship between what is the right deficit to get the right economic performance is not a good way to think about it.

With respect to the question of what would economic growth have to be in order to, for example, stabilize the debt-to-GDP ratio under this set of policies, that is something that we could certainly investigate. I would hesitate to do that calculation in my head, but I do think that, in terms of framing the question, if there was a particular set of policies that was enacted going forward, one would want to identify the impact on the debt-to-GDP ratio and whether that did in fact stabilize at some point in time. If it did, then the economy would be capable of supporting not just the debt but the payments on that debt without any sort of tendency to explode in an ever-increased need for borrowing. I would be happy to work with you on that.

Mr. SHAYS. Mr. Baird, you have the floor. We might be able to do both you and Mr. Cooper, and we are happy to come back to take advantage of you if you want to come back after the vote.

Mr. BAIRD. I thank the chairman.

I appreciate the report you have produced, and I have a couple of brief questions about it. Many of us in this body have pledged to put Social Security and Medicare in a lockbox. That includes the

President of the United States as well as the chairman of this committee and most Members probably. At the same time, many people have called for a balanced budget amendment to the Constitution. If we put Social Security and Medicare in a lockbox and did not include it in the unified budget calculus, at what point would we be adhering to a balanced budget?

Mr. HOLTZ-EAKIN. I guess I would have to understand a little better what lockbox means.

From an economic point of view, the administration of the on budget and off budget surplus is an intergovernmental——

Mr. BAIRD. Let's suppose we——

Well, we all voted for it. Maybe somebody in this body understood it, but let me guess that what we meant was that we shouldn't be borrowing from it and including it in a unified budget. In other words, we should report the—let me say it differently then. At what point will the on-budget numbers be in balance?

Mr. HOLTZ-EAKIN. Well, I can take a look at the table. I am not sure what the answer to that is, but I guess I could—in the baseline projection, the on-budget deficit is $104 billion in 2013, so at the end of this window it is not yet——

Mr. BAIRD. In other words, if we honored our commitments to put Social Security and Medicare in a lockbox and if those who have called for a balanced budget amendment adhered to their own rhetoric, we don't need that rhetoric until at least 2013 and possibly well beyond?

Mr. HOLTZ-EAKIN. Yeah. I think that—I guess so that I can understand the question—not to be difficult—but you can think of the balanced budget excluding the Social Security surplus, the off-budget surplus as a fiscal target, and the degree to which you legislate a fiscal target will be similar in spirit to the Hollings and——

Mr. BAIRD. Folks have called for a constitutional amendment to require it, and they have said that the only exemption would be in a time of national disaster. So presumably either a national disaster continues till 2013 or we are not consistent with our own rhetoric, at least those who have said they support a balanced budget amendment and Social Security and Medicare in a lockbox.

Let me point out an interesting thing. You, I think, fairly and accurately observe that the—you put the context of the deficit in relation to the Federal GDP. I did some looking, and my guess is that it is—and it is an estimate, but as a percentage of California's domestic product, the California deficit today is about 2.8 percent. How does that compare to the deficit as a percent of GDP in the United States?

Mr. HOLTZ-EAKIN. Fiscal year 2003 would be 3.7 percent in our estimates.

Mr. BAIRD. So the Federal budget deficit is higher as a percent of GDP at the Federal level than is California's deficit as a percent of California's overall economy, and yet the State of California is seeking to recall their governor over the deficit.

Mr. SHAYS. Would the gentleman yield?

Does that include, though, debt service, in other words, the money that they legally can borrow? I don't think it does. I think it just includes their deficits, not their debt service.

Mr. BAIRD. I don't know the answer to that, Mr. Chairman. I would be interested in that.

Mr. HOLTZ-EAKIN. More generally, clean comparisons between State-level accounts and Federal accounts are not easy. State-level accounting often includes capital accounts in addition to the general fund and a variety of other things.

Mr. BAIRD. That is helpful to know. And ours doesn't.

I am sure it has already been addressed, but the chairman at the start talked about whether or not someone would be bold or foolhardy enough to raise taxes, and yet—do we have chart No. 1 of—maybe somebody has already addressed this in my absence. I was over at the floor. Do we have chart 1 from the chairman's own charts? Can we call that up? The chart where he basically saw that the tax cuts—the impact of the tax cuts on the budget had minimal——

That is it. Thank you very much.

I regret the chairman is not here, but it would seem to me that if indeed the tax cuts become such a small portion of impact at 2006, then the chairman himself must be advocating for a repeal of the tax cuts or, in other words, a sunset, which I think he tried to imply that if you support a sunset of the tax cuts then you have actually supported a tax increase.

Can you get to that number, as reflected on his chart, without sunsetting the tax cuts? In other words, if you extend the tax cuts, can that red line get so small as that?

Mr. HOLTZ-EAKIN. If I understand the chart, it is what has happened since the March baseline provided by CBO, which is the top; and indeed legislation since March has largely had near-term impacts on the tax line, which is I think the part at the bottom. Then there were legislative impacts on the outlay side in the supplemental, and the rest would be the economic. So that is what has changed since our March baseline.

Mr. BAIRD. Maybe I didn't——

Mr. HOLTZ-EAKIN. And our March baseline included the sunset, as does the——

Mr. BAIRD. So this chart includes a sunset?

Mr. HOLTZ-EAKIN. Both.

Mr. BAIRD. Implying then that——

Mr. HOLTZ-EAKIN. The top line and the bottom line both have a sunset——

Mr. BAIRD. I understand that.

Mr. SHAYS. Let's see if we can get Mr. Cooper in before, unless he wants to come back after, because I know others will come. But do you want to do yours now or when we get back, Mr. Cooper?

Mr. COOPER. I will try to be brief, Mr. Chairman.

This is a grim day for the country, because we are basically facing the largest absolute deficits in our Nation's history and also the worst job performance. As I understand it, we have lost some 2.7 million jobs in the last 2 or 3 years. What advice would you have for this Congress? What do we need to be doing to promote job growth in this country? We have bills that we passed that are called growth bills, but they don't seem to be working. This is the worst job performance since Herbert Hoover was President. What can we be doing to put more people in America back to work?

Mr. HOLTZ-EAKIN. Well, as you know, the CBO is not in the position of providing policy advice and particular recommendations. I will point out that in our baseline projections we anticipate that the resumption of economic growth will, with the typical fashion, carry with it increases in payroll employment, something to be on the order of 150,000 or so a month, but that the unemployment rate doesn't come down as fast as one might expect because people come into the labor force.

The question then is whether policies would be desirable to make more quickly the return to full employment or to let that pace be satisfactory. Our baseline projection shows a return to potential GDP and full employment over the next several years, and it is an issue of timing—instead of do we have it or not.

Mr. COOPER. Economic growth according to technical measures seems to be resuming. It was just revised upward for the second quarter. We had 3.1 percent growth in our economy in the second quarter of 2003, and yet the job performance doesn't seem to be there. At least it is not pulling overall unemployment down from the 6.2 percent level. So it suggests to me that maybe tax cuts are not the right medicine. We need to do more than that, and the other party has traditionally spurned direct government spending programs, public works program and other things like that where you can say with certainty that you are putting people to work.

You don't have to rely on indirect effects to get people employed; you know you are putting people to work, and yet this administration has generally opposed efforts like that in favor of more indirect approaches, tax cuts.

One of the reasons I appreciate you is you do seem to be willing to tell truth to power. On your other report, on our situation in Iraq you point out that our Army could be short-staffed as soon as March of next year. But in this report that you issued to this committee, on page 45 you point out that the tax legislation that has been passed in the House of Representatives and the Congress since 2001, quote, will probably have a net negative effect on saving, investment, and capital accumulation over the next 10 years.

That is a powerful condemnation of what this Congress and the prior Congress has passed into law, to have a net negative effect on savings investment and capital formation. Isn't that largely the source of new jobs? You have to have new savings, investment, and capital formation in order to create a genuinely growing economy, don't you?

Mr. HOLTZ-EAKIN. This particular comment is about the potential GDP, the long-run growth. The near-term job creation will be the return of the economy to full employment. So I would distinguish between the cyclical component—about which I think there is broad consensus that we have not seen a recovery in the labor market yet and would anticipate to have at some point—and then, the pace of long-term economic growth. And with respect to capital accumulations, that probably shows up more in wages per job than in the number of jobs over the long-term.

Mr. SHAYS. Let me just interrupt the gentleman. We have 4 minutes left; we need to get back. I think the ranking member is not coming back. I don't want to have the Director stay if we are not coming back. So are you coming back? You two gentleman are coming back? Then we will come back. OK. I am sorry to hold you up, but that is your job, Right?

Mr. HOLTZ-EAKIN. That is my job.

Mr. SHAYS. OK. Thanks. We are not adjourning. We are in recess.

[Recess.]

Mr. HENSARLING [presiding]. The committee will come to order. And, Mr. Edwards, you are recognized.

Mr. EDWARDS. Mr. Chairman, thank you very much. Let me say, first of all, in my 12 years in Congress I have never questioned attendance at a committee hearing, because we all are busy and have busy schedules, and I appreciate the chairman coming back to oversee the continuation of this. But out of 24 Republican members of this committee, I am not sure if there were more than 4 or 5 that actually showed up for this hearing, and it just seems to me if one is going to be a proponent of the tax cuts as part of the heart and soul of our Nation's fiscal policy, then it would be certainly good to show up on the day when we have to face the bill collector, and admit to policies that have been a big part leading to the largest deficit in American history. And I think, Mr. Chairman, it is not that you and I might have differences over how we get out of this mess, but by the total lack of interest today. This is the first week after a 5-week break. We knew about this hearing, and while members do have other things on their schedules I would like to know how many of those things are more important in terms of priorities than dealing with the largest deficit in American history. And if I were an American citizen watching this hearing, I guess that would concern me, the lack of interest in this, and frankly even on the Democratic side. While we had more members attending before all of the votes, I would be the first to say I wish we had more Democrats here.

Having said that, I do appreciate the chairman allowing us to continue with a few questions on this vitally important national issue. And perhaps maybe what we ought to do is hold this hearing again at a time when members would find it in their schedule the ability to deal with one of the most pressing problems facing our country with this committee having direct responsibility for that budget.

Dr. Holtz-Eakin, what I would like to ask you is this, and you can tell me if these are ballpark numbers. But there has been a discussion about what extent of the tax cut has been a contributing factor to the deficit. According to a document put out by the House Budget Committee Democratic staff, I show that for 2004, if you count net interest costs, the 2001 tax cut cost $121 billion in lost revenues; the 2002 tax cut cost $34.8 billion in lost revenues for fiscal year 2004; and then the 2003 tax cut is $153 billion. If I add that up, including extra interest on the debt, which is a direct cost of deficit spending partly caused by tax cuts, I am talking about, according to the Budget Committee Democratic staff, $309 billion of the deficit in fiscal year 2004 as a direct result of the tax cuts.

Do you have any numbers to suggest that those are not in the ballpark?

Mr. HOLTZ-EAKIN. Well, table 1–8 shows the impact of the 2003 tax cuts on our baseline projections, and we could certainly go back and check.

Mr. EDWARDS. What numbers do you show?

Mr. HOLTZ-EAKIN. Well, for 2004 the total revenue changes are $135 billion. I think you said $150 [billion].

Mr. EDWARDS. We used $153 [billion]. I think we counted some net interest on that. So let us just round it off to the nearest $50 billion. For those who had suggested that the tax cuts haven't really played a role in contributing to the largest deficit in American history, the fact is that somewhere between $250 [billion] and $300 billion of the 2004 projected deficit will be a direct result of the 2001 tax cut as well as the 2002 and 2003 tax cut, making the note, if I could, that the 2002 tax cut and the 2003 tax cut were after September 11 of 2001 and the unexpected tragedy that our country faced.

Let me ask just a series of quick—perhaps you can answer this yes or no—quick questions in terms of the numbers projected for the largest deficit in American history. It does not include the full cost for the $60 billion in today's Washington Post the President is asking for as an addition to the Iraqi war. Is that correct? It doesn't assume the full cost of that $60 [billion] to $70 billion. Is that correct?

Mr. HOLTZ-EAKIN. It does repeat the supplemental from 2003, so that was about $60 [billion] for defense and it is deflated above that. So that is in our baseline.

Mr. EDWARDS. Some of that might be included in that?

Mr. HOLTZ-EAKIN. So to the extent that it covers that, it does.

Mr. EDWARDS. With 9-percent increase in the number of veterans enrolled in VA health care, what do you assume for increased cost in VA spending between 2003 and 2004?

Mr. HOLTZ-EAKIN. I don't know that number, but it is in the report.

Mr. EDWARDS. I will continue on, Mr. Chairman.

Mr. HENSARLING. The gentleman's time has expired. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Director, can you give us an idea of the impact of 2001 and 2003 tax cuts on stimulating the economy?

Mr. HOLTZ-EAKIN. Well, as I mentioned earlier, one could derive estimates of the impact of the tax cuts on household consumption and the degree to which that helped demand. One can provide estimates of the impact of the partial expensing in section 179 investment, expensing for small businesses on business investment.

For the 2003 tax cut, our baseline includes some impacts on business fixed investment and thus GDP, which are modest in 2003 and larger in 2004, perhaps contributing as much as a half a percentage point of GDP to additional growth. If one were to try to do a retrospective on the overall impact, it would be difficult to do because the existence of those policies changes the incentives of other policymakers, especially the Federal Reserve.

So the net impact is very difficult to ascertain without making some specific assumption with what the Feds would have done in the absence of the tax cut.

Mr. SCOTT. Are you familiar with the Joint Committee on Taxation models that came up with the conclusion that long-term there would be a fewer jobs as a direct result of the 2003 tax cut than if you hadn't passed it?

Mr. HOLTZ-EAKIN. I am familiar broadly, not in intimate detail, with the joint committee's efforts to do modeling similar to what we do with the analysis of the President's budget.

Mr. SCOTT. Could we get number 11, chart number No. 11?

Net interest on the national debt again goes from $322 [billion] to $647 billion in your report. Is that right?

Mr. HOLTZ-EAKIN. I am sure——

Mr. SCOTT. That is $647 billion interest on the national debt.

Mr. HOLTZ-EAKIN. I will just take that.

Mr. SCOTT. 2013. That is on page 10.

Mr. HOLTZ-EAKIN. Net interest in 2013.

Mr. SCOTT. No. Gross interest. Well, I assume you expect to pay Social Security back with interest.

Mr. HOLTZ-EAKIN. It has no net effect on the budget. That is an intergovernmental transfer.

Mr. SCOTT. Well, and when the time comes—well, if you are going to repeal Social Security, then you don't have to worry about it; you can do net interest. If you are talking about replacing the money in the fullness of time, then you need to talk about gross interest.

Is that right?

Mr. HOLTZ-EAKIN. But what we show in our baseline is the overall impact on receipts, outlays, and borrowing from the public that would allow you those gross interest payments that are intergovernmental transfers.

Mr. SCOTT. The income tax generates $765 billion in income tax. That is on page 8—excuse me. That is on page 4.

Mr. HOLTZ-EAKIN. Yes.

Mr. SCOTT. In 2013, you have $1.9 trillion.

Mr. HOLTZ-EAKIN. Yes.

Mr. SCOTT. That assumes all those tax cuts expired. Is that right?

Mr. HOLTZ-EAKIN. Yes.

Mr. SCOTT. And if we adopt the Republican proposals of continuing extending those tax cuts, it wouldn't be anywhere near that amount, would it?

Mr. HOLTZ-EAKIN. In our baseline total receipts would rise by 4 percent, a little more than 4 percentage points of GDP, of which 2.3 percentage points are due to the sunsets and the remaining 2 percentage points come from a variety of other sources, rises in real income, the alternative minimum tax, taxation of tax-deferred savings plans, and then some technical factors.

Mr. SCOTT. Well, add these up. Because as we can tell from the Social Security chart, in a few years we are not going to have this gravy train Social Security generating $150 billion. We are $644 billion on budget deficit next year. Where are we going to get the money? If the income tax this year only generates about $765 [billion], where are we going to get all that extra money and then some to be able to come anywhere close to balancing the budget unless we repeal Social Security?

Mr. HOLTZ-EAKIN. It is a policy decision how one arranges the various pieces of the government budget.

Mr. SCOTT. What kind of cuts would have to be made after Social Security starts running the deficit to come anywhere close to balancing the budget? Or are we just into a structural deficit where we don't care about deficits?

Mr. HOLTZ-EAKIN. If the question is about what happens after 2018 when the cash flow in the Social Security trust fund turns negative, our projections don't extend that far, and I am not exactly sure what policy it is that you would like me to look at.

Mr. SCOTT. Well, I think the policy is you have got to repeal Social Security, or the numbers just don't add up.

Mr. HENSARLING. Mr. Scott, your time has expired, and members are advised there is approximately 8 minutes left in a vote.

Dr. Holtz-Eakin, we appreciate your testimony and your patience with us today, and the committee stands adjourned.

[Whereupon, at 1:30 p.m., the committee was adjourned.]

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