THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2005–2014

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THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2005–2014

TUESDAY, JANUARY 27, 2004

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

The committee met, pursuant to call, at 2:09 p.m., in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Shays, Portman, Schrock, Brown, Wicker, Hulshof, Tancredo, Vitter, Bonner, Garrett, Diaz-Balart, Brown-Waite, Spratt, Moran, Moore, Neal, DeLauro, Edwards, Scott, Thompson, Baird, and Emanuel.

Chairman NUSSLE. Good afternoon, the Budget Committee will come to order. Welcome everybody on the committee back for a new year and for a new budget season. We have invited the CBO Director Doug Holtz-Eakin here today to ensure that we have a clear understanding of our Nation's fiscal picture. We are here today to ensure that we have a very clear picture and understanding of our Nation's fiscal situation. It is critical for us to understand just what the bottom line is, so to speak, and so we have invited the Congressional Budget Office Director Doug Holtz-Eakin to provide us with that.

The resource that we use as a starting point is the report that was released just yesterday from the Congressional Budget Office, which gives their estimations of the budget and economic outlook for the coming decade.

Director Holtz-Eakin is here not only to discuss with us the hard and fast numbers of this report but to explain just what all these numbers mean and to put them into some context; in other words, how did CBO arrive at these estimates and what are some of the key variables that could affect our economic and budgetary future.

And again to be clear, the purpose of today's hearing is not to guess what will be in the President's budget or to even for that matter begin writing our budget, but to get a solid understanding of where we are right now so that we can have a better idea of where we should go from here.

Next Monday the President will introduce his budget and we will begin a series of hearings, at which time it will be appropriate to discuss what should or for that matter what should not be in next year's fiscal budget.

That said, let's get this process started by taking a look at what we have got. First, this report tells us in one very important respect that we are in a pretty similar situation or position as we were back in August when we received these projections. We have large deficits in the near term, $477 billion in fiscal year 2004, and then $362 billion in fiscal year 2005, with deficits declining over the next decade according to this estimation.

This is really not a surprise. We have these deficits because we intentionally spent—and I say intentionally spent—at an extraordinary pace to react to extraordinary circumstances ranging from terrorist attacks and conflicts in Iraq and Afghanistan to an economic recession.

Now, does that mean these deficits are unimportant? Of course not. I have said that the spending driven deficits are an issue that we do need a get a handle on, we are going to get a handle on this information today because we are going to have a lot of serious discussion and have to make a whole lot of tough choices in the next few weeks to try and figure out where we need to go from here.

Before I turn this over to Director Holtz-Eakin for his explanation of the report, I would like to stress a couple of key points that I noticed in looking through the report. First, last year at this time we made it clear that we needed to invest in our economy to get it growing again. Those investments have clearly paid off. From GDP growth to retail sales we are seeing record highs; and most important, the economy has begun to create jobs again. Not as quickly as we would like, but it is moving in the right direction and faster than just about anybody predicted a year ago today.

In fact, to quote the report, “The economy should continue to grow at a healthy rate over the next 2 years for a recovery appears to have taken hold.” There should be no question that the economy has begun to recover and that the tax cuts that we installed are working.

That said, I believe our starting point for the budget is really different in two cases. First, CBO’s baseline assumes that Congress will raise taxes or that in fact the tax cuts will not be made permanent. This assumes that expiration of a whole range of tax relief provisions, including increasing the marriage penalty, reducing the child tax credit, resurrecting the death tax, increasing taxes on capital gains and stock dividends and increasing taxes on small businesses, for that matter increasing taxes on every American who pays income taxes, will occur.

That is not an assumption that anyone should make as we move forward. This will not happen as far as I am concerned in this budget or under our watch. In fact, I would be willing to wager that we might even have a few Democrats who might be willing to support it in that regard. So I think you can safely rule out that part of the assumption.

Second, the baseline assumes that the $87 billion of the Iraq supplemental that we spent last year will continue to be spent every year for the next decade. I think that also we can presume, barring extraordinary emergencies, that that will not also be the case.

So with that context and that understanding, we need to turn to the report and to get the wisdom of the Director of the Congressional Budget Office. Before we do that, let me turn it over to Mr. Spratt for any comments that he would like to make.

Mr. SPRATT. Thank you, Mr. Chairman. Dr. Holtz-Eakin, we welcome you back. As always, you have done an excellent job as the

Director of the Congressional Budget Office, and we welcome you today even though you are not exactly the bearer of good tidings. You have got some very sobering news for us about the budget.

Your projections show that deficits loom far into the future, that we are not going to grow out of them and somehow glide effortlessly to the conclusion we all want, which is a balanced budget, and frankly I think they cast grave doubts on the Bush administration's claim that it will be able to cut the deficit in half over the next 5 years.

In particular, the first chart that I would like to call up here gives you a summary of the deficit for this year and the decline in that deficit over 3 short years. January 2001, CBO projected we would have a unified surplus of $397 billion. Instead, we have a unified deficit this year of $477 billion.

Next chart. This shows the cumulative surplus or deficit over the period of 10 years, a deterioration from $5.6 trillion to 10-year estimated surplus between 2002 and 2011 and a cumulative deficit as CBO now sees it. That is a swing of about $8.5 trillion in the wrong direction.

Next chart. And tax cuts add to the problem. We are not here to advocate the nonrenewal of the child tax credit or the expansion of the 10 percent bracket or the 15 percent bracket, but we are here to call attention to the fact that the whole agenda of the Bush administration is tax cuts if they are extended aggravate the bottom line significantly. They increased the January 2004 baseline. With the expansion of the tax credits, the cuts come out to $4.150 trillion.

Next chart. This is the only budget surplus, excluding Social Security, which I think we should do and which Congress has dictated we should do in putting Social Security off budget. Back out Social Security, and you will see the debt accumulation between 2005–14. If you do the tax cuts, if you renew them all, we will be $7.177 trillion. That is what we will add to our national debt over that period of time.

Next chart. Now, the Bush administration is apt to say in the face of forecasts like these this is why we need pro-growth policies. We couldn't agree more. We would love to grow out of it, but the truth of the matter is that CBO is assuming pretty robust growth, 4.8 percent for 2004, 4.2 percent for 2005, tapering off to 3 percent and then dropping slightly below 3 percent, but substantial robust growth for the next 10 years and particularly in the near term.

Next chart. If you look at pages 92 and 93, that is the only place where the small print is big enough to read, you will see that if you do extend the tax cuts, you will add $2.3 trillion to the deficit over 2005, between 2005–14, that 10-year period of time.

All that is going to the bottom line. In 2001 when it appeared that we had a surplus of $5.6 trillion, some may have felt that a tax cut of $1.350 trillion was defensible, but now we know we don't have a surplus. We have a deficit, and the renewal of these tax cuts when they expire will add $2.3 trillion to that deficit. There is no way around it.

Next chart. Now, it is also said by the Bush administration frequently we have got to rein in spending, and in that regard they mean discretionary spending, which is in the 13 different appropriation bills that we pass every year. But if you look where the increases in spending over and above current services have come over the last four fiscal years, you will see that the lion's share of it, 90–95 percent, has gone to defense, homeland security and our response to 9/11 for New York City and for the airlines relief. Ninety to 95 percent of it has gone there.

I would like to think we could rein in some of that, but I don't think we can. In truth, I think you will probably see when the budget comes up an increase in homeland security because there is a fairly common feeling that we are standing on thin ice and barely funding that at an adequate level.

Next chart. So a couple quotations there that ended up. We have got a serious problem on our hands. I don't know whether we will get down to brass tacks in dealing with it this year or not but sooner or later we will have to deal with it.

One particular statement you made in the report today—a couple of them struck me, Dr. Holtz-Eakin. First of all, you noted that if we allowed the tax cuts to expire as scheduled and held discretionary spending to the rate of inflation, then the budget would balance itself over this period of time of 10 years. That is the way I read your report.

On the other hand, you said if you renew all of the tax cuts that in 2014 we will have a deficit of $484 billion. There on the eve of the retirement in big numbers of the baby boomers we will still have a huge deficit which will aggravate the problem of supporting the retirement programs that the baby boomers are looking forward to. That is the gravity of the situation we find ourselves into, and there is no way out of it except a budget plan that comes to grips with the different elements of it. It has got to include taxes, it has got to include spending, it has got to include all of these elements because this is a big intractable problem, it is not going away, and we can't grow out of it.

We will look forward to your testimony.

Chairman NUSSLE. Director Holtz-Eakin, thank you for coming back to the committee and for your work. Your entire report will be made a part of our record here today, and you may proceed as you wish to give us the details of the report. In addition, all members will have 7 days to enter statements for the record.

[The information referred to follows:]

PREPARED STATEMENT OF HON. MARIO DIAZ-BALART, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Thank you, Mr. Chairman. Today's hearing marks the first in a series of hearings leading up to the debate over the fiscal year 2005 budget. It is important to not only review the current economic state, but also evaluate the projections for the next 10 years.

Over the last 4 years, the U.S. economy has experienced significant hardship due to the 9/11 terrorist attacks, corporate accounting scandals and the wars in Iraq and Afghanistan. These events have greatly contributed to the sharp increase in spending and, ultimately, the current deficit levels.

Fortunately, the third quarter highlighted a strong recovery in the economy attributed to the growth from the tax relief passed last year and the return of investor confidence. It is now our responsibility to create policies that will not only extend this growth, but foster greater growth in the future.

It is clear that the major source of recent growth has been the tax relief passed by Congress and signed into law by the President last year. In fact, estimates show that the combined tax relief between 2001–04 amounts to nearly $600 billion (or about 6 percent of gross domestic product). Additionally, 2.1 million more Americans would be out of jobs without the tax cuts and the unemployment rate would be around 7.5 percent rather than the current 5.7 percent.

As we enter a period of growth, I strongly believe that our economic path should be focused on adhering to the concept of fiscal discipline. We must—in every way possible—help Congress restrain spending and work on eliminating wasteful spending that is hamstringing the Federal Government and greatly burdening the American taxpayer.

I look forward to working with my colleagues on the Budget Committee to ensure that the fiscal year 2005 budget not only represents a restraint on spending, but also a clear path to economic recovery.

Thank you.

STATEMENT OF THE HON. DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, thank you, Congressman Spratt, members of the committee. I appreciate the chance to be here today to talk about the CBO provisions for the budgetary and fiscal and economic outlook for fiscal years 2005–14.

We have submitted our entire report for the record. There is a short extract of it that serves as a written testimony. I will provide an even shorter version in my oral remarks so that we can turn to any questions that you might have on the material.

Briefly, the facts are as follows. CBO projects that the Federal budget deficit will be $477 billion in fiscal year 2004, will diminish to $362 billion in 2005, $269 billion in 2006, and then will steadily diminish thereafter until the budget reaches balance at the end of the budget window.

These deficits, while large in dollar terms—$477 billion is the record in dollar terms—are 4.2 percent of GDP in 2004, dropping to 3 percent of GDP and 2.1 percent by 2006. So relative to the national income and the economy, these are not the largest deficits.

Over the 10-year budget window, as the slide shows, we have a cumulative deficit of $1.9 trillion. Because the budget is largely in balance roughly after 2011, the 5-year total is the majority of that $1.4 trillion.

A different way to look at the situation—a different fiscal barometer—is the cumulative effect of deficits or debt relative to GDP in the economy, and in these projections we see debt relative to GDP rising from about 38 percent at the beginning of the budget window and hitting between 40 and 41 percent, where it stays until after 2011 and then diminishes to about 45 percent.

Now, since the projections that we put out in August two things have happened. The first is that the economy has performed better than we projected it at that time. The third quarter is much stronger than we had expected. And indeed, we have altered our near-term economic assumptions accordingly and it may be the case in fact that the fourth quarter, which the data are not yet available, is stronger yet than what is included in the projections that you see before you today.

CBO's Baseline Budget Outlook

	Actual 2003	2004	2005	2006	Total, 2005-2009	Total, 2005-2014
			In Billions of Dollars			
Total Revenues	1,782	1,817	2,049	2,256	11,840	28,004
Total Outlays	2,158	2,294	2,411	2,525	13,282	29,897
Total Deficit	-375	-477	-362	-269	-1,443	-1,893
			As a Percentage of GDP			
Total Deficit	-3.5	-4.2	-3.0	-2.1	-2.2	-1.3
Debt Held by the Public at the End of the Year	36.1	38.3	39.5	39.9	n.a.	n.a.

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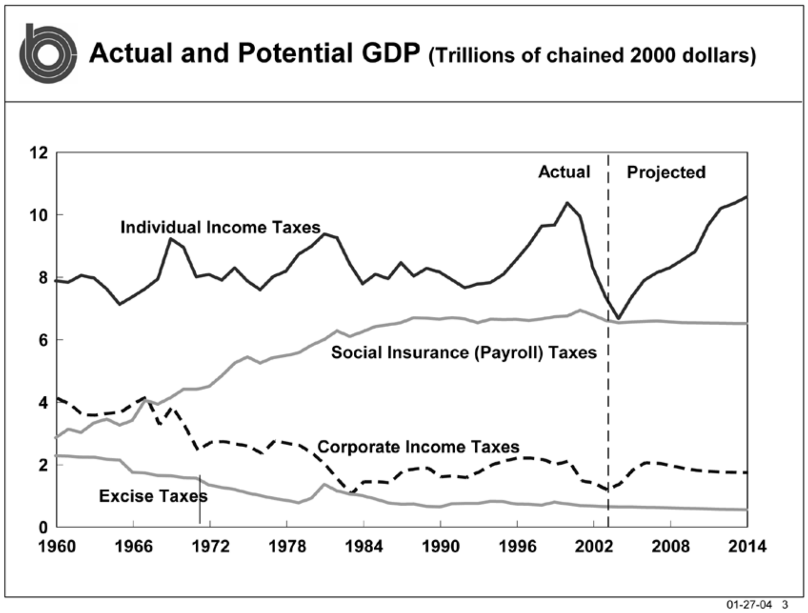
Nevertheless, these economic growth rates will simply bring the cyclical recovery on more quickly and get us back to full employment. Our estimate of the capacity of the economy to produce has also been moved up since August. We have seen rapid productivity growth, and we have tried to adjust for that in our projections. And I can come back to that in a second.

The second major innovation is legislative. Since August, over the 2004–13 budget window, the one we used last year, we have seen an increase of $1 trillion in the cumulative deficit. That change comes from $700 billion roughly—about $680 billion more precisely—in legislation, largely the Medicare prescription drug bill but also concurrent receipts, the Air Force's Boeing tanker acquisition, appropriations and then roughly $300 billion from economic and technical sources, roughly evenly divided. And I can talk about the details of that.

As has been noted, the CBO projections assume current law prevails over the baseline projection period. On the tax side, that assumes that tax law has the sunset of the 2001 and 2003 tax cuts as scheduled, and that is included on the outlay side. It also assumes that we have an ever-increasing reliance on the alternative minimum tax in the collection of our individual income tax receipts. So both of those are built into our baseline.

On the outlay side, the notable features is that we assume the current programs on the mandatory side, but we also for discretionary spending include all appropriations on the books, including the $87 billion supplemental, and we inflate those only at the rate of inflation. So discretionary spending rises at 2.5 percent in these projections.

Now, what I thought I would do in conclusion is to touch briefly on those three topics and then take your questions—first the economic forecast, then the pattern of receipts and then the pattern of outlays.

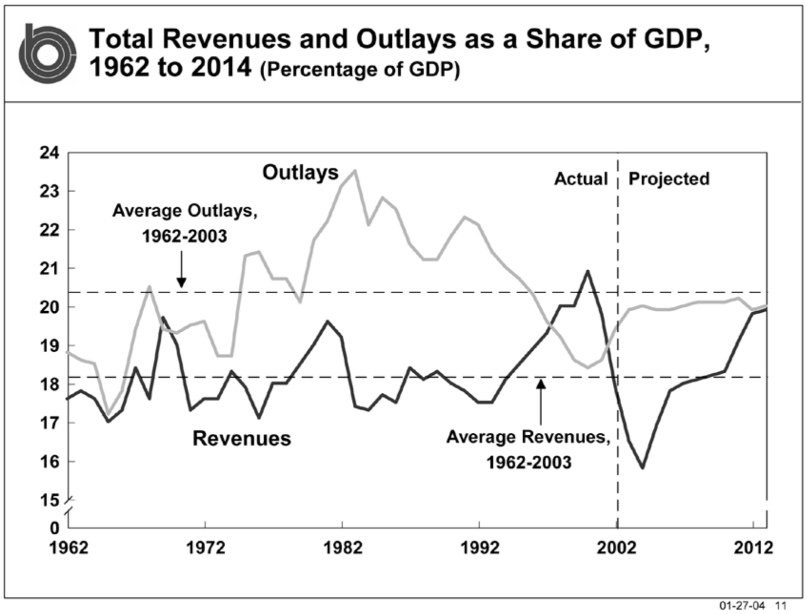


On the economy, we do expect a robust cyclical recovery, and if we can go to the next chart, the key features are represented in this graph of actual versus potential GDP. The actual course of the economy is the light blue line, and we anticipate that economic growth will be rapid over the next 2 years, at 4.8 percent, and 4.2 percent, and this will bring us back to potential and at the same time we will see the unemployment rate diminish as the economy comes closer to utilizing its capacity fully.

To the extent that the economy grows faster over that period than we projected, it will close that gap more quickly, but in the long run the capacity of the economy to produce and the long-run revenue potential that it will deliver is driven by the dark blue line, which is the potential GDP. And there the big news has been productivity in the U.S. economy.

As we detail in the report, we have experienced a recent period of very rapid productivity growth of origins not well understood, and in the interest of acknowledging the increased potential for production in the U.S. economy, we have raised the potential for GDP, but we haven't really changed its long-run growth rate. So we get a one-time increase in the level. That gives us more room to grow quickly and our projections assume that we will. They assume that we can grow quickly without large amounts of inflation, and our projections include a modest inflationary environment, both over the near term and over the long term where we have lowered our long term rate of inflation modestly.

As it turns out, the budgetary impact of these various changes is on balance a little bit negative. In the near term, the faster economic growth is a good piece of news from a budgetary point of view. Over the longer term, the combination of higher health costs lowers the fraction of compensation that comes in the form of taxable wages, and lower inflation on net has a modestly downward impact on the budget. And as a result, we get a net negative, which is really not quite substantial from our economic assumptions.



In the next slide, receipts are shown as the dark line at the bottom. The bottom dotted line is the historical average in the United States from 1962 forward, about 18 percent of GDP collected in revenues by the Federal Government. These projections have revenues rising rapidly at a rate of something in excess of 7 percent. The economy is growing, including inflation, growing at 4.7 percent. So we are seeing revenues rise faster than GDP in these projections.

As a result, revenues rise from 15.8 percent of GDP this year, which is a low number, the lowest number we have seen since the 1950s, to 20.1 percent in 2014. That growth in revenues comes from two sources. One source is the expiration of various tax provisions, first the partial expensing provision at the end of 2004, then the provisions in EGTRRA and JGTRRA, and with those we see the sunsets raising revenues. That contributes to about 2.3 percentage points or a little over half of that rise.

The remainder comes from other sources. It comes from the fact that real growth in the economy raises real incomes and moves people into higher tax brackets. That is one source of revenue growth. It comes from the presumption in these projections that we will see capital gains realizations return to closer to their normal relationship with the economy, and we will get more capital gains tax receipts as a result.

During this period as well, we will begin to see the retirement of the baby boom population and with that will come the cashout of tax preferred savings accounts like IRAs and 401(k)s. That will contribute as well to receipts into the Federal coffers.

And finally, as I mentioned earlier, the alternative minimum tax will become increasingly important both as a revenue source and in the number of taxpayers that it affects. We have a discussion in chapter 4 of the report pointing out that under our baseline projections the number of individuals affected, the number of taxpayers affected by the AMT, rises from about $3 million to close to $30 million at the peak. Depending on how things proceed, those receipts could become as important as 7 percent or so of individual income tax receipts.

On the outlay side, the light blue line at the top, we assume that current law will deliver a growth in mandatory spending that is about 5.5 percent a year over the budget window. That is going to increase largely because of the effects of Social Security, Medicare, and Medicaid to the point where in the last year, 2014, the growth rate will be 6.5 percent. And that is the beginning of a long-run interaction between rising health care costs in the U.S. economy and an aging population that will lead Social Security, Medicare and Medicaid, the latter two programs in particular, to demand an increasing fraction of budgetary resources, or indeed national income, on the current track.

On the discretionary side, as I mentioned earlier, we include the $87 billion supplemental increased at the rate of inflation. If one were to remove that $87 billion for each of the 10 years and the inflation and the debt service associated with it, it would lower the baseline projected deficit by $1.1 trillion over this 10-year period; so the inclusion following baseline rules contributes $1.1 trillion in these projections. And as well, I would note that the assumption of growth at 2.5 percent is at odds with past growth rates, which have been much higher, and we present in the report as a result some broad brush alternatives that would lead to different budgetary outcomes.

I think the fair message of the report is that it anticipates cyclical recovery. It gets the economy back to potential. It is an economy that grows at a relatively rapid rate, and our productivity growth assumptions are laid out in the report. As a result, policy choices will matter for where we actually end up.

The Budgetary Effects of Policy Alternatives Not Included in CBO's Baseline (Billions of dollars)

	Total, 2005-2009	Total, 2005-2014
Policy Alternatives That Increase the Deficit or Reduce the Surplus		
Extend Expiring Tax Provisions	-553	-2,230
Reform the Alternative Minimum Tax	-161	-469
Increase Discretionary Appropriations by the Growth Rate of Nominal GDP After 2004	-374	-1,618
Increase Discretionary Appropriations by 6.9 Percent a Year After 2004	-641	-3,157
Policy Alternatives That Reduce the Deficit or Increase the Surplus		
Increase Discretionary Appropriations (Excluding Supplemental Appropriations for 2004) by the Rate of Inflation After 2004	421	1,108
Freeze Total Discretionary Appropriations at the 2004 Level ($876 billion)	280	1,320
Memorandum:		
Total Deficit in CBO's January 2004 Baseline	-1,443	-1,893

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And in the final slide and in the report, we sketch the ones that stand out in most discussions. The impact of expiring tax provisions is laid out in considerable detail in a table in chapter 4. This includes not only the provisions of EGTRRA and JGTRRA but all expiring tax provisions. We include an impact of the reform of the alternative minimum tax. Here reform should be taken as a loose, stylized reform in which we index the alternative minimum tax for inflation so that no one ends up paying the AMT unless he is really rich. The effects of inflation alone don't put you on AMT. And the consequences there, about $4.5 billion over 10 years, are shown.

Finally, some outlay projections for discretionary spending that are both faster and slower than the baseline. At the top increasing discretionary spending at its historical rate would have a consequence of about $3.2 trillion over the 10-year budget window, whereas removing the effect of the supplemental, as I mentioned, would be worth $1.1 trillion, or an absolute freeze would reduce the 10-year budget deficit by $1.3 trillion.

Those I think make clear that the range of budgetary outcomes is considerable from the perspective of policy decisions that the Congress and the administration might make, and we also try to display in Appendix A the range of budgetary outcomes that might come from simple uncertainty over the future path of the economy and the technical assumptions associated with it.

So with that I would close. These are our baseline projections constructed according to the standard procedures. We have also displayed the economic uncertainty and some of the policy uncertainty that surrounds them, and I will be happy to go through it in any way that you might desire and look forward to your questions.

[The prepared statement of Douglas Holtz-Eakin follows:]

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

Chairman Nussle, Congressman Spratt, and members of the committee, thank you for giving me this opportunity to present the Congressional Budget Office's (CBO's) budget and economic outlook for fiscal years 2005–14. CBO projects that under current laws and policies, the Federal Government will incur a total budget deficit of $477 billion this year and $362 billion in 2005 (see table 1). Such a deficit for this year would set a record in dollar terms, but at 4.2 percent of the nation's gross domestic product (GDP), it would represent a smaller share of the economy than the deficits of the mid-1980s and early 1990s. In the absence of further legislative changes, deficits would diminish after their peak in 2004, although outlays would continue to exceed revenues for most of the next 10 years. Deficits are projected to total $1.4 trillion for the 5 years after 2004 and $1.9 trillion for the 2005–14 period.

By statute, CBO's baseline projections must estimate the future paths of Federal revenues and spending under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to taxes and spending.

New legislation can significantly affect the budget outlook. For example, laws enacted since CBO's previous baseline projections were published in August have increased spending by an estimated $681 billion (0.5 percent of GDP) between 2004 and 2013.[1] Much of that total stems from the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108–173). The outlays resulting from that law will steadily increase between 2006 and 2013, totaling nearly $400 billion over the 2004–13 period (not including debt-service costs).

The baseline projections reflect CBO's forecast of robust economic growth for the next 2 years. By late 2003, stronger investment by businesses, a weaker dollar, and a rising stock market—augmented by expansionary monetary and fiscal policies—were spurring economic activity. CBO forecasts that real (inflation-adjusted) GDP will grow by 4.8 percent in calendar year 2004 and by 4.2 percent in 2005 and that the unemployment rate will fall to 5.8 percent in 2004 and 5.3 percent in 2005. Between 2006–14, the annual rise in real GDP will average 2.7 percent, CBO projects.

Even if economic growth turns out to be greater than projected, however, significant long-term strains on the budget will start to intensify within the next decade as the baby boom generation begins to reach retirement age. Federal outlays for the three largest retirement and health programs—Social Security, Medicare, and Medicaid—will consume a growing share of budgetary resources

even under moderate assumptions about the programs' growth, rising from over 8 percent of GDP in 2004 to more than 14 percent in 2030. Such increasing demands on spending will exert pressure on the budget that economic growth alone is unlikely to alleviate.

THE BUDGET OUTLOOK

CBO projects that if current laws and policies remain unchanged, Federal deficits will begin to decline after this year. In the ensuing years, under CBO's baseline, deficits drop as a percentage of GDP, from 4.2 percent in 2004 to 3.0 percent in 2005 and 1.7 percent in 2010. After 2011—if the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expired as scheduled, growth in discretionary spending continued to be limited to the rate of inflation, and other policies stayed the same—the budget would essentially be in balance.

Over the 2004–14 period, outlays are projected to grow at an average annual rate of 4.7 percent and to remain near 20 percent of GDP. That level would be slightly below the average share of the economy devoted to Federal spending since 1962 (see figure 1).

The constant share of outlays as a percentage of GDP, however, masks opposing trends in mandatory and discretionary spending. Under the assumption that no changes in policy take place, spending for entitlements and other mandatory programs is projected to grow by 5.5 percent a year—faster than the rate projected for the economy as a whole. Such growth is driven largely by spending for Medicare and Medicaid, which is projected to rise at average rates of 9.0 percent and 7.2 percent a year, respectively, from 2004 through 2014. Toward the end of that period, Social Security spending is also expected to grow faster than the economy as the baby boom generation begins to retire.

[1] That estimate includes the increased interest payments on Federal debt attributable to legislative changes.

CBO projects discretionary spending as specified in the Balanced Budget and Emergency Deficit Control Act of 1985 (using the GDP deflator and the Employment Cost Index for wages and salaries). The combined rate of growth of those factors is about half of that projected for nominal GDP. As a result, the baseline projection for discretionary outlays falls from 7.8 percent of GDP in 2004 to 6.4 percent in 2014. If instead such spending kept pace with the growth of GDP (and the other assumptions incorporated in the baseline remained the same), discretionary outlays would maintain a share of about 7.8 percent of GDP throughout the projection period and the deficit in 2014 would be $323 billion, or 1.8 percent of GDP (compared with a small surplus for 2014 under the baseline's assumptions).[2]

Revenues are projected to total 15.8 percent of GDP this year—about 2.5 percentage points below the average since 1962 (18.2 percent). As the economy continues to improve and certain tax provisions expire, revenues will increase to 16.9 percent of GDP in 2005, CBO projects. In 2006 through 2010, rising income and the expiration of more tax provisions will push revenues up to about 18 percent of GDP, by CBO's estimates. In the baseline, projected receipts rise more rapidly after the major provisions of EGTRRA expire at the end of 2010, reaching 20.1 percent of GDP in 2014. If those provisions—together with the expiring provisions of other tax laws—were instead extended and all of the other assumptions underlying the baseline were held constant, receipts would be 18.1 percent of GDP in 2014, and the deficit would total $443 billion, or 2.4 percent of GDP.

Debt held by the public (the most meaningful measure of Federal debt in terms of its relationship to the economy) is anticipated to equal 38 percent of GDP at the end of this fiscal year. Under CBO's baseline, that debt will stabilize at around 40 percent of GDP through 2011, at which point the Federal Government's diminished need to borrow will reduce the growth of such debt.

Since CBO last issued its baseline (in the August 2003 Budget and Economic Outlook: An Update), the cumulative deficit over the 2004–13 period has increased by nearly $1 trillion, or 0.7 percent of GDP (see table 2). About 70 percent of that total results from new legislation, such as the Medicare law. Another $171 billion stems from economic factors—mainly the decline in CBO's forecast for inflation, which reduces estimates of both revenues and outlays (although the effect on revenues is moderately larger). Changes in projections of the unemployment rate, real GDP, and other variables also play a role. Technical revisions to CBO's baseline—mostly on the revenue side of the budget—account for another $134 billion of the addition to the cumulative deficit over the 2004–13 period.

Chairman NUSSLE. Thank you. Thank you for your testimony, and we appreciate the professionalism that the report was put together in and all of the folks who work at CBO should be commended for their work on this, because I know it is quite a job getting this all together for us. We appreciate it.

I wanted to make a couple of comments before I start. I basically have only a couple of questions. First of all, just to let the committee know and to let those that are listening know that deficits do matter. I said that last year. I said that the year before. I will open it again by saying that the deficits that we are hearing about again today from the Director—and we will continue to hear about for some time—do matter in the overall scheme of things.

This committee has led the effort, and we produced a very austere budget last year, led the effort to pass the budget, and with very few exceptions stuck to that budget. It wasn't the budget that in final analysis we passed out of this committee, but I think we should always remember that we have led the effort when it comes to controlling spending on this committee, and I am proud of that.

Let me just say as we set the table for the coming year we will do it again. The President is certainly ready to present his budget on Monday, and I have been hearing different things about it, and I am increasingly impressed at the level of interest that we are

[2] That projection includes an extrapolation of the $87 billion in supplemental appropriations for 2004 enacted in November 2003 to fund defense spending and reconstruction in Iraq and Afghanistan.

hearing from the administration on controlling spending. I hope that they hear even more between now and Monday, when the budget is presented, because that is a message that they need to hear.

We need the President to lead that effort to control spending. It cannot only be done from this committee and be successful. We will do it if no one else takes the lead, but we hope that as the President presents his budget on Monday and as we ask for testimony from his OMB Director coming up next week that the administration will lead the effort on controlling spending, because these are spending-driven deficits, and that is the first question that I wanted to get to.

There are some—I hear the arguments—I heard them in Iowa of all places. I don't know what necessarily was so special about Iowa over the last few months, but I have heard in Iowa this issue about how Republicans have squandered the surplus, and if you would parachute into the committee room today and having not known much about the last 3 or 4 years of history, I could see how you might come to that conclusion, but since we all have subscriptions to newspapers and know exactly what had been going on with the war and Iraq and Afghanistan, the global war on terrorism, 9/11, the economic recession that the President inherited from the previous administration, et cetera. I would hope there would be a better understanding of exactly how we got here.

But just in case we need a refresher course—and judging from the media reports that I saw yesterday, I think it probably would bear repeating—would you please review for us once again the largest factors in reducing the $5.6 trillion surplus and led us to today's point in time in borrowing, what the different amounts or what the different factors would be or percentages would be that got us to this particular point in budget history?

Mr. HOLTZ-EAKIN. Well, certainly. If one were to compare, for example, the 2004 projection, the $477 billion, with the projection of a surplus made in 2001, 40 percent of that decline would be from economic and technical factors. The remaining 60 percent would be equally divided between legislative initiatives on the receipts and legislative initiatives on the outlay side.

If one were to extend the 2002–11 budget and look at the whole thing and do the same kind of a decomposition of where the surplus went, one would find 40 percent came from economic and technical factors: recession, equity market fall-off, and associated declines in receipts. Then on that longer horizon, 30 percent can be traced to legislative initiatives on the receipt side and 70 percent to the legislative initiatives on the outlay side.

Chairman NUSSLE. I have actually—we can use that chart too, but why don't you go to the next one. No, you were there, right there—No. 4.

This is the chart we have been using. We have now added to it based on numbers that CBO has provided for us in your report. Is this what you are referring to? I think you were just explaining the last line there, the last column for fiscal year—were you explaining fiscal year 2005, or was that——

Mr. HOLTZ-EAKIN. The example I gave was fiscal year 2004, 40 percent economic and technical and the remainder equally divided.

And then for the budget window as a whole, 2002–11, if you go back and look at what went on and do the same kind of decomposition, it is 40 percent economic and technical, 30 percent on the legislation on the receipts side, 70 of the remainder, 30 and 70 on the receipts and outlays sides respectively.

Chairman NUSSLE. And, again, this is right out of the CBO report and these are numbers that are readily available, but I don't want anyone to either bury their head in the sand or to forget where we have come from. There certainly is a portion of this that was done to stimulate the economy. In fact, it was done in some respects in a bipartisan way. Again, a lot of the spending to support the global war on terrorism, the war in Iraq, a lot of the rest of the spending was done in a bipartisan way. In fact, we were able to add up the amount of proposals of reconciliation—excuse me, motions to recommit that were offered by the Democrats this year, and we have about $900 billion of extra spending just through motions to instruct and motions to recommit. So certainly a lot of the spending was deliberate.

I think the factor that was certainly out of anyone's control was the economic impact, and that is that—the bottom shaded portion there, which was as much as 68 percent in 2002 and now as you said 40 percent in 2004 and 2005.

The second question I had for you is: I do hear that the tax cuts themselves caused the deficits, that there weren't any other factors. I am interested if you would tell us how much of the total deficit was caused by tax relief. The way I have it added up, even without tax cuts, even without tax relief, we would still be in deficit. We would still be running deficits even without the tax relief packages that were passed. In fact, they may even be deeper as a result of the fact that the economy would not have recovered. I know that is difficult to play the guessing game on what would have happened without tax relief vis-a-vis economic growth but just from a dollar amount, the way I have read it the tax cuts not only did not cause the deficit, we would be in deficit anyway even without the tax cuts.relief packages caused the deficits?

Mr. HOLTZ-EAKIN. Certainly. There are two different questions, one of which is simply the budgetary math in the absence of economic feedback. And as I said before, for 2004 the revenue decline on the legislative front is $268 billion. So if that were not present, we would still—on just budgetary math—be below zero: take $260 [billion] back from the $477 [billion].

The deeper question of what would have been the path of the economy in the absence of tax cuts is not something I have a ready and simple answer to. But it is, I think, pretty much the case that if one looks back at the impact of the fiscal policy, the entire package of a swing from surplus to deficit, roughly 6 percentage points of GDP over a 3-year period in the presence of the economic headwinds that we faced, the equity market fallout, in which we saw the stock markets fall; a sharp decline in business fixed investment; terrorism events; war in the Middle East; corporate scandals and the necessity of Sarbanes-Oxley legislation the fiscal policy served to support the economy and support demand at a time when the economy was relatively weak. So in that sense certainly deficits matter and they matter in different ways, and in an economy that is weak, they support a demand. The shift from national saving to national spending was beneficial. Going forward, it might be a very different story. If you had a full-employment economy, you wouldn't need that kind of support for demand and the shift from saving to spending would not be as beneficial and indeed could have economic consequences that were not particularly desirable.

Chairman NUSSLE. Thank you. Mr. Spratt.

Mr. SPRATT. Dr. Holtz-Eakin, the recession was over in November of 2001, according to the National Bureau of Economic Research I believe. Growth surged in the third quarter of this year, this past calendar year, and still the deficit picture has deteriorated radically, dramatically since last January when you were here presenting the same report.

If you look at the same time frame, 2004–13 for last year's report, during that period of time last year you foresaw on the assumption that there would be no policy changes a cumulative surplus of about $1.350 trillion.

Now if you look at the same time frame in this year's report, 1 year later, there is a cumulative deficit of $2.350 trillion. Basically, there is a swing of about $3.6 [trillion], $3.7 trillion over a 1-year period of time. How do you account for that?

Mr. HOLTZ-EAKIN. Well, as I mentioned, if one goes from the $2.4 trillion back to the August number, which was a deficit of $1.4 trillion, that $1 trillion swing is composed of roughly $700 billion in legislation, including debt service and $300 billion in economics and technicals.

If I recall correctly, in going from January to August last year, that swing, which was $2.7 trillion, consisted of—I forget the exact amount, which was economic and technical—probably $700 billion or so, and probably $1 trillion—ballpark—on legislation. Some of that was the tax cuts in the spring that was much at the front end of the budget window, so that was a legislative initiative on the tax side, and then a larger amount was outlays, including supplementals, which were carried forward in the baseline. But I think that contributed to the large majority of the swing, from $1.3 trillion in surplus to the $1.4 [trillion] in deficit.

Mr. SPRATT. All those factors, legislative initiatives taken here in the Congress, principally the surplus deteriorated, got worse by $3.65 billion, or $3.7 trillion over the last—over that time frame just in 12 months time.

Mr. HOLTZ-EAKIN. It is largely legislative, yes.

Mr. SPRATT. Going back, as you did with your bar chart a minute ago, to January of 2001, when we received the first forecast from OMB and CBO, is what the expected cumulative surplus would be between 2002–11, the number from CBO I think was $5.6 trillion, a slight difference between the two.

Yesterday I asked your staff when they presented the budget how much have you made in the way of economic and technical adjustments that reduce that original $5.6 trillion surplus. In other words today, knowing what you know, what would you project the surplus for that period, 2002–11, to be? I was told it was $3.4 trillion in economic and technical adjustments.

Mr. HOLTZ-EAKIN. That looks about right.

Mr. SPRATT. That means that we didn't really have a surplus of $5.6 trillion on which these big tax cuts were predicated. It was far less than that over that same period of time. It was more like $2 [trillion], $2.3 trillion, something like that. Is that correct?

Mr. HOLTZ-EAKIN. That is what it looks like today, yes.

Mr. SPRATT. And all of that was Social Security, was it not? The Social Security surplus was $2.4 [trillion], $2.5 trillion. Once you adjust for economic and technical, there was no surplus over and above Social Security, was there?

Mr. HOLTZ-EAKIN. I am not familiar with the Social Security number, but we will stipulate you are right.

Mr. SPRATT. Let me also get clear what was said earlier, because I may have written it down wrong when I read your book last night, but it is my understanding that you say in this book, this presentation, that if the tax cuts are not renewed and if discretionary spending is basically kept at current services baseline, the budget will just about balance over the next 10 years by itself.

Mr. HOLTZ-EAKIN. That is the baseline projection, yes.

Mr. SPRATT. So the tax cuts are a critical—if they weren't renewed, then this situation would go away in 10 years?

Mr. HOLTZ-EAKIN. If all the aspects of this policy package were adhered to for 10 years.

Mr. SPRATT. I will let you clarify that, because there is a chart in the Washington Post today that omits one of the critical assumptions that goes along with this, and that is that discretionary is held to no more than inflation over the next 10 years. Those two factors together, then the budget would be in balance in 10 years' time?

Mr. HOLTZ-EAKIN. Yes. That is the baseline projection.

Mr. SPRATT. By the same token, I read that—or conversely, I read that if the tax cuts were not renewed—if they were allowed to expire as scheduled according to their own original legislative terms, then we would have in the terminal year, the last year of your forecast here, 2014, a deficit of I think $484 billion, something in that range.

Mr. HOLTZ-EAKIN. I think it is a little smaller but it is close to that.

Mr. SPRATT. So we wouldn't be able to cut the—according to your projection here, unless you take other actions, you would not be able to cut the deficit—today's deficit of $477 [billion] in half, even over the next 10 years, if you renew the tax cuts.

Mr. HOLTZ-EAKIN. If you just do that policy from the baseline, yes.

Mr. SPRATT. Let me also mention one thing, because it is—I understand was a subject of discussion in the other body this morning when you testified before the Senate Budget Committee. You have included, as the law requires you to include, the supplemental for defense and international affairs of about $87 billion adopted in 2004, because you are required by law to put that in the baseline for the next year, and therefore when you extend it out over a 10-year period of time you have got—I think you told us—$880 billion for that addition, plus interest, which is $227 billion I believe—about $1.1 trillion.

Could I show you a little chart and ask you to take it back and let your staff work on it and let us know if it comports with your own analysis? Because what we have done is taken another analysis from CBO, namely on the defense budget, and used those numbers. The argument being that if you remove the $800 billion for the supplemental, most of which went to the deployments in Iraq and Afghanistan, if you remove that, you have got to put something in that place, because then you don't have anything included for the likely continuation of those deployments or anything included for international aid which we are still providing to Afghanistan, still providing to Iraq. We won't be—you can remove that, but you are left with an unrealistic baseline. This thing is not exactly self-explanatory. That is the best I can do to hand it out. If I put it up on the screen, you would never be able to see it.

But basically we went back to your study on the defense budget in which you essentially said once you allow for contingency costs, that is, for the worldwide—or that was not in your study, but there ought to be some allowance made here for the global war against terror, and we have got, included starting at this year's level, 51 bills down to 31, down to 30, down to 20 and tapers off in the low to mid $20 billion a year to maintain that effort, and I don't think that is an unrealistic effort. But you don't have to comment on that.

The other three items, the risk, cost risk in weapons systems, procurement and development now underway was a number that you developed for your study based on historical experience with the defense budget. The next was benefits based upon the experience we have had recently and the things that are on the agenda, the risk of personnel costs going up significantly due to various policy changes like TRICARE for life.

Finally the total for that comes over a 10-year period of time to $700 billion if you add all of those things. Fifty declining to 24 for the global war against terror. The items that you included in your defense study as risk over and above the budget. And in addition there is another factor. You take what we are spending on defense this year and each year you adjust it by inflation, and yet that amount, your current services baseline projection of defense spending, is less than the so-called FYDP, the Future Years Defense Plan, in the Department of Defense. We know more or less what is in that budget and we know it is more than what you have got in current services.

So if you also adjust for the DOD's, Department of Defense, FYDP, what they have got as opposed to what you get automatically by simply adjusting every year for inflation, there is another item to be added. That is the item of A, and it adds up to about $447 billion, the difference between current services and the FYDP for the period of time we are talking about.

And then if you assume that if we are going to be in Afghanistan, we are going to be in Iraq, we are going to be doing the things we are doing, we are probably going to have a larger budget for international affairs as a small plus-up in international affairs. On top of that you don't have to include it to get to $1.1 trillion.

What I am suggesting is that when you take that $87 [billion] out on the basis that it was arbitrarily included to comply with black letter law and put something in its place, what you put in its place is pretty close to what you get anyway by extrapolating forward the $87 billion over the 10-year period of time.

Would you care to comment on that?

Mr. HOLTZ-EAKIN. Well, certainly we would be happy to go back and go through this and make sure we come up with the same kinds of costs for this particular policy scenario. Indeed, this simply constitutes another future scenario for the course of policy. The baseline is meant to be a neutral benchmark against which policies are measured, and this would be one. I would be happy to go back and make sure that these numbers, which strike me as quite close to our original estimates, are still good estimates, and we will get back to you on it.

Mr. SPRATT. We very much appreciate your response to it, and thank you very much.

[The information referred to was subsequently provided to the House Budget Committee Democratic staff.]

Chairman NUSSLE. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman. Mr. Holtz-Eakin, we certainly appreciate you coming today and sharing all this information with us, and I was just going to follow up on John's [Spratt] question, if I may. The $87 billion is factored in through the—I guess the 10-year cycle, and I was just wondering if there are other items, these nonrecurring items, which also could be identified as factors through this cycle too. Do you have any kind of an estimate of what those numbers might be?

Mr. HOLTZ-EAKIN. In principle, that is possible. I can't think of anything else major that would enter into these projections.

Mr. BROWN. I was just thinking of building battleships, aircraft carriers, or some of the other large initiatives that are actually there.

Mr. HOLTZ-EAKIN. As the Congressman mentioned, there is a Future Year Defense Program, which lays out the administration's initiatives in that area, and we have in a separate analysis attempted to look at the budgetary consequences of that. That is slightly different than the discretionary baseline you will see here, and it is different again from including one-time events, which you might plausibly argue wouldn't continue. So the baseline includes all appropriations which are on the books at the end of 2004 and extrapolates them in a fairly mechanical fashion.

Mr. BROWN. One other question. I serve on the Transportation Committee, and we are in the process of trying to get the reauthorization bill. What dollar figure are you using in these figures?

Mr. HOLTZ-EAKIN. I think we have in this baseline $480 billion over 10 years, and that represents a continuation of the extension that was passed last fall.

Mr. BROWN. OK.

Mr. HOLTZ-EAKIN. I will get the precise number with my staff.

Mr. BROWN. Somewhere less than $300 [billion]—I guess—let's see. It would be $48 billion a year. Right?

Mr. HOLTZ-EAKIN. A little under $300 billion for the 6-year reauthorization window.

Mr. BROWN. Right. What I think we are looking at in the Transportation Committee is some $375 billion, and so this would change our numbers too if in fact that was passed.

Mr. HOLTZ-EAKIN. Yes, to the extent that there was a new policy beyond the continuation, that will be priced the next time in August.

Mr. BROWN. Thank you.

Chairman NUSSLE. Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman. Let's go back over the current deficit. You estimate it to be $477 billion for the current fiscal year.

I heard you say earlier that $268 billion was attributable to tax cut legislation in 2004.

Mr. HOLTZ-EAKIN. That is right. If I read my notes right.

Mr. MORAN. OK—$268 [billion] is more than 40 percent of $477 [billion]. So I understand the 40 percent is over a 10-year period, but clearly for the current budget deficit the tax cuts were the predominant factor?

Mr. HOLTZ-EAKIN. The number I gave was as a measure of the swing from surplus to deficit, which is larger than the deficit itself. So that is the difference there.

Mr. MORAN. But I still think it bears out a contention that the tax cuts were the principal factor in the current year's deficit. Is that not accurate?

Mr. HOLTZ-EAKIN. The number I gave was the swing from surplus to deficit, and the tax cuts contributed about 30 percent of that spending legislation; economic and technicals, the rest.

Mr. MORAN. Well, the point when you add the tax cuts with the war in Iraq, both of which were an issue of the prerogative of the President, it was certainly up to the President to decide whether or not to cut tax cuts. That was not essential, and as we are finding out more clearly every day, the Iraq war was a war of choice, not of necessity. And I think when you consider that, that these deficits were not inevitable, that they were the result of decisions made by this administration and the majority, although a bare majority of this Congress.

In the outlook volume that you presented to us, Dr. Holtz-Eakin, it says that CBO has conducted detailed analysis of a sample of tax returns, which is to suggest that some of the decline in receipts which was believed to be temporary last summer is likely to be permanent. I would like to get a sense of whether as a result of that there is any real hope for achieving the President's objective stated in the State of the Union Address that he plans to cut the deficit in—was it the deficit or the debt, because either one is impossible, certainly improbable, within 5 years. Given the fact that he wants to make permanent all of the tax cuts and the fact that there has been this permanent reduction in tax receipts, do you see anything that would confirm the assertion of some who have said that over the last 2 years cutting tax rates would increase tax revenues to accomplish the President's stated objective?

Mr. HOLTZ-EAKIN. Well, I can't speak to the President's objectives, and we will certainly analyze his budget when it is delivered. I know that when we do each projection we start it at the ground and work up all the details, and in scrubbing the revenue numbers, there are always gaps left between what we think we should be getting in terms of receipts given the state of the economy and the structure of the tax code and what it looks like will be coming in, and those gaps are called technicals. And what goes in are various things.

Mr. MORAN. I don't want to interrupt but I know we are going to run out of time. You said that the traditional revenue is about 20 percent of GDP, I understand, and if the tax cuts were made permanent it would be about 15 percent, 15, 16 percent.

Mr. HOLTZ-EAKIN. That is not quite——

Mr. MORAN. No?

Mr. HOLTZ-EAKIN. No. The average has been about 18 percent of GDP. If you go to the end of the budget window, these projections have receipts of 20.1 percent of GDP.

Mr. MORAN. But that is assuming that the tax cuts are not permanent, that the President does not achieve his objective of making them permanent. And the point I am getting to is that if we were to follow through on the President's legislative priority of making permanent the tax cuts, then the receipts would be considerably less and in fact it would negate the achievement of his other objective, which is to eliminate the deficit within—halve the deficit in 5 years. Is that not accurate? I think that is supported by all of your numbers.

Mr. HOLTZ-EAKIN. The numbers that I know—I again can't speak for the President, but of the rise in receipts, 2.3 percentage points comes from sunsets. So if you took that out mechanically, you would be at 17.8 percent of GDP, and that would be what I would refer to as a very conventional budgetary static estimate. In our baselines we try to incorporate the impact of the tax law on the economy in the numbers that we talk about in terms of what it would cost to make tax cuts permanent things. We don't have any economic feedback at all.

Mr. MORAN. As Mr. Spratt pointed out in your table, it is 2.3 trillion, is the cost of making permanent the tax cuts. I am just factoring that in and suggesting that the two objectives of halving the deficit in 5 years or making permanent the tax cuts, they are mutually exclusive, and I think your numbers support that.

Mr. HOLTZ-EAKIN. Well, what policies people pursue are clearly not something that I can decide, but I want to just make sure that it is clear that the table in chapter 4 has all expiring tax provisions, not simply those that can be traced to 2001, 2003, and the difference will depend on which ones are chosen.

Chairman NUSSLE. Mr. Wicker.

Mr. WICKER. Thank you.

Mr. Chairman, I notice that my friend, Mr. Spratt, and my friend, Mr. Moran, have asked questions about what, in theory, would happen if the tax cuts were allowed to expire on time. Then I think I listened carefully and I think I heard Mr. Spratt say that he did not advocate a full return to the higher taxes that we had earlier. For example, I believe he said he did not advocate doing away with the additional child tax credit or the new 10 percent income tax bracket, things of that nature. I was glad to see him say that, Mr. Chairman, because that is something he and I can agree on; but it creates a problem in asking these questions about what would happen if we did certain things that I do not think very many of us in this room want to do.

To me, when you take away a child tax credit, that is a tax increase; and when you eliminate a 10-percent tax bracket and push someone up to 15 percent or higher, that is a tax increase; and with what we have seen in the economy and where we need to go, I do not think we need to do that. When you eliminate partial expensing on small business, that is a tax hike, and I do not advocate that.

When you go back to a higher marriage tax penalty, that is a tax increase, so I hope that when we are doing assumptions we can rule out some of these assumptions that we have asked questions about, because they are not realistic in terms of where we need to go with the American people. But let me ask you, Mr. Holtz-Eakin, about where we have been in the economy since the income tax cuts and other tax cuts that have been enacted.

You would think, listening to some people, that we have gone to hell in a hand basket, but, actually, the economy is pretty good, in terms of the recent news.

- Real GDP grew at a rate of 8.2 percent the third quarter of last year, back down to between 4 and 5 percent in the last quarter, but projected to be in that range for the entire coming year.
- Manufacturing reached its highest pace of activity in 20 years at the end of last year.
- Housing starts at their highest pace in 20 years.
- Industrial production at a 6 percent annual rate of increase.
- Real fixed business investment again growing faster than it has in years and years, and the Dow Jones Industrials up 26 percent.

It is clear to me, and I think it should be clear to an objective observer, that the economy is coming back, and we do not need to do anything to dampen what seems to be a real good recovery from this recession which we inherited in the year 2000, 2001.

In your opinion, Mr. Holtz-Eakin, do not you agree that this is good economic news and that we are going to see more of it and that a great deal of that is as a result of our actions in this Congress in reducing the tax burden on American families?

Mr. HOLTZ-EAKIN. Well, I certainly agree that we were surprised by the strength of third quarter. We certainly did not anticipate that in August when we put together our projections.

As you have seen in our projections, we do anticipate that the cyclical recovery will continue, and continue robustly, returning us to potential output in the U.S. economy. As I said earlier, I believe that the swing from surplus to deficit, when viewed looking backward, did tend to support the economy at a time when private demand was quite weak. We do not have a decomposition of that, but there is evidence to support that, yes.

Mr. WICKER. Thank you, Mr. Chairman.

Chairman NUSSLE. Mr. Neal.

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

Thank you, Mr. Holtz-Eakin.

In response to my friend, Mr. Wicker: I know that the Massachusetts unemployment rate caught the national average for the first time in many, many years. At a meeting that I had with construction people yesterday, they tell me it is the worst it has been in memory, so perhaps something is happening in Mississippi that is not happening in the northeastern part of the country.

Mr. Holtz-Eakin, let me talk to you about an issue that I know the chairman would tell you that I have been consistent on, even in my work at the Ways and Means Committee, and that is fixing the alternative minimum tax.

The President's budget I assume is going to call for a short-term fix, and could we not argue that the tax cuts during the last 3 years have only exacerbated the problem in the sense that, on the one hand, we give tax cuts to people and, on the other hand, they get hit with the AMT and that revenue ends up going back to the Treasury.

Mr. HOLTZ-EAKIN. You can certainly see the interaction between the AMT and the tax cuts in chapter 4. There is a box—Box 4–2—which you can read at your leisure—that shows at the end of the projection window, when the tax cuts sunset, the sharp drop in AMT payers because their regular income tax liability will be high enough to keep them off the AMT.

Mr. NEAL. Right. You estimated there will be 23 million taxpayers who will be subject to the AMT by the year 2014.

Assuming that the Bush tax cuts expire and no other AMT fixes are enacted, can you estimate for me how many taxpayers will be subject to the AMT if the Bush tax cuts are extended, as he has requested, without any fix in the AMT?

Mr. HOLTZ-EAKIN. I do not have the number off the top of my head. I would be happy to work with you about it.

Mr. NEAL. That is part of the problem. Everybody is happy to work with me on it. We just cannot get it resolved.

Mr. HOLTZ-EAKIN. I will get you an estimate.

[The information referred to follows:]

LETTER FROM MR. HOLTZ-EAKIN IN RESPONSE TO MR. NEAL'S QUESTION REGARDING THE ALTERNATIVE MINIMUM TAX (AMT)

CONGRESSIONAL BUDGET OFFICE,
WASHINGTON, DC 20515,
February 6, 2004.

DEAR MR. NEAL: At my testimony on January 27, before the Committee on the Budget regarding CBO's budget and economic outlook, you asked how many taxpayers would be subject to the alternative minimum tax (AMT) in 2014 if the recent tax cuts were extended without any change to the AMT. We estimate that, under those assumptions, about 40 million taxpayers in 2014 would be subject to the AMT. Under our baseline assumptions, the number would peak at about 29 million in 2010 and then drop in 2011 after the tax cuts expire. If instead the tax cuts were extended, the number would continue to rise beyond 2010.

If you wish further details on this estimate, we will be pleased to provide them.

Sincerely,

DOUGLAS HOLTZ-EAKIN,
Director.

Mr. NEAL. That is different than getting it resolved.

Thank you for qualifying that.

Do you not think that people that advocate tax cuts and that have been consistent and even at moments vociferous in their support of tax cuts, do they not have some responsibility to those that are about to get bumped into an AMT situation that it would be appropriate for the tax cut advocates to do something about it, rather than leaving it to future generations to foot this bill?

I mean, in deference again to the gentleman from Mississippi, he talked about how the tax cuts have been important here, and he does not want this tax increase, does not want that tax increase, and I understand that, but let's remind people that the deficits belong to them, too, and that the debt belongs to them. But this notion that has become popular that will let future sessions of the Congress and future administrations deal with this AMT issue, does not that mean that we are also suggesting that we ought to let future generations of Americans deal with it as well?

Mr. HOLTZ-EAKIN. I can tell you that I will leave it to the committee to assign the standards for public responsibility in assessing public policy, and you can ascribe the deficit only to the cumulative of net policies, and I could not parcel it out to net pieces in any scientific way.

Mr. NEAL. Well, do you think we are going to tackle AMT in a serious way this year?

Mr. HOLTZ-EAKIN. I would prefer not to speculate.

Mr. NEAL. Let me take you to another favorite topic of mine, these U.S. corporations that go to Bermuda.

The joint tax has estimated that we can collect $5 billion. We have 134,000 troops in Iraq, we have 12,000 troops in Afghanistan and at the cost of $1 billion a week; and we all know after the election there will be a request for another supplemental, tens of billions of dollars for Iraq. Wouldn't it be very helpful that if we were to go out and collect the $5 billion that we could for these corporations who enjoy the protection of the American military and enjoy many of the other nice things that come along with being an American citizen except on tax day for these folks?

Mr. HOLTZ-EAKIN. Again, which path for policy the Congress and the administration should take is really not something that I can speculate on.

The joint committee, I think, has taken a good crack in making that estimate; and certainly it is one policy option available to the committee and the Congress as a whole.

Mr. NEAL. Would it ease your projections if we were to collect the $5 billion?

Mr. HOLTZ-EAKIN. If we added $5 billion in receipts it would lower the deficit $5 billion other things being equal.

Mr. NEAL. Thank you very much.

Chairman NUSSLE. Mr. Bonner.

Mr. BONNER. Thank you, Mr. Chairman.

Dr. Holtz-Eakin, I would like to just seek your definition as an economist. Our friends talk about tax cuts not being renewed, and I was hoping that the tax cuts would not expire.

The way we think in my district in south Alabama, letting the tax cuts expire or not having the tax cuts be renewed would be equivalent to a tax increase, so, from your perspective, if this Congress or future Congresses does not make permanent if the tax cuts of 2001 and 2003 and those tax cuts do expire, is that a tax increase on the American people?

Mr. HOLTZ-EAKIN. I would not be a professional economist. I could not give you two answers to that question. Let me give you two answers to that question.

I think if you consciously attempt to raise more tax revenue from the same base, that is a tax increase; and that seems fairly straightforward to me. A key part of this would be—expectations in the private sector are the second thing. If people expect those tax cuts to be permanent, they would perceive their expiration as a tax increase. I think that is fair, and we have actually, in doing our projections, tried to think hard about how to handle that.

Certainly, we build into our projections, the economic projections, the budget law on which they are based; and this tax law has lots of sunsets in it, so people will behave based on what they expect.

We do not know if they expect the tax cuts to be permanent, expect them to sunset, or expect something in between, but it is generally consistent, and, as a result, the economic behavior in these projections is based on that. And what will happen actually when we get out to 2010, 2011, I do not know.

Mr. BONNER. As a follow-up, because I have friends in Massachusetts and I have friends in Mississippi——

Mr. NEAL. Would the gentleman yield?

Mr. BONNER. Be happy to yield.

Mr. NEAL. You have a friend right here in Massachusetts.

Mr. BONNER. I am looking at him, yes, sir.

Mr. NEAL. You know that.

Mr. BONNER. But to the constituents that you represent and to the constituents that I represent who have had difficulty getting jobs in the last few years, I guess my question again is to your background as an economist: Is there anything in the history of this country that would suggest that increasing taxes on people who are already struggling to find jobs is going to enhance their ability to find jobs? Will it be healthy for the economy if we increase taxes?

Mr. HOLTZ-EAKIN. The correct answer to that, the scientific answer, is: It depends what you do along with that. If you do it in isolation, you bring budgetary resources into the budget.

Mr. BONNER. So it will be the government's money.

Mr. HOLTZ-EAKIN. You know, a fair answer involves asking both parts of the policy package. If the money comes in and you spend it, we can analyze that. If the money comes in and you buy back debt, we can analyze that. So that is a careful answer.

It would also depend on the state of the economy, quite frankly. As I have said to the chairman in the past, deficits certainly matter, but their impact differs, and it differs in this economy which is very weak, but we anticipate it will recover quite nicely.

Mr. BONNER. Mr. Chairman, I yield back.

Chairman NUSSLE. Mr. Edwards.

Mr. EDWARDS. Mr. Chairman, these alarming deficits should be a wake-up call for the country and the Congress. For the second year in a row, we will have the largest deficits in American history, adding $852 billion to the debt on the backs of our children and grandchildren in just simply 24 months. These deficits are a cancer that will eat away at the long-term economic growth in America and put our children's future at risk. They can also undermine Social Security and Medicare benefits for present and future seniors and will likely force cuts in vital programs for homeland security, education, defense, and health care.

I believe the dirty little secret about these historic deficits is a country such as China had been purchasing this year and last enormous amounts of U.S. debt, so they now have a knife at our economic throat. So, if some future administration wants to negotiate, for example, a tough, fair trade deal with China or Japan, they can threaten the American economy by simply saying maybe it is time for them to turn in that debt, back to the United States, and doing so could devastate our economy.

To put in perspective for those who might minimize the size and historic nature of these deficits, Dr. Holtz-Eakin—and I think you can answer this yes or no—prior to this administration, was not the largest single deficit in American history $292 billion in 1992?

Mr. HOLTZ-EAKIN. Yes.

Mr. EDWARDS. So, in actual dollar numbers, the fiscal year '04 deficit will be $185 billion higher than the deficit was in the largest single deficit year prior to this administration. That is a 63 percent increase and the largest deficit in American history in any one year.

Now, I am going to assume 4 percent costs of funding this $852 billion debt that we have added to our children and our grandchildren. I think your assumptions assume 4.5 percent. I am going to assume we will get a little cheaper money, but 4 percent times $852 billion, Mr. Chairman, is $34 billion a year that our children and grandchildren will pay in interest on the national debt from these 2 years of deficit spending; and they will pay those taxes until the day they die.

Now, to put that amount in perspective, since $34 billion goes over the heads of most of our family budgets, the United States Federal budget only puts $29 billion a year on all education programs, from Head Start, to kindergarten, through the 12th grade, so the deficit interest costs from 2 years, without that, we could have doubled our commitment to education and still had money left over.

Now, to put it in more family budget terms, I would like to put in the record Mr. Chairman, that, using administration numbers and CBO, the Democratic staff of this budget committee estimated by 2013 a family of four will be paying $9,493 for their share of interest on the national debt.

Perhaps those that talk about what is a real tax increase ought to look at the honesty of those numbers.

Now in terms of the myth that we can solve these historic high deficits by simply being a hawk on cutting spending, Dr. Holtz-Eakin, am I not correct that in three of the five largest programs of the thousands of Federal programs, five of them represent 70 percent of every Federal dollar spent, defense, Social Security, Medicare, Medicaid, interest on the national debt?

Now, am I correct, Dr. Holtz-Eakin, that the Bush administration actually wants to increase defense spending, Medicare, and is increasing interest on the debt, and three—even from this budget-hawkish administration, three of the five largest programs in the entire Federal budget that make up the vast majority of Federal spending, this administration is asking we spend more and not less? Is that correct, Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. We have not yet seen the President's budget, and we will be back to discuss it. We will be happy to.

Mr. EDWARDS. Let me say for fiscal year '03 the administration, while talking about being tough on spending, actually requested increases in three of the five largest Federal programs—and, frankly, I supported them in some of those increases—but let's do away with the myth that spending alone is going to keep our grandchildren from being drowned in a $7-trillion sea of national debt.

Thank you, Mr. Chairman.

Chairman NUSSLE. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman.

You know, it is encouraging to sit on this side of the aisle and find out that we do have some commonality on some of the issues that we are discussing here, that, just as we would see that a tax increase is a burden on the individual, so, too, that an increase in borrowing today is a burden that is going to be placed maybe not on people today but on future generations.

I do recall, Mr. Chairman, sitting here a year ago and heard your statement as you reiterated today at the outset of this meeting that deficits do matter. I appreciated your comment, back then, as a freshman member of this committee, to stress the importance of us to address the issue; and I think we need to continue that as well.

To the gentleman from New England, I hear the same things to some extent back in my district in New Jersey as well when we hear, gee, we do hear some good economic news. But we have certain pockets in certain areas where people are not exactly where they want to be economically, for one reason or another. But I will tell you this, that I concur with the comments of Mr. Wicker, that, overall—and I say this each time I go out to a town hall meeting—that, overall, the economic indicators are certainly positive and encouraging economic indicators, whether you are talking about the manufacturing numbers, up to the best numbers in 20-odd years; housing starts, best and largest in 20-odd years.

Maybe that is one of the conundrums that we have in New Jersey, that, on the one hand, the economic numbers are so good, that housing starts are so great. But, on the other hand, I go back to my constituents and they talk to me that, if they are so great, we have suburban sprawl. The housing is so great that they are building too many houses and that we actually have an environmental issue that things are going so well back in our State that we have to address it.

So what I hear from my constituents is we do have certain areas we have to address economically, but, in the long term, things are improving and that what they do not want to have is an additional burden on them in the future, which would be a deficit today, nor do they want an additional burden on them today, which would be increases in taxes, which would be the result of us not continuing the tax cuts that we passed in the years in the past.

My questions to you, though, still sitting here somewhat as a freshman, I will say this: When I was here at the beginning of last year I was amazed at the projections and how accurate I thought they could all be 10 years down the road. Now I know I was a little naive in that. I read through your report, and I see that maybe we are not even that accurate 5 years down the road.

I look in the details that you have, I think, in your report. Is it correct to assume that the numbers that we are looking at today in the short term are usually more optimistic as to where our deficit is going to be and in the long term that they are going to be more pessimistic?

Mr. HOLTZ-EAKIN. Actually, in one of the appendices, we walk through in fairly great detail and show the historic range of uncertainty that surrounded budget projections.

Certainly, the near-term ones are more accurate than the longer-term ones. The more time you have in the future, the more likely you are to not anticipate things; and not just for the CBO but for economists in general, at the turning points, the same would be true. We have not experienced a large number of business cycles that would allow us to get projections around turning points as well as I would like, but that is a weakness that we will face now.

I would also point out that in this particular business cycle, one of the things that the CBO as well as the economic profession has really worked to try to understand is the labor market and how it hasn't quite picked up, its inconsistency with the pace of overall economic activity. We can talk about that more if you want to, but it does show up in the budgets, because the incomes haven't picked up as much as the production and output have. There is a little bit of a mismatch at the moment, and that affects the budget as well.

Mr. GARRETT. Is it better to err on reigning in spending today than to continue on either the flat line or a slight increase in budget expenditures?

Mr. HOLTZ-EAKIN. We do not have a particular bias that we attempt to introduce in the numbers; let me be clear about that. I think when you look at the appendix and look at the fan chart, it is out to 5 years, which is the horizon that we can analyze at all carefully. The central forecast is for deficits, and there is a very small likelihood that, just through the course of economic events, everything breaks to the upside.

In an economic technical fashion, you end up in surplus. The chances of that are much thinner than the chances of being further south.

Mr. GARRETT. Thank you.

Chairman NUSSLE. Mr. Baird.

Mr. BAIRD. Thank you, Mr. Chairman.

We have about 8 percent unemployment in our district, so when my good friends talk about the economy getting better I just came from a lot of unemployed workers who sure do not feel it is getting better, and when Mr. Bonner talks about taxing people who are looking for work, I think that is disingenuous.

Those folks who are looking for work are not paying income tax, and when we have the opportunity to help them by extending unemployment benefits we do not do so, and when we have the opportunity to help them by extending the child tax credits to help their children, this Congress refused to do so.

We spoke some time back in this Congress—most of us ran for Congress on a premise of a thing called the lockbox, and I asked the distinguished gentleman last year: How much will we be borrowing from Social Security over the next 10 years in your estimates from the trust fund?

Mr. HOLTZ-EAKIN. In the CBO projections, we have a on-budget deficit of $4.3 trillion over the 10 years and an off-budget surplus of $2.4 trillion over the 10 years.

Mr. BAIRD. So if I were to tell the average citizen how much we have taken out of the lockbox that we promised to lock up, what figure would I give them?

Mr. HOLTZ-EAKIN. With the stipulation that I do not believe we actually have a budgetary lockbox, the accounting is such that, instead of $4.3 [trillion], we have $1.9 trillion, and the difference is the 2.4.

Mr. BAIRD. So we all ran for office saying we would not touch the Social Security Trust Fund, we would put it in a lockbox, but yet we are borrowing about $2.4 trillion from that lockbox over the 10 years so that we can make this budget deficit look smaller.

Do we have a viable plan to pay back what we borrowed from the Social Security Trust Fund?

Mr. HOLTZ-EAKIN. There are budgetary plans, and then there is the future path. The future path is that all budgetary responsibilities, all outlays, come from the economy in the end, and the Social Security Trust Fund does not contain any real economic resources. It is an intragovernmental accounting device that keeps track of particular transfers from the Treasury general fund to the Social Security Administration and vice versa. So in the end, the obligations that are out there for Social Security and other entitlements will be paid for out of the economy, and those resources will come into the government by taxes or borrowing, and they will go out in the form of benefit payments.

Mr. BAIRD. When people talk about lowering the deficit by half in the next 5 years, my reading is that we are going to lower the deficit but we are not going to count the borrowing from Social Security and Medicare. If we actually did count that in any feasible way, would we actually see the deficit reduce by half?

Mr. HOLTZ-EAKIN. Again, I do not know what people have in mind when this target gets tossed around. I have heard dollar values. I have heard as a fraction of GDP.

You would like, it sounds like, to count it in strictly the on-budget portion. Again, the baseline projections show the deficit going from 4.2 percent of GDP to 2 percent of GDP in 2 years. So as a fraction of GDP on a unified basis, that is in the baseline projection. That is a particular policy. You could choose another policy which counted it using only the on-budget portion; and again for dollar values—it would be without taking advantage of the GDP growth, it would be a different policy.

Mr. BAIRD. I appreciate that.

I just find it a little ironic that we run for office on one policy and then we defend our actual actions based on a different policy.

One of the things that always puzzles me is the tendency for correlation causation reasoning, and it goes something like this: There were tax cuts passed, the economy got better, ergo it got better because of the tax cuts.

Seems to me lower interest rates have something to do with that, and neither I nor my friends on the other side of the aisle are responsible for that, but I can tell you a lot of folks invested in their business.

Have you attempted to look at what percentage of the economic recovery and the resulting reduction in deficit has been the result of lower interest rates versus tax cuts?

Mr. HOLTZ-EAKIN. No, we have not done a decomposition of all the potential factors that led to recovery from the recession.

I think as a matter of trying to relive an alternative history, you are exactly right. The path of monetary policy and the path of fiscal policy are intertwined; and if one had chosen another path, one would have gotten a different answer.

Mr. BAIRD. I raise that because, as we look toward the possibility of extending the tax cuts, one might want to decide whether or not we deserve crediting those tax cuts with a recovery and recovery of jobs productivity, et cetera, or whether lower interest rates may be more responsible. If deficits drive those interest rates up, we could have an unpleasant surprise.

I thank the gentleman for his commentary.

Chairman NUSSLE. Ms. Brown-Waite.

Ms. BROWN-WAITE. I have a couple of questions, they are not related but totally disjointed, but they are questions that I have as a result of listening to some of the other testimony.

As a freshman, I need to ask this question: Is borrowing from Social Security, the Social Security Trust Fund, new? I mean, was it done long before these projections whenever there was a deficit?

Mr. HOLTZ-EAKIN. Certainly there is no economic division between the Social Security deficit and the on-budget deficit, and so to the extent that we have run unified surpluses smaller than the Social Security surplus, the same kind of math applies.

Ms. BROWN-WAITE. OK. And following up on Congressman Wicker's point, if we were to increase taxes, would we not risk it having a negative effect on the economy, especially in light of the fact that things do seem to be economically turning around?

Mr. HOLTZ-EAKIN. Again, in the absence of a particular proposal—it depends if you mean right now, if you mean in 2011, and what else you might do with that. When we did, for example, our analysis of the President's budget last year, I tried to take pains to explain that you cannot look at one piece of the fiscal policy in isolation. Indeed, the entire budget has consequences for the economy. So specifying the whole policy is actually the key, and if the policy involves tax cuts or tax increases, there has to be some other part to it. You have to figure out what would be done with those revenues—would they be spent? Would they be used to retire debt? And that package has to be analyzed. You cannot look at one piece in isolation.

Ms. BROWN-WAITE. OK, but if we look at the tax breaks that went to businesses, particularly small- and moderate-sized businesses, particularly the accelerated depreciation, would not that have somewhat of a stagnating effect on the economy?

Mr. HOLTZ-EAKIN. The question is magnitudes.

In our baseline, we anticipate that the partial expensing goes away at the end of 2004. That provides a tax base incentive for firms to move their investment expenditures from 2005–14. We expect they would take advantage of that, and we have an increase in our business fixed investment in 2004 from that fact alone. But that is by no means the only reason that we expect an investment recovery: The return of the stock market to higher levels, increased profitability, some increase in foreign demand because of the growth in the international economy. So it is true that the expiration of partial expensing is there, but it is not the only part of the decision-making, and, in this case, I would think that the timing issue is far the most important one in terms of the economy.

Ms. BROWN-WAITE. OK. The last question that I have, I come from an area of west central Florida with a very high percentage of veterans; and, obviously, the veterans' budget has mandatory spending. I just would like to know what kind of projections that your baseline assumes about veterans spending, both discretionary and mandatory.

Mr. HOLTZ-EAKIN. Well, for the discretionary, the baseline projections would follow the usual rules of inflating at the appropriate price index, the discretionary appropriations that we have in 2004, the omnibus.

For the mandatory programs, I confess that I am not intimately familiar with the details, but we can easily show those numbers to you.

Mr. WICKER. I wonder if the gentlelady would yield in her final minute?

Ms. BROWN-WAITE. Yes.

Mr. WICKER. In terms of assuming that tax cuts will be extended beyond their repeal or deadline, I assume that your office is required to assume that the law will be followed and does not take into account the fact that many of the repealers were placed in there simply for parliamentary reasons, to comply with the budget rules, particularly in the U.S. Senate, that did not allow us to have the tax cuts be permanent as we intended.

Are you able to take into consideration at all the fact that almost all of the debate surrounding these tax cuts has assumed that they would be permanent?

Mr. HOLTZ-EAKIN. I will repeat something I said earlier. I will try to say it more clearly. As a budgetary matter, we assume current law, and in figuring out receipts, we assume that tax cut sunset when we do our calculation.

In doing our economic projection, we are forced to forecast the behavior of the private economy, and people will behave based on what they believe will be the tax law. It could be made permanent, and the private sector could believe it will sunset, or the private sector could believe on a provision-by-provision basis that some things stay, some things go.

We do not know exactly what those beliefs are. So into our baseline, we assume that the private sector believes that the tax cuts will sunset as written in law and our economic forecast and medium-term projections are consistent with that. So, in particular, when the tax cut sunset in 2011 and there are higher marginal tax rates, that will have incentives for labor supply and other economic incentives. We did show a modest negative impact on GDP as a result of that sunset, and so we have taken it into account in doing our baseline projections.

Mr. WICKER. Thank you very much.

Chairman NUSSLE. Mr. Emanuel.

Mr. EMANUEL. Thank you, Mr. Chairman.

I look at this record of $477 billion and I think it underscores the point that it is almost impossible to finance three wars with three tax cuts. I am reminded of the Vice President's comment in the recent book that is out that deficits do not matter, and I think the $477 billion almost underscores that point.

Now I actually believe, and I have had discussions with friends on both sides of the aisle, a growing economy should reduce the deficit. I am struck by all those who claim that the economy is growing at record pace and yet we have a record deficit when, in fact, the net result should be of a growing economy, should be of reducing deficit, not one that is growing.

Last year we had a record number and now this year we surpass last year's number, so I am struck both by what should happen is not happening.

I understand you are not willing to enter into some policy disputes and get yourself caught in the crossfire, but I do understand that, as I read your report, that you seem to think deficits are manageable. But yet when I read the IMF's report about the danger of the U.S. deficit to the economy, the two different tones, tenors, and also conclusions, one is we believe our deficit is not a problem to either our economy or the world's economy and their conclusion in the IMF, that, in fact, the biggest danger to the American economy today is the American deficit and the permanence of it. If you look at the size of the deficit and the way the economy is growing, we are going from a cyclical to a structural deficit, and once that attitude changes, as Mr. Baird noted, my colleague, interest rates are going to spike. Everything we have been whistling by, you know, will catch up with us.

So I do think that deficits matter, having the right foundation matters, having tax cuts matter, but not all tax cuts lead to the same economic benefit. Some are stronger, and some are weaker. Not all spending leads to the same economic growth. Investments in education, health care, and the environment lead to greater long-term growth than other types of spending.

So as I read your report and try to look forward both to the cause of the deficit as well as to future types of spending and you talk about Medicare and some of the other entitlements, I was surprised. I am asking for a clarification.

You wrote a letter last week to Senator Frist about the ability of the Secretary of HHS to negotiate prices. In front of this committee, our chairman had a hearing on waste, fraud, and abuse. The Inspector General from HHS was sitting there and said, under their study of 10 drug costs, between veterans and HHS, veterans, because they negotiate close to $2 billion, $1.8 [billion] to be exact, in their study and if HHS had that same right on 10 drugs they could save money, and yet you wrote a letter saying you did not see that type of savings.

Now either I misunderstood that letter and I took it out of context, and I apologize, but you see the growth in Medicare as a threat to the long-term economic fiscal structure of the government and yet not give the Secretary of HHS the ability to create a Sam's Club and negotiate lower prices in the same way we give veterans the right to do that. Could you please explain why you wrote that letter and the basis behind that?

Mr. HOLTZ-EAKIN. Certainly. The majority leader in the Senate asked for an understanding of the impact of this language; and in looking at the Medicare bill as passed by the Congress, signed by the President, we determined that for the prescription drug plans, the private sector delivery of the prescription drug benefit, the key of their ability to manage costs is to have both the incentives and the ability. Do you give those firms the tools and the incentives to manage costs?

In the way the bill was passed, those are at risk for cost overruns. They have every incentive to control costs for the usual reasons and they indeed are given the tools to do that. So our reading of the law as written is that those private sector plans would have tremendous incentives to cut the best deal possible with pharmaceutical companies and that, as a result, removing the language, the noninterference language, would have a negligible influence on the cost of the bill because they would have done what you would have. I am not familiar with the Veterans Administration example, but it has already taken advantage of the best discount prices.

Mr. EMANUEL. Let me share this with you.

The Veterans Administration, since 1992, has the right to negotiate bulk prices, and under this committee in this hearing room they do far better than HHS on an analysis of 10 drugs used by seniors on savings. If we can trust the private sector—the last time I remember we have a responsibility to the taxpayers—we can also trust the Secretary of HHS.

I have trust in Tommy Thompson. I do not think he is inadequate or incompetent. I think he can somehow put together 41 million seniors and get a good deal. I think he is a good negotiator. I have seen him do it as a governor, and I will send you what the Veterans Administration does.

I see your economic incentive that you think the private sector has. My own view is all of us, Democrats and Republicans alike, as well as this administration, Tommy Thompson is fully capable of negotiating something because he has an incentive, too, and that is honoring the taxpayers who are going to be asked to foot $400 billion.

Chairman NUSSLE. Mr. Diaz-Balart.

Mr. DIAZ-BALART. Thank you, Mr. Chairman.

I am tempted to respond Mr. Moran's comments on the reasons of the Iraq war, but I know this is not the appropriate forum, and it has been covered by the national press. So even though I am tempted, it is a new year, I will direct my attention to the director.

There are a number of different ways that you can reduce the deficit. The government can take steps to reduce deficit. You know, we can increase revenues, we can increase taxes and hope that that will lower the deficit. We can try growing the economy, and there are different ways that we can do that. Tax cuts is one of the ways that this Congress and this President chose to do so, and many will argue it is working.

We can also reduce spending, and from what I heard today, spending is one of the large segments of our problem.

Would it be advisable—and I guess I am allowed to ask advice—would it be advisable, then, to take steps to further reduce spending in order to try to reduce the deficit if in fact you believe as I do, that the deficit is something that does count, as our chairman continuously reminds us?

Mr. HOLTZ-EAKIN. Well, I will say at the outset that it is not my portfolio to advise on particular policies.

I do think the things that are in the report and that I would highlight show that to run large, sustained deficits going forward in the face of a fully employed economy is, among other things, easily economically detrimental.

The second thing that we have discussed in this committee, as I testified last August, is that over the long term, government spending is a good indicator of the overall cost, and that once the decision is made to spend the monies in the Federal Government, the next decision is how to finance it.

You can finance it with taxes, or you can finance it by borrowing, which is simply a decision to defer the taxes. And going forward, it is clear that there will be a vigorous policy debate on how to do that financing mix. But certainly over the long term, one of the messages of both I think this report and some other studies that we have done is that there are spending demands built into the government programs that will simply have to be debated and discussed in terms of how they are financed or whether they will be mitigated.

Mr. DIAZ-BALART. And just a follow-up. So therefore an increase to that deficit of $900 billion would be, I would imagine, worrisome; in other words, if this Congress had gone ahead and accepted the amendments posed on the floor by our friends on the Democratic side, which would have increased the deficit by about $890 billion, $900 billion, despite all the rhetoric, that clearly would have created a major problem, would it have not?

Mr. HOLTZ-EAKIN. There is no magic line between the correct amount of a deficit or a harmful or not harmful amount.

The U.S. Federal budget averaged a deficit of 2 percent of GDP in the 1970s, it averaged 2 percent of GDP in the 1990s. Economic performance was clearly superior in the 1990s. And so there is no simple relationship between a level of the deficit and economic performance, in the same way there is not a magic line that separates a sustainable level of debt from one where investors lose confidence in your ability to service that debt. So I do not know whether the $900 billion hits the magic line.

What we do know is that going forward, the economy does not need this sort of short-term support, and we are running a sustained large deficit that has a negative economic consequence.

Mr. DIAZ-BALART. I understand that you do not know how to find out what that magic number is; but clearly, you know, close to 500 is better than 500 plus 900. Is that an accurate statement?

Mr. HOLTZ-EAKIN. We are getting the direction squared down.

Mr. DIAZ-BALART. OK. So clearly I do not think, at least I am not comfortable with the deficit we have today and the ways we have to reduce it, and it seems to me that that plus another $900 [billion] would be irresponsible. I am not asking you to comment on that, but clearly it probably would not be good fiscal policy to add another $900 billion to that large deficit.

Mr. HOLTZ-EAKIN. I think you have exhausted my views on what the consequences will be going forward. I think we are pretty clear.

Mr. DIAZ-BALART. Thank you, Mr. Chairman.

Chairman NUSSLE. Mr. Thompson.

Mr. THOMPSON. Thank you.

Your report states that about a third of our Federal debt is held by investors outside of this country, foreign investors. Can you tell us how much we pay in interest on that portion of the national debt that is held by foreign investors; in other words, how much money do we send out of this country to people living in other countries in regard to paying the interest on our national debt?

Mr. HOLTZ-EAKIN. Our net interest in 2004 is $156 billion. Without a detailed knowledge of the composition or holdings, the cheap answer is to divide by 3, so it is on the order of $50 billion. We can get you a detailed estimate if you are interested.

Mr. THOMPSON. Fifty billion dollars? Does that have any implications on our economy, the strength of our economy; say, for instance, in regard to interest rates? Could there be some complications here at home because of monetary fiscal policy of our countries that hold the vast amount of our debt?

Mr. HOLTZ-EAKIN. From a strictly economic point of view, the net issuance of the debt and who buys it, picking out particular buyers, not matter very much.

The question is, at what market price will they buy the debt? These particular governments have bought the debt at market prices, and we can see what they are. There is another layer on top of it that many people speculate about in terms of the broader political goals of a government in purchasing U.S. securities. That is a noneconomic thing. It has to do with their domestic agenda or their international relations.

Mr. THOMPSON. So their domestic economic policy could have some spillover, as I think someone mentioned here; in something such as trade negotiations, could be a leverage point that we could feel?

Mr. HOLTZ-EAKIN. Perhaps. I am not conversant enough to know what is going on there.

Mr. THOMPSON. And I heard in response to numerous questions the fact that you are not interested in getting involved in giving us policy advice, but——

Mr. HOLTZ-EAKIN. There is actually a law that prohibits that.

Mr. THOMPSON. So you say you are not interested in breaking the law.

Mr. HOLTZ-EAKIN. It is something I did not——

Mr. THOMPSON. I do not know how to frame it to sort of keep you out of trouble, but there has been a lot of discussion about this effort to reduce our deficit, 50 percent reduction number.

Would it seem plausible that reinstitution of some budget enforcement act language, such as PAYGO would be a good tool that we could rely on to get us there?

Mr. HOLTZ-EAKIN. We actually have a quick review in part of the report on budgetary mechanisms, and at least my reading of the historical evidence, PAYGO discretionary caps were very useful in supporting the consensus when attempts have been made in the '80s and '90s to reduce the deficit.

However, in the absence of the consensus first to do that, such rules themselves will not bind the Congress. There are alternatives that can always be imposed on a year-to-year basis. And so the first step, I think, is to develop a consensus for the fiscal policy going forward, and then for the Congress to define rules to support that consensus. But I think the order is most effective if the it comes that way. Rules cannot come first.

Mr. THOMPSON. There has been some talk today about reaching that goal. The President mentioned in the State of the Union 50 percent reduction, I think in 5 years, and your data suggest that our deficit in 2004 is $477 [billion]. To reduce that by 50 percent in 5 years, our deficit would still be $240 billion in 2009.

In the same speech, and I think it has been supported here by our friends across the aisle, the President has suggested that we make permanent the tax cuts. And again your data suggest that that would be $132 billion cost, including debt service in that figure. So that means that if you exclude the discretionary spending, the rate of inflation holds, we are still in 2009, a deficit of 310 billion; is that right?

Mr. HOLTZ-EAKIN. The number for 2009 for the tax cuts, the $132 billion, would be the piece that we would have to make sure we got exactly right. The baseline has the deficit at $268 billion. That includes the expiration of the partial expensing and some of the dividend tax in 2008, so we can work on exact numbers, but certainly that is the kind of calculation we need to do.

Mr. THOMPSON. So can we get to the 50 percent number if we reinstate the tax cuts or extend the tax cuts? And, if we would, what sort of policy changes would we be looking at?

Mr. HOLTZ-EAKIN. We can certainly show you the net combination of making permanent some tax provisions and then whatever other policies you might need on the mandatory and discretionary side. Obviously there is an infinite number that will get you to $240 billion.

Chairman NUSSLE. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and Mr. Holtz-Eakin, thank you for your good testimony again. Appreciate your latest report.

We have had a lot of talk today about deficits. Deficits do matter, but there has been a lot of talk about these being record deficits. What is the critical measure of the deficit in terms of its impact on the economy? Is it the percentages of GDP or is it an absolute actual number?

Mr. HOLTZ-EAKIN. I think it's the percentage of GDP. You should always measure this relative to the size of the national income available to service it.

Mr. PORTMAN. I do not know what the percentage of GDP is in your latest report. I know when I was first elected in 1992, when I first ran for office, the percentage of GDP was 4.7 percent, which is not as high as in the '80s when it was over percent of GDP.

What is your percentage of GDP that you are estimating?

Mr. HOLTZ-EAKIN. For 2004 it is 4.2 percent.

Mr. PORTMAN. It is 4.2 percent. So it is not a record level.

In terms of the tax cuts, what do you think the impact of the tax cuts was in terms of business investment and lowering the cost of capital? What impact did they have on the economy over the last year?

Mr. HOLTZ-EAKIN. We have not done a particular scientific decomposition by any means. The broad fiscal policy, I believe, supported the economy when private demand was weak, including the household sector as well as the business sector.

Mr. PORTMAN. And recent industrial production rose at 6 percent this year, the fastest in over 3½ years, certainly is attributable to lowering the cost of capital, I would say. And so my friends on the other side of the aisle say, "Gee, how can you make these comparisons and was not it just lower interest rates?"

We talked about adding value to the market. It has gone up about 25 percent over the last year, which helps everybody invested in the 401(k), the IRA, and helps the economy, so I do not think there is any question there is a cause and effect here.

In terms of interest rates, interest rates were high during the recession, is that why we had a recession, because of interest rates?

Mr. HOLTZ-EAKIN. No. I think the Fed moved fairly aggressively to lower short-term rates. We have seen the rates down as well.

Mr. PORTMAN. Rates have been down over the last few years, so it helps. But I just think we have to give credit where credit is due, and when you look at what happened over the last few years, looking at these charts coming up here, was it spending, was it the tax cuts, was it the economy?

If you believe that it was tax cuts, then you better look at this chart, because even if you think tax cuts did not help, which I argued they did, the tax cuts would be roughly 20 percent—when you add all the tax cuts—of the reason for us going into a deficit position. About 30 percent as I read these charts is reduced spending, so it is bigger than tax cuts, and the biggest cause is the economy.

So the one piece of that that is getting the economy moving is the tax relief, particularly I would say on the business investment side, which includes the cost of more tax relief, because that goes to small businesses, largely those who have subchapter S companies and sole proprietors and partnerships.

I just think we have to look at the analysis carefully and not say, "Gee, tax cuts did not help." And we have to admit that the goal here is to get the economy moving. That is how we got the surplus this time. That is how we will do it again. And I appreciate again some of the testimony you have given as to the impact of the tax cuts.

Finally, with regard to your analysis, the $87 billion for Iraq would have been continued through the 10-year period. Why do you assume that, that there would be an $87 billion supplemental for Iraq? Is that based on some policy from the administration?

Mr. HOLTZ-EAKIN. The baseline rules as outlined in the Budget Act can't ask the CBO to prepare a baseline projection that includes all appropriations, in this case from the end of 2004, and to extend them for the entire projection period, so it is consistent with the——

Mr. PORTMAN. Under the rules you have to add the $87 billion supplemental, even though the administration has indicated the opposite, that they don't expect to have another supplemental, the $87 billion this year, and certainly hope not to have it over the 10-year period. And that adds, what, about $1 trillion?

Mr. HOLTZ-EAKIN. About $1.1 [trillion], including debt service.

Mr. PORTMAN. I appreciate that clarification, and again, I appreciate your coming to the committee again and giving us some hard-number analysis. The key is clear to me. It is keeping spending under control, and the President, I understand, is going to submit an austere budget on nondefense, nonhomeland domestic spending, which is a real problem around here.

I hope the Democrats come up with a budget this year. I look forward to seeing it. I am sure there will be a responsible debate because we will have two budgets to talk about. When you add up all the amendments from last year, I think we had about $900 billion of additional spending. Taking Mr. Edwards 4 percent number into that, which is about $36 billion, not $32 billion, so it is more than even the additional spending due to the interest on the debt over the next 10 years.

So the key to me is keeping the spending under control and letting the economy grow; and if we do that, we will get not just half the deficit reduced, but even more over the 5-year period.

Chairman NUSSLE. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. Mr. Holtz-Eakin, we have heard a lot about this budget. The fact is we passed massive tax cuts in 2001 and 2003, and the economy has been in the tank ever since. Cause, effect, I don't know. That is what happened. We passed the tax cuts. That is what happened. The fact of the matter is it makes a difference as to which taxes you cut, whether you had used the money for other stimulus, but the $100 billion, you could hire 3 million people at $30,000 a piece, and we would have hundreds of billions of dollars.

And you mentioned swings of $500 [billion], $600 billion in terms of the deficit. We have heard the economy in terms of jobs listed as good. I think that the fact is it is going to be the worst job-producing record since the Great Depression. The stock market is doing great, yeah, I mean, its average over the last 30, 40,50 years is about 8, 9, 10 percent a year. It is exactly where it was 3 years ago. It should be up 8, 9 percent compounded a year, but it is exactly where it was 3 years ago, and that is great.

Let me ask you a couple of questions on policy. You indicated the budget might be balanced in 8–10 years, but I understand that whatever you call the—making the tax cuts permanent, the balancing of the budget would require that we reject making the tax cuts permanent. Is that right?

Mr. HOLTZ-EAKIN. The projection that we show shows the budget coming to balance and a modest surplus———

Mr. SCOTT. If we reject the permanent tax cuts?

Mr. HOLTZ-EAKIN. Under current law.

Mr. SCOTT. Does it have any room for going to Mars?

Mr. HOLTZ-EAKIN. This does not include any new policies.

Mr. SCOTT. Does it include any policy of privatizing Social Security and the trillion dollars that that is going to cost?

Mr. HOLTZ-EAKIN. It is a projection of current law.

Mr. SCOTT. So if we make the tax cuts permanent, go to Mars and try to privatize Social Security, we are back in the ditch; is that right?

Mr. HOLTZ-EAKIN. We haven't analyzed that. We can look at it.

Mr. SCOTT. What portion of the Federal budget was paid for with borrowed money at the beginning of this administration?

Mr. HOLTZ-EAKIN. The historical deficit? I don't remember the number off the top of my head, but we have seen it swing from surplus of about 2½ percent of——

Mr. SCOTT. We weren't borrowing any money. So zero.

Now, what portion of the Federal budget right now are we spending—are we paying for with borrowed money?

Mr. HOLTZ-EAKIN. It is $477 billion out of total outlays on the order of $2.3 trillion.

Mr. SCOTT. On budget, not Social Security, because that is supposed to be paying for itself? About 37½ percent of the Federal on-budget spending paid for with borrowed money?

Mr. HOLTZ-EAKIN. Typically, it is defined as going to private credit markets and raising funds, and that doesn't include the Social Security part, which is just an intergovernmental transfer. So it would be the $477 billion, which is how much is actually borrowed.

Mr. SCOTT. Plus taking the spending in Social Security surplus that was in a lock box when this administration came in.

What was the net interest that we are going to be paying in 2014? Net interest, you have at $338 billion?

Mr. HOLTZ-EAKIN. Yes.

Mr. SCOTT. Social Security surplus, $284 billion.

Now, in 2017, the net interest will be a little more than $337 [billion]. Is that a fair assumption?

Mr. HOLTZ-EAKIN. On this—based on the projection——

Mr. SCOTT. About the same, a little more?

Mr. HOLTZ-EAKIN. Well, under the baseline, we have gone back to surplus, so the debt to outstanding will be diminishing, and interest rates are stable in the long-run. So it will start to go down.

Mr. SCOTT. About $300 billion? Would it go down $30 billion?

What is the Social Security surplus in 2017?

Mr. HOLTZ-EAKIN. I don't know that number.

Mr. SCOTT. Isn't it zero?

Mr. HOLTZ-EAKIN. I don't know.

Mr. SCOTT. Doesn't it go to zero in 2017?

Mr. HOLTZ-EAKIN. I have to check.

Mr. SCOTT. Have you heard the joke about the guy falling down a 20-story building and passing the eighth floor? It says so far no problem. You have net interest of $300-some billion offset by $200-some billion in Social Security surplus. The Social Security is going to go down to zero in 2017, putting a hole in the budget of almost $300 billion.

Is there anything in this budget proposal—I will just ask it another—is that a problem? I mean, we have all these happy faces on the budget. It is nice. Do we have a problem?

Mr. HOLTZ-EAKIN. I think that to pull any particular piece, Social Security or Medicare Part A or any subpart of the Federal budget out is not revealing. I think that the important thing from the perspective of long——

Mr. SCOTT. A $300 billion hole in the budget does not constitute a problem?

Mr. HOLTZ-EAKIN. I think that without knowing how the rest of the budget will play out, it is impossible to say. The long-run problem from the perspective of the entitlements is that they are structured in a way that regardless of how they are financed, they will demand ever-increasing fractions of our national income under current law, and that is, I think, the fundamental issue that is important.

Mr. SCOTT. A $300 billion budget in 3 years, a swing in a budget is not a problem. Is that your position?

Mr. HOLTZ-EAKIN. In the absence of knowing what the rest of the budget does, it is impossible to answer.

Chairman NUSSLE. Ms. DeLauro.

Ms. DELAURO. Thank you, Mr. Chairman, and my apologies. I was chairing a food safety hearing, and so I am sorry I missed most of the testimony—or all of the testimony. So I guess I have a two-part question.

What percentage of the GDP was a deficit in the Clinton years?

Mr. HOLTZ-EAKIN. Depending on the year chosen, it was different. First there were deficits and then surpluses in the 1990s.

Ms. DELAURO. Looks to me like it was pretty much zero if I look at the chart that you have listed here.

And does the Bush administration have a plan to get us back into surplus?

Mr. HOLTZ-EAKIN. I am not privy with the administration's plans.

Ms. DELAURO. So you know of no plan that the administration has to get us back into a surplus position? So in the Clinton years it was a zero percentage of—the deficit was a zero percentage of GDP, and we have no plan now to get us back into the surplus.

A lot of discussion on cutting spending in order to reduce the deficit. If you take a look at nonhomeland security, which my colleague, Mr. Portman, mentioned, that discretionary spending has been virtually frozen for the past 3 years. If the President proposed only a minimal increase of .9 percent, he would only save about $4.8 billion. Do you think that this is the most effective way to address our projected deficit of $362 billion in 2005?

Mr. HOLTZ-EAKIN. Which ever package the Congress and the administration choose, no matter their policy preferences, I can tell you the cost. The programs are chosen for their benefits. The budget reflects the costs, and my goal here today is to illuminate those costs as clearly as possible.

Ms. DELAURO. Without using the Social Security surplus, the deficit will be $631 billion. Is it credible to think that we can control the deficit simply by looking at this small part of the budget? And which you do have some views, I would think, as to where you might look to address these issues.

Isn't it true that we could completely eliminate domestic appropriations that aren't related to homeland security and still be left with a deficit?

Mr. HOLTZ-EAKIN. Certainly the budget authority for particular subset of the budget was $341 billion in fiscal year 2004. That is our projection, and that is smaller than the deficit we project.

Ms. DELAURO. Where would you continue to look for opportunities to lower the deficit?

Mr. HOLTZ-EAKIN. I would say this is Casablanca. You can round up the usual suspects, you can look at the rest of spending, and you can look at the remainder of the receipts.

Ms. DELAURO. Well, it is not exactly like Casablanca. Maybe some of us will get up and sing the Marseillaise. But it is not. This is a reality, and you make commentary on how you might be able to handle these significant deficits. And, you know, where do you look for your biggest bang for the buck here, if you will, to try to deal with your cost—be able to bring your budget into some sort of either balance or surplus?

Mr. HOLTZ-EAKIN. I hope it has been clear from the outset that my goal is to inform the committee about the current track of the Federal budget. Left under current law, that is the neutral baseline provided by the projections. And to show the budgetary implications of some broad alternatives, we sketched those in our report because they are commonly discussed. And indeed, we could analyze further specific proposals. I do not believe—I hope it is not interpreted that I am providing commentary on the best way to proceed in fiscal policy. That is not my role here today.

Ms. DELAURO. It may not be your role here today, but you certainly might have some thoughts that you impart maybe confidentially here to members or to the chairman or ranking member or to the administration about what they might do or maybe the view is just a hands-off view of this is it and come what may.

Mr. HOLTZ-EAKIN. The CBO works with the Congress. If you would like to have a discussion about particular ideas that you might have, I would be happy to pursue that.

Ms. DELAURO. I am happy to do it. Thank you.

Chairman NUSSLE. Mr. Shays.

Mr. SHAYS. Thank you very much for your testimony here. I think it is fair to say that neither Republicans or Democrats feel necessarily that you have sided with their position. You have provided information, and that information is not too pleasant.

A lot of people don't like deficits on either side of the tables here, but I didn't hear hardly any solutions. I heard that we have deficits, and I heard that some wanted to blame the economy, some wanted to blame tax cuts, some wanted to blame spending, and we all have our view. I happen to think it is spending. And others think it may be the tax cuts. But ironically if they think it is the tax cuts, they don't want to raise taxes and put them back to where they were. So they certainly don't have a solution there.

I just remember when I was on the committee during the early years, the Bush years and the Clinton years, when President Clinton got elected, he didn't have a plan to balance the budget either. It was never in balance under his plan. Republicans were elected in 1994, took office in 1995, and we had some major debates. And what we did ironically is we cut taxes and we froze spending, and ultimately we balanced the budget.

Ms. DELAURO. Would the gentleman yield?

Mr. SHAYS. No, I won't.

Ms. DELAURO. Thank you.

Mr. SHAYS. No. I have been here all day. I have been listening to everybody else, and now it is my turn to talk. And what happened was that we ultimately balance this budget by freezing spending over a number of years or at least slowing the growth in spending. We don't seem to have the appetite to do that frankly on either side of the aisle, because when we voted out a budget last year and sent it to the floor, we couldn't get any Democrats to support it, and we couldn't get enough Republicans to support it. So we raised spending. And the reality was that we couldn't get out of town unless we had President Clinton signing the budgets, and it always was we had to spend more.

So I don't know ultimately if we are going to find a solution here, because I know Republicans are going to be the ones that have to vote this budget out and we are going to get no help on the other side of the aisle. What I would like to know, though, is I would like to know what the impact of these extraordinary productivity growth gains have been. It strikes me a few things. The economy grows at 3 percent, and we still aren't seeing the kind of employment that we want to see, but it also strikes me that if we get large productivity growths, that we are likely not to see interest rates go up all that significantly, because we continue to do a lot more with not as many resources and not as many people. Tell me the significance, please, of productivity growth, the pluses and the minuses.

Mr. HOLTZ-EAKIN. I think the way you characterize it is exactly right and the way that we handled it in our baseline. Now, certainly we have seen extraordinary productivity growth measured over the recent recession and recovery, with some caveats that often, especially in the recent data, productivity gains are revised in the data and that coming out of recessions, the economy is capable of displaying a couple of quarters of very big productivity growth that aren't permanent.

But we have seen a period that is really quite remarkable. As a result, what we have done in the projection that is before you is raised the economy's capacity to produce, and that has given us more room to grow and grow rapidly without placing upward pressure on prices, which would ultimately translate—higher inflation will translate into higher interest rates.

So the rapid cyclical recovery that you see in our projection—at 4.8 percent and 4.2 percent, and continued low inflation—is in part a reflection of that productivity growth.

What we have not done is dramatically change our estimate of the long-run rate of labor productivity. It is still about 2 percent a year in our projection. To the extent that one were to develop a sufficient comfort that this was a persistent faster rate of productivity growth, it would be appropriate to raise that. That would mean that that extra room would get bigger every year. In our projections, we have revised the economy's capcity to produce in a one-time fashion that is there for all 10 years but we haven't caused it to expand. That would provide further room for the economy to grow with less inflationary pressure, and as a result, less nominal interest rate pressure as well.

Mr. SHAYS. Does productivity growth provide ultimately greater wealth for individuals? How does it impact wealth?

Mr. HOLTZ-EAKIN. Productivity growth, in the long-run, improves the Nation's standards of living. You get more national output for every unit of labor input, for every person in simple terms. It typically, over the long-run, translates into higher real wages for workers, and the degree to which those higher national incomes are saved and invested leads to higher national wealth as well.

Mr. SHAYS. Thank you.

Chairman NUSSLE. Thank you.

Are there other members, other questions that—just before we go into a second round, let me just make it clear that the witness has been before Congress for 7 hours today. It is going to be questions. If you want to make a comment, the microphones will be available, I am sure, for the media to do that, but if you have a question for the witness as we proceed, I am happy to entertain a very brief, quick question from those who would like to inquire.

Are there members wish to do that? Mr. Edwards.

Mr. EDWARDS. Thank you, Mr. Chairman. I don't know of anything else we are going to do the next 2 hours that would be more important than looking at the largest deficit in American history, and my question is——

Chairman NUSSLE. Do you have a question for the witness?

Mr. EDWARDS. Yes, I do. I keep hearing that, you know, let's protect the tax cuts. Those that pushed them in 2001 would have admitted that wasn't a $1.3 trillion tax cut if you extend it. Do you know if you assume that you extended all the temporary tax cuts, they were part of the $1.3 trillion tax cut in 2001, would have been more like a $2 [trillion], $3 trillion tax cut, Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I forget the number, to be honest. We could go back and check.

Mr. EDWARDS. And let me ask you this. I hear a lot about let's balance this budget by cutting spending. I want to go back to the fiscal year 2003 budget and look at the five largest programs in the Federal budget that represent 70 cents of every single dollar we spend. Now, in the administration budget request for 2003, was defense spending—was the request to increase it or decrease it?

Mr. HOLTZ-EAKIN. I recall it was an increase.

Mr. EDWARDS. So it was an increase, significant one, I believe. Social Security, was there any request to reduce spending on Social Security?

Mr. HOLTZ-EAKIN. I don't remember any proposals for Social Security at all. It is current law.

Mr. EDWARDS. If we privatize it as proposed, there would be a trillion dollar hole there. That would be an increase in Medicare—the recent Medicare prescription drug bill, did that increase or decrease out-year expenditures for Medicare?

Mr. HOLTZ-EAKIN. The President's proposal, when we analyzed it, was simply an allotment of $400 billion over 10 years.

Mr. EDWARDS. So it increased the Medicare budget, third of the five largest expenditures of the Federal Government. The administration asked for an increase there.

Medicaid, did the administration in fiscal year 2003 ask for a reduction in Medicaid spending in 2003?

Mr. HOLTZ-EAKIN. The President's budget had a proposal in Medicaid, the details of which I forget. It involved changing the program somewhat in the out-years and I forget the net budgetary consequences.

Mr. EDWARDS. To your knowledge for the 2003 budget year, the administration did not ask for a decrease in the Medicaid expenditures?

The final one, the interest on the national debt, the administration didn't have a choice. It had to ask for a massive increase in spending. So actually, as we look at spending reductions, the administration actually asked for increases in three of the five largest programs that represent 70 percent of the budget.

One final point and in terms of a question. When we borrow money—now, this $477 billion deficit we are going to add as a debt to our children's future this year, that does not include the money we are borrowing, the billions we are borrowing, from Social Security and Medicare.

Now, do we have as a Nation a legal obligation to repay that money borrowed from the Social Security and Medicare Trust Funds? Is that a legal debt?

Mr. HOLTZ-EAKIN. I am not a lawyer, but my understanding is that the legal implications of the trust fund balance are that benefits cannot be paid unless there are funds in the trust fund. So it has a triggering mechanism for the benefit payment.

Mr. EDWARDS. So bottom line, that is a legal debt we are incurring. So it is just as real as the $477 billion deficit we are going to have this year. If you add the Social Security and Medicare Trust Fund borrowings for fiscal year 2004 to the $477 billion deficit you project we will have, what would that deficit be?

Mr. HOLTZ-EAKIN. Well, if one took comprehensively all of the off-budget and trust fund-like activities, then you would have the $630-odd billion number that was referred to earlier.

Mr. EDWARDS. So it would be $631 billion deficit that we are, in effect, adding to the national debt for fiscal year 2004 if you count the money we are borrowing from Social Security and Medicare; is that correct?

Mr. HOLTZ-EAKIN. And, again, you can do the accounting for informational purposes any way you like, but from the strict point of demands on credit markets, the 477 represents the net demand on credit markets. The remainder is an intergovernmental transfer, which may have programmatic implications, and I understand that.

Mr. EDWARDS. One last question about the chart. You often said 40 percent of the deficit this year can be chalked up to economic changes from assumptions that were made. A lot of us said several years ago those assumptions were never honest. But the fact—based on your knowledge of American history's economy, would it be honest to say and project as a professional economist that you don't expect America to ever again have a recession?

Mr. HOLTZ-EAKIN. I think there is no way to rule out the fact that we would have a recession in the future.—I want to thank the chairman for acknowledging the efforts of the staff at the outset. I wasn't at CBO for that projection, but I take issue with the phrase "never honest." This staff does its very best to——

Mr. EDWARDS. No. I am talking about from now forward. I am not talking about something that was done in the past. What I am saying is looking from now forward, would it be honest to suggest to the American people that we will not have a recession in the next 10 or 20 or 30 years? Would that be consistent? Would it be honest to suggest that?

Mr. HOLTZ-EAKIN. And no one is suggesting that. Instead, what we project are near-term business cyclical recoveries——

Mr. EDWARDS. I understand.

Mr. HOLTZ-EAKIN [continuing]. Please let me finish. And over the out-years we project the average performance of the economy in the face of unknown timing of business cycle fluctuations, and that is the right way to interpret our medium term projections.

Mr. EDWARDS. Put that into lay terms, and I will finish with this, Mr. Chairman. The point is we make budget projections, assuming there will be no recessions. You are required to do that, you know. I assume that you are required, in effect, to do that. But the truth is, just like we said 2 years ago when we debated the 2001 tax cut bill, you can't assume that we are never going to have an economic slowdown. So to all of a sudden say oh my gosh, we have an economic slowdown, that is why we have the deficit, we should have been honest with the American people in the first place 3 years ago.

Thank you, Mr. Chairman.

Chairman NUSSLE. Thank the gentleman. I turned off the clock. I counted 12 questions. I really am trying to ask if members have one final brief question.

Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman. I have a question with regard to the process. These are all helpful analyses that you provided us with Dr. Holtz-Eakin, but in many ways as of next week, they are going to be outdated, given the fact that we will then embark on a legislative struggle, if you will, process with regard to the President's legislative initiatives.

And in the President's budget in the first place, he will give us defense spending assumptions for Iraq, Afghanistan, and so on. So that will presumably update the numbers you have for the $87 billion supplemental repeated on an annual basis with inflation, but he also has projections for the individual savings accounts as an alternative to Social Security. He will have the long-term revised projections that OMB does of the effect of the Medicare and prescription drug changes to legislation. There will be a number of tax proposals.

There is a tax benefit for health insurance, for example, and all of these combined—and I think it is a reasonable assumption that most of them are going to get passed, since it is the House and Senate are of the same party, and the President has had a remarkable success with the legislation he has proposed.

All of them combined, I think present a very different budget picture. That plus the fact that you suggested earlier that the numbers start changing as to the role of Social Security and Medicare in the out-years. The proportion of spending on Social Security and Medicare, because of the dramatic addition of retirees, I guess beginning in 2008, but really accelerating after 2013. Those policies, plus the changes in Social Security and Medicare dynamics, it seems to me, we really ought to be looking at perhaps a 20-year projection. I don't know if that is conceivable, but we really need to look at revenue flow and entitlement demands over the long period, particularly with regard to tax policy, because once taxes are imposed, it is very—or once they are cut particularly, it is very difficult to reinstate them as we are going to find out.

So I wonder if CBO is considering giving us updated analyses in that context once the President's budget is introduced? Will you be able to give us that kind of updated commentary after next week's budget submission?

Mr. HOLTZ-EAKIN. Well, certainly we will follow the usual process, in that with the receipt of the President's budgetary proposals, we will do two things: We will revise our baseline projections, the ones that you see today in light of information that we receive from the administration in terms of credit reestimates and a variety of other aspects of it.

We also have the opportunity to revisit any new information about the economy and put that in. So we will comprehensively revise these baseline projections as new information indicates we should. We will then analyze the President's budgetary proposals off of that new baseline and give our estimate of their budgetary implications. We will also, in the standard fashion, take a look at their economic impact as is necessary. And to the extent that the Budget Committees are interested in analyses that have a different duration than the 10-year window, I would leave it to work with Chairman Nussle and members of the committee so that we provide the information you need to do your work.

In the end, that would be the key issue, and we would be happy to work with you on that.

Mr. MORAN. Well, I would, Chairman Nussle, that you might consider even longer-term projections, at least in terms of the tax and revenue front given the additional context of Social Security and Medicare retirees accelerating after 2013. So it really doesn't present a different budgetary context. So I would hope you might consider requesting that of the CBO. Thank you, Mr. Chairman.

Chairman NUSSLE. Mr. Scott, do you have a question?

Mr. SCOTT. Yes. Thank you, Mr. Chairman. We have a chart that is going up.

Mr. Holtz-Eakin, are you familiar with this chart?

Mr. HOLTZ-EAKIN. I have seen it.

Mr. SCOTT. Well it is a budget deficit—on-budget deficit over the last few years. In 1993 when President Clinton came in, he passed a budget. That is right when the green starts—with no Republican votes. You are aware in 1994 the Republicans campaigned against those votes, and in 1995, came in control of the House and the Senate and passed—are you familiar with the massive tax cuts that were in the bills that they passed? Anyway, they were vetoed by the President. We closed down the government because President Clinton would not sign those massive tax cuts, and the green continued.

In 2001, are you aware that budgets were passed by the Republican Congress similar to the ones that were vetoed in 1995, only these were signed by President Bush? And you will see the red ink flowing after that. Is that an accurate——

Chairman NUSSLE. Does the gentleman have a question for this witness?

Mr. SCOTT. Is that an accurate description of what happened?

Mr. HOLTZ-EAKIN. I can go back and look at the bills. I am not intimately familiar—you were there.

Chairman NUSSLE. Is this a chart that is written by CBO or is this written by whom?

Mr. SCOTT. It is the CBO numbers. It is written by the Democratic staff, but that little uptick there is really assuming that we reject the President's initiatives, otherwise it will be going down off the chart.

One other question. You had indicated to my colleague from Texas about the Social Security. In 2017, we do have a problem. My colleague from Virginia also indicated that a 20-year budget would be important, because we have a severe crisis with Social Security running instead of huge surpluses. They start to run huge deficits.

Wouldn't one solution to this problem be just to repeal Social Security? Would that be legally permissible?

Mr. HOLTZ-EAKIN. The Congress could choose to alter any program, and Social Security is one of them.

Mr. SCOTT. And if we are not ready to pay for it, that probably would be what we would end up having to do, wouldn't it? Unless we get the budget straight now.

Thank you, Mr. Chairman.

Chairman NUSSLE. If there is nothing else to come before the committee—does the gentlelady have a brief question?

Ms. DELAURO. Yes, I do. I have a brief question. Thank you. It is a question that has to do with your opinion as a professional economist, and that is we are talking about—my colleague from Connecticut talked about productivity. It is all about economic growth. It is about job creation. We talked about productivity. There hasn't been any real job creation, but the fact of growth, and in the future that if—if your professional opinion, that if we continue to have tax cuts that are deficit-financed, in your view, will that lead to higher growth in the United States?

Mr. HOLTZ-EAKIN. Other things equal—again, the important stipulation—productivity growth comes either from technological innovation or providing workers with more of those new technologies—capital deepening. So we save, invest, provide capital to the future.

To the extent the fiscal policy in a noticeable fashion detracts from our ability to save as a Nation and invest, that will affect productivity growth.

Ms. DELAURO. Thank you.

Chairman NUSSLE. I thank the witness for your testimony. We will certainly be in touch, I am sure, throughout the year on a number of different items. We appreciate your work and your staff's work in preparing this report, and we look forward to working with you again this year.

Mr. HOLTZ-EAKIN. Thank you.

Chairman NUSSLE. If there is nothing more to come before the committee, this committee stands in recess.

[Whereupon, at 4:31 p.m., the committee was adjourned.]