S. HRG. 113–229

BUDGET COMMITTEE MID-SESSION HEARINGS FISCAL YEAR 2014

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

February 13, 2013 –The Impact of Federal Budget Decision Families and Communities
February 26, 2013 –The Impact of Federal Investiments on People, Communities and Long-Term Economic Growth
March 5, 2013 –Reducing the Deficit by Eliminating Wasteful Spending in the Tax Code
May 22, 2013 –Supporting Broad-based Economic Growth and Fiscal Responsiblity through Tax Reform
June 4, 2013–Fiscal and Economic Effects of Austerity
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September 24, 2013 –The Impact of Political Uncertainty on Jobs and the Economy

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THE IMPACT OF FEDERAL BUDGET DECISIONS ON FAMILIES AND COMMUNITIES

WEDNESDAY, FEBRUARY 13, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:31 a.m., in Room 608, Dirksen Senate Office Building, Hon. Patty Murray, chairman of the committee, presiding.

Present: Senators Murray, Stabenow, Sanders, Whitehouse, Warner, Coons, Baldwin, Kaine, Sessions, Johnson, Ayotte, and Wicker.

Staff Present: Evan T. Schatz, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. Good morning. This hearing will come to order, and I want to thank our witnesses today, who I will introduce shortly. I want to again welcome my Ranking Member, Senator Sessions, and all of our colleagues who are joining us here today.

Yesterday, we heard from the Congressional Budget Office Director, Dr. Doug Elmendorf, on the budget and economic outlook. His testimony and answers to our questions provided an extremely helpful look at the issues facing this community at the macro level. And based on what he said about our fragile economy, it is very clear to me the highest priority of this committee should be broad-based economic growth and job creation as we work to responsibly tackle our deficit and debt challenges.

But as we work to put together our pro-growth, pro-middle class budget resolution over the coming weeks and months, I feel very strongly we cannot just limit ourselves to discussions of numbers and charts and trajectories, though those are important. We need to make sure we are hearing from the families and communities across the country who are impacted by the decisions that we make here in

Washington, D.C. They need to have a seat at the table. Their values and priorities need to be represented and their stories need to be heard.

That is what today's hearing is about, and I am going to work every day over the coming weeks and months to make sure families across our country are heard loud and clear in a budget process that is too often limited to politicians and bureaucrats.

But before I ask others to share their stories today, I wanted to start off by sharing mine, not because my story is unique—it is not, similar stories are told by millions of families across our country—but because it has shaped who I am and how I approach this issue, and I think stories like it have a place in this conversation.

I was born and raised in a small town, Bothell, Washington, in a big, loving family with six brothers and sisters. I was one of the oldest and we were all very close. My dad ran a small five-and-dime store on Main Street and everyone in my family worked and helped out at that store. We did not have a lot, but we never felt very deprived.

But when I turned 15, things started to change dramatically. My dad, who was a World War II veteran, was diagnosed with multiple sclerosis. In a few very short years, his illness got so bad that he could not work anymore, and my mom, who had stayed home to raise seven kids, had to take care of him, but she also needed to get a job so she could support our family. She found some work, but it did not pay very much, and not enough to support seven kids and my dad, who had growing medical bills, and suddenly we found ourselves as a family having fallen on very hard times.

Now, fortunately for all of us, we lived in a country where the government did not just say, tough luck. It extended a helping hand. Because our nation honored the commitment it made to the veterans who had served it, my dad got some of his medical care through the VA. But for some time, for a few months, my family had to rely on Food Stamps. They were meager, but they kept food on our table at a very critical time.

To get a better paying job, my mom needed some training. Fortunately, at the time, there was a government program that helped her attend Lake Washington Vocational School, where she worked very hard and got a two-year degree in accounting and eventually a better job.

My twin sister, my older brother, and I were able to stay in college through all of that because of student loans and support from what later came to be called Pell Grants. And all of us kids were able to stay in school because we were lucky enough to have strong local public schools.

My family got by with a little bit of luck and we pulled through with a lot of hard work. And while I would like to say we were strong enough to make it on our own, I do not think that is really true. Today, my family may have been called takers, not makers. Others may have said the programs we used to keep our heads above the water were immoral. Presidential candidates may have told their donors we were in the 47 percent who could not be convinced to take personal responsibility or care for our lives.

But I know the support we got from our government was the difference between seven kids who might not have graduated from high school or college and the seven adults we have grown up to be today, all college graduates, all working hard, all paying taxes, and all of us contributing back to our communities. In my book, the taxpayers got a pretty good return on their investment.

Now, I do not think government can or should solve every problem. People do need to take responsibility for their actions. Families need to take care of each other. Private businesses need to drive our economy. And communities and religious organizations need to play a strong role.

But America has always come together as a nation to stand with families like mine, to invest in our people and our communities, to plan for the future and to build the most robust middle class the world has ever seen.

So that is the prism that I view our nation's budget through and it is what guides me as I work in the Senate and on this committee to impact the choices that we make. I rely on my story, my experiences, and the experiences of people in communities across the country, people like Katyanne Zink, a young woman who is in this room today. I just had a chance to talk with her a few minutes ago. She grew up in low-income neighborhood in New Hampshire with parents who did not go to college themselves but who desperately wanted the best for their children. She had a great public school teacher who helped guide her into a TRIO program, and only because of Pell Grants and student loans was she able to go to college, earn her degree in nursing, and give back to her community as an urgent care nurse in her home State. She is a proud homeowner, as well.

Our witnesses today also have stories to share with this committee about the impact of Federal budget decisions. Tara Marks will be sharing her story about the support she received to get back on her feet after circumstances pulled her and her son out of middle class life.

Patrick Murray is an Operation Iraqi Freedom veteran who will tell us about the opportunities he was able to access after he sacrificed so much for our country.

Also, Robert Greenstein from the Center on Budget and Policy Priorities will share his expertise on how budget decisions impact the lives and the opportunities of families throughout our country.

And Senator Sessions will introduce his witnesses in a minute. He is invited to make his opening statement. But I also want to thank Secretary Gary Alexander from the Pennsylvania Department of Public Welfare and Robert Woodson, Senior, from the Center for Neighborhood Enterprise for joining us here today.

Two weeks ago, I also rolled out an online platform called "My Budget" for members of the public to share their stories and ideas and priorities with me and the committee. I have already received over 2,000 responses, and I encourage everyone watching today to go to our site at budget.senate.gov/democratic to weigh in, because as we work to write our pro-growth budget resolution, I am going to make sure it represents the values and priorities of the people we represent. That is the most important thing we can do here on this committee.

When I go back to my home State of Washington, my constituents tell me they want a budget that works for people like them. They want their government to be there when they need some support and to help make sure they have the opportunity they deserve to succeed and do better for themselves and their families. In other words, they want what my family had, what Katyanne and Tara and Patrick and millions of others had.

Yes, our constituents want us to take responsibility and tackle our deficit and debt, and they certainly do not want to hand the bill to their kids. But they want that to be done in a balanced and fair way that does not sacrifice jobs and opportunity and broad-based economic growth. And at a time when so many families are still fighting their way back from the hit they took in the great recession, when so many workers are still struggling to find work, stay in their homes, and put food on the table, and when our tax code remains riddled with loopholes and giveaways for the wealthiest Americans and biggest corporations, I think most families agree that while every program should be examined and made more efficient if it is not working as well as it should, and we certainly should make sure we are weeding out fraud and abuse in defense as well as domestic programs, it does not make sense to focus exclusively on slashing programs that help the neediest, especially the ones that have expanded to support struggling families and that will shrink to their historical norms once we get this economy back on track. And I think Americans agree, it is absolutely wrong to call on the middle class and seniors and most vulnerable families to bear the burden of deficit reduction alone.

That is how I view this issue, as we work to replace sequestration in a balanced way over the coming days, and I have to say, it was disappointing this morning to hear from a number of Republicans that they did not want to replace sequestration and avoid those devastating cuts that are coming at us. So I hope that we can change that and work to replace those cuts at a time when our country is really struggling financially.

This is how I am approaching the pro-growth, pro-middle class budget resolution that we will be working on in the weeks ahead, and I think this committee hearing will be very instructive in that.

So I thank again all of our witnesses and Senators who are here today, and with that, I will turn it over to Senator Sessions for his opening remarks.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Madam Chairman. It is a delight to be with you and I appreciate your leadership.

This is an important hearing. I am glad we are having it. We need to take another opportunity now, since 1996, to review our safety net programs and see how they are working and see if we can make them better. We know that welfare now makes up 83 programs that amount to as much as $750 billion a year. That larger than Medicare, Social Security, and the Defense Department budgets.

I would just say on the question of sequestration, half of the cuts fall on one-sixth of the Federal budget. That is the Defense Department. That is the hardest hit agency by far. I think it is doing damage to that Department. Republicans in the House have twice passed legislation—to alter the sequester, find other areas of the budget that received no cuts, and fix it. So we favor fixing the sequester, but we do not favor increasing spending or increasing taxes. We just raised taxes.

We have a great American tradition of helping those in need, but we also have a great American tradition of self-reliance and independence and we want to encourage both of those, and Federal policy should do both of those.

So we are going to hear from Secretary Alexander from Pennsylvania who really has a first-hand experience as a manager in the various Federal welfare programs and he will show how we have drifted away from the reforms in 1996 to now a complex welfare bureaucracy that tends to penalize work and promote dependency.

Bob Woodson from the Center for Neighborhood Enterprise came down to one of Alabama's poorest counties with his group and had some fabulous ideas to help poor people improve their lives. Thank you for your contributing to Alabama, Dr. Woodson, and I was pleased to have a visit with you when you were there and get your understanding. And I know how deeply you care about poor people, how deeply you care about helping them advance and move out of poverty and dependency and we look forward to hearing you and appreciate your lifetime of service in that regard.

In his State of the Union Address, the President suggested last night again that Republican policies are focused on protecting the rich and not sufficiently on helping those in need, but I do believe that his policy agenda is not being helpful. I believe his policy agenda has the tendency to not create the kind of growth and upward mobility that we absolutely must have in America. He talked again and again about helping people, suggesting that we should extract more wealth from the economy and hand it to people and that this would somehow help them. Sometimes, as you indicated, Madam Chairman, this is critical. People's lives are in turmoil. They are in danger. They have problems. And it can be a life-saving event for them to have Federal benefit programs. But I do not think it amounts to an economic stimulus. I do not think it amounts to the kind of growth we want. It is a temporary assistance that is part of our tradition and we will continue.

So our goal is to rescue Americans that are being entrapped in the world of dependency. That is happening today. Some people might deny that, but I think anybody that works in this area and really cares about poor people have seen this tendency. It was lessened with the 1996 Act, but it is returning full force.

Our goal is to help more of our fellow citizens find good-paying jobs sos that they can support themselves and their families, jobs that will allow them to progress, advance, and get themselves promoted. Our goal is to strengthen human networks of family, charity, and community.

In 1965, economist James Tobin wrote, quote, "It is almost as if our present programs of public assistance had been consciously contrived to perpetuate the conditions they are supposed to alleviate." If there is much truth in that, and I think there is, that is a real serious charge. History, I think, has proven him too correct.

Since President Johnson's Great Society, the Federal Government has spent $15 trillion on the War on Poverty, yet poverty remains largely unchanged and has even increased during the last several years. During the last several years, we have also seen an historic surge in Federal poverty spending. Welfare is now the single largest item in the budget.

It is time to return, I think, to the moral principles of the 1996 welfare reform. That reform was guided by the principle that, over time, unmonitored welfare programs were damaging not merely to the Treasury, but to the recipient. Today, like 1996, opponents of reform labeled any attempts to change the way these programs operate as cruel, uncaring, as dangerous. But what is actually cruel and uncaring is to oppose reforms that will help lift millions of Americans out of poverty.

Consider the results of the 1996 reform. There were so many dire predictions at that time. But Ron Haskins of the Brookings Institute reported this. "Until the mid-1990s, never-married mothers seldom worked outside the home, had poverty rates of over 60 percent, and were at least five times more likely than married couples to be poor. Between 1996 and 2000, after the passage of the bill, the percentage of never-married mothers in jobs increased by about a third, while the poverty rate for those mothers and their children declined by about a third. For the poorest of the poor, this large improvement based on their own efforts was unprecedented. Since then, two recessions have reduced these gains somewhat, yet even in the worst recession since the depression, more are employed and they are less poor than they were before the 1996 law."

So, unfortunately, the gains in 1996 have been slipping away from us. Welfare spending has increased every year, regardless of whether the economy was growing or declining. Welfare spending has continued to go up. Based on CBO data, welfare spending is projected to increase 80 percent over the next decade. Let me repeat. Spending on means tested Federal aid will increase another 80 percent over the next ten years. Including State contributions, we already spend a trillion dollars a year on Federal means tested poverty programs, more than any other program in the Federal budget.

Converted to cash, if you spent that money—we spend enough money on welfare to mail every household in poverty a check for $60,000 a year. Can anyone honestly say this huge sum of money is all being wisely and effectively spent, that no improvements are needed?

Spending on Food Stamps has more than quadrupled since 2000, and the Federal Government actively promotes Food Stamps to those who say they do not need them. The USDA created a Spanish language radio ad in which an individual is pressured to enroll against her will. She protests, "I do not need anyone's help. My husband earns enough to take care of us." Eventually in the video, she succumbs and signs up.

This is only one of many controversial promotions where individuals are pressured, actually, to enroll, even if they insist they do not want or need the program. One recruitment worker was even given an award for overcoming "mountain pride" and had language to use to try to encourage people who say they do not need it to overcome their pride and get them to accept these benefits.

The agency laments that communities loose out when people do not choose to go on Food Stamps. Quote, "Each five dollars in new SNAP benefits generates almost twice that amount in economic activity for the community. Everyone wins when people take advantage of benefits to which they are entitled." Well, it does not increase the economy like that. I mean, how silly is that? We could just give everybody everything and the whole economy would boom, I suppose.

So, clearly, we need to think more about the social and economic consequences of encouraging people to accept welfare if they do not want it and do not need it. If they need it, we want them to have it. No longer can we measure and should we measure compassion by how much we spend on poverty, but how many people we lift out of poverty. I think that is what Mr. Woodson has given his life to.

One consequence of the massive surge in welfare spending has been the creation of a growing penalty for working. Experts have dubbed this the welfare cliff. Welfare recipients reach a point, actually reach a point where every additional dollar earned can result in more than a 50 percent reduction in net income through lost benefits and taxes. CBO estimated that for every dollar in additional earnings through work, many households on welfare stand to lose 50 cents to either taxes or lost Federal benefits. With a high penalty to earning more by working, CBO finds that a strong incentive is created to, quote, "put in fewer hours or be less productive."

A paper presented to the American Enterprise Institute by Secretary Alexander, from whom we will hear, found that because of the stacking of welfare benefits, many individuals receiving welfare stand to lose financially by increasing their income. That is an actual analysis that we need to examine. In one example, a study demonstrated how a single parent with two children earning $29,000 would have a net income, including welfare benefits, of $57,000. Therefore, the individual would need annual earnings to jump from $29,000 to $69,000 pre-tax to maintain the same standard of living.

Madam Chairman, I grew up in the country. I recently had some work done on the little house I grew up in. It had 900 square feet. It seemed bigger at the time. It never had central air and heating. The fireplace was where we had our heating. My father ran a country store and later struggled with a small farm equipment dealership. I was taught to work hard. They did their best. Pell Grants did help me in college. I grew up with people who did not get to go to college, had less money than we did, and I think I understand something about human beings who work hard and try to do the right thing and how to help them improve.

So I guess I just would say, let us work together, bring our values to the table, and see if we cannot make this system work better for America.

Chairman MURRAY. Thank you very much.

We will now turn to our witnesses and then we will turn it to questions from our Senators.

I am going to begin with Tara Marks, if you want to share your comments.

STATEMENT OF TARA MARKS, ADA, OHIO

Ms. MARKS. Good morning, Chairwoman Murray and Senators of the Budget Committee. I want to thank you for allowing me to speak about the impact Federal programs have had on my family.

I know from personal experience the importance of SNAP and other Federal programs that provide a safety net. SNAP and WIC were there for me and my son Nathan when we needed help. I never thought I would need to ask the government for help putting food on the table. I am thankful that these programs were available so that I could focus on getting us out of poverty.

While I was pregnant with Nathan, his dad and I decided I would be the stay-at-home parent. The arrangement was working well until his father abruptly left me and my eight- month-old baby. He took everything. I knew that I needed to go back to school so that I could someday provide for the two of us and raise Nathan not in poverty. Student loans, Pell grants made that education possible.

We lived on credit cards and the grace of God for many months. I started having trouble affording food. The trips to the grocery store became a game of what can I afford. I only had a few dollars per trip, so I began eating smaller portions so that Nathan could have nutritious meals. This was not a question of availability of food, but affording it. I did not live in a food desert, I lived in a food mirage.

One weekend in particular was just awful. That was the weekend I knew I had to ask for help. I picked Nathan up from day care, and as I was driving home, I thought out loud, what is for dinner? I knew the pickings were slim, but I did not realize how little we had in the house. When we got home, I had to ration food. I realized I had just enough in the house for Nathan. Nathan ate and I did not.

I was studying for an exam, but was distracted by my hunger. I had not been eating well for months, so the absence of food that weekend caused me to pass out. Come Monday morning, I was so lightheaded that I had trouble maneuvering through rush hour traffic. I cried the entire car ride. Once we arrived at the day care, I swallowed my pride and asked for help. I was put in touch with a local food pantry. I was told that I should apply for SNAP benefits because I had no income.

The first time I applied for SNAP, after waiting for hours, I was urged by the caseworker to withdraw my application. I felt as if the message was, I did not deserve food.

I continued to receive food from the local pantry. I was very grateful. But the food was very limited and I could only receive it twice a month. I managed, but wanted to pick out ingredients for recipes given to me by my grandmother. I wanted Nathan to grow up enjoying Sunday dinners like I did as a child.

One day at a parenting meeting, a woman from Just Harvest, a local anti-hunger organization, spoke to us about SNAP. She offered to help me with the application. I went back to DPW and this time I was given SNAP benefits. I cannot put into words the feeling of relief that came over me. I felt like a more responsible mom. I knew I could now provide meat and fresh produce for Nathan.

I still remember that first trip to the grocery store. I was able to hand-pick tomatoes, apples, bananas, and other produce. Because of SNAP, I was a part of the regular food purchasing economy once again. I could shop just like other mothers. I am immensely grateful for SNAP, but I have to agree with the recent Institute of Medicine study. SNAP benefits are crucially valuable, but not enough to get most families through the month.

I was able to lift Nathan and myself out of poverty by finishing school. SNAP was a critical factor in my success. SNAP benefits allowed me to focus on school. I no longer stressed over purchasing food. I graduated from community college, went on to receive my

Bachelor's and Master's degree. I worked for Just Harvest as a Co-Director of Policy and Communications. I am married today with a wonderful supportive husband and three healthy children, Nathan, 12, Christian, eight, and Tatum is four. My husband is working and I am currently a law student in Ohio. Through the help of Stafford loans, I plan to graduate in 2015.

I do not like thinking about those earlier days. For the longest time, I would not tell anyone that I went hungry or that I received SNAP benefits. When I told Nathan I did not eat to ensure that he would not go without, he hugged me and said, "I would have shared my food, Mama." I asked him if I could share our story. He nodded his head and said, "No mama should ever go hungry."

I know that my experiences of hunger and poverty are not unique. There are many who fall on tough times and rely on SNAP to put food on the table.

In conclusion, I am very thankful that SNAP was there for us. I urge the committee and the Congress to take stories like mine into account as you put together your budget. I ask the Congress to continue to invest in life-saving programs that families like mine all across the country can get the support they need to get back on their feet, back on track, and back into a job. They were there for me when I needed it most and they should not be cut now when so many others are struggling in this tough economy.

I am here to keep my promise to Nathan. I am asking you to fund SNAP and protect it from cuts so that no other mama, child, dad, or grandparent goes hungry.

On behalf of my family and many other families, I thank you for your time and consideration.

[The prepared statement of Ms. Marks follows:]

Testimony of

Tara Marks

Before the

U.S. Senate Committee on the Budget

"The Impact of Federal Budget Decisions

On Families and Communities"

February 13, 2013

Good morning Chairwoman Murray and Senators of the Budget Committee.

I want to thank you for allowing me to speak about the impact federal programs for the middle class and low-income families have had on my family. I know from personal experience the importance of SNAP and other federal programs that work to provide a safety net for people in need. In particular, SNAP and WIC were there for my son, Nathan and me when we needed help to have food in our home.

I never thought that I would ever have the need to ask the government for help putting food on our table. I never thought that I would be so poor that food would be out of reach for me. But it all happened. I am thankful that these programs were available for me and my son so that I could focus on getting us out of poverty.

While I was pregnant with Nathan, his dad and I decided that I would be the stay at home parent. I was so excited to be there for every second of my son's life. When Nathan was born I left my job to stay home with him. The arrangement was working out just as planned until his father abruptly left me and my eight-month-old baby. He took all our money with him. I no longer had any income so I had to rely on savings and credit cards. Soon I was not able to afford our lifestyle and I had to make many changes. Nathan and I had to move from our comfortable home to government housing. The day we moved in, I decided that I was going to get us out as soon as possible. I did not want Nathan to grow up in poverty. I knew that I needed to go back to school so that I could someday provide for the two of us without help.

We lived on federal student grants and loans, including Pell Grants, credit cards and the grace of God for many months. As my credit card balances were increasing, my cash was decreasing. I started having trouble affording food. The trips to the grocery store became a game of what can I afford. I stopped buying meat and fresh produce because I only had a few dollars per trip. I began eating smaller portions so that Nathan could have nutritious meals. Then the time period between meals became longer for me. Sometimes I would eat one meal a day and other times, I would not eat at all. I knew that our situation was getting worse, and I did not know what to do. This was not a question of availability of food, but a question of affording it. I did not live in a food desert; I lived in a food mirage. I had many grocery stores around me but I could not afford to go in and shop.

One weekend in particular was just awful. That was the weekend that I knew I had to ask for help. I picked Nathan up from daycare just like any other Friday afternoon. As I was driving home I thought out loud, "What is for dinner?" I knew that the pickings were slim, but I did not realize how little we had in the house. When we got home I did something I only had heard about, I rationed food. I realized that I had just enough food in the house for Nathan. Nathan ate and I did not.

I was studying for an exam but was distracted by my hunger. As I pointed out earlier, I had not been eating very well for months so the absence of food that weekend caused me to pass out. Come Monday morning I was so light-headed that I had trouble maneuvering through rush hour traffic. I cried the entire car ride. I had to pull over twice to gain my composure. Once we arrived at the daycare, I swallowed my pride and asked for help. I was put in touch with the local food pantry and was able to get immediate help from the daycare. I was told that I should apply for SNAP benefits because I had no income.

The first time I applied for food stamps, after waiting for hours, I was urged by the caseworker to withdraw my application. I felt as if the message was that I didn't deserve food.

I continued to receive food from the local pantry. I was very grateful, but the food from the pantry was very limited and I could only receive a food box twice a month. I managed but longed for the day that I could make a meal of my choosing. I wanted to pick out ingredients for recipes given to me by my grandmother. I wanted Nathan to grow up enjoying Sunday dinners like I did as a child.

One day at a parenting meeting at Nathan's daycare a woman from Just Harvest, a local anti-hunger organization, spoke to us about SNAP. I told her that I tried to apply but withdrew my application. She explained the process and guidelines to me. She offered to help me with the application. I went back to DPW and this time I was given SNAP benefits. I cannot put into words the feeling of relief that came over me. I felt like a more responsible mom. I knew I could now provide meat and fresh produce for Nathan.

I still remember that first trip to the grocery store. I was able to hand pick the tomatoes, apples, bananas and other produce to fill the hanging basket in my kitchen. Because of SNAP, I was a part of the regular food purchasing economy once again. I could shop just like other mothers. I am immensely grateful for SNAP, but I would be remiss if I did not say, given this wonderful opportunity today, what the Institute of Medicine (IOM) study last month also said: SNAP benefits are crucially valuable but not enough to get most families through the month.

I was able to lift Nathan and myself out of poverty by finishing school. SNAP was a critical factor in my success. Having SNAP benefits allowed me to focus energy on school so that I could support us. I no longer stressed over purchasing food. I graduated from community college with two associate degrees and was the student speaker at commencement. I went on to receive my bachelor's and master's degrees. I worked for Just Harvest, the local anti-hunger program that helped my family, as the Co-Director for Policy and Communications. I am married today with a wonderful, supportive husband and three healthy children; Nathan 12; Christian 8; and Tatum 4. My husband is working and I am currently a law student in Ohio. Through the help of Stafford Loans, I plan to graduate in 2015.

I do not like thinking about those earlier days. For the longest time I would not tell anyone that I went hungry or that I received SNAP benefits. I was scared I would be judged. However, I did tell Nathan about those tough times and he cried. When I told him that I did not eat to ensure he would not go without, he hugged me and said "I would have shared my food, mama." I smiled and reassured him that I made that decision and he was only two years old at the time. I asked him if I could share our story. He nodded his head and said, "No mama should ever go hungry." He reminded me that I needed to help others because so many people helped us when times were tough.

I know that my experiences of hunger and poverty are not unique. There are many families – all kinds of families and individuals – that fall on tough times and rely on SNAP to put food on the table. SNAP helps families every day.

I am very thankful that it was there for us. I urge the Committee and the Congress to take stories like mine into account as you put together your budget. I ask that Congress continue to invest in life-saving programs so that families like mine all across the country can get the support they need to get back on their feet, back on track, and back into a job. They were there for me when I needed it most, and they shouldn't be cut now when so many others are struggling in this tough economy. I am here to keep my promise to Nathan. I am asking you to fund SNAP – and protect it from cuts – so that no other mama goes hungry. And, of course, it is not just mamas, but children and dads and grandparents. I am asking you to protect these federal programs so that no child in America has to sit at an empty table at dinner time.

On behalf of my family and others similarly situated, I thank you for your time and consideration.

Chairman MURRAY. Thank you very much.
Pat Murray.

STATEMENT OF PATRICK MURRAY, ARLINGTON, VIRGINIA

Mr. MURRAY. Chairman Murray, Ranking Member Sessions, members of the committee, I would like to thank you for the opportunity to share my experience and concerns as a retired Marine and student veteran.

I grew up in Rhode Island and joined the Marines at 19 years old while going to the University of Rhode Island. I had two goals in life that both revolved around service, to join the Marines like my grandfather and afterwards to become a firefighter like my father. I had taken all the certifications, passed all the tests, and gotten hired on the North Kingstown Fire Department for their January 2006 class. That would have to wait, because I was deploying to Iraq in December 2005.

On September 4, 2006, while on patrol in Fallujah, the vehicle I was in hit an IED. I was severely wounded in the blast, resulting in the amputation of my right leg above the knee. I spent the next year recovering from my injuries and learning how to perform day-to-day tasks with a new prosthetic leg at Walter Reed Army Medical Center. At Walter Reed, I quickly realized that my career as a fireman was over before it had even begun.

While in the hospital, I met a peer mentor, Bob Nillson. Bob is a former Marine who served in Vietnam, so we quickly bonded through our shared experiences. He helped me realize that I had to change my direction in life and guided me towards a career with Turner Construction Company, where for the next five years I was part of the team that built the Fort Belvoir Community Hospital.

Turner also gave me the opportunity to occasionally visit Walter Reed as a peer mentor myself. This experience helped me realize what I really wanted to do. I was fortunate to have enough help and assistance in overcoming my difficulties after losing my leg. I wanted to help veterans in similar circumstances, and in order to do that effectively, I was going to need a college degree.

I always had the itch to go back to college and finish my undergraduate degree, but before the Post-9/11 G.I. Bill, it was not financially possible. I had to stay near

Washington, D.C., because this is where I had access to my prosthetic care. As some of you may know, changing doctors is difficult. Changing prosthetists is even harder. I understand other programs would have helped me get through school, but without the Post-9/11 G.I. Bill living stipend, I could not afford to live independently in this area and focus on finishing my degree full time.

In September, I started classes at Georgetown University and made the Dean's List in my first semester. My second semester has just started and I am on track to graduate in about two years, where after that I could pursue a career in veterans' advocacy.

So why is my story important to the Budget Committee? I am here today as an example of a veteran whose life plans were changed because of my military service. But thanks to a variety of programs available to me, I was able to adapt and overcome. I can return to school in order to better myself and those around me.

When I arrived at Walter Reed, I knew my life had changed forever. Fortunately, thanks to programs funded through this committee, whether through the National Defense Authorization or the VA military construction budget, transitioning service members in situations like mine have the tools to succeed and I have the opportunity to sit here before you today and share my story.

Offering veterans the tools to properly transition back to civilian life, furthering their education, and ultimately their careers, is a benefit not only to the individual veteran but to our country as a whole. Continuing to make these programs a priority fulfills our commitment to the men and women who volunteer to serve in harm's way. Do not get me wrong. We understand the risks associated with serving in the military during a time of war. But knowing that the country is prepared to care for us when we come home is critical to morale and the overall welfare of our voluntary military.

I want to go beyond the cliche that these programs are a cost of war. Nobody denies that. But these programs are also an investment into proven leaders. Just look at my grandfather's generation. The late Senator Inouye wanted to become a surgeon, but lost his arm saving his buddies in World War II. The country invested in veterans like him who overcame life-changing injuries and found other ways to serve the country they loved. I am confident that my generation can do the same. But as our troops come home from Afghanistan, we have to continue to support them in every way possible.

I recognize this committee has difficult decisions to make on the fiscal future of our country. We need to continue investing in programs like peer mentorship, physical and mental health care, and education programs like the Post-9/11 G.I. Bill. I also recognize there is room for improvement in some of the existing services. There needs to be a serious upgrade in the quality of VA employees that are providing service to our veterans, and there needs to be significant improvement in the military and VA's recordkeeping system.

Chairman Murray, Ranking Member Sessions, members of the committee, thank you for this opportunity. I look forward to answering any questions you may have.

[The prepared statement of Mr. Murray follows:]

STATEMENT OF

PATRICK D. MURRAY

BEFORE THE

BUDGET COMMITTEE
UNITED STATES SENATE

WITH RESPECT TO

The Impact of Budget Decisions on Families and Communities

WASHINGTON, D.C. FEBRUARY 13, 2013

Chairman Murray, Ranking Member Sessions, and members of the committee, thank you for the opportunity to share my experiences and concerns as a retired Marine and a student-veteran.

I grew up in Rhode Island and joined the Marines at nineteen years old while going to school at the University of Rhode Island. I had two goals in life that both revolved around service, to join the Marines like my grandfather, and afterwards become a fireman like my father. I had taken all the certifications, passed all the tests and had gotten hired on the North Kingstown Fire Department for their January 2006 class. But that would have to wait, because I was deploying to Iraq in December 2005.

On September 4, 2006, while on patrol in Fallujah, the vehicle I was in hit an IED. I was severely wounded in the blast resulting in the amputation of my right leg above the knee. I spent the next year recovering from my injuries and learning how to perform day-to-day tasks with a new prosthetic leg at Walter Reed Army Medical Center. At Walter Reed, I quickly realized that my career as a fireman was over before it even began.

While in the hospital, I met a peer mentor, Bob Nillson. Bob is a former Marine who served in Vietnam, so we quickly bonded through our shared experiences. He helped me realize that I had to change my direction in life and guided me towards a career with Turner Construction Company, where for the next five years, I was part of the team that built the Fort Belvoir Community Hospital. Turner also gave me the opportunity to occasionally visit Walter Reed as a peer mentor myself. This experience helped me realize what I really wanted to do. I was fortunate to have enough help and assistance in overcoming my difficulties after losing my leg. I want help veterans in similar circumstances. In order to do that effectively, I need a college degree.

I always had the itch to return to college and finish my undergraduate degree, but before the Post-9/11 GI Bill, it was not financially possible. I had to stay near Washington DC because this is where I had access to my prosthetic care. As some of you may know, changing doctors is difficult enough; changing prosthetists is even harder. I understand other programs would have helped me get through school, but without the Post-9/11 GI Bill living stipend, I could not afford to live independently in this area and focus on finishing my degree full time.

In September I started classes at Georgetown University and made Dean's List in my first Semester. My second semester just started and I'm on track to graduate in about two years, when I can pursue a career in veterans' advocacy.

So why is my story important to the Budget Committee? I am here today as an example of a Veteran whose life plans were changed because of my military service, but thanks to a variety of programs available to me, I was able to adapt and overcome. I could return to school in order to better myself and those around me.

When I arrived at Walter Reed, I knew my life had changed forever. Fortunately, thanks to the programs funded through this committee, whether through the National Defense Authorization or the VA/Military Construction Budget, transitioning service members in situations like mine have the tools to succeed, and I have the opportunity to sit before you today and share my story. Offering Veterans the tools to properly transition back to civilian life, further their education, and ultimately their careers is a benefit to not only the individual veteran, but to our country as a whole.

Continuing to make these programs a priority fulfills our commitment to the men and women who volunteer to serve in harm's way. Don't get me wrong, we understand the risks associated with serving in the military during a time of war, but knowing that the country is prepared to care for us when we come home is critical to morale and the overall welfare of our volunteer military.

I recognize that this committee has difficult decisions to make on the fiscal future of our country. I also recognize that some veterans programs need significant improvements. If I had my way, I would keep investing in programs like peer mentorship, health care – both physical and mental, and education programs like the Post-9/11 GI Bill. I would continue to work on improving military record-keeping so that veterans do not have to hand-carry their paperwork from one hospital to another. I would keep investing in quality VA employees so that veterans can speak to another veteran when they call for help.

I want to go beyond the cliché that these programs are a cost of war. Nobody denies that. But these programs are also an investment in proven leaders. Just look at my Grandfather's generation: The late Sen. Inouye wanted to become a surgeon, but lost his arm saving his buddies in World War II. The country invested in veterans like him, who overcame life-changing injuries and found other ways to serve the country they loved. I'm confident that my generation can do it again, but as our troops come home from Afghanistan, we have to continue to invest in them. Chairman Murray, Ranking Member Sessions, members of the committee. Thank you for this opportunity. I look forward to answering any questions you may have.

Patrick Murray is a retired Marine Corps corporal who, while on patrol in Iraq in 2006, lost his leg in an improvised explosive device attack. Murray spent the next year recovering from his injuries at Walter Reed Army Medical Center. Prior to his deployment, Murray was an undergraduate student at the University of Rhode Island, where he planned to complete his education and pursue a career as a firefighter. As a result of his injury, Murray needed to choose a new career field. Murray is currently enrolled at Georgetown University where he seeks to complete his education and pursue a career in veterans' advocacy. Murray is also a member of John Lyon VFW Post 3150 in Arlington, Va.

Chairman MURRAY. Thank you very much. We really appreciate it.

Bob Greenstein.

STATEMENT OF ROBERT GREENSTEIN, PRESIDENT, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. GREENSTEIN. Thank you. Good morning.

The Bowles-Simpson Report made it a core principle that deficit reduction should not increase poverty or harm the disadvantaged and largely shielded core programs for the disadvantaged from the cuts it recommended. The Gang of Six plan did so, as well.

Our current system of supports for low-income families surely is not perfect and can be strengthened, but it does a great deal of good. The best data from the Census Bureau show that the safety net cuts poverty nearly in half compared to what it otherwise would be.

Recently, a comprehensive review was conducted by a number of the leading scholars in the field of all of the research on the impacts of safety net programs. It took into account behavioral effects, such as impacts on work. And it found that one of every seven Americans, more than 40 million people, would be poor without the safety net, but are lifted above the poverty line because of it. For example, Census data showed that the Earned Income Credit and the Child Credit lift nine million people in low-income working families above the poverty line, including five million children.

Two questions often asked are the impact of the safety net on work and on our long-term fiscal problems. The major piece of research, the leading review of the research in the field that I just mentioned, reviewed the impact of the safety net programs on work and found that while it is not zero, it is small and was far outweighed by the big reduction in poverty that resulted.

This is not unrelated to the fact that over the last several decades, we have had a big change. The U.S. has moved heavily towards what analysts call a work-based safety net. Cash welfare assistance for families without earnings has diminished dramatically. Support for the working poor has increased. Over 90 percent of all Federal spending on entitlements today goes for people who either are not expected to work because they are elderly or disabled or people who are members of working households. And most of the other nine or ten percent is for things like unemployment insurance and Social Security benefits for widows and children who have lost a parent.

There is also the question of cost. Senator Sessions cited high figures for low-income programs. Those figures are dominated by health care. We all know that we have rising costs for all health care programs, including Medicaid, as a result of the aging of the population and rising health care costs.

But let us examine costs for all other means tested programs outside of health care. When we look at that, we find the following. In 2011, total health care costs for means tested entitlements outside health care equaled two percent of GDP. Now, that was 50 percent higher than the average over the previous 40 years. But that increase was a result of the recession and temporary increases, which are expiring, enacted in the Recovery Act.

So let's look at the new CBO report that just came out. It shows that costs for means tested programs other than health care will decline all the way back to the prior 40- year average of 1.3 percent of GDP by 2020, and that is just entitlements. Low-income discretionary programs are slated to decline as a share of GDP. Total means tested spending outside health care, mandatory and discretionary combined, will decline over the course of the coming decade to a share of GDP below its prior 40 percent—40-year average.

I would also briefly note that I think the $60,000 figure Senator Sessions mentioned is really not meaningful. Half of the money that goes into producing the $60,000 estimate is payments to doctors, hospitals, and nursing homes for health care. A lot of this is payments for people in nursing homes who are not counted as poor because the poverty count does not include people in institutions. All of that money is taken and divided by households who are poor to push up the number. Similarly, a lot of that spending is for people who are hard pressed but are above the poverty line, including people lifted out of poverty. All that money is then divided by people left below the poverty line. We have actual Census data on the average assistance per family of people who are poor, what they really get, and it is far, far below $60,000.

Finally, it is important to look at some of the research on the impacts of these programs beyond income and poverty. A strong body of research finds, for example, that the Earned Income Credit substantially increases work, and the research finds that the expansions of the EITC in the 1990s had as large an effect in inducing single mothers to go to work and leave welfare as the changes in the 1996 welfare law.

Important recent research finds that programs that supplement the income of low-income families, like the Earned Income Credit and the Child Credit, boost children's school achievement and are associated with increased work and earnings in adulthood. New research on Food Stamps finds that children who had access to Food Stamps in early childhood and whose mothers had access during pregnancy had improved health outcomes as adults years later, and that the women who had access to Food Stamps as young children did better in employment, poverty status, and high school graduation later in life. And the landmark study on Medicaid, co-led by a former member of President George W. Bush's Council of Economic Advisors, found very substantial health impacts from Medicaid. And another study examining Medicaid expansions in three States found reductions in mortality.

So there are major effects here. They affect school achievement, earnings, health care. And I would urge the committee to follow the Bowles-Simpson and Gang of Six principles and the Hippocratic Oath of doing no harm as you face the difficult task of deficit reduction.

[The prepared statement of Mr. Greenstein follows:]

TESTIMONY OF ROBERT GREENSTEIN

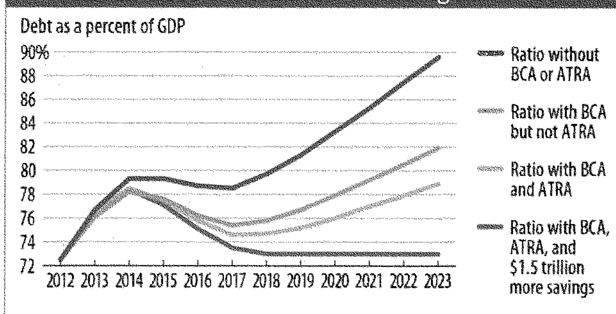
President, Center on Budget and Policy Priorities
Before the Senate Budget Committee

February 13, 2013

I appreciate the invitation to testify today on the impact of federal budget decisions on families and communities. This is an important matter. As you know, the nation will have to make tough decisions to put the budget on a more sustainable fiscal course. The issue is not only *whether* policymakers act to secure adequate deficit reduction, but also *how* that is done.

On Monday, we issued an analysis which finds (based on the new Congressional Budget Office projections, with several adjustments that analysts commonly make to reflect the cost of continuing current policies[1]) that policymakers could stabilize the public debt over the coming decade with $1.5 trillion in additional deficit reduction. Policymakers could achieve these savings with $1.3 trillion in policy savings (that is, spending cuts and tax increases), which would generate about $200 billion in savings in interest payments. The $1.5 trillion in total savings would stabilize the debt at 73 percent of gross domestic product (GDP) over the latter part of the decade. (Stabilizing the debt at a somewhat lower level of GDP would require a larger

$1.5 Trillion in Additional Deficit Reduction Would Stabilize the Debt Over the Coming Decade



Notes: BCA stands for the Budget Control Act, enacted in August 2011; ATRA stands for the American Taxpayer Relief Act, enacted in January 2013.

Source: Center on Budget and Policy Priorities based on Congressional Budget Office and Joint Committee on Taxation data.

[1] In calculating that another $1.5 trillion in deficit savings would stabilize the debt over the latter years of the decade at 73 percent of GDP, we start with the budget baseline that CBO has just released. We use CBO's economic assumptions and make certain adjustments to its policy projections, which are identical to the adjustments that organizations such as the Committee for a Responsible Federal Budget also make. We freeze Medicare reimbursement rates for physicians at current levels, rather than assuming they will be slashed deeply. We phase down war funding over the next few years to a lower level, as policymakers are on course to do, rather than assuming that current levels of war costs continue (and rise with inflation) through 2023. We assume disaster funding will revert to the ten-year historical average level, as allowed by the Budget Control Act, rather than grow with inflation from the unusually high levels resulting from Hurricane Sandy. We assume that the scheduled across-the-board spending cuts (known as "sequestration") do *not* occur. We also assume that policymakers will continue certain improvements in refundable tax credits that they have just extended for five years. At the same time, we follow the CBO baseline in assuming that policymakers either will not continue a series of tax provisions often referred to as the "tax extenders," which expire at the end of 2013, or will offset the costs of continuing those "extenders" they do maintain.

amount of deficit reduction; stabilizing at a somewhat higher level of GDP would require a lesser amount of deficit reduction.)

The fact that $1.5 trillion in deficit savings (rather than a much larger amount) would stabilize the debt over the coming decade at about the 2012 debt-to-GDP ratio is primarily due to two factors. First, Congress and the President have enacted significant deficit reduction over the two-plus years since the Bowles-Simpson report and Rivlin-Domenici task force made major deficit-reduction proposals; over this period, policymakers have enacted nearly $1.5 trillion in spending cuts for appropriated programs (relative to the CBO baseline in use at the time of the Bowles-Simpson and Rivlin-Dominici reports), mainly through the annual caps enacted in the 2011 Budget Control Act, as well as nearly $600 billion in revenue increases in ATRA. Including the related savings in interest payments, policymakers have achieved about $2.35 trillion in deficit reduction so far. (Other analysts like those at the Committee for Responsible Federal Budget use the same $2.35 trilliion savings estimate.) These savings are for the ten-year budget window of *2013-2022*. Over the new budget window of *2014-2023*, the same policies are estimated to produce savings of $2.75 trillion, as Table 1 indicates.

Table 1
Deficit Reduction to Stabilize the Debt
Cumulative totals, 2014-2023, in billions

	Policy savings	Interest savings	Total deficit reduction
Discretionary savings from cuts in 2011 funding and caps imposed by the BCA	1,576	336	1,912
Savings from the ATRA	732	117	850
Further savings to stabilize debt at 73% of GDP	1,327	202	1,529
TOTAL	**3,636**	**655**	**4,290**

Notes: BCA stands for the Budget Control Act, August 2011; ATRA stands for the American Taxpayer Relief Act, January 2013; all savings measured relative to current policy (see Appendix I)

Source: Center on Budget and Policy Priorities based on Congressional Budget Office and Joint Committee on Taxation data.

The other factor is that CBO's economic and technical projections have improved over the past few years. Not counting the reductions in discretionary funding and the savings from ATRA, the new projections reduce estimated deficits under current policies by about $750 billion over the coming decade, relative to CBO's forecast of last March. Relative to CBO's August 2010 forecast, which the Bowles-Simpson and Rivlin-Domenici panels relied upon for their reports, the new CBO economic and technical projections reduce estimated deficits by about $1.3 trillion.

Is Stabilizing the Debt the Right Target?

Stabilizing the debt-to-GDP ratio over the coming decade — so the debt grows no faster than the economy — is the minimum appropriate budget policy. Stabilizing the debt at 73 percent of GDP would require shrinking annual deficits to below 3 percent of GDP.

Stabilizing the debt ratio for the decade ahead would still require policymakers to enact additional deficit reduction for the long term. In ensuing decades, the aging of the population and increases in per-capita health care costs (which are likely to rise faster than per-capita GDP) will raise costs for health and retirement programs, returning the budget to a path where debt is increasing as a share of the economy.

Some call for greater deficit reduction now in order to achieve a declining debt ratio, citing these long-term trends. Enacting larger deficit reduction now would require deeper program cuts, larger revenue increases, or both. At issue here is the *quality* of these policy choices. One concern is that enacting steeper deficit reduction now could lead policymakers to make decisions, particularly in the health care arena, where desired solutions currently are elusive and knowledge about effective ways to slow health care cost growth is likely to be greater in coming years, due to changes now underway in the health care sector and various research and demonstration projects.

To be sure, policymakers can enact measures now, as part of a balanced deficit-reduction package, that would achieve significant Medicare savings for the decade ahead without jeopardizing the quality of care or access to care. But rushing now to enact cuts much deeper than that in federal health spending could result in measures that largely shift costs to states, individuals, and private employers and harm some of the most vulnerable members of society, while failing to address the underlying causes of the unsustainable growth in costs across the U.S. health care system. (Analysts have found that some proposals to enact large cuts in Medicare or other health programs would actually *increase* total U.S. health care costs, not a desirable outcome.)

Stabilizing the debt for the coming decade would give policymakers time to figure out how to slow the growth of health care costs throughout the U.S. health care system without impairing the quality of care. While stabilizing the debt during the decade ahead won't permanently solve our fiscal problems, it would represent a significant accomplishment.

Designing Deficit Reduction

Given the continued weakness in the economy — with the unemployment rate still close to 8 percent and CBO projecting that it will take four more years for the economy to recover fully — deficit reduction needs to be designed carefully to avoid making the recovery even slower. Deficit reduction should be phased in over coming years. Preferably, policymakers would couple some *temporary* fiscal measures to accelerate growth and job creation now with *permanent* deficit reduction measures.

And the design of permanent deficit reduction measures matters. Deficit reduction should be secured through well-designed, balanced policies that do not impede the economic recovery and don't jeopardize future productivity growth (by providing inadequate resources for areas like education, infrastructure, and basic research), don't increase poverty and inequality (which already are larger in the United States than in most of the Western world), and don't sacrifice health care quality or access or raise overall U.S. health care costs. The *quantity* of deficit reduction over the next ten years is not the only important issue; the *quality* of the deficit-reduction measures adopted matters as well.

Deficit Reduction and the Well-Being of Americans of Modest Means

The Bowles-Simpson report made it a core principle that deficit reduction should *not* increase poverty or harm the disadvantaged. It largely shielded core programs for the disadvantaged from the cuts that it recommended. It also sought to design its revenue increases so they would maintain or improve the progressivity of the tax code.

These principles and design features are also reflected in the plan presented in July 2011 by the Senate's bipartisan "Gang of Six." (They have also been highlighted by a group of Christian leaders that ranges from the Catholic Bishops' Conference and the Episcopal Church to the Salvation Army and the National Association of Evangelicals, which has issued a call for policymakers to safeguard the poor in deficit reduction and draw a "circle of protection" around programs targeted on them.)

Our current system of supports for low-income families and individuals surely isn't perfect. But it does a great deal of good for tens of millions of our less fortunate fellow citizens. Using a measure of poverty that many analysts favor because it *counts* rather than *ignores* major benefits like food stamps and refundable tax credits — the Census Bureau's Supplemental Poverty Measure — we see that the poverty rate would have been 29 percent in 2010 without government assistance. But it stood at 15 percent when those benefits were counted. In other words, the safety net cuts U.S. poverty nearly in half, compared to what it would otherwise be.

Of course, it may be that in the absence of safety-net programs, some people might have worked more (although it is hard to see where the additional jobs would have come from in 2010, given the depressed labor market). But the impact of the safety net on poverty, including its effect on work, has been studied extensively. In a recent comprehensive review and synthesis of the research literature, some of the field's leading scholars examined the impact of the safety net on the amount that people work and found the safety net's overall impact on work to be small. They found that, after taking behavioral effects into account, the safety net lowers the U.S. poverty rate by approximately 14 percentage points. In other words, one of every seven Americans — more than 40 million people — would be poor without the safety net but are above the poverty line because of it.[2]

One can also look at the Census data on how many people individual programs lift out of poverty. In 2010, for example, the Earned Income Tax Credit and the Child Tax Credit lifted about 9 million people in low-income working families above the poverty line, including 5 million children. SNAP (formerly called the Food Stamp Program) lifted about 4 million out of poverty.

Among the most striking figures are those that track poverty rates over the last few years. Given the depth and severity of the Great Depression, one would have expected poverty to have soared. It didn't. The Census Bureau's broad poverty measures show relatively modest increases in poverty, which stands in sharp contrast to the deep plunge in the economy and the doubling of the unemployment rate. Why didn't poverty rise much more as unemployment rocketed upward? The "automatic stabilizer" response of programs like SNAP and unemployment insurance, supplemented by the temporary increases in assistance in various safety net programs provided under the Recovery Act, counteracted most of the increase in poverty that would otherwise have occurred.

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[2] Yonatan Ben-Shalom, Robert A. Moffitt, and John Karl Scholz "An Assessment of the Effectiveness of Anti-Poverty Programs in the United States," NBER Working Paper 17042, May 2011.

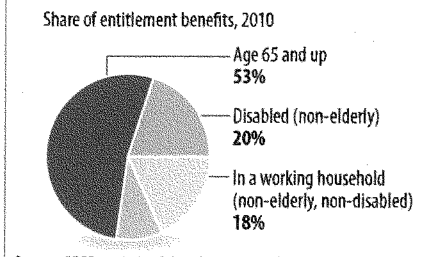
Issues Related to the Safety Net and Criticisms of It

Various questions are raised about safety-net programs. These include its impact on dependency and on our long-term fiscal problems.

Over the past several decades, the United States has moved heavily toward what analysts call a "work-based safety net." Cash welfare assistance for families without earnings has diminished greatly, while support for the working poor and near poor through the EITC, the Child Tax Credit, Medicaid, and SNAP has increased. The results are notable. Even though 2010 was a year of economic distress, with an average unemployment rate of 9.6 percent, it was marked by the following results:

- Some *91 percent* of all spending on federal entitlement benefits in 2010 went to people who either aren't expected to work because they are 65 or older or disabled, or were members of working households (with work defined as a household with a member who worked more than 1,000 hours during the year).
- Seven of the other nine percentage points of entitlement benefits went for unemployment insurance that people must have a significant recent work history to qualify for, Social Security survivor benefits for widows and orphans of deceased workers, Social Security benefits for retired workers aged 62-64, or medical care.

Nine-Tenths of Entitlement Benefit Spending Goes to the Elderly, Disabled, or Working Households



Source: CBPP analysis of data from Office of Management and Budget, U.S. Departments of Agriculture, Health and Human Services, and Labor, and the U.S. Census Bureau.

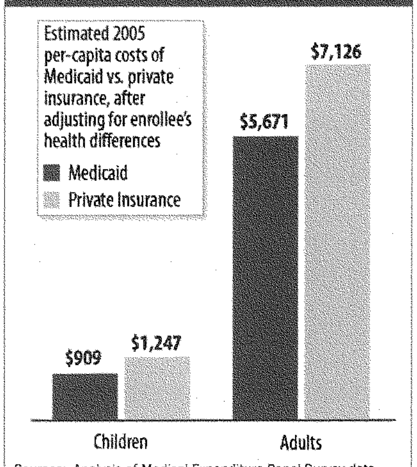
Concerns that the safety net is leading millions to become dependent and cease working are not borne out by the research. (I believe, however, that we should explore ways to encourage more people nearing retirement age to work longer. The challenge there is to find ways to do so without impoverishing people in that age bracket who can't work or can't find a job because of their occupational background or skills or because of health issues.)

A second issue — and an important one in the current budgetary context — involves the safety net's cost trajectory. The nation faces a significant long-term fiscal problem as a result of a large projected imbalance between revenues and expenditures. Under current policies, expenditures will climb as a percentage of GDP, while revenues remain at levels that are low relative to need, given the aging of the population and continuing increases in health care costs throughout the health care system.

This raises an important question: will *means-tested* programs rise in cost as a share of GDP and thereby contribute to our long-term fiscal problems?

As is well known, Medicaid is projected to rise in cost for various reasons. Health care costs throughout the entire U.S. health care system — in both the public and private sectors — have been growing faster than GDP for several decades. Medicaid isn't the *cause* of this systemwide cost growth, and over the past decade, Medicaid costs per beneficiary have been rising more slowly than per-beneficiary cost under private insurance. Moreover, Medicaid costs per beneficiary (adjusted for differences in health status) are substantially lower than those under private insurance (because Medicaid pays providers lower rates and has lower administrative costs.

Medicaid Costs Are Well Below Those for Private Insurance



Sources: Analysis of Medical Expenditure Panel Survey data.

But systemwide health care cost increases, driven in part by medical advances that improve health and lengthen life but add to costs, will push up health care costs across the board.

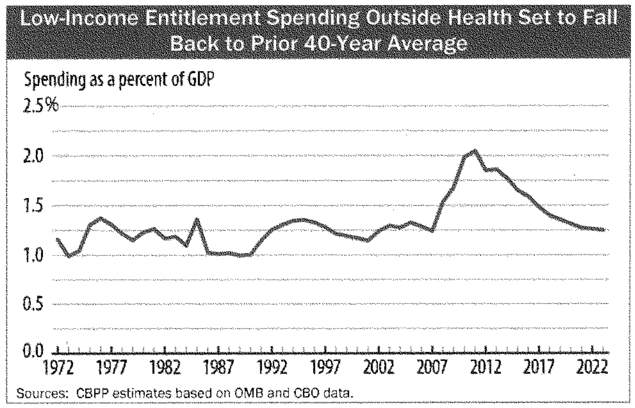
A second reason that Medicaid costs will rise is the aging of the population. Older people have much higher average health care costs than younger people do. Elderly and disabled beneficiaries account for 25 percent of Medicaid beneficiaries today but 68 percent of program costs. As the population ages, the number and share of beneficiaries who are elderly will rise, increasing program costs.

Another reason that Medicaid costs will rise is the continued erosion of employer-based health coverage. Over time, fewer low-income people are able to get coverage through their (or a family member's) employer, causing more of them to turn for coverage to Medicaid.

Finally, the coverage expansions in the Affordable Care Act — both in Medicaid and for subsidies to help near-poor and many middle-income families afford coverage in the new health insurance exchanges — will raise expenditures for means-tested health care expenditures as coverage is extended to millions of uninsured Americans (although CBO projects that these expenditure increases will not add to deficits because the costs are offset under the Affordable Care Act, primarily through savings in Medicare and new revenues).

For these reasons, if one looks at total means-tested program costs, they appear to remain high in the years to come. But if one examines costs for means-tested program other than health care programs, the picture changes dramatically. *Means-tested programs outside of health insurance will decline in cost as the economy recovers and are not projected to rise in future decades as a percentage of GDP.* Here are the data, which come from the official historical tables on federal budget expenditures and the new CBO projections of future expenditures.

- In fiscal year 2011, total federal expenditures for means-tested entitlement (or mandatory) programs outside health care programs equaled 2.0 percent of GDP. This was about 50 percent higher than the average for the prior 40 years — which was 1.3 percent of GDP. The costs of these programs have risen significantly in the last few years.[3]



Sources: CBPP estimates based on OMB and CBO data.

- But, the recent increases are largely driven by the economic downturn and temporary program expansions under the Recovery Act. The CBO projections show that total expenditures for means-tested entitlements outside health care will decline steadily as a share of the economy as the economy recovers, falling to 1.3 percent of GDP by 2020 and thereafter. (These figures do not assume savings under sequestration.)

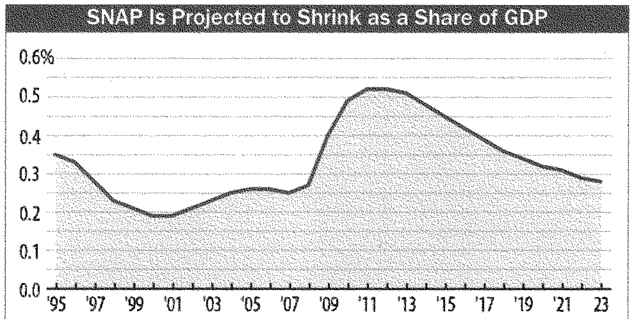
- In other words, by 2020, total means-tested entitlement expenditures outside health care, measured as a share of GDP — including expenditures for SNAP, the EITC, and other programs — will return all of the way to their prior 40-year average.

- The foregoing figures do not include low-income *discretionary* programs. Under the Budget Control Act's caps, non-defense discretionary spending will fall over the decade to its lowest level as a share of GDP since 1962. As a result, some decline in low-income discretionary programs appears inevitable. Thus, *total* expenditures on low-income (or means-tested) programs outside health care, including low-income discretionary programs, are expected to decline over the coming decade to a level *below* their average over the prior 40-year period. This indicates that this part of the budget isn't contributing to the long-term fiscal problem

I would also briefly note that there has been particular misunderstanding of what is happening with expenditures for the SNAP program. SNAP participation and costs have risen substantially in recent years. But CBO projects that SNAP caseloads and expenditures will decline markedly as unemployment and poverty fall. The graph below shows actual SNAP costs, as a share of GDP, from 1995 to the present, and CBO's projection of costs as a percentage of GDP through 2023. As

[3] Means-tested mandatory health care programs include Medicaid, CHIP, and subsidies for the purchase of health insurance under the Affordable Care Act (along with a few very small programs such as mandatory supplements to a few areas of discretionary health funding).

the graph indicates, by 2018, costs are expected to decline back to their mid-1990s level as a percentage of GDP, and then to edge below that.



Sources: Congressional Budget Office (CBO February 2013 budget and economic forecast) and Office of Management and Budget historical data.

Finally, I would note that over recent decades, the minimum wage has been allowed to erode and is now 20 percent lower, after adjusting for inflation, than in the late 1960s. For this and a number of other reasons (relating in part to globalization of the economy), wages for low-paid jobs have fallen. Partly in response, policymakers also have expanded refundable tax credits for low-income working families with children, principally the EITC — which has offset part of the wage decline for working parents with children. Any examination of increases in federal costs for refundable tax credits and other supports for low-income working families needs to be put in the context of what has happened to these families' wages.

Beneficial Effects of Programs to Assist People of Modest Means

A focus simply on the extent to which various assistance programs lift low-income Americans above the poverty line or lessen the severity of their poverty (or, for that matter, a focus simply on their budgetary costs) is too narrow. An extensive body of research finds that various of these programs also have other important effects.

A strong body of research finds, for example, that the Earned Income Tax Credit increases work substantially, especially among single mothers.[4] The research indicates, in fact, that the expansion of the EITC in the 1990s had as large or larger an effect in inducing more single mothers to go to work than the changes in the 1996 welfare law. (The EITC and the welfare changes reinforced each other in this respect.) The research similarly finds that the EITC likely contributed as much to the decline in cash welfare receipt among female-headed families as did time limits and other welfare reforms.[5]

Of particular note is the growing body of research which finds that certain types of assistance for low-income families can have significant positive long-term effects, especially on children, such as

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[4] Stacy Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," Tax Policy and the Economy, Vol. 9, MIT Press, 1995. V. Joseph Holt, Charles H. Mullin, and John Karl Scholz, "Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare," NBER Working Paper No. 11968, January 2006.

[5] Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Chnages on Welfare Use, Work, and Income among Female-Head Families," *Review of Economics and Statistics*, May 2003. In separate study using different data, Grogger reaches similar conclusions. Jeffrey Grogger, "Welfare Transitions in the 1990s: the Economy, Welfare Policy, and the EITC," NBER Working Paper No. 9472, January 2003, http://www.nber.org/papers/w9472.pdf.

improvements in educational success, children's health status, and their future labor-market outcomes.

- A growing body of research finds that programs that supplement the earnings of low-income working families — like the EITC and the low-income component of the Child Tax Credit — boost children's school achievement and are associated with increased work and earnings in adulthood. (Economists Raj Chetty and John N. Friedman of Harvard University and Jonah Rockoff of Columbia University analyzed school data for grades 3-8 from a large urban school district and found that additional income from the EITC and CTC leads to significant increases in students' test scores.[6] Economists Gordon B. Dahl of the University of California, San Diego and Lance Lochner of the University of Western Ontario concluded, after studying nearly two decades' of data on mothers and their children, that additional income from the EITC significantly raises students' math and reading test scores.[7])

- The beneficial effects of the EITC and CTC appear to follow children into adulthood. Harvard's Chetty and his coauthors note evidence that test-score gains can lead to significant improvements in students' later earnings and employment rates when they become adults.[8]

- These findings are consistent with other research that followed poor children from early childhood into their adult years and found that significant increases in the incomes of these children's families led to enduring beneficial effects. The researchers found that each additional $3,000 in annual income in early childhood (whether from earnings or government assistance) was associated with more hours of work and an additional 17 percent in annual earnings in young adulthood.[9]

- Recent research on Head Start also is noteworthy. David Deming of Harvard found that children who participated in Head Start subsequently measured better on young-adult outcomes that included high school completion, being out of work and out of school, and poor health. Deming's concluded that Head Start, "...closes one-third of the gap [on the measure of adult outcomes] between children with median and bottom quartile family

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6 Chetty, Friedman, and Rockoff 2011.

7 Gordon Dahl and Lance Lochner, "The Impact Of Family Income On Child Achievement: Evidence From The Earned Income Tax Credit," *American Economic Review* (2012), 1927-1956, http://www.aeaweb.org/articles.php?doi=10.1257/aer.102.5.1927.

Building on Dahl and Lochner's research methods, economists Alexander M. Gelber of the Wharton School of Business and Matthew C. Weinzierl of the Harvard Business School conclude that the income boost that low-income families with children receive from the EITC helps the tax system raise revenue more effectively. In essence, they conclude, when low-income families with young children receive additional income, their children perform better in school, which increases the opportunities that their children will have to succeed. Alexander M. Gelber and Matthew C. Weinzierl, "Equalizing Outcomes vs. Equalizing Opportunities: Optimal Taxation When Children's Abilities Depend On Parents' Resources," NBER Working Paper No. 18332, August 2012, http://www.nber.org/papers/w18332

8 Raj Chetty, John N. Friedman, Nathaniel Hilger, Emmanuel Saez, Diane Whitmore Schanzenbach, and Danny Yagan, "How Does Your Kindergarten Classroom Affect Your Earnings? Evidence from Project Star," *The Quarterly Journal of Economics* (2011), http://qje.oxfordjournals.org/content/126/4/1593.abstract

9 Greg J. Duncan, Kathleen M. Ziol-Guest, and Ariel Kalil, "Early-Childhood Poverty and Adult Attainment, Behavior, and Health," *Child Development* (January/February 2010), pp. 306-325.) The $3,000 figure is in 2005 dollars, equivalent to approximately $3,530 in 2012.

income." Researchers Jens Ludwig of the University of Chicago and Douglas Miller of the University of California, Davis also found a reduction in mortality rates among children aged 5 to 9 as a result of screenings conducted as part of Head Start's health services.[10]

- Other studies have found that the Pell Grant program reduces the likelihood of students dropping out.[11] A Department of Education study found that college graduates who received Pell Grants earned degrees faster than non-recipients.[12] A separate 2008 study found that low-income students receiving a Pell Grant were 63 percent less likely to drop out than low-income students without Pell Grants.[13]

- In the housing area, research indicates that four housing-related problems — homelessness, frequent moves that result in school changes, overcrowding, and poor housing quality — can impair children's academic achievement. Children in homeless families are more likely than other low-income children to drop out of school, repeat a grade, or perform poorly on tests.[14] Housing assistance has been shown to reduce these housing-related problems. In a multi-site, rigorous evaluation, low-income families that received Section 8 housing vouchers were 74 percent less likely to become homeless, 48 percent less likely to live in overcrowded housing, and moved fewer times over a five-year period than similar low-income families that did not receive housing assistance.[15]

Recent studies regarding food stamps and Medicaid are of particular note. An important new study makes use of the fact that in the late 1960s and early 1970s, some counties operated the food stamp program while others did not; this enabled the researchers to compare low-income people from different counties. The researchers found that children who had access to food stamps in early childhood and whose mothers had access during pregnancy had improved health outcomes as adults years later, compared to children born at the same time in counties that hadn't yet implemented the program. In addition to lower rates of "metabolic syndrome" — obesity, high blood pressure, heart disease, and diabetes — adults who had access to food stamps as young children reported better health, and women who had access to food stamps as young children reported improved economic

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[10] Jens Ludwig and Douglas L. Miller. "Does Head Start Improve Children's Life Chances? Evidence From a Regression Discontinuity Design." NBER Working Paper No. 11702, October 2005. http://www.nber.org/papers/w11702

[11] Eric Bettinger, "How Financial Aid Affects Persistence," in Caroline M. Hoxby, editor, *College Choices: The Economics of Where to Go, When to Go, and How to Pay For It*, University of Chicago Press, 2004.

[12] Christina Chang Wei, Laura Horn, and Thomas Weko, *A Profile of Successful Pell Grant Recipients: Time to Bachelor's Degree and Early Graduate School Enrollment*, U.S. Department of Education, National Center for Education Statistics, July 2009. The study controlled for factors such as parental education.

[13] Rong Chen and Stephen L. DesJardins, "Exploring the Effects of Financial Aid on the Gap in Student Dropout Risks by Income Level," *Research in Higher Education*, v. 49 pp. 1-18, February 2008.

[14] E.g., Rubin and colleagues also found, after controlling for differences in socioeconomic status, demographic characteristics, and schools, that homeless children scored lower on tests of reading, spelling, and math proficiency. David H. Rubin et al., "Cognitive and Academic Functioning of Homeless Children Compared with Housed Children," *Pediatrics* 97:3: 289 – 94, 1996. Similar results have been found in more recent studies.

[15] Michele Wood, Jennifer Turnham, and Gregory Mills. 2008. "Housing Affordability and Family Well-Being: Results from the Housing Voucher Evaluation." *Housing Policy Debate*, 19:2, pp. 367 – 412. The study did not collect data on school outcomes.

self-sufficiency, as measured by such factors as employment, income, poverty status, and high school graduation.[16]

Another important recent study, conducted by a team of leading researchers including a former member of President George W. Bush's Council of Economic Advisers, examined the effects of Medicaid. Their study is considered the most important and reliable research on Medicaid's effects, because the researchers were able to compare adults who *were* and *were not* offered Medicaid in Oregon through a random "lottery" system — allowing a type of scientific comparison not usually available to researchers in the health field. The study found that adults with Medicaid coverage were 40 percent less likely than uninsured adults to experience a decline in their health over a six-month period.[17] (Those with Medicaid also were 40 percent less likely to have to borrow money or leave other bills unpaid in order to meet medical expenses, and were more likely to receive physician-recommended preventive care. Women, for example, were 60 percent more likely to have a mammogram.) Other research, published in the *New England Journal of Medicine*, found that expansions of Medicaid coverage for low-income adults in Arizona, Maine, and New York resulted in a sizeable reduction in mortality.[18] Research has also found that children covered by Medicaid or CHIP are more likely than uninsured children to receive preventive health services like regular check-ups that are important for spotting health problems early.

Social Insurance Programs

Finally, a brief word on Social Security and Medicare. The beneficial effects of these programs are well known. And we know some changes will be needed here to restore long-term solvency to these programs and to help attain long-term fiscal sustainability.

In considering such changes, I would urge policymakers to consider the circumstances of Social Security and Medicare beneficiaries with very modest incomes. People sometimes think of affluent seniors playing golf and receiving benefits from these programs, and to be sure, some beneficiaries are affluent and can afford to pay somewhat higher Medicare premiums or receive somewhat less from Social Security. But we should keep in mind that half of all Social Security and Medicare beneficiaries have (including their spouse's income) of less than about $25,000 a year.

It's often also assumed that people who are elderly or disabled face little in the way of out-of-pocket health-care costs because they are covered by Medicare (or by Medicare *and* Medicaid, Medigap, or other supplemental insurance). Yet data from the Kaiser Family Foundation show that while U.S. households who are not receiving Medicare spend an average of 5 percent of their budgets on out-of-pocket health costs, Medicare households spend 15 percent of their budgets. And, near-poor Medicare beneficiaries — those with incomes between 100 percent and 200 percent

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[16] Hilary W. Hoynes, Diane Whitmore Schanzenbach, Douglas Almond, "Long Run Impacts of Childhood Access to the Safety Net," National Bureau of Economic Research Working Paper No. 18535, November 2012. http://www.nber.org/papers/w18535

[17] Amy Finkelstein, Sarah Taubman et al., "The Oregon Health Insurance Experiment: Evidence from the First Year," National Bureau of Economic Research Working Paper No. 17190, July 2011. http://www.nber.org/papers/w17190

[18] Benjamin Sommers, Katherine Baicker, and Arnold Epstein, "Mortality and Access to Care among Adults after State Medicaid Expansions," New England Journal of Medicine; 367:1025-1034, September 13, 2012.

Emerging Research Offers Clues on Connections Between Poverty and Child Outcomes and Why increases in Income and Other Assistance Can Have Substantial Positive Impacts

Research conducted by Dr. Jack Shonkoff, Director of Harvard University's Center on the Developing Child, has shown that when children live in highly stressful situations — in dangerous neighborhoods, in families that have difficulty putting food on the table, or with parents who are unable to cope with their daily lives — they experience "toxic stress" that has damaging neurological impacts. His research finds that these neurological changes can negatively affect the way a child's brain works and impede children's ability to succeed in school and develop the social and emotional skills they need to function well as adults.

One study documented that a young adult's working memory (measured at age 17) "deteriorated in direct relation to the number of years the children lived in poverty (from birth through age 13)." The study found "such deterioration occurred only among poverty-stricken children with chronically elevated physiological stress." The mechanism by which early childhood poverty affects memory appears to be related to the stress that "usually accompanies poverty."[a]

Other recent research has found connections between swings in income around the time of a pregnancy and dangerous levels of stress that have effects on both the mother and the infant. Temporary spells of low income during pregnancy appear to come with an increase in the maternal stress hormone cortisol; a high cortisol level during pregnancy was associated with negative child outcomes, specifically, "a year less schooling, a verbal IQ score that is five points lower and a 48 percent increase in the number of chronic [health] conditions" for the exposed children, relative to their own siblings who were born at times when the family had lower stress (and, usually, higher income).[b]

Programs that help poor families with children afford the basics may help improve longer-term outcomes for children by reducing the added stress that parents or children may experience if they cannot pay their bills or do not know there will be food on the table. While researchers are only starting to explore the relationship between safety net programs and toxic stress and its long-term consequences, the early findings are striking.

As one other example, economist Hilary Hoynes of the University of California, Davis and her colleagues find that "access to food stamps in utero and in early childhood leads to significant reductions in metabolic syndrome conditions (obesity, high blood pressure, heart disease, and diabetes) in adulthood and, for women, increases in economic self-sufficiency (increases in educational attainment, earnings, and income, and decreases in welfare participation)."[c] Other researchers also found signs of reduced stress (such as less inflammation and lower diastolic blood pressure) among mothers targeted by a 1993 expansion in the Earned Income Tax Credit; this expansion was also followed by a significant improvement in self-reported health status for the affected mothers.[d]

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[a] Gary Evans, Jeanne Brooks-Gunn and Pam Klevanov , "Stressing Out the Poor: Chronic Physiological Stress and the Income-Achievement Gap," Pathways, winter 2011, http://www.stanford.edu/group/scspi/_media/pdf/pathways/winter_2011/PathwaysWinter11.pdf

[b] Anna Aizer, Laura Stroud, Stephen Buka (2012), "Maternal Stress and Child Outcomes: Evidence from Siblings," National Bureau of Economic Research Working Paper 18422, www.nber.org/papers/w18422.pdf.

[c] Hilary W. Hoynes, Diane Whitmore Schanzenbach, and Douglas Almond (2012), "Long Run Impacts of Childhood Access to the Safety Net," National Bureau of Economic Research Working Paper 18535, www.nber.org/papers/w18535.

[d] William N. Evans and Craig L. Garthwaite (2010), "Giving Mom a Break: The Impact of Higher EITC Payments on Maternal Health," National Bureau of Economic Research Working Paper 16296,

of the poverty line, or between $11,500 and $23,000 for an elderly or disabled individual — spend an average of 23 percent of their modest incomes on out-of-pocket health costs.

I bring up these figures not to argue for placing Medicare and Social Security off limits or to argue for placing all changes affecting beneficiaries off limits, but to make the point that any changes impacting beneficiaries should be designed carefully to avoid causing hardship and impeding access to needed health care among near-poor as well as poor beneficiaries.

(I would note that the Social Security checks which beneficiaries receive equal their Social Security benefits *minus* their Medicare premiums, which are deducted from the checks; the premiums increase with health care costs, which tend to rise faster than general inflation, and that erodes the purchasing power of Social Security checks over time.)

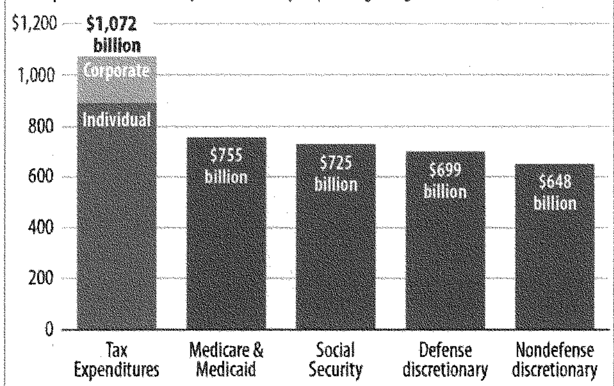
The nation will not be well served if elderly widows trying to live on $15,000 a year can't afford to see a doctor because we have set their Medicare deductible too high.

The Need for Balanced Deficit Reduction

We need to make more progress in getting our fiscal house in order. *How* we do so will have large consequences for tens of millions of Americans. One way to look at this is to say that changes will be needed on both the spending and revenue sides of the budget. Perhaps a better way to look at this is to say that changes will be needed *both in spending in the tax code and in spending on the outlay side* of the budget.

Figure 3
Cost of Tax Expenditures and Other Parts of the Budget

Tax expenditures and outlays for other major spending categories in 2011, in billions



Notes: Tax expenditure estimates do not account for interaction effects; estimate does not include outlays.

Source: Office of Management and Budget, Historical Tables 8.5 and 8.7 and Analytical Perspectives Table 17-2.

As individuals such as Martin Feldstein, who served as Chairman of President Reagan's Council of Economic Advisers, and former Federal Reserve chairman Alan Greenspan have pointed out, a great deal of spending occurs through the tax code, in the form of tax expenditures. The Budget Act of 1974 defines tax expenditures as revenue losses attributable to provisions in federal tax law that provide special benefits to particular taxpayers or groups of taxpayers. Deductions, exemptions, exclusions, credits and preferential tax rates on certain forms of income all are tax expenditures.

The tax code now includes about $1.1 trillion a year in tax expenditures. Their cost exceeds that of Medicare and Medicaid combined ($755 billion), of Social Security ($725 billion), and of non-defense discretionary programs, which stood at $648 billion in 2011.

Martin Feldstein has written that tax expenditures are the single largest source of wasteful and low-priority spending in the budget and should be the first place that policymakers go to restrain spending. Alan Greenspan has referred to tax expenditures as "tax entitlements" and said they should be looked at along with other entitlements.

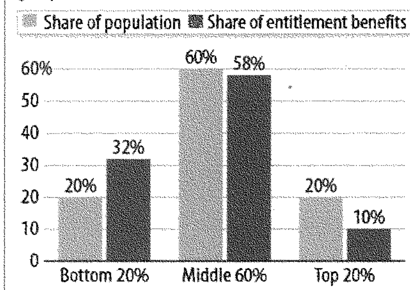
Tax expenditures differ from spending entitlements in terms of the distribution of their benefits. With spending entitlements, the middle class receives roughly a proportionate share: in 2010, the middle 60 percent of the population received 58 percent of the entitlement benefits. The bottom 20 percent received 32 percent of the benefits, while the top 20 percent received 10 percent of the benefits.[19]

But with the tax entitlements, the situation is different. The Urban Institute-Brookings Institution Tax Policy Center has estimated that for tax year 2011, the top fifth of the population received 66 percent of all individual tax-expenditure benefits — with the top 1 percent of households receiving 24 percent of the benefits. Meanwhile, the middle 60 percent of the population received a little over 31 percent of the benefits, and the bottom 20 percent of the population received 2.8 percent of the benefits.

That policymakers should look *together* at tax and spending entitlements can be illustrated by

Middle-Income Households Receive a Proportionate Share of Entitlement Benefits

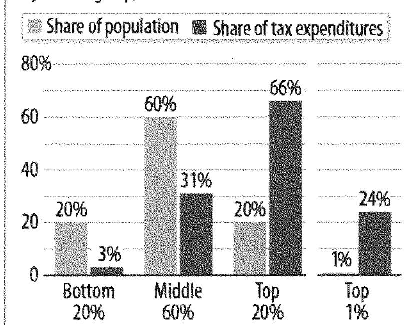
Share of population and entitlement benefits by income group, 2010



Source: CBPP analysis of data from Office of Management and Budget, U.S. Departments of Agriculture, Health and Human Services, and Labor, and the U.S. Census Bureau.

High-Income Households Receive Disproportionate Share of Tax Expenditures

Share of population and total individual tax expenditures by income group, 2011



Note: The bottom 20% means the 20% of tax units with the lowest incomes; the same is true for the other income categories.
Source: Tax Policy Center.

[19] Spending entitlement figures include the outlay components of the Earned Income Tax Credit and the Child Tax Credit. See Arloc Sherman, Robert Greenstein, and Kathy Ruffing, "Contrary to 'Entitlement Society' Rhetoric, Over Nine-Tenths of Entitlement Benefits Go to Elderly, Disabled, or Working Households," Center on Budget and Policy Priorities, February 10, 2012, http://www.cbpp.org/cms/?fa=view&id=3677.

examining the subsidies the federal government provides for child care costs. A parent with low or moderate income may be able to obtain a subsidy to help defray child care costs, with the subsidy being provided through a government *spending* program. A parent higher on the income scale also can receive a government subsidy that reduces her child care costs, but this parent's subsidy is delivered *through the tax code*, via a tax credit.

The two types of subsidies differ in their availability to eligible families. The low- or moderate-income parent may *fail* to get any subsidy to help with her child care costs, because the spending programs that provide these subsides are *not* open ended; they can serve only as many people as their capped funding allows, and only about one in six eligible low-income working families with children receives such a subsidy. By contrast, the child care subsidies for higher-income households are *guaranteed*, because the child care tax subsidy operates as an open-ended entitlement (and there is no limit on how large a family's income can be to claim this tax credit). *All* higher-income households that qualify receive the subsidy, even though — unlike many of the working-poor families — they generally would be able to afford child care without the subsidies. It would not be sound policy to make the tax-code subsidies sacrosanct and the program subsidies a target for deficit reduction because one type of subsidy is delivered through a "spending" program and the other is delivered through the tax code.

Chairman MURRAY. Thank you very much.
Secretary Alexander.

STATEMENT OF HONORABLE GARY D. ALEXANDER, SECRETARY, PENNSYLVANIA DEPARTMENT OF PUBLIC WELFARE

Mr. ALEXANDER. Thank you, Madam Chair, Ranking Member Sessions.

I would like to start with a quote from the Concise Encyclopedia on Economics. "The United States welfare system would be an unlikely model for anyone designing a welfare system from scratch. The dozens of programs that make up the system have different, sometimes competing goals, inconsistent rules, and overlapping groups of beneficiaries. Both the hidden and known cost of the system, which lacks the reciprocity of earned benefit social insurance programs like Social Security and Medicare, places unsustainable burdens on the Federal budget and is creating a fiscal migraine for the States. Welfare programs represent a complex web of multiple Federal agencies acting in a manner that are rarely coordinated. Moreover, welfare recipients are not generally well served. Yes, advocates for specific programs will always find isolated examples of a person or household in need and make a case for a particular assistance program. However, if we take a more informed view beyond the immediate emotions of selected anecdotes, for the majority of families and individuals, we will find a system that entraps parents and children in dependency while not improving their overall well-being. The system needs reform."

Like many other States, the Commonwealth of Pennsylvania is struggling with the unprecedented growth of Medicaid and other public welfare expenditures which constitute increasingly larger portions of the Commonwealth's budget. Today, that cut is at 43 percent of the State's budget, and at its current growth rate, it will be over 50 percent of the State's budget in the next ten years, crowding out other important programs like education and other needs like transportation.

Look at one specific program, for example. A common misperception is that economic conditions were solely responsible for the dramatic increase in the Food Stamp caseload. Empirical data shows otherwise. The percent of the United States population on Food Stamps has grown despite a reduction in employment prior to the last recession. The forces at work are policy and statutory changes that were made, one being the farm bill in 2002, which expanded categorical eligibility well before the recession.

The expansion of any program, whether Food Stamps or Medicaid, also increases the opportunity for fraud and abuse. Please hear what I am saying. Not every recipient on welfare cheats. However, benefit systems run by bureaucracies attract certain people, both on the provider side and the recipient side, who will find ways to fraud and abuse the system.

For example, in 2009, 178 convenience stores in Pennsylvania were banned from the Food Stamp program, and we have estimated that more than a quarter-billion dollars in Food Stamp payments that should not have been made over the last few years.

What does this translate to? In Pennsylvania today, every 1.8 privately employed persons supports one person on the welfare system.

Let us move to outcomes. It has long been understood that the welfare system can trap recipients in poverty. The model presented today here is based on the actual rules of receiving benefits in Pennsylvania. Other States will have similar results because these are driven by Federal rules. Sample runs of the model demonstrate that when welfare assistance benefits are added onto net income, not one but several welfare cliffs emerge. A welfare cliff is defined as a point along the range of increasing gross income where the sum of net income and welfare assistance benefits decrease. These are points where a household would be worse off financially if that household were to increase its gross income. Worse off financially is measured by the sum of net income and welfare assistance benefits.

For example, as Senator Sessions said earlier, a welfare recipient with two children earning gross income of $29,000 would receive the sum of $57,327 in net income and welfare assistance benefits if you count the value of the Housing Choice Voucher, Food Stamp, day care subsidies, and medical assistance. The same household would have to earn a gross income of $69,000 with a net income of $57,000 to enjoy a comparable standard of living. In other words, if the welfare recipient were earning a gross income of $29,000, the household would turn down an opportunity to earn a gross income of $30,000 because the benefits begin to fall off, making that household financially worse. Therefore, the recipient gets trapped at the gross income of $29,000. A scenario like this might make a hard-working American making a median gross income of $50,000 per year think about applying for welfare benefits.

Where do we go from here? The only way to solve the problem is to reconstruct and redefine the entire Federal means tested welfare benefit program system. There is no other way. States need flexibility, either through more block grants or through waivers where they can combine programs, braid funding, so that the welfare cliff is moved in an upward slope and that individuals will be incentivized to work instead of staying on the system.

Thank you very much.

[The prepared statement of Mr. Alexander follows:]

Statement of Gary D. Alexander
Secretary of Public Welfare, Commonwealth of Pennsylvania
Before the Senate Budget Committee, United States Senate
February 13, 2013

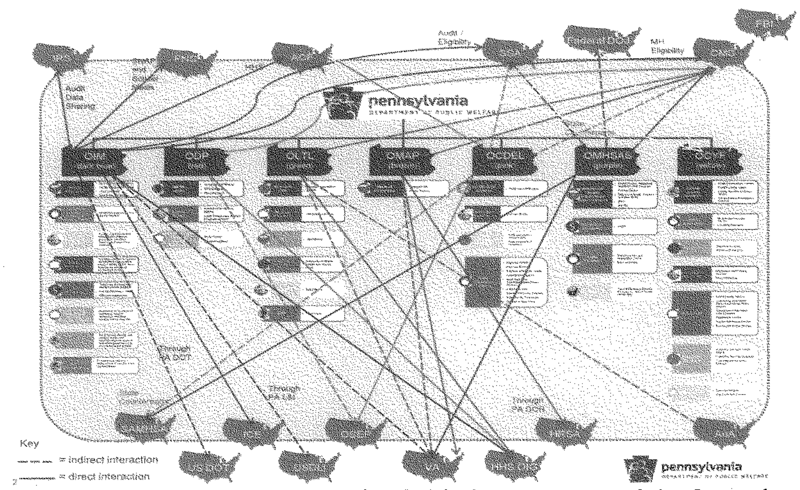
I would like to start with a quote from the *Concise Encyclopedia on Economics.*[1]

> "The U.S. welfare system would be an unlikely model for anyone designing a welfare system from scratch. The dozens of programs that make up the 'system' have different (sometimes competing) goals, inconsistent rules, and over-lapping groups of beneficiaries."

This assessment is an understatement. Over the years we have created program after program in a haphazard manner without regard to the actual ineffectiveness or effectiveness of the entire whole. The net result is a "means-tested" welfare system that is not only disjointed and dysfunctional but also a bureaucratic mess. Both the hidden and known cost of the system, which lacks the "reciprocity" of earned-benefit social-insurance programs like Social Security and Medicare, places unsustainable burdens on the Federal budget and is creating a fiscal migraine for the states.

Welfare programs represent a complex web of multiple federal agencies acting in a manner that are rarely coordinated; more often than not the programs, regulations, and actions are independent and conflicting. It's an alphabet-soup array of federal bureaus, offices, and departments that are overwhelming and confusing: FNS, ACF, CMS, HUD, DOJ, FBI, IRS, VA, SSA, DOT, and SAMHSA. These federal agencies interact with multiple state agencies and a large array of local entities.

This description understates the complexity. The federal government also bypasses the state on numerous welfare-related programs that are disconnected from state efforts to serve the welfare population. Public housing, Section-8 housing vouchers, Supplemental Security Income, and earned-income tax credits are examples of federal programs that completely bypass the states.



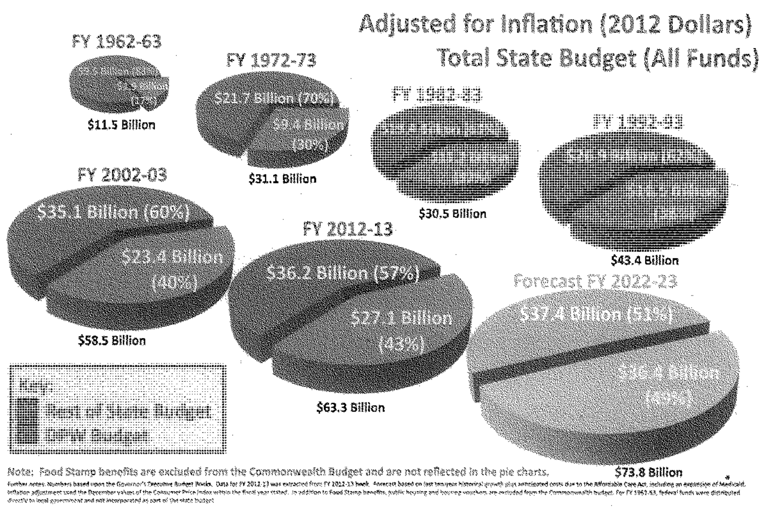
This a snapshot of what a state has to deal with from the federal government: a myriad of conflicting rules and regulations from a massively disorganized bureaucracy.

Moreover, welfare recipients are not generally well served. Yes, advocates for specific programs will always find isolated examples of a person or household in need and make a case for a particular assistance program. However, if we take a more informed view beyond the immediate emotions of selected anecdotes, for the majority of families and individuals, we will find a system that entraps parents and children in dependency while not improving their overall well-being or their chances of joining the middle class. The system needs reform.

Growth in the System Beyond a Safety Net

Like many other states, the Commonwealth of Pennsylvania is struggling with the unprecedented growth of Medicaid and other public welfare expenditures, which constitute increasingly larger portions of the Commonwealth's budget. Fifty years ago, the Department of Public Welfare constituted 17 percent of the total Commonwealth Budget. Today that cut is 43 percent. If the ACA Medicaid expansion is implemented, it will grow to more than 50 percent.

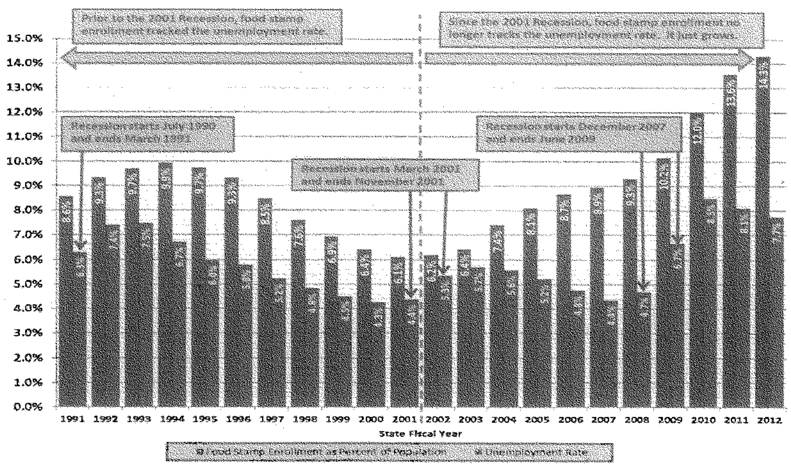
Real PA Budget Growth in Magnitude and Percent



Data by the National Governor's Association and the National Association of State Budget Officers shows that this is now true for all states as a whole. States are now spending more on Medicaid and welfare than any other priority, including education. So here's the bottom line: Welfare spending exceeds revenue growth and is forcing the states to abandon other funding priorities, including education and infrastructure. This type of welfare expansion will not help spur economic expansion and grow jobs.

Look at one specific program: food stamps. A common misperception is that economic conditions were solely responsible for the dramatic increase in the food-stamp caseload. Empirical data shows otherwise. The percent of the U.S. population on food stamps has grown despite a reduction in unemployment prior to the last recession.

The forces driving this growth are policy and statutory changes. The Farm Bill of 2002, for example, contained provisions that gave states the option to expand "categorical eligibility," making it easier for households to qualify for food stamps. The American Recovery and Reinvestment Act of 2009, another example, suspended food-stamp work requirements among able-bodied adults without dependent children. That 2009 legislation also increased the dollar value of food-stamp benefits.



This slide demonstrates that the growth in the food stamp program since 2001 is not totally linked to the 2007-09 recession. We expect, of course, enrollment to increase during recessionary times, but this growth predated the 2007-09 recession and had abnormal growth beyond the simple impact of the recession. We know for a fact that policy and program changes changed the rules of the game that made food stamp enrollment grow faster than it would have otherwise. Policies were eased or not enforced in the earlier part of the decade and then the asset test was removed in 2008.

Fraud, Abuse and Inefficiency

The expansion of any program, whether food stamps or Medicaid, also increases the opportunity for fraud and abuse. Please hear what I am saying. Not every recipient on welfare cheats. However, all benefit systems run by bureaucracies attract certain people, both on the provider side and the recipient side, who will find ways to fraud and abuse the system.

I am stating this from years of experience running welfare systems. On a daily basis, our auditors and inspectors uncover incidences of fraud and abuse, despite the fact that we have put systems into place to prevent such cheating. In 2011, 178 convenience stores in Pennsylvania were banned from the food-stamp program. We have estimated that more than a quarter-billion dollars in food-stamp payments that should not have been made. Applicants and recipients do not properly report income, and we do not catch it. Recipients sell EBT cards for cash so they can buy tobacco, alcohol, or illegal substances.

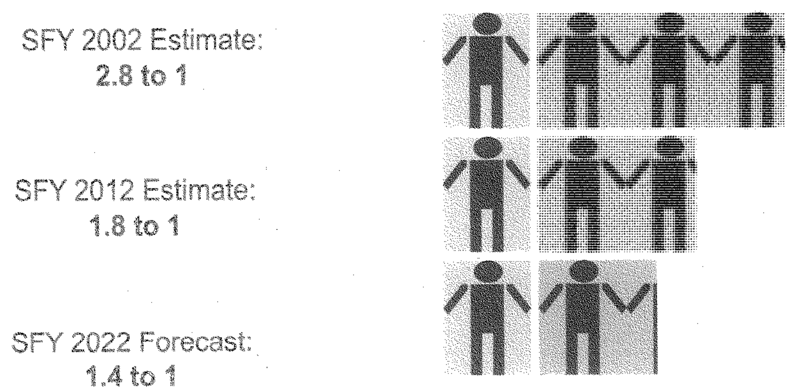
To make matters worse, most states have abandoned asset-limit tests in regards to food stamps. This is why a news story every now and then arises about a person winning a large payout from a state lottery but nonetheless still qualifies for food stamps. This is one reason Pennsylvania reinstituted its food-stamp asset test last year.

Medicaid is by far the largest welfare program. For years, states have been struggling with the costs of Medicaid, a program that has supplanted other funding priorities to become one of the largest single expenditures for states. Essentially, we have concluded that Pennsylvania cannot expand Medicaid under the current rules. If we expand under the current system, we would be expanding an inefficient system.

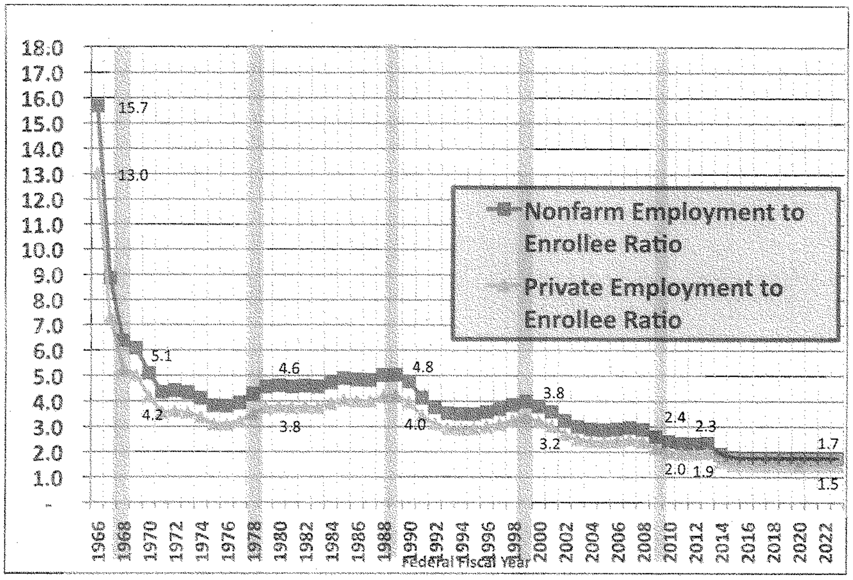
Burden on the Taxpayers

In Pennsylvania today, every 1.8 privately employed persons support 1 person on welfare. Ten years ago, 2.8 persons privately employed supported 1 person on welfare. This already represents a significance increase in the tax burden on every working man or woman. If we were to expand Medicaid, that already heavy burden would increase further.

Taxpayers to Welfare Recipients in Pennsylvania



For every 1.8 persons employed in the private sector in Pennsylvania, there is one person on welfare. The ratio was 2.8 to 1 in SFY 2002, and the projection for SFY 2022 is 1.4 to 1.



This slide compares Medicaid enrollment to employment overtime. The purpose of this slide is to demonstrate the societal burden to carrying Medicaid. The comparison being is used the number of person employed relative to the number of persons on Medicaid: the higher the ratio, the lighter the burden; the lower the ratio, the heavier the burden. Two numbers were used for employment: total nonfarm employment and private employment, as published by the U.S. Bureau of Labor Statistics. Private employment was also chosen to be displayed because that is where wealth is being created. With minor and insignificant exceptions, the public sector relies on taxation to exist. If other words, without a private sector to tax, the public sector could not exist. As is demonstrated in the graph, the ratios over time keep getting worse

The Welfare Cliff

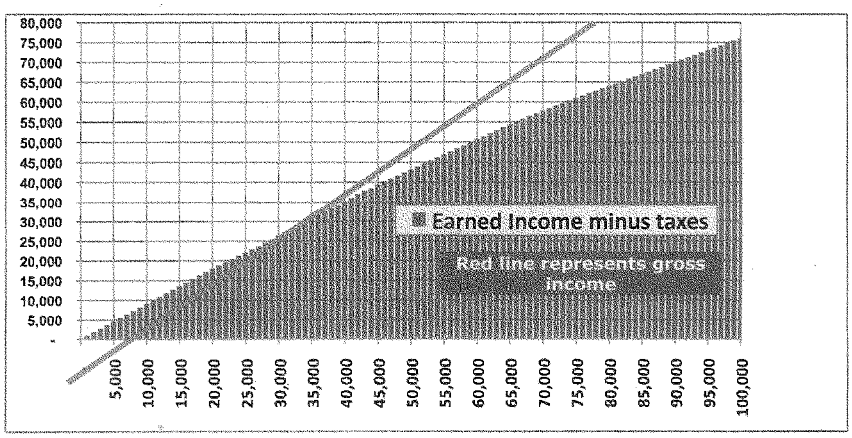
Let's move to outcomes. It has long been documented that the welfare system can trap recipients in poverty.

Many Americans either know this intuitively or possess personal experience with the system. The phenomenon is often called the welfare-cliff effect. If a typical single mother on welfare earns just a little bit more income, or if she marries a man with a job, the household stands to lose far more in benefits than what the marginal income is worth.

The model presented today here is based on actual rules of receiving benefits in Pennsylvania. Other states will have similar results, because most assistance programs are based on eligibility criteria established by the Federal government.

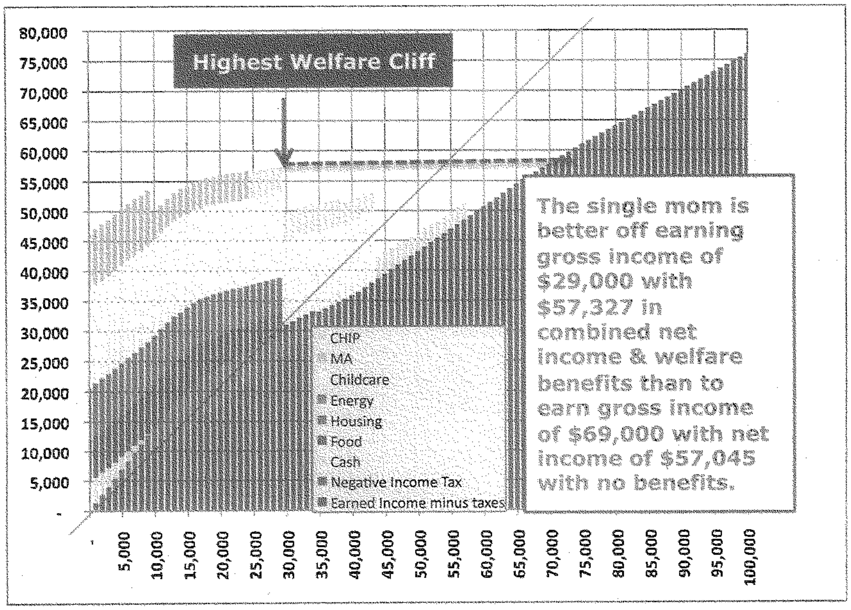
Sample runs of the model demonstrate that when welfare-assistance benefits are added onto net income, not one but several welfare cliffs emerge. A welfare cliff is defined as a point along the range of increasing gross income where the sum of net income and welfare-assistance benefits decrease. These are points where a household would be worse off financially if that household were to increase its gross income. "Worse off financially" is measured by the sum of net income and welfare-assistance benefits.

For example, a welfare recipient with two children earning gross income of $29,000 would receive the sum of $57,327 in net income and welfare-assistance benefits, if you count the value of the housing-choice voucher, food stamps, daycare subsidies, and medical assistance. The same household would have to earn a gross income of $69,000, with a net income of $57,045 to enjoy a comparable standard of living. In other words, if the welfare recipient were earning a gross income of $29,000, the household would turn down an opportunity to earn a gross income of $30,000 because the benefits begin to fall off, making that household financially worse off. Therefore, the recipient gets trapped at the gross income of $29,000. A scenario like this might make a hardworking American earning a median family income of $50,000 per year think about applying for welfare rather than working.



In the U.S. today, despite the progressivity of the income tax, a family is always better off taking a better job and making more money.

Testimony of Gary D. Alexander, Secretary Pennsylvania



If we stack on welfare benefits, you can quickly see what happens. Welfare cliffs crop up in several spots, trapping people in a life of poverty and low-income. With a job that offers no health benefits, the single mom is better off earning gross income of $29,000 with $57,327 in net income & welfare benefits than to earn gross income of $69,000 with net income & benefits of $57,045. That family is dependent. As the mom looks over the horizon, she realizes she must find a job worth $69,000 in order to maintain her current quality of life. Taking a job that makes less than $69,000 will actually hurt her family.

This sample demonstration represents just one outcome of the model. The model is capable of altering assumptions, such as the household type, quality and cost of the daycare, and county of residence. Alternative scenarios produce different numbers, but they show the same pattern of perverse incentives against work and upward mobility.

By looking across the broad spectrum of welfare programs, the model validated what many Americans suspect: a parent on welfare faces built-in disincentives to earn more income because the household would face the potential loss of benefits even greater than the potential increase in income. In economic terms, the opportunity costs of earning more marginal income or marrying were greater than the benefits of that marginal earned income.

A real example might put this into perspective. Linda, a single mother with two dependent children losses her job. She possesses an associate degree and worked in banking. After she lost her job, she applied for welfare benefits. After 24 months of being without work she obtained a lower paying job without medical benefits at a retail store. This retail store offered management training that would certainly increase her pay. Although working, she still obtained a myriad of federal means-tested benefits. She claimed that while on welfare, she felt no incentive to attempt the management-training class offered through the retail business because increasing her income would decrease her benefits and she would lose thousands of dollars. She decided the management training was not in her best interest financially.

This was a real example. Is this the best that we can do?

But this is not the only problem with the welfare system. The system is also inequitable to those households who want to join the vast middle class. Parents that want to follow the family-formation and employment route end up with less income in real terms than the welfare households that they end up subsidizing through their taxes. Consequently, our system discourages not only work and family formation for those stuck in the system but also for those who barely live above the poverty line.

Redesign the Federal Welfare System

So where do we go from here? The only way to solve the problem is to reconstruct and redesign the entire system. There is no other way. The system must be rethought so that programs not only dovetail together but that the total benefits package, when added onto net income, has an upward slope as income increases for recipient households. In short, programs should reward work because employment is the best anti-poverty remedy.

For every extra effort, for every opportunity to earn more income through employment or marriage, the person deserves to be better off. It is only fair.

Redesigning the system is a major undertaking. It will require congressional action. After having managed the welfare system in two states and having worked on these issues at the state level on both sides of the aisle for close to twenty years, I have designed a comprehensive redesign of the system that would solve much of the problem, but we do not have the time to dive into the specifics. Without diving into what I have created, here are some positive first steps that should be taken to enable state innovation:

Provide states generous latitude and flexibility to redesign and run welfare programs in a manner that makes sense so that we can "smooth out" the welfare cliffs and ensure that households obtain "upward" mobility and become motivated to benefit from employment.

Such latitude can be offered to states in one of two ways.

First, Congress can streamline all welfare programs into block grants and allow states to braid or combine funding streams. The programs that will need to be "block granted" are SNAP, Medicaid, housing-choice vouchers, and public housing. Currently, TANF and federal daycare programs are block grants, but any redesign should also allow states to include these two programs in any block-grant reform. Of course, the Federal government should provide broad performance measures to the states surrounding health, safety, employment and education -- and then allow each state to design appropriate programs and services as each state deems best and then compete among each other. This will spur creativity and ingenuity – both hallmarks of our republic. Let the states function as laboratories of democracy.

A second, although less desirable option is to allow states to obtain federal waivers, giving them maximum flexibility for all of the programs utilized in the redesign. Waivers would be needed for Medicaid, SNAP, housing-choice vouchers, public housing, and daycare. Federal law should be written that such waivers are easily obtained and not micromanaged by the Federal bureaucracy. Both of these options might just leave the Federal government out of the business of micromanagement and in the business of oversight only.

Both of these options might just allow states to redirect some of these funds to focus on a pro growth agenda that would decrease welfare spending and dependency and help generate economic expansion.

My fundamental point is this: rely on the strength of our federal system. We are blessed in this nation to have fifty states that have been called the laboratories of democracy. We need to unleash the power of competition and innovation of the states, instead of relying on a top-down approach where everything is determined in Washington, D.C.

Conclusion

The vast majority of welfare recipients would prefer a system with the right incentives rather than face the cliff. The current American welfare system is failing them and their chances of realizing a true opportunity to obtain self-sufficiency and independence. Redesigning the system to focus on incentivizing upward mobility for the people we serve rather than the feeding a massive bureaucracy of overlapping programs that discourage work and independence might just help us to eradicate the welfare cliff.

I will be happy to answer any questions you might have.

[1] http://www.econlib.org/library/CEE.html. Written by Thomas MaCurdy and Jeffrey M. Jones. MaCurdy is the Dean Witter Senior fellow at the Hoover Institution and a professor of economics at Stanford University. He is a member of standing committees that advise the CBO, the U.S. Bureau of Labor Statistics, and the U.S. Census. Jones is a research fellow at the Hoover Institution.

Chairman MURRAY. Thank you.
Mr. WOODSON.

STATEMENT OF ROBERT L. WOODSON, SR., PRESIDENT, CENTER FOR NEIGHBORHOOD ENTERPRISE

Mr. WOODSON. Thank you, Madam Chairman. Senator Sessions, it is good seeing you.

Like you, Madam Chairman, I am from Philadelphia and my dad died when I was nine, leaving my mother to raise five children in a very troubled neighborhood. Because my father died from war-inflicted wounds as a veteran, we were entitled to government assistance. But I dropped out of high school at age 17 and went into the military and completed my GED and then went to college on the G.I. Bill of Rights. Then I got involved in the Civil Rights movement, leading demonstrations in my native Philadelphia and the surrounding area.

I realized that many of the people who suffered and sacrificed most for civil rights progress did not benefit from the change because their problems were not just race, but also poverty. I began to work at a juvenile jail as a correction officer and also as a trained social worker in the child welfare system. It was there that I realized how we were beginning to injure people with the helping hand.

Yes, there are people who are poor and who just need a hand up, like your parents and the other witness. But otherwise, their attitudes and values are intact, and they use the welfare system as it was intended, as an ambulance service and not a transportation system. But for those who are poor because of the chances that they take and the values that they exercise, spending on them can injure with the helping hand.

In a recent article in the New York Times, many politicians on both sides were shocked to learn that parents of Appalachian children were refusing to send their children to literacy classes because they would lose $600 in SSI payments. So the future of the children was sacrificed for the short-term interests of the family.

Colbert King, certainly no conservative, writing in the Washington Post recently said the solution to the poor is not to integrating and funding more programs, but creating a civic infrastructure focused on building stronger families, fathers living at home married to mothers of their children.

In other words, Washington, D.C. leads the nation in 21 separate categories of poverty expenditures, and yet we are dead last when it comes for outcomes for children. So we cannot equate how much we spend on the poor in terms of how much we help the poor. We must reform some of these programs that are really discouraging people from moving forward. A member of my own family is an example.

Before welfare reform, my niece, who was in her 30s, had been on welfare for many years. I spent thousands of dollars trying to discourage her dependency and give her an opportunity to move toward self-sufficiency. I obtained an apartment and a job for her in Arlington, Virginia, and I went to pick her up in this very dangerous public housing project in Philadelphia. My nephew, told me, who was a police officer, told me not to go up in there because it is so dangerous. But I went to pick her up and at two in the afternoon she was in a nightgown with a beer can in her hand. She would not leave because she knew that she could depend on welfare. She could depend on daycare for her child. Unfortunately, many years later, I was on a juvenile justice panel with a judge who informed me that he had sentenced her son, and my great-nephew, to prison. So she and others like her are trapped in this system. We have other programs, again, well intended, but noble intentions cannot always lead to noble outcomes.

My organization supports 2,500 grassroots groups living in 39 States. These are the people who are providing moral guidance and character coaching to people who are poor, because for many of them, redemption and moral revitalization is a prerequisite to being helped. It is important to support structures like this.

But instead, we support programs like the one in Colorado and other places that we call ″Bunks fo Drunks.″ Homeless alcoholics are put in these fine hotels at a cost of $4,000 per person per month and they can drink in their rooms. But this is because we are looking at it as a medical problem.

We are also injuring people in foster care and adoption. For instance, we spend $75 billion on children who are in foster care where there are disincentives for them to reunite. Many of these providers will not reunite children with their parents because it would injure their cash flow. There are endless other examples of how we are injuring people with the helping hand and rewarding behavior that is self-destructive.

My recommendation is that we support institutions like we did in Alabama, Lowndes County, where we were instrumental in the development of two industrial parks. They now have the county's first daycare and recreation center. So it is really not just aiding individuals but also supporting structures that produce jobs and providing incentives so people are not discouraged from work because they are getting rewarded.

Thank you.

[The prepared statement of Mr. Woodson follows:]

Testimony before the United States Senate Committee On The Budget

by Robert L. Woodson, Sr.
Founder and President of the Center for Neighborhood Enterprise
February 13, 2013

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I'm speaking as someone whose life's work has been committed to helping low-income people to help themselves to rise up. Along the way, it became obvious that what I was fighting against wasn't just the dysfunction of the people I was helping but it was also the dysfunction of the system that was put in place to help them.

Since its inception in 1964, the War on Poverty has spent nearly $20 trillion. Today, the federal government runs 80 means-tested programs providing aid to the poor at the cost of $1 trillion a year. If we were going to have won the war on poverty with spending, it would have been done a long time ago.

The issue isn't amount of funding but the outcomes of the programs. Those outcomes are a direct result of the incentives built into those programs. Sometimes those incentives encourage dependence, even for generations. Sometimes incentives help people gain personal responsibility and pursue their dreams.

So if we want to help those in need, we need to ask: Is the approach we are taking to relieve poverty by what we call the safety net actually helping or is it injuring with the helping hand?

It's not surprising that, regardless of intention, a system that rewards failure and punishes success has generated ever-increasing dependency. You get more of what you reward and less of what you punish.

Not long ago, a story in the *New York Times* shocked politicians on both sides of the aisle when it revealed that an impoverished Appalachian couple had pulled their kids out of a literacy program because they feared they would not qualify for their SSI check if their children could read.

It was not a shock to me. I have seen similar cases again and again.

When my daughter was earning her degree in pastoral counseling, she was an intern in a high-school class for low-income kids with behavioral problems. One girl she met with was under a lot of stress. She was 15 and had a two-year-old baby. She and her boyfriend were living with her grandmother because her father was out of the picture and her mom was on drugs. But one day she came into my daughter's office and was very excited. She had figured out a plan. She would try to get pregnant again, and then would qualify for more money and more food stamps and she and her boyfriend would move into Section 8 housing. The girl even knew how much of the rent she would have to pay. That was her dream. She had her whole life figured out within the government programs.

The entrapment of the system even hit closer to home. I had a niece who was in her 30s and had been on welfare for years. She was living with her child in one of the most dangerous public housing projects in Philadelphia. The apartment complex was so dangerous that my nephew who was a police officer warned me about going there and said he wouldn't even go in there with his gun.

I spent thousands of dollars trying to help her relocate. I found an apartment for her in Arlington and found a job for her. But when I went to pick her up, she was in a bathrobe with a beer in her hand in the middle of the afternoon. She couldn't bring herself to make the move and leave the situation she had.

My efforts to help her help herself couldn't compete with the welfare system.

In the system, she knew she had a place to live, no matter how dangerous, and she had food and day-care benefits.

It wasn't until welfare reform became a reality that she changed. Welfare reform did what all of my efforts to persuade her could not do. It compelled her to go out and get a job. She had been on welfare for years and the only thing that interrupted that cycle was welfare reform.

Once again, the issue is not whether we cut or expand our welfare funding. More or less of a bad thing is still a bad thing. The issue is how we can reform our approach so that we can effectively help people to rise from poverty and stop wasting billions of dollars every year on counterproductive programs intended to help the poor.

We should look for models of approaches that work—both in the public and private sector—based on two core principles:

1. **Stop driving out personal responsibility and good works with government largesse.** It's hurting the people it's supposed to help, and hindering the efforts of those that love them. I couldn't help my niece because welfare programs created a path of least resistance.

   We need to continue the work of welfare reform and not live any longer under the illusion that an ever-increasing budget is the answer to poverty.

2. **Strengthen and support the foundation of civil society.** Not all poverty is caused only by a lack of money. Community groups address these problems at their root. As Colbert King (not typically a conservative spokesperson) recently wrote: The solution for the poor is not funding and integrating more government programs but creating "a civic infrastructure focused on building stronger families: fathers living at home, married to the mothers of their children; parents who see that their kids get to school on time, ready to learn, and who raise their children to respect others and themselves."

   The Center for Neighborhood has a 30-year history of supporting grassroots organizations in low-income communities that have demonstrated their ability to reassert moral authority, enabling people to get off of drugs and stop their self-destructive behavior. They have established a track record in which hundreds of people's lives and communities have been reclaimed.

Policymakers and philanthropists who truly want to make a difference need to look to these grassroots groups who are making an impact because they understand how incentives work and have the relationships that transform lives and communities.

That's what happened in the Alabama Rural Initiative: In 2002, my organization, The Center for Neighborhood Enterprise (CNE), joined with Senator Jeff Sessions and Household International—now HSBC-North America--in Lowndes County, Alabama. Though that county had been the site of annual civil rights memorial marches, the conditions of the poor there hadn't improved for forty years. In a five-year initiative, we helped Lowndes County improve sanitary conditions, create economic development, provide training in financial literacy and created new housing opportunities.

With unemployment at more than 11%, and most jobs paying little more than minimum wage, there was a great need for economic development in Lowndes. The advent of a $1 billion Hyundai manufacturing plant just six miles away from the Lowndes border opened the possibility that Lowndes could attract supplier companies to within its borders. CNE facilitated the Comprehensive Economic Development Strategy (CEDS) that was the prerequisite for two tier-one auto suppliers.

And there were ripple effects for families and neighborhoods where fathers had a job. This effort did not involve spending more money for welfare: it made a lasting difference in the lives of the residents of that impoverished county.

From personal experience, I believe that nation's strategy to address poverty must be reformed. I have spent my life working on behalf of low-income people and that meant fighting against well-intended policies that have injured with the helping hand.

I think of the words of Dietrich Bonheoffer who declared that the greatest enemy to the good is not malice but folly. It is folly when people do things to help people that end up destroying them.

Chairman MURRAY. Thank you very much. Thank you to all of our witnesses today, and I will begin with my questions. We will each have five minutes and we will go in order of appearance and I appreciate everybody keeping to their five-minute time limit.

Ms. Marks, I want to start with you. Thank you so much for being here today. I know it is not easy talking about facing some of the challenges like the ones you have seen, and when I hear stories like yours, it makes me very concerned about the direction some of our members of Congress want to take us in. House Budget Committee Chairman Ryan last year released his budget that would have reduced Federal support for SNAP by 17 percent, which could lead to more than eight million people being removed from the program. I wanted to ask you where you thought you would end up if that Federal safety net had not been there for you when you needed it so badly.

Ms. MARKS. I would still be in poverty, ma'am.

Chairman MURRAY. You would still be in poverty?

Ms. MARKS. Yes.

Chairman MURRAY. Do you think you would have finished school?

Ms. MARKS. No. No, because I knew that I needed to be there, but I was not able to be able to afford it outright myself. So I was very much dependent on student loans and Pell Grants to get me through.

Chairman MURRAY. Mr. Greenstein, what sort of effect would a cut like the one Chairman Ryan proposed have on American families and communities and the economy, and what do you think about the idea of block granting programs like Medicaid and SNAP and housing?

Mr. GREENSTEIN. Well, with regard to Medicaid and SNAP in particular, there is both the effect on the individual families, but there is actually also a significant adverse effect on the overall U.S. economy. The reason is that those programs are automatic stabilizers. They automatically grow when the economy turns down and put more purchasing power into the economy and they come back down when the economy recovers.

The Congressional Budget Office actually noted in a report a couple years ago that increases in Food Stamp benefits during economic downturns were, along with unemployment insurance, the two most effective forms of stimulus in terms of bang for the Federal buck because virtually all of the money is then spent.

In terms of the impact on the families, I would be extremely concerned. I remember the period in the late 1960s when each State set its own rules in Food Stamps. Some States—South Carolina—cut off people at 50 percent of the poverty line. It was in that period that, on a bipartisan basis, we had a team of medical researchers that went into Appalachia, the Deep South, and elsewhere, and they found in a report that shocked the nation rates of childhood hunger and malnutrition—incidents of child hunger and nutrition-related conditions akin to those of some third-world countries. They then went back ten years later, after we went to national standards in Food Stamps. It was President Nixon who led that effort. And they found dramatic improvement.

So I think it would be a major step backward to move from the kinds of national standards that have served us well since President Nixon's day.

Chairman MURRAY. Thank you.

Ms. Marks and Mr. Murray, I have to say I was really impressed by both of your stories and your testament. You mentioned something that I often hear from people who have a government investment in them that helps them get out of poverty and into middle class and that is giving back again to the community that helped you when you needed it the most. And I imagine that most taxpayers would look at both of you and think that they received a pretty solid return on their investment.

Can either of you talk a little bit about how you have been able now to contribute back because of the investment the Federal Government has given to you? Mr. Murray.

Mr. MURRAY. Ma'am, thanks to the military health care system and significant upgrades in prosthetic technology through added funding, I was able to quickly transition back to somewhat of a normal lifestyle. When I got out of Walter Reed, like I said, I went to work for Turner Construction and got to be part of a great team that then built another hospital for our soldiers and sailors, airmen and Marines coming home, down in Fort Belvoir. Without the ability, without the technology to get around as well as I can, that would not have happened for me and I do not think it would have been possible.

Chairman MURRAY. Ms. Marks.

Ms. MARKS. You are asking me about the investment—

Chairman MURRAY. And how you contribute back now because of that investment.

Ms. MARKS. First of all, I just want to say thank you to anybody and everybody who ever had anything to do with any Federal program that helped me in the time when I needed it. The investment, I hope, was well worth it, and I would have to say, yes, that it has worked for me.

I was able to go back into the workforce and to be able to be a productive member of society, of taxpaying and all that good stuff that I was very happy to be able to do so. And also that I have this firm belief that people need help, and I know that from firsthand, and so I tried to give back as much as I can when it is my turn to be able to help people.

Chairman MURRAY. Okay. Well, thank you to both of you. My time is up and I will turn it over to Senator Sessions for his questions.

Senator SESSIONS. Thank you.

Ms. Marks, you benefit from the program like it is supposed to be, our design and vision for it. I think what Mr. Woodson is saying, that for a lot of other people, somehow, it can become a trap and a dependency. It actually hurts their morale, their independence, and their ability to be successful, and we do not want that to happen.

I know, Mr. Greenstein, you tend to suggest that all spending is good, that no—well, you praised the committee for, what did you say, shielding poverty programs from any cut. Medicare, Medicaid, Food Stamps got zero reductions, zero. It has increased 300 percent in the last 11 years. So I just would say that we have a program that has been surging and I think it is not wrong to examine them and see if we cannot make them work better.

Secretary Alexander, you have administered these programs. I see that last year, Secretary Vilsack claimed the Food Stamp error rate is less than 3.5 percent and the fraud rate is less than one percent, a historic low. As a young Federal prosecutor, I prosecuted stores that sold liquor and other things, non-food items, misdemeanor cases. Now, I guess I have observed this situation for a long time. What would your feeling be, as someone who has administered this program, about fraud and abuse, people who just do not qualify for the benefits they are receiving?

Mr. ALEXANDER. Well, first of all, I believe that if we create a vast system like we have with many, many bureaucracies and Federal agencies that trickle down to the State and local level, you are inviting more fraud and abuse, whether it is from recipients or from, potentially, providers. People do not necessarily want to cheat the system, but if it is available to them, they will take advantage of it.

In regard to the Secretary's claims of the error rate, it sometimes can be a bit misleading, because if the individual is not providing the right information a lot of times, sometimes it is very difficult for State administrators or workers who are seeing sometimes upwards of over a thousand clients in their caseload to be able to keep track of all of these things. So I think that—

Senator SESSIONS. But just fundamentally, right there, if a person comes in and says they have five children, they say they have a certain amount of income, there is no way most State agencies who administer that program are going to go out and investigate, send the FBI out to verify that, right? They take basically what they are told.

Mr. ALEXANDER. We have very few investigators. The workers do the best job they possibly can on the front line. And they try to check. But, for example—I will just give you an example. In the TANF program, when the law was being passed in the 1990s, there was talk of a national database so that we could check across State lines. We do not have that ability today in real time to be able to do that. I think the government, whether it is State or Federal Government, is looking at increasing its technology capabilities. However, we certainly have a long way to go. And the fact that the Federal Government is so vast and complex and that the rules that are set forth here in Washington overlap, are inconsistent, they are inconsistent sometimes just between programs.

So, for example, in Medicaid, States operate multiple Medicaid waivers with competing service definitions, rules, regulations, reporting requirements. These are very, very difficult for States to administer. And because of that, it trickles down to the recipients we serve. We are not creating a round wheel for administrators at the State or local level to operate so that we can, as individuals come into the system that are able-bodied, we are able to get them off of the system very quickly.

Yes, there are examples of individuals who are self- motivated, but the majority of our recipients need to be helped and we need to incentivize them. The current system incentivizes nobody, as we saw with the welfare cliff. But in addition to that, there is no motivation for individuals to really better themselves. We would be much better off taking the vast amounts of money that we put into some of these programs and redirecting that towards a jobs program or toward technical training, vocational training for a lot of these individuals. They could achieve more, become more mainstream, get into the middle class, and become real taxpayers and lifted out of poverty.

What we are doing, Senator, is we are essentially providing them with a plethora of benefits, and yes, they are important, but if we were to teach them how to fish rather than providing them with the fish, these individuals would make it off of the system more.

We cannot continue to keep the status quo. We have to look at these programs critically. We have to start to braid funding and we have to start to create a continuum of care to get people off of the system.

Senator SESSIONS. Thank you, Madam Chairman.

Chairman MURRAY. Thank you.

Senator SESSIONS. I would just say, I did talk to a lady who manages a sewing plant and I asked her how she was doing with employees. She said, "We are doing pretty well, but we compete against the government every day," and I think that is what you are saying. That is a sad thing.

Mr. ALEXANDER. If I could offer just—

Chairman MURRAY. And I would just say, we have a number of Senators who want to—

Mr. ALEXANDER. Okay.

Chairman MURRAY. —and you will have time to respond.

Mr. ALEXANDER. Okay. Thank you.

Chairman MURRAY. Senator Warner.

Senator WARNER. Thank you, Madam Chairman. Thank you for this hearing and the powerful testimony.

I know you both made mention, both you and Senator Sessions, of personal stories. I am sure we all will make some mention. I put myself in a category of the first and only member of my family to graduate from college. I would not have been here if there had not been a student loan program.

I also want to say a personal thanks to Bob Greenstein, who through my journey around these issues is somebody who falls very much on the deficit side, has—and concerns about that, pushed me hard on issues. And, Senator Sessions, I will tell you, Bob Greenstein has been out there on a number of reforms and, I can assure you, taken a good set of grief from many colleagues on this side of the aisle for being willing to point out areas where we have to get our debt and deficit under control. So I really want to thank him—

Senator SESSIONS. He has been a valuable witnesses before here, too.

Senator WARNER. He has the scars to prove it, I can assure you.

I also want to just reiterate, as Bob has mentioned and others, that many of us have cited the Simpson-Bowles report as a guideline that, while not perfect, set out meaningful deficit reduction. The Gang of Six had built upon that. And I again just want to reiterate that even in those reports, there was that philosophical goal to maintain parts of the safety net that are important and valuable.

So, for example, even though we put forward Social Security reforms, there was a bumping up of the bottom quintile of those recipients on Social Security to make sure they at least got to a poverty level, to make suer that those folks above 85 who may have run out of their private pensions got a bump-up, as well. And while there are areas, particularly on the SNAP program, where we can do better enforcement, it was the consensus not only of Simpson-Bowles but of the Gang of Six that the SNAP program, net-net, was a good value for the investments we have made, and Ms. Marks' comments, I think, reflect that.

But I have also got to say that, you know, at $16.5 trillion in debt that goes up $3 billion a day, if we were to have interest rates at anything close to historic levels already, we would see interest costs alone on that debt outcourse Medicare at this point. So the idea that we do not need to rethink and find better efficiencies is something, even though we may have different philosophical views of the role of government, there ought to be at least some space here for common ground.

I would simply add—and there will be a question at some point on this, but—

[Laughter.]

Senator WARNER. —say as a former Governor—I think about my good friend, Governor Kaine—former Governor—as well—there are times when this myriad of Federal programs restrict the ability for States to do the kind of value and protections, but the kind of approach that we have had as, at least I can say, as a Governor, having those maintenance of efforts requirements so that you can try to deliver a better product without simply then being able to dramatically cut back on the benefits that people receive, finding better ways to deliver those at a better value is something that we don't get enough attention. And, quite honestly, we kind of hear on a one-off basis.

The National Governors Association does a fairly good job, but I have been amazed in my relatively short time here, in four years, how rarely we see how best practices are taken from State levels and then built into Federal programs. And I think that ought to be a part of our discussion on a going forward basis—not decreasing efforts, making sure that folks still get the need in an appropriate way that they should receive, but making sure that where there are examples, and I would take one exception with Secretary Alexander. On one hand, you say you complain about the myriad of Federal regulations, but one of the ways that is, you have to give flexibility with waivers. A waiver system is still, as long as there is that maintenance of effort, something that I think that we need to look at and how we get that best practice system better in place.

I am down to 20 seconds. Bob, if you want to make a comment. I think one of the things you may want to simply reiterate, EITC and Child Tax Credit, while we can talk about some of the programs, these have been initiatives that, again, with some broad-based, I think, bipartisan support really have been very successful. You may want to comment.

Mr. GREENSTEIN. Well, they are only for people who work. You have to have earnings to qualify for them. And in the EITC and the Child Credit, actually, in both of them, they have a structure where the credit goes up as you earn more, from very low levels, which is really the reverse of a number of other programs. And the research is very clear that they have quite powerful effects in bringing more people into the labor market and increasing earnings.

What is new and we did not know before is the new research finding that the increased income they provide—apparently by stabilizing family circumstances so they are not so poor—is actually linked to increased performance by the children in the families in school, which then pays off later in life in terms of earnings and employment.

So this is, I think, an area where, while not perfect, we have actually come up with very good programmatic designs that are really yielding positive results.

Chairman MURRAY. Thank you very much.

Senator JOHNSON.

Senator JOHNSON. Thank you, Madam Chairwoman.

Mr. Murray, thank you for your service.

Ms. Marks, I am sure I share everybody's feelings here that we are so glad that your story has a happy ending here.

As we move forward in this hearing and as we try fixing these very serious problems facing our nation, I hope we do not question each others' motives. I mean, I truly believe we share the same goal. I think we are a compassionate society. We want a strong social safety net. We want to help individuals that cannot help themselves. We want to help people help themselves. I think that is the bottom line.

The trick is, how do you design that social safety net so that it does not incentivize people into bad behavior. So I just want to—I am an accountant, so I like figures. I would like to ask Mr. Greenstein, when you take a look at Census Bureau information on some pretty serious societal metrics—number of people in poverty, poverty rates, out-of-wedlock birth rates—in 1959, which is when the first good information became available on poverty rates, there were 34 million people in poverty. By the time we embarked on the War on Poverty, the $16 trillion War on Poverty, that had actually declined to 23 million. Today, it stands at 43 million. It has actually increased.

Now, you can say, okay, the population increased. So let us look at poverty rates. In 1959, the percentage of Americans in poverty was 19.3 percent in 1959. It had dropped to 12 percent by 1966, and today it stands at 14 percent, so it has actually increased. Again, all of our wonderful intentions on the War on Poverty, poverty rates have increased according to the Census Bureau.

And then out-of-wedlock birth rates. In 1940, they stood at four percent. By 1966, they are up to eight percent. They doubled, and people like Democratic Senator Patrick Moynihan was writing eloquently on his concern about that as a societal metric. Today, overall, that stands at 41 percent.

So, again, the question—again, I am very fact-based. I mean, we embarked on this $16 trillion War on Poverty, which just happens to, coincidentally, equal our national debt. We have not had those metrics turned down. It has not improved. I mean, do you have any explanation on maybe all those good intentions, how they could have actually contributed to the upward turn in those metrics?

Mr. GREENSTEIN. With all due respect, Senator, and a number of people use the metric, but the poverty metric example you just did, it really is not valid. Let me explain why.

Senator JOHNSON. Well, then—

Mr. GREENSTEIN. Let me—

Senator JOHNSON. No. Then deal with out-of-wedlock birth rates. I do not want to—

Mr. GREENSTEIN. No, no, no, no—

Senator JOHNSON. Let us do one that is really solid, out-of-wedlock birth rates, because it is—

Mr. GREENSTEIN. Let me try to do both.

Senator JOHNSON. Okay.

Mr. GREENSTEIN. It is very important. The official poverty rate only counts cash benefits. It does not count Food Stamps. It does not count the Earned Income Credit. It does not count the Child Credit. It does not count any of the things that expanded. It does count the cash welfare benefits, which went down.

Senator JOHNSON. Okay, good. Now comment on—

Mr. GREENSTEIN. Apples and oranges—

Senator JOHNSON. Now comment on out-of-wedlock birth rates that have gone from eight percent to 41 percent.

Mr. GREENSTEIN. Out-of-wedlock birth rates have gone up. They have gone up not only among the low-income population or the minority population. They have gone up broadly throughout U.S. society.

Senator JOHNSON. I know. Forty-one percent is average, and the minority population is far worse.

Mr. GREENSTEIN. I do not have the specific figures in my head. The point that I am making is—

Senator JOHNSON. Mr. Woodson, do you want to—

Mr. GREENSTEIN. —the research suggests that this is not primarily a result of the way particular social programs are structured, and the single program that was viewed as having the biggest adverse effect, the old welfare program, was dramatically changed in 1996. This is a larger question of societal-wide changes in mores and values.

Senator JOHNSON. Okay. Mr. Woodson, would you comment on that.

Mr. WOODSON. Yes. In the black community, as you know, it is about 70 percent. But it is interesting, in the years 1930 to 1940 in the black community, when we had no representation, when our poverty rates were much worse, we had a higher marriage rate than the white community. Even up until 1960, before the War on Poverty, 82 percent of all black families had a man and a woman raising children. And now, since the War on Poverty, that has gone up to about 70 percent.

So I think we have a series of policies that, first of all, discredits any moral influence institutions. But, also, we have provided disincentives for people to marry. As it has often been said, if you became pregnant out of wedlock, drop out of school and you can get more benefits. There are just endless examples in the black community of how we are being destroyed by these perverse incentives. And that is why I think benefits ought to be associated with personal responsibility.

All the witnesses that testified here, my colleagues on this panel, they all worked hard. They had a positive, life-affirming attitude. They were not where they were 20 years ago because of their own personal initiative, their own values.

But we discount this when it comes to addressing poverty. We never discuss the moral choices that people make and what are the institutions indigenous to those communities that help people to make better choices, to bring about redemption and transformation. We do not look at these as factors in our fight on poverty. We act as if poor people are the agents of incentives and disincentives rather than moral people whose attitudes and behavior are influenced by the chances that they take and the choices that they make.

Senator JOHNSON. Thank you very much.

Chairman MURRAY. Senator Kaine.

Senator KAINE. Thank you, Madam Chair, Mr. Ranking Member, colleagues, and to our witnesses today.

This committee will write a budget and we need to get it through the Senate by mid-April. A lot of the discussion has been a helpful discussion about kind of program design, and I think everyone around the table could agree, we want programs to be designed well. We want to minimize fraud. We want to minimize abuse. We want to minimize overlap. And your insights can help us do that. But the primary task of this committee is to write a budget.

Just real quick, I mean, I am new to the body, but I have done a lot of work on budgeting in the private sector and also as a mayor and Governor. We had a presentation yesterday—you are following a presentation from the CBO Director Dr. Doug Elmendorf, and his basic position in laying out historical data was that, right now, we do have a budgetary problem. We are spending more as a percentage of GDP than historical averages. And we are taxing, taking in revenue, less than historical averages. We all understand basic math. If you spend more than historical averages and you have taxes and revenue that are less than historic averages, you are going to have a challenge.

And I just wanted to kind of throw it to all of you and just announce to my colleagues, my basic belief about budgets is you cannot fix a balance sheet without fixing both sides of the balance sheet. If we are spending more than historic averages and our revenues are less than historic averages, then we need to fix both sides of the balance sheet. We can say, well, we just let taxes go up. We cannot do it again. We can say, we just cut spending, so, of course, we cannot do it again. But the way I look, and I just would love your thoughts, the only way we are going to be able to find a better budget path forward is to find smart ways to reduce spending, but also to have more revenue and trying to get this more toward historic averages and more in concert, and I would love any of your thoughts on that. Mr. Greenstein.

Mr. GREENSTEIN. I agree with that. I think there is even another formulation you could look at. You could say that the main focus could be on spending, but that that ought to include spending in the tax code as well as spending on the outlay side of the budget. We have $1.1 trillion a year in tax expenditures. President Reagan's Chief Economic Adviser for a number of years, Martin Feldstein, has called tax expenditures the least efficient, most wasteful part of spending in the Federal budget and the first place to look at to restrain spending.

I had the honor of being on the Deficit Commission, the Kerrey-Danforth Commission in 1994. Alan Greenspan testified before us and he said, tax expenditures are really tax entitlements and you ought to look at entitlements on both the spending and the tax side of the ledger.

It is also interesting when you look at the distribution. So the bulk of spending entitlements go to middle- and lower-income families and the bulk of tax expenditures go to the upper end of the range. So I think you could put together a package that was a balanced mix of changes on the spending side and changes on the tax expenditure, tax entitlement side, and come up with a package that does not hit hard while the economy is still weak, but you enact it now and it phases in over a number of years and it stabilizes the debt over the course of the decade.

Senator KAINE. Other thoughts on the fix both sides of the balance sheet? Sir, please.

Mr. ALEXANDER. States have to balance their budgets, as you know as a former Governor.

Senator KAINE. Yes.

Mr. ALEXANDER. And with revenues growing—

Senator KAINE. I have a lot of scar tissue on that one.

Mr. ALEXANDER. Well, me, too.

[Laughter.]

Mr. ALEXANDER. With revenues growing at a little over two percent and the programs that we operate growing at eight-plus percent, nine percent, some double-digit percent, year over year, other priorities in the State budget are crowded out—education, which is extremely important to make investments in, transportation so that we can create more and more jobs. And States do not have the luxury of waiting for the Federal Government to fix its own budget crisis. States have to fix them year after year after year, and at the point of spend we are at right now, as I said earlier, we are, in Pennsylvania, projected to spend over 50 percent of the State's budget in the next decade on these programs.

So they are important, but we need relief from Washington, flexibility from Washington, whether it is block grant and waivers, so that we can operate these in a much more simple fashion to be able to serve the people we need.

Senator KAINE. Mr. Woodson.

Mr. WOODSON. Yes. One example is that we can invest in social interventions that have the consequence of changing the risky behavior of people. In the City of Milwaukee, Wisconsin, for instance, during the last five years we have been engaged in a program with the school system. We have young adults advisors in the schools and we were able to reduce violence by 25 percent in the first three months, which means fewer police calls—

Senator KAINE. Do what works.

Mr. WOODSON. Do what works.

Senator KAINE. Secretary Alexander mentioned job training is an excellent example of something we should be investing in.

Mr. WOODSON. We have the data that shows that when you invest in interventions that alter people's behavior. The police are not called and fewer kids are being killed. That is the kind of intervention that we ought to be investing in.

Senator KAINE. Right. The last thing I will just say to Mr. Murray, I was at the hospital that you built Monday, and you have every reason—you and your colleagues—to be extremely proud. That is a wonderful facility.

Mr. MURRAY. Thank you very much.

Senator KAINE. Thank you, Madam Chair.

Chairman MURRAY. Thank you.

Senator AYOTTE.

Senator AYOTTE. Thank you, Madam Chair.

I want to thank the witnesses who are here. I also want to thank my constituent, Katyanne Zink, for her terrific story of success, and thank you so much for being here today. We really appreciate it and I am inspired by reading what you have done. Thank you.

I wanted to follow up, because I certainly would like to get the advice of our panel on how we could better improve what we are doing, because I think that, as Senator Warner pointed out, one of the issues we have is if you look at the CBO projections on if we continue on the trajectory that we are on in terms of interest payments, basically, it would take—crowd out and cover all of the spending we are doing as a safety net. I mean, there are certain pieces you could include, but the bulk of the spending that we would do. So if we do not come up with a deficit reduction plan, obviously, we are not going to be able to make the choices we would like to make for a safety net, our military, whatever the choices we want to make for our nation. So I think that we all recognize the urgency of doing this.

But some of you had mentioned—first of all, I want to thank Mr. Murray for his service. Thank you very much. You mentioned that you had some recommendations of how we could improve the experience you had at the VA, including upgrades to VA employees and also how we can improve recordkeeping, and I just wanted to get your advice on that.

Mr. MURRAY. Ma'am, the VA medical records are somewhat still paper. There was $126 million put into trying to upgrade the system. It came back last week that because the DOD medical record system is not necessarily compatible, it is very difficult for the VA to even transition to get those same records. Medical files being lost is delaying claims being processed. It is adding more work for the VA employees and a lot more headache for some of the veterans. That just adds to a lot more of the stress and turning people away from looking to get help.

Senator AYOTTE. Okay. I appreciate your advice on that, and I may follow up with some additional questions for you just so that I can understand fully how we could be better effective for the VA in both delivery and also electronic records, so I appreciate your testimony on that.

Secretary Alexander, as I understood what you had to say, that right now, for example, if you're receiving benefits in Pennsylvania, Federal benefits, there's no way to connect up to a national system so we could determine whether, for example, someone is defrauding the system and also seeking to obtain them in Arizona or some other State. Is this something you think is an important measure for us to take?

Mr. ALEXANDER. As long as the Federal Government is involved the way it is, I think that Washington should be monitoring, doing oversight on programs, providing broad performance measures for States to hit so that States can compete and innovate, and one of the things that they can do is establish that national database in real time so that States know if somebody is receiving benefits in another State. It takes us an enormous amount of time to be able to contact States to find if the person actually accesses benefits, and the Federal Government—I would see it as one of the duties of the Federal Government to be able to do something like that to help States out.

Senator AYOTTE. Also, I would like to ask Mr. Greenstein, I appreciate your being here. You said in your testimony that there are a number of reforms we should make, and I believe that Senator Warner said that you have been a champion of some reforms that we could make to better improve our safety net, our delivery systems. What are those? What recommendations would you make for us, because knowing the fiscal challenges that we face, we want to, of course, make sure that—I really agree with, certainly, what Mr. Woodson is saying, of create opportunities for people so that certainly our panelists and my constituent can have the type of success they have had. But also, if there are ways that we can improve our system to more efficiently deliver to make sure that those that need it the most get it and that we eliminate fraud, I would certainly appreciate your advice on that.

Mr. GREENSTEIN. Well, I think what Senator Warner was referring to were particularly things he and I and others have talked about in the context of deficit reduction. And I think on the spending side, it's pretty clear that the program that one would look at to make the single largest contribution to deficit reduction at this time is actually Medicare. And I think there are a variety of things to look at in Medicare.

On the provider side, I think there are some further savings to be had in Medicare Advantage and on drug pricing. On the beneficiary side, I think we can ask affluent beneficiaries to pay somewhat higher premiums. I think there are some things that can be done to restructure deductibles, cost sharing, and Medigap, so long as we do it in a way that does not impede access to care for, low income individuals, such as elderly widows at $15,000, $20,000 a year. There are other things in other programs, but in terms of the dollars, probably the single area at this point, if one is doing a budget plan, where one could in a careful way get the dollars is Medicare.

In the long term, we are going to need to find more ways to slow the growth of health care costs systemwide and that would yield benefits for Medicare, Medicaid, and other areas. There are hopeful signs in the degree of slowdown of health care costs in the last few years. Medicare costs last year rose only four-tenths of one percent per beneficiary. That is remarkable. But we do not know if it will last and we have to find ways systemwide to be reforming the delivery of health care that yield significant savings across Medicare and Medicaid and other programs.

Senator AYOTTE. So we need to reform it to preserve it, obviously. I think there is—just based on the sheer numbers.

Mr. GREENSTEIN. Excuse me?

Senator AYOTTE. We would need to reform Medicare just to preserve it, based on the sheer numbers and the actuarial analysis—

Mr. GREENSTEIN. Yes, but we do need to be careful. There is a lot we do not know yet. So we want to do the things we know we can do now without reducing the quality of care now, and they will fall well short of the savings we need for future decades. And as we learn more over the next several years with the big changes that are going on in health care delivery now in the private sector as well as demonstration projects and research, some private, some publicly funded. I think by later in the decade, we will be in a position to come back and do a second round of things that are perhaps a little more related to the structure of how the whole U.S. health care system delivers care.

Senator AYOTTE. And Mr. Greenstein—

Chairman MURRAY. I hate to interrupt, but—

Senator AYOTTE. I know my time is up—

Chairman MURRAY. —but we do have Senators who have been waiting, so thank you.

Senator AYOTTE. Thank you.

Senator SESSIONS. Could I just say, Madam Chair, that in our analysis of the numbers I have used, Medicare was not included. We are talking about the means tested poverty programs.

Chairman MURRAY. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Madam Chair.

Thank you to all of the witnesses, particularly Patrick Murray of Rhode Island. I am delighted that you are here and I thank you for your wonderful service to our country and I hope that, if you are lucky, maybe some of those Georgetown credits can be honored at the University of Rhode Island so you get a good URI degree.

[Laughter.]

Mr. MURRAY. It was actually the other way around.

[Laughter.]

Senator WHITEHOUSE. Well, I am delighted to have you here and I appreciate it.

Just to follow the conversation, there are, I think, inevitably, hard and necessary choices that have to be made when there is not enough money to go around. There are also tragic choices that have to be made when you make a bad decision and you miss an opportunity because of it. The hard things, you can understand. The tragic stuff would be really a shame. And I am worried that we are headed for tragic choices on Medicare and Medicaid if we do not appreciate, Mr. Greenstein, what you were saying, which is that you cannot cut Medicare and Medicaid enough to solve the problem of the underlying explosive cost growth of our health care system.

We cannot long manage a successful competitive enterprise in the United States of America in which 18 percent of our nation's

Gross Domestic Product gets burned up by our health care system when the most inefficient other country in the world that competes with us is at 12 percent. We cannot continue to pay a 50 percent inefficiency penalty and ignore that problem and instead look at Medicare and Medicaid simply because that is where the real problem happens to touch the Federal budget and then whack the elderly on Medicare, the families with disabled kids on Medicaid, while we are ignoring the real underlying problem, and I think that is a fight that we really need to clarify, because, among other things, we should have Common Cause in the fight for a more efficient health care system.

Senator Ayotte is from New Hampshire. Some of the best evidence about the opportunities in improving our health care system comes out of the Dartmouth studies, which are famous in this area. They show this huge variation in our country between States that deliver relatively low-cost, high-quality health care and other States that deliver very high-cost, low-quality health care. And when you drill down even further to cities, there are amazing differences in cost per capita, even adjusted for demographics. Al Franken represents Minnesota, which is a particularly high-quality, low-cost State, so he is always complaining about why they have to carry other States along that do a lousy job of providing decent health care.

The other great thing about addressing that problem, the real problem, is that what we have discovered is that the solutions are win-win solutions. And over and over again, private organizations that deal in this area—Kaiser, Intermountain in Utah, Gunderson Lutheran in Senator Johnson's home State of Wisconsin, Geisinger in Pennsylvania, and Rhode Island is a leader, as well, on this—when you improve the quality of care, you lower the cost. When people have a real working electronic health record that is integrated, it improves the quality of care. When you are not giving people hospital-acquired infections, which are now, I think, killing more Americans than, I forget, is it breast cancer and car accidents combined? I mean, it is a massive cost on our system, and you can be rid of them. We are virtually rid of them in Rhode Island because of work that we have done in our intensive care units.

We have to focus, I think, relentlessly on that, and I am going to use every opportunity I have to speak in this committee and anywhere else that I can, when we are talking about Medicare and Medicaid benefits being cut to solve this problem, we are looking at the wrong problem. We are misdiagnosing the problem. If we get it right on delivery system reform and can save $700 billion a year in this country, as the President's Council of Economic Advisers says, $750 billion a year, as the Institutes of Medicine say, a trillion dollars a year if you believe the Lewin Group and George Bush's Treasury Secretary, that is where we have to put our energy.

I am sorry, I am not going to ask a question because I spent all my time saying that, but it is immensely frustrating to have this conversation over and over again and have it be Groundhog Day on cutting Medicare benefits when we are not addressing in a meaningful way the most wasteful health care system in the world.

Chairman MURRAY. Senator Sanders.

Senator SANDERS. Thank you, Madam Chair.

Mr. Murray, thank you very much for your service to our country, and I thank all the panelists for being here.

I want to put this discussion in a broader context than just Federal Government policies. The United States is the only country in the industrialized world that does not guarantee health care to all people as a right. Some 45,000 Americans die each year because they do not get to a doctor when they should.

Secretary Alexander, my understanding—correct me if I am wrong—but according to the Kaiser Commission on Medicaid and the Uninsured, in the State of Pennsylvania, and I only pick out Pennsylvania because you are sitting here, there are 232,000 children who have no health insurance at all and there are 1.1 million adults who have no health insurance at all. Do you believe that all people should be entitled to health care? There are 50 million in America who have no health insurance. And what happens to a family making $25,000 a year who has no health insurance and has some kids?

Mr. ALEXANDER. Senator, you bring up a good point. I would say that all individuals should have access to quality health care. If a family, as you say, making $25,000 a year does not have access to health insurance, they will, if they need health care, go to an emergency room, which is very costly.

Senator SANDERS. Good.

Mr. ALEXANDER. Okay. I want to just—

Senator SANDERS. But let me just interrupt you, if I might—

Mr. ALEXANDER. Yes.

Senator SANDERS. —because your point is exactly correct.

Mr. ALEXANDER. Yes.

Senator SANDERS. My understanding is that going to, depending on location, going to an emergency room, you agree with me, is not the way to do primary health care.

Mr. ALEXANDER. Absolutely not.

Senator SANDERS. Okay. And it will cost ten times more than going to a community health center.

Mr. ALEXANDER. Correct.

Senator SANDERS. That is my understanding.

Mr. ALEXANDER. Yes.

Senator SANDERS. Continue.

Mr. ALEXANDER. Oh, okay.

Senator SANDERS. But your answer—we talk about government policy. You are not suggesting that the solution is we should have the hundreds of thousands of kids in Pennsylvania flock to the emergency room when they have the flu.

Mr. ALEXANDER. No, absolutely not, and that is why in my Governor's budget this year, he has invested more money in the CHIP program, which, as you know, was, I think, founded in Pennsylvania, and it is a very efficient program- -

Senator SANDERS. All right, but my—

Mr. ALEXANDER. —to be able to—

Senator SANDERS. I am sorry.

Mr. ALEXANDER. —to be able to ensure that children have access to care.

Senator SANDERS. I certainly agree with that.

Mr. ALEXANDER. What I would say is that we are operating an inefficient system—

Senator SANDERS. Yes.

Mr. ALEXANDER. —that is causing us to have to spend all of this money, and because of that, we cannot afford to provide more access to care. So to go back to—

Senator SANDERS. But in terms of inefficient, my understanding—and certainly Senator Whitehouse and I have been working on this issue—he and I understand that, as a nation, we spend almost twice as much per person on health care as any other, and you know why? Because all the other countries have universal national health care systems. Are you an advocate of a universal national health care system?

Mr. ALEXANDER. Not a Federal-run system.

Senator SANDERS. A Federal-State system, where everybody in America—

Mr. ALEXANDER. Not—the private sector would have to be involved, and so—

Senator SANDERS. If the private sector is involved, my guess is you are not going to cut the cost.

But let me ask you this. Anybody else can pipe in.

Mr. ALEXANDER. If—

Senator SANDERS. I am sorry. I do not have a whole lot of time.

Mr. ALEXANDER. Oh, okay. Sorry.

Senator SANDERS. I would love to dialogue.

Mr. ALEXANDER. Yes.

Senator SANDERS. Five minutes is not a long time.

Mr. Greenstein, we talk about—and Secretary Alexander raised this, Senator Sessions had raised this issue in a broad sense—one of the great welfare beneficiaries in this country, of course, as we know, is the Walton family, the wealthiest family in America. That one family owns more wealth than the bottom 40 percent of the American people, and yet one of the reasons they are so rich is the wages and benefits they provide to their workers force many of those people to be on Medicaid, housing programs, and Food Stamps. Do you think we should end the welfare program to the wealthiest family in America by raising the minimum wage and by asking them, in one form or another, to provide decent wages and benefits to their employees?

Mr. GREENSTEIN. I am very much in favor of raising the minimum wage. I was glad to hear the President propose it last night. Raising the minimum wage is not going to be sufficient. Its impact on reducing poverty is significant, but well short of what we need.

But if I could take this into a related area, we have had a lot of discussion today about discouraging people from working, marriage penalties and the like. One of the most important steps to make progress, not a full answer, just one important step, is actually the Affordable Care Act, because today, if a family is on Medicaid and maybe the mother gets married and the income goes up or the family's income rises, the parents lose eligibility, and if their employer does not offer coverage, they are uninsured. That is part of the poverty track.

Changing the law so that people who are lower-middle income, moderate families, above the poverty line, go to work and get coverage, whether the employer offers it or not, removes, eases that part of the poverty trap and it also reduces inefficiency, because one of the inefficiencies you and Senator Whitehouse are talking about is all the cost shifting that goes on to deal with uncompensated care for the uninsured.

Senator SANDERS. Right. Let me just say to Mr. Murray, one of the proposals that is being contemplated, which I vigorously oppose, along with the AFL–CIO, every veterans' organization, every senior organization, every disability organization, is the so-called chained CPI. That is a recalculation of how you determine what a COLA is. It would impact people on Social Security and it would impact disabled veterans.

Madam Chair, what I would like to do is introduce into the record a letter from the American Legion in opposition, and virtually every—all of the veterans' organizations, opposition to the chained CPI. Under the chained CPI, a disabled veteran who started receiving benefits at age 30 would have their benefits reduced by $1,425 at age 45, $2,300 at age 55, and over $3,000 at age 65. I do not believe that is the way you treat disabled veterans in this country and I would like to introduce the American Legion letter to the record.

[The letter from the American Legion follows:]

The American Legion

OFFICE OF THE NATIONAL COMMANDER

★ WASHINGTON OFFICE ★ 1608 "K" STREET, N.W. ★ WASHINGTON, D.C. 20006 ★
(202) 263-2986 ★

December 14, 2012

Honorable Harry Reid, Majority Leader
United States Senate
Washington, DC 20510

Honorable Mitch McConnell, Republican Leader
United States Senate
Washington, DC 20510

Honorable John Boehner, Speaker
United States House of Representatives
Washington, DC 20515

Honorable Nancy Pelosi, Democratic Leader
United States House of Representatives
Washington, DC 20515

Dear Leader Reid, Leader McConnell, Speaker Boehner, and Leader Pelosi:

As efforts to address our nation's debt continue, we understand many proposals and policies are being reviewed. One proposal appears to be the changing of the formula used to calculate the annual cost of living adjustment (COLA) that affects Social Security and other beneficiaries, including many veterans. On behalf of the 2.4 million members of The American Legion I voice our opposition to this proposal because of the harmful effects it will have on veterans' and Social Security benefits.

The Congressional Budget Office estimates adopting the chained consumer price index (CPI) to calculate annual COLAs could save the government $208 billion over ten years by reducing payments of Social Security, disability, and other benefits. More than half of this amount – $112 billion – would come from Social Security cuts, which many veterans rely on for both retirement and disability benefits. Another 11 percent of the savings – $24 billion – would come from Department of Veterans Affairs (VA) benefits, civilian pensions, and military retired pay. The American Legion opposes the use of the chained CPI because using it would have significant deleterious effects on the benefits millions of veterans depend on in the following ways:

Social Security Retirement Benefits: Adopting the chained CPI significantly reduces these benefits by changing the manner in which COLAs are determined. Not only would a Social Security COLA cut hurt veterans, their families, and their survivors; it is misguided public policy. Social Security is financed by the contributions of our members and their employers. In effect, it belongs to its contributors. It is separate from the rest of the budget. To use it to reduce the federal deficit, which it did not cause, breaks the promise of Social Security and it could have harmful effects on the recruitment and retention of the Armed Forces.

VA Service-connected Disability Compensation: Veterans are eligible for VA service-connected disability compensation if they become disabled due to injuries or illnesses incurred during, or as a result of, military service. Under the chained CPI, which cuts the formula used to determine the COLA for VA benefits, disabled veterans who receive this benefit would have their benefits reduced by thousands of dollars over their remaining life times.

VA Pension Benefits: Veterans with low incomes who are permanently and totally disabled, or are age 65 and older, may be eligible for pension benefits if they served during a period of war. Under the chained CPI, VA pension benefits for veterans aged 65 and older living in poverty would be reduced over their remaining life times.

Social Security and veterans' benefits do need to be based on an accurate measure of inflation. The current COLA formula already understates the true cost-of-living increases faced by seniors and people with disabilities because it does not take into account their higher share of spending devoted to health care, and health care prices rise more rapidly than overall prices. Even though veterans who have service-connected disabilities and those receiving pension benefits are eligible for VA health care, they will still be impacted by rising out-of-pocket health care costs not covered by the VA. Adopting the chained CPI would make their situations much worse over time.

The American Legion understands the need to restore fiscal discipline, but it should not be done by reneging on this country's promises to its veterans who already have earned these benefits through their service to country. For these veterans and their families, reducing the current COLA represents real sacrifice. We ask you not to do harm to those who have already sacrificed so much for this great nation.

Thank you for your consideration. And thank you for what you have done on behalf of the nation's servicemembers, veterans, and their families and survivors.

Sincerely,

James E. "Jim" Koutz
JAMES E. 'JIM' KOUTZ
National Commander

Chairman MURRAY. Without objection, and thank you, Senator. Senator STABENOW.

Senator STABENOW. Well, thank you very much, Madam Chair, for this very important hearing and bringing the voices of real people who have experienced the issues and the programs that we are working on. Thank you very much.

I first want to say I agree with Senator Whitehouse, and Senator Sanders mentioned, as well, about inefficiencies in the health care system. Michigan started something called the Keystone Quality Initiative, which is in health reform, which has shown very specifically how we can address cost.

And, also, I think it is important, Mr. Greenstein, as you talked about in health reform, we begin—we are beginning the process of bringing down the rate of growth, and so on Medicare Advantage, I believe, last year, the premiums went up—were actually reduced seven percent because of changes that we have been putting in place, and we definitely want to get folks out of emergency rooms and into what will be a public-private sector system starting in January, where the private sector is involved in a competitive way.

I would like to go back with my hat on chairing the Agriculture Committee, since we have been deeply involved in looking for ways to address waste, fraud, and abuse throughout that system, including the nutrition programs, and Mr. Greenstein, thank you for your input as we look for ways to be able to do that. Certainly, whether it is the Crop Insurance Program, which is a safety net for farmers during times of disaster, or nutrition programs, which are a safety net for families during times of disaster, we have been looking at all of that.

Could you speak to what I know is actually the error rate in the SNAP program? It is my understanding, correct me if I am wrong, that the error rate on overpayments is actually 2.9 percent, which we found to be less than anything else under the jurisdiction of the Agriculture Committee. But could you speak to what is actually the error rate as we look at this program and we want to make sure it is going to the families that need it?

Mr. GREENSTEIN. Yes. There has really been very strong progress here. The error rate, as you said—the combined rate of payments to people who are ineligible and overpayments to people who are eligible, the two combined are now only about three percent of total program payments. That is maybe a fifth below the error rate in the tax code, for example.

I would have to disagree with something Mr. Alexander said earlier in response to a question from Senator Sessions. He questioned whether the error rate was really that low because he talked about how difficult it was for caseworkers to check all of this information. The error rate does not come from what caseworkers do. The error rate is computed under very strict rules under which a national sample of something like 50,000 households is chosen, and not caseworkers but trained investigators spend an average of something like 12 hours per family. They sometimes go to their homes. They check the automatic wage records. And then after those reviewers come up with the error rate, Federal investigators take a sample of what the State looked at and further review it, and if they find that the State investigators underestimated the error rate, they adjust it up.

So, yes, the figure is not perfect, but it is one of the most rigorous set of analyses of error rates we have in any program. If we did something as rigorous in the tax code, you would not want to know what the result would be.

So this is not perfect. More progress can be made. But it is significant progress and it is a quite low error rate for a program of that size.

Senator STABENOW. And in the five-year farm bill we pass in the Senate, we did even more by looking at areas where there have been abuses. In my State of Michigan, we had two people who won the lottery that were able to continue on food assistance. We eliminated that and looked at a variety of other things to tighten up the system and to actually create more savings. And so I am actually very proud of the collective work that we have done to focus on waste, fraud, and abuse.

Could you also speak, though, Mr. Greenstein, and maybe you did earlier, but just because the food programs follow the economy, and certainly as all of these programs do, when we have more crop disasters, Crop Insurance goes up. It goes down when we have fewer disasters. In the area of SNAP, it is my understanding the CBO number that we have received, the new number we are working with as we write a new farm bill is that the food programs are actually going to be down over the next ten years by $11.5 billion because the economy is getting better, people are going back to work, and they, frankly, do not need to have the help. Could you speak to that more?

Mr. GREENSTEIN. Yes. SNAP is one of the most responsive of all programs to the economy. The CBO projections are that by about 2019, SNAP spending as a share of the economy will be all the way back to its 1995 level. It has gone way up—

Senator STABENOW. Nineteen-ninety-five?

Mr. GREENSTEIN. As a share of GDP. It is also—there has been a little bit of misunderstanding. Some people look back just ten years and say, look at how big the increase in SNAP was. But ten years ago was an unusual low point. What happened is that following passage of welfare reform in 1996, something unintended occurred in the initial implementation which was lots of people leaving welfare for work lost their Food Stamps, as well, which then lessened the incentive to go to work. There was a bipartisan agreement that this should be addressed and it was. And we had ten years ago a remarkably low percentage of eligible working poor families getting Food Stamps. You do not want a situation where everybody on welfare gets something and the working poor do not. So that has been corrected and that contributed to the expansion of the program.

But even with that, the CBO estimates show that by 2018, we will be back to levels of many years ago in terms of SNAP expenditures as a share of GDP. And if a program's costs are not rising over future decades as a share of GDP, then it cannot really be said to be contributing to the long-term fiscal problem.

Senator STABENOW. Thank you.

Chairman MURRAY. Thank you very much.

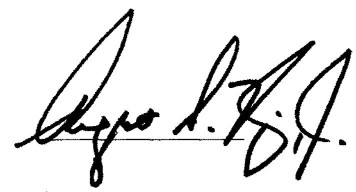
We have run out of our time here, and I want to really thank the participation of all our colleagues on the committee. I especially want to thank all of our panel members today, particularly Tara Marks and Patrick Murray. As I said at the beginning of this hearing, I am really committed to making sure that your stories are heard and your families and communities have a seat at the table as we discuss these really important issues, and today's hearing was a small but important step in making progress on that.

As a reminder to all of my colleagues, additional statements and/ or questions for any of the witnesses from today's hearing are due in by 6:00 p.m. today, to be submitted to the Chief Clerk in Room 624.

I do plan on the committee holding one or more hearings the week we return, the week of the 25th, and we will have more information to your offices on that in the next several days.

With that, again, thank you very much to all of our witnesses and I call this hearing to a close.

[Whereupon, at 12:17 p.m., the committee was adjourned.]



Statement for the Record
from Senator Angus S. King, Jr.
Impact of Budget Decisions on Families and Communities
February 13, 2013
Senate Budget Committee

Chairman Murray, Senator Sessions, fellow Members of the Budget Committee: Thank you for the opportunity to discuss the federal budget and its long-term impact on American families and communities. Too often, discussions about budgets, debt, and deficits fail to include the perspectives of ordinary Americans and those most affected by decisions made at the federal level. As this Committee moves forward with our work to address our nation's challenges, I believe that we must balance our commitment to safety net programs with the need to put America back on a path to fiscal responsibility and economic prosperity.

I would also like to thank all of our hearing's witnesses for sharing their time and expertise, which provide valuable insights to this Committee.

Patrick Murray
Question for the Record
From Sen. Kelly Ayotte (R-NH)
February 20, 2013

Question: *While you were able to briefly discuss your recommendations on how to improve the experience at the Veteran's Administration (VA), please provide a more detailed description of each of those recommendations so that Congress can create a better, more efficient VA.*

Answer: The fundamental problem facing the departments of Veterans Affairs (VA) and Defense (DoD) in developing the Integrated Electronic Health Record (iHER) is the inability of the three military medical commands (Navy, Army and Air Force) to communicate with one another. From this point, VA has a near-impossible task of deciphering military health records into something that is compatible with VA's own proprietary health care record system.

When Secretaries Panetta and Shinseki broke the news last month that they would scrap plans to develop iHER from the ground up, Senators like Committee Chairman Patty Murray chastised VA and DoD for wasting more than $1 billion over the last four years on the project.

As a wounded Marine who relied on the Navy's health care system, but needed to recover at Walter Reed Army Medical Center, I learned back in 2006 that the different military networks can't easily speak to one other. How did VA and DoD not see this coming? Now, the secretaries are saying they can set benchmarks to integrate the military record-keeping systems without much more investment. How did it take four years and a billion dollars to figure that out?

Seamless record-keeping is long overdue and, if implemented, could save time and money for every department involved. The first step is reconciling the record systems for each military branch, then allowing seamless communication between the military and VA. Again, as a veteran, it makes no sense to me that VA – a federal agency that only serves former military personnel – still cannot communicate readily with DoD.

VA has taken steps to improve how it interacts with veterans online, but they seem to have gone about it the wrong way. Veterans Benefits Administration developed the eBenefits online portal, which is based on the military's DEERS system, and the Veterans Health Administration developed its proprietary MyHealtheVet portal. On eBenefits, veterans can check the status of their disability claims, GI Bill processing and apply for home loan eligibility. On MyHealtheVet, veterans can review VA medical records and send secure messages to care providers. Unfortunately, veterans need to enroll in the systems at different times, veterans have a different username and password for each system, and the systems are not interoperable. To the average veteran, this makes no sense. While both portals offer good tools and seem to be improving every day, veterans would be better served to have access to one online portal through which they could navigate all VA services.

VA is not alone in managing redundant and confusing programs designed to better serve veterans. When veterans don't know where to go for the right answer, odds are that a program isn't working correctly. This is why I believe savings could be easily found across the federal government by better managing resources and initiatives for veterans across federal agencies. Veterans should have a single point of access and efforts should be managed by a single point of contact to avoid redundancy across agencies like VA, DoD, Housing and Urban Development, Small Business Administration, Department of Homeland Security, or any of the others with responsibility over a veterans' program.

When I was filing my VA disability claim in 2006, my paper military health care record was temporarily lost in transit around VA. Eventually I learned that it arrived at a VA regional office in Colorado. I share this story because it emphasizes both shortcomings I see in the current VA system: Poor record-keeping and the quality of employees.

In 2006, there was no reason why VA and DoD health care systems couldn't communicate effectively, and it's even more inexcusable today. Plus, when I asked some pointed questions to a VA employee about why my records were lost, the person on the other end of the phone insisted that I either lived in Colorado or somehow sent it to their office in error. I was furious – especially now that I know another regional office likely farmed out my claim to the regional office in Colorado, unbeknown to me and the VA employee on the other end of the phone.

Still, why must VA employees consistently treat me and my fellow veterans as if we're a burden? I believe that we are VA's customers and I know that Secretary Shinseki agrees with me. VA has invested a tremendous amount of taxpayer money trying to convince veterans from my generation to come into the VA system and use our earned benefits. These remarkable benefits like health care and the GI Bill can help veterans like me get our lives in order after military service. Unfortunately, many veterans are driven away because of bad experiences interacting with ambivalent VA personnel both in person and over the phone.

I do not want to lump all VA employees together. Some of the men and women who work for the department are hard-working and dedicated. But they are consistently overshadowed by the "bad apples." In an effort to improve this situation, VA first needs to invest in quality veteran employees. Veterans like dealing with veterans, so I echo Secretary Shinseki's call to make VA the most "veteran-friendly" employer in the federal government. Beyond this, employees need better training. They need to understand customer service, strive to meet the needs of their customers, and face reprimand if they fail to meet expectations. When I worked for Turner Construction, I knew that if I consistently failed at my job, Turner would have no qualms about firing me. Underperforming VA employees need to face the same kind of scrutiny.

Thank you for the opportunity and I welcome any additional questions you may have on this issue.

Question #1:

During the hearing, I questioned you about your recommendations on how to reform our safety net programs, and you responded with some recommendations on Medicare and Medicaid. Please describe any recommendations you have for any other welfare or poverty programs.

While the safety net has gotten *stronger* in recent years for low-income working families who struggle to make ends meet because of their low wages, the safety net has gotten *weaker* for poor families in which a parent struggles to find and keep a job. More could be done to improve outcomes for these families and doing so could significantly improve prospects for the children in the families.

Using Census data and counting non-cash benefits as income, as most analysts favor, the number (and percentage) of children living in deep poverty — below *half* of the poverty line — increased by 650,000 between 1995 and 2005, even before the economy turned down.[1] The welfare law played a role here. On the one hand, changes wrought by the 1996 welfare law, in combination with expansions in the EITC and, in the late 1990s, a very strong labor market, pulled more single-mother families into the labor market and raised many of their incomes. This was a very positive development. But at the same time, the welfare changes also deepened poverty among another group of single-mother families — including some mothers with less education and skills and more physical, mental health, or other problems. Increased earnings, supplemented by the EITC, lifted some families out of poverty. But other families fell deeper into poverty as a result of having neither earnings nor cash assistance (or earnings that the loss of cash assistance more than offset).

The data indicate that this was the primary cause of the increase in deep poverty. In 1995, cash assistance provided by the former AFDC program lifted 2.2 million children out of deep poverty. It raised 62 percent of the children who otherwise would have been *below* half of the poverty line *above* that level. By 2005, cash assistance provided under the Temporary Assistance to Needy Families (TANF) block grant lifted 650,000 children above half of the poverty level, or just 21 percent of those who otherwise would be in deep poverty.

The same phenomenon is reflected in a recent study by poverty researchers that finds that both the number of families and the number of children who live below a standard that the World Bank uses to measure serious poverty in third-world countries — living on less than $2 per person per day — has doubled in the United States since 1995.[b]

These findings are of particular concern in light of emerging research that shows that among low-income families, the level of family income when a child is young affects his or her school achievement and may well influence later employment and earnings as an adult.[2]

It bears noting that were it not for SNAP, the rise in severe poverty would be substantially worse. The data show that SNAP cuts nearly in half the percentage of children living below the

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[1] In this measure, non-cash benefits are counted (and taxes subtracted), consistent with the broad measures of poverty.

[2] H. Luke Shaefer and Kathryn Edin, "Extreme Poverty in the United States, 1996 to 2011," National Poverty Center, 2012, http://npc.umich.edu/publications/policy_briefs/brief28/

aforementioned World Bank poverty standard. (In 1996, a number of the Republican members of the House Ways and Means Committee responded to criticisms that the welfare reform legislation would harm poor children in part by noting that food stamps would remain as a floor under poor children.)

This evidence suggests that the Temporary Assistance for Needy Families (TANF) program could be doing a better job in helping the most disadvantaged parents prepare for, find and keep a job. States from across the political spectrum have reported that overly prescriptive federal TANF requirements have hindered some of their efforts to innovate within their TANF programs and develop more effective employment programs. And, many states have indicated that they would prefer to be held accountable for outcome measures — such as their success in helping people get jobs — than be required to comply with detailed federal "bookkeeping" rules that limit their ability to tailor employment services to the needs of their families.

The Department of Health and Human Services issued guidance last year to allow states to apply for waivers of those prescriptive rules if they were willing to be held accountable for improving real, measurable employment outcomes for TANF recipients. Given the importance of finding more effective ways to help parents succeed in today's labor market, allowing states more flexibility to test new approaches — and carefully evaluating the effectiveness of those approaches — holds promise for improving outcomes for both parents and their children.

Response to Questions from Senator King

Question. Bob, thank you for your testimony on the impact of federal budget decisions on families and communities. In your statement, you advocate that deficit reduction should be designed carefully to not impede our economic recovery and that it should not increase poverty or adversely affect the disadvantaged. Both the Simpson-Bowles report and the 2011 bipartisan Gang of Six plan share this principle.

Given that the unsustainable rise in health care costs is the largest single threat to long-term fiscal sustainability, how would you advise addressing increases in health care expenditures while maintaining access to quality care? What steps can this committee take to ensure that we protect the most vulnerable members of society without simply shifting the costs to states, individuals, and private employers?

Answer. Some changes to Medicare can achieve budgetary savings over the next ten years while preserving Medicare's defined benefit, and without raising the eligibility age or otherwise shifting costs onto vulnerable beneficiaries. These include:

- Ending the excess prices that Medicare pays for drugs for low-income beneficiaries,
- Eliminating remaining overpayments to Medicare Advantage plans,
- Reducing payments to post-acute-care providers, as proposed by the Administration,
- Expanding the scope and size of Medicare's income-tested premiums, and
- Restructuring Medicare cost-sharing and limiting Medigap and other supplemental insurance in a way that protects low- and moderate-income beneficiaries.

Additional steps will need to be taken to slow the growth of health care costs in the longer run, but we currently lack much of the information needed to do so without impairing access or reducing quality. The Affordable Care Act begins to restructure the health care payment and delivery system to stop paying providers for more visits or procedures and begin rewarding effective, high-value health care. If successful, the ACA reforms hold the potential to both bend the cost curve and improve the quality of care. Making major changes in Medicare before we know the results of these efforts, however, would be ill-advised and could produce unintended consequence. Fortunately, the recent slowdown in the growth of health care costs reduces pressure for overly hasty action and provides time to collect the necessary data.

Question. In your testimony, you also raise concerns about the growth of federal tax expenditures as a share of the federal budget. It is my view that reforming tax expenditures in order to achieve credible deficit reduction should be prioritized before cutting federal discretionary spending.

What recommendations do you have for this committee on reforms to our tax code?

Of these recommendations, which do you see as having the most potential for achieving bipartisan consensus?

Answer. Senator King, I agree with you that future deficit-reduction efforts should prioritize reductions in tax expenditures over further reductions in discretionary spending. Both defense and nondefense discretionary funding are subject to tight caps imposed as part of the Budget Control Act in 2011. Indeed, under these caps, nondefense spending by 2017 will fall to its lowest level since 1962 (the earliest year on record). This part of the budget funds a diverse set of programs, including those such as education and scientific research that will affect the future productivity of the economy. So further reductions would be unwise. In contrast, the focus of the tax policy changes to date has not been on tax expenditures, and this area of the budget is ripe for reform.

The soundest approach to tax expenditure reform would be to examine each tax expenditure on its merits and to eliminate or restructure expenditures individually, as warranted. However during last year's budget negotiations and even during the Presidential campaign, there was some bipartisan interest in addressing tax expenditures through a type of across-the-board limitation. This approach has the attraction of treating a number of tax expenditures in a similar fashion and obviates the need for Congress to develop extensive reforms specific to a large number of individual provisions. A well-designed limitation could retain tax subsidies to encourage activities regarded as producing social or economic benefits, but limit those subsidies to make them more cost-effective and less regressive, and deliver substantial deficit reduction savings.

Of the various limitation proposals that have emerged to date, the President's proposal to limit the value of itemized deductions and certain other tax expenditures to 28 cents on the dollar has the soundest design. It would retain tax incentives for desired activities (such as charitable giving) rather than eliminating such incentives altogether for some taxpayers, reduce tax-code inefficiencies (under which high-income taxpayers get larger tax-incentive subsidies to undertake certain activities than lower- and middle-income households do, even when the high-income taxpayers generally would engage in the activities anyway and lower- and middle-income households are the ones more responsive to the tax incentives), and be progressive.

Policymakers also should scrutinize, and narrow or close, various tax breaks that allow very affluent individuals to pay much lower or no taxes on certain forms of income. In many cases, these tax breaks cannot be addressed through an across-the-board tax expenditure limit, or it may make more sense to restructure (or repeal) these tax breaks directly. Examples of such tax breaks include the "carried interest" tax break on the compensation of hedge fund managers and the loophole that allows S corporation owners to avoid their full payroll tax liability.

THE IMPACT OF FEDERAL INVESTMENTS ON PEOPLE, COMMUNITIES, AND LONG–TERM ECONOMIC GROWTH

TUESDAY, FEBRUARY 26, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Committee met, pursuant to notice, at 10:31 a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, Chairman of the Committee, presiding.

Present: Senators Murray, Wyden, Whitehouse, Warner, Baldwin, Kaine, King, Sessions, Toomey, Johnson, Ayotte, and Wicker.

Staff Present: Evan T. Schatz, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. Good morning. This hearing will come to order, and I want to thank all of our witnesses who are here with us today, who I will introduce in just a few minutes, as well as our Ranking Member, Senator Sessions, and all of our colleagues who are joining us here today.

The Budget Committee is a place where some of the most important questions facing our Nation are asked and hopefully where we can come together in a responsible way to answer them. Many of those questions will be about how we can tackle our debt and deficit challenges responsibly, and while this is important, it is not all this Committee is about.

A budget is a reflection of our values and priorities. It is a vision for what we believe creates economic success and broad-based national prosperity. It outlines our short- and our long-term economic policies. It is where we make decisions about what kind of Nation we want to be now and where we lay down the foundation for accomplishing even more in the years ahead.

This last point is what we will be discussing in today's hearing—the role and impact of Federal investment on people, communities, and long-term economic growth. And it is going to be a critical part of the pro-growth, pro-middle-class budget resolution we are working to write, because there is no question getting our debt and deficit under control is a challenge we have to confront.

But we have many other challenges we cannot ignore. We need to repair our crumbling roads, bridges, and highways. We need to ensure our students receive an education that offers them the opportunities they deserve and ensures our Nation has a skilled workforce for the 21st century. And we need to fight to maintain our edge in research and innovation because the next Apples or Microsoft or Google should be started right here in the United States.

These are the kinds of investments that make us stronger, and as any businessperson will tell you, when you have a budget problem, the last areas you want to cut are those that will help you grow. Slashing R&D or capital investments may allow a business to look like they are lean and efficient in the short term, but only by undermining their competitive advantages over the long run.

The same is true for the Federal Government. Both parties used to understand this.

Strong Federal investments played a key role in the broad-based economic growth that carried millions of families into the middle class in the 20th century.

The Simpson-Bowles Commission report stated that one of its guiding principles and values was to invest in education, infrastructure, and high-value research and development to help our economy grow, to keep us globally competitive, and to make it easier for businesses to create jobs. But that bipartisan consensus seems to have eroded.

Recently, more and more lawmakers here in Washington, D.C., have focused on shrinking short-term numbers, regardless of the impact on jobs and economic growth. This has led to attempts, too often successful, to choke off the investments today that could make all the difference down the line.

The fact is that if we slash our investments in infrastructure like roads and bridges, we are not really saving money at all. We are making things worse. We are weakening our basis for private investment and economic growth; we are putting public safety at risk; and congestion is taxing families times with painfully long commutes and health-threatening pollution.

Roads are going to need to be fixed eventually. Bridges will need to be strengthened at some point before they collapse, and waiting will only make the work more expensive when we eventually do it. And what will happen in the meantime?

When a bridge deteriorates, at some point it is no longer safe for heavier traffic such as emergency vehicles or large trucks. When roads fill with potholes, it makes traffic worse and driving more dangerous. So our families are less safe, our businesses cannot move their goods quickly, and all just to save money in the short term. It is short-sighted and does not make sense.

The American Society of Civil Engineers released a report card for America's infrastructure back in 2009. Our country got a D. More than 70,000 of our bridges across the country have been deemed "structurally deficient." We are not keeping up with the repairs and have not for years, much less accounting for the growth of our country's population.

This is an area where you see agreement from the U.S. Chamber of Commerce, major labor groups like AFL–CIO, and economists and policy experts across the political spectrum. Investing in infrastructure creates jobs today, makes our families safer, and lays down a strong foundation for long- term growth.

We are going to be hearing more about transportation infrastructure investments from one of our witnesses, the Under Secretary for Policy at the U.S. Department of Transportation, Polly Trottenberg. But this is a clear case where investment cuts make our short-term budget deficit look better on paper, but cost us more in the long run and make other deficits worse—in this case, our infrastructure deficit.

But it is not the only one. When we slash investments in our schools, Pell grants, or worker training programs, we increase our skills and education deficit. This is not good for our students and workers, and it is devastating for our economy over the long run. Investments in education from early childhood programs through college are some of the smartest the Federal Government can make.

According to a study done at the University of Chicago by Nobel Prize winner Dr. James Heckman, high-quality early childhood education programs have a 7- to 10-percent rate of return through better educational outcomes. We also know those with a high school diploma or less are more likely to be unemployed, to be among the long-term unemployed, and earn substantially less than their counterparts. And according to the Bureau of Labor Statistics, workers with a college degree can expect to make about $1 million more over the course of their career than those with a high school diploma.

But this is not just a problem for the people and families directly affected. It is a challenge for our Nation. If our workers do not have the skills they need to fill the jobs of today and tomorrow, our economy and our businesses pay the price, too. Among our Nation's manufacturers, 82 percent report a moderate to serious skills gap in their skilled positions. Seventy-four percent say that this skills gap has negatively impacted their business and 70 percent expect it to get worse.

McKinsey Global Institute estimates that the U.S. will need to produce roughly a million more postsecondary degrees by 2020, 40 percent more than today, to ensure we have the skilled workers our economy needs.

One of the witnesses we will hear from today, Tony Carnevale, the director of the Georgetown University Center on Education and the Workforce, has estimated that by 2018 nearly two-thirds of U.S. jobs will require some education or training beyond a high school diploma.

We know these investments pay off. In my home State of Washington, for example, a study found that the return on investment is 7:1 for the resources put into serving dislocated workers, 13:1 for the postsecondary professional and technical education offered through the Perkins Act, 87:1 on Perkins funding at the secondary school level, and an astounding 91:1 on apprenticeship programs.

We simply cannot expect our economy to grow in a way that creates broad-based prosperity if we continue allowing our skills and education deficit to increase. If our businesses are going to be creating 21st century jobs, we need our students and workers to have 21st century skills.

Today we will also be hearing more about the role of Federal investments in research and innovation from Hunter Rawlings, the president of the Association of American Universities. These investments have led to private sector growth in areas from pharmaceuticals to the Internet to GPS and much more. They have led to new industries, new drugs, new interventions, and new jobs. They have led to private sector growth in areas such as pharmaceuticals, the Internet, communication technology, products that keep our troops safe, the development of alternative energy sources and improved energy efficiencies, and much more. They have led to new industries, new drugs, new interventions. They have provided jobs. They have expanded our economy. Today 40 percent of U.S. GDP, $6 trillion, comes from companies that did not exist 30 years ago.

Innovation is beneficial for the economy overall but also for families. A recent review by the Hamilton Project described how innovation improves life expectancy, makes technology affordable, and improves standards of living.

The United States has been a leader in this area for decades, and we cannot afford for countries that understand the value of these long-term investments to overtake us. Cutting these investments off would help our budget deficit in the short term, but only at the expense of long-term increases in our research and innovation deficits, and that does not make sense.

Although the role of Federal investments is an important issue for us to address in the context of the pro- growth budget resolution we are currently working to write, this conversation is especially appropriate as we head toward the March 1st sequestration deadline.

I remain hopeful that we can find a balanced and bipartisan replacement to sequestration in the next few days, but if we cannot, investments in people, communities, and innovation would be hit hard. According to the White House, Title I education funding would be eliminated for more than 2,700 schools, cutting support for nearly 1.2 million students and putting thousands of teacher jobs at risk. Head Start would be eliminated for approximately 70,000 students, and over 7,000 special education staff would lose their jobs. The National Institutes of Health and the National Science Foundation would have to delay or end scientific projects and make hundreds fewer research awards, which would mean an estimated 200,000 fewer jobs across America. And the FDA's Center for Drug Evaluation and Research would face cutbacks which would cause delays on new drug approval.

This, of course, would come alongside the hundreds of thousands of jobs lost, major cuts to defense and nondefense programs, and the economic impact that could be devastating to our fragile economy.

Even for people who think that investments need to be cut, sequestration is an awful and short-sighted way to do it. And I hope Republicans join us soon and work with us to replace it with a balanced mix of responsible spending cuts and new revenue from those who can afford it most.

Now, I already mentioned the three witnesses that were invited by the majority, and Senator Sessions will introduce the witnesses he has invited, but I want to thank David Malpass and Stephen Ferguson as well for taking the time to be here today.

And I am looking forward to hearing more from all of our witnesses about the role of Federal investments and the impact of automatic cuts. This is going to be an important issue for us as we work on our budget resolution here in the Senate.

We absolutely need to tackle our debt and deficit. We need to cut spending responsibly. And of course, for Government investments to truly pay off, we need private industry to succeed and innovate and create jobs.

I believe smart Federal investments will create jobs and help the middle class right now, they will help lay down a strong foundation for long-term and broad-based economic growth, and they will help position our country and our economy to compete and win in the 21st century global economy.

Recent Republican budgets have moved away from these critical national investments, but I am really hopeful that the bipartisan work can continue to make sure we leave our children a stronger country than the one we received. And I am looking forward to engaging the American public in this debate that is so central to their economic future.

And with that, I will turn it over to Senator Sessions for his opening statement.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Madam Chairman, and I appreciate this hearing, which deals with an important subject—Government spending, and long-term economic growth. It provides an important opportunity to address the economic harm that is caused by excessive Federal spending and debt.

We will examine studies showing that the expansion of the Federal Government can actually depress economic growth, hurting all Americans, especially those who work their way out of poverty.

The truth is that growth and prosperity is furthered by a lean, responsive, limited Government that can sustain itself, not an ever-growing, debt-incurring, amorphous entity like the Great Blob.

Madam Chairman, you mentioned that 40 percent of businesses did not exist 10 years ago. I would doubt that any of those—what is that?

Senator WHITEHOUSE. I am sorry. I did not hear the Ranking Member. Did he say "the great block" or "the great blob"?

Senator SESSIONS. I said "the Great Blob."

Senator WHITEHOUSE. "Blob," okay.

Senator SESSIONS. Metaphorically suggesting that ever-growing Federal investments can turn into a Federally financed Great Blob.

So those businesses for the most part, I am sure, had

no knowledge whatsoever of Washington, D.C., participating in their creation. And we do need to deal with cutting spending responsibly, but what we are seeing today is nothing is responsible. Every cut in spending is resisted as being fatally damaging to the Republic.

And I do not think slowing the growth in spending—which is what we are talking about. Indeed, we are projected to increase spending in the next decade by $10 trillion. The cuts in the Budget Control Act would have allowed that increase to go up 8 instead of 10.

Tomorrow will mark 1,400 days since the Senate held a budget, but hopefully we can work our way through this year and get us a budget. I think it will help us.

But today we will hear from two witnesses who will explain the human consequences of large Government and surging deficits. David Malpass, a writer who writes for Forbes and the Wall Street Journal, a former staffer on this Committee for tax policy and many other such positions in his background, will review the growing body of evidence about excessive spending and how large debt suppresses growth, job creation, and lowers—keeps higher wages from occurring.

Steve Ferguson, chairman of the Cook Group, a private entity, a business, will talk about how the President's health care law and its new taxes are hampering medical innovation and research that could save thousands of lives.

We remain on an unsustainable debt course, and one major reason for that is the lack of honesty in evaluating the cost of new spending programs and the benefits, which are exaggerated. Invariably, the projected costs are underestimated—good politics maybe, but not good policy.

A new Government report dramatically proves that the promises made assuring the Nation that the largest new entitlement program in history since Medicare, the President's health care program, would not add a dime to the long- or short-term debt of America was false. Just this morning, the nonpartisan Government Accountability Office released a report I requested regarding the deficit impact of the President's health care law. The results of this brand-new report confirm everything critics and Republicans were saying about the cost of this bill and reveal the dramatic falsehoods that were used to push it to passage.

At the signing ceremony for the Patient Protection and Affordable Care Act, the President claimed that his law would "lower costs for families and for businesses and for the Federal Government." The President went on to say, "It is paid for. It is fiscally responsible."

On her website, then-Speaker Pelosi said the bill is "the great deficit reduction effort in two decades."

Speaking before a joint session of Congress in 2009, the President had this to say: "And here's what you need to know. First, I will not sign a plan that adds one dime to our deficits, either now or in the future. I will not sign it if it adds one dime to the deficit, period, now or in the future, period." Pretty much like "Read my lips."

But the GAO's investigation reveals these claims to be false. According to GAO, under a realistic set of assumptions, the health care law will increase the deficit by seven-tenths of 1 percent of GDP or roughly $6.2 trillion over the next 75 years—$6.2 trillion unfunded liability of the United States. In other words, the GAO reveals that the big tax increases in the bill come nowhere close to covering the even more massive spending. Again, $6.2 trillion is only a fraction of what the bill will spend, but that number is how much new deficit spending, excluding interest costs, will result despite trillions in new taxes.

The Big Government crowd in Washington manipulated the numbers in order to get the financial score they wanted, in order to get their bill passed and to increase power and influence. The goal was not truth or financial responsibility, but to pass the bill. This is how a country goes broke. It is also how the economy and jobs are destroyed.

Economic research by a wide spectrum of organizations has discovered harmful economic impacts from excessive levels of Government debt. When total Government debt rises near or above 90 percent of GDP—and our gross debt now is over 100 percent—the economy slows, resulting in fewer jobs, smaller paychecks for working Americans.

Using this research, Dr. Salim Furth from Heritage estimated that even "a two-tenths of 1 percentage point drop in the annual GDP growth over the next 10 years would cost Americans $1.9 trillion in income." He further estimates that from 2009 to 2011, 3 years has already cost Americans $200 billion in foregone growth, which is nearly a full year of normal GDP growth.

At this point in history, the key to producing greater economic growth is returning Government spending to responsible levels. Attempting to combat the debt drag through higher taxes just will not work.

First, the Federal debt is projected to grow by $9 trillion over the next decade, and there is no tax hike large enough to stem that tide.

Second, raising taxes would produce the same economic harms as high debt. It drains wealth and weakens the private job-creating sector.

The problem is spending is growing faster than the economy, which is what Mr. Elmendorf told us at the last hearing. There is no free lunch. Nothing comes from nothing. Everything consumed will be paid for sooner or later. Reforming and making more productive failing Government programs is not only an economic necessity but a moral necessity. Raising taxes instead of reforming Government means turning a blind eye to the colossal waste of taxpayers' money that too often occurs.

I am not aware of any serious leadership effort from the President or his top officials to systematically reduce waste and abuse and to save money, as we have seen from Governors and mayors and families all over America that continues daily. I know Senator Warner is working on a bipartisan effort, and I understanding that.

So how can anyone contend that eliminating waste, fraud, duplication, and abuse is bad for America? A leaner, more productive, more competitive American Government is certainly good for America and American workers. It almost seems the President believes all spending is stimulative to the economy and no spending, even wasteful spending, should be cut. Raising taxes instead of reforming Government means hurting the very people who need it the most, need help the most.

For too long, Washington has defended the bureaucracy at the expense of the American people. Until this National Government gets serious about containing runaway costs and establishing efficient management programs, the American people should not even consider sending one more dime to this Government. The budget process provides us with an opportunity to right that wrong and to restore growth and opportunity to the Nation.

And we do believe in infrastructure, but I would just note that in the stimulus bill that spent over $800 billion, only 4 percent went to roads and bridges and less than 1 percent of our total spending each year goes to roads and bridges. So when we talk about spending, we are not talking about cutting only highway funds, many of which are productive and help us make our Nation healthier.

So, thank you, Madam Chairman, for your leadership. I look forward to working with you throughout this budget process.

Chairman MURRAY. Thank you very much.

With that, I am going to turn to our witnesses. We do have a vote at noon, and I want to make sure everybody has a chance to ask questions, so I am going to ask you, if possible, to limit your statement to 5 minutes for us today, and we will begin with Ms. Trottenberg.

STATEMENT OF THE HONORABLE POLLY TROTTENBERG, UNDER SECRETARY FOR POLICY, U.S. DEPARTMENT OF TRANSPORTATION

Ms. TROTTENBERG. Chairman Murray, Ranking Member Sessions, members of the Committee, thank you for inviting me here today to testify on behalf of the Obama administration about the importance of transportation investments to our Nation's economy, our States and local communities, and the traveling public.

From waterways to railroads, highways, airways, and transit, our transportation system has been critical to our Nation's economic success, providing remarkable mobility and opportunity to our citizens and their families, and fueling the prosperity of our businesses, factories, and farms.

Transportation is one of the largest sectors of the U.S. economy, with transportation-related goods and services representing nearly 10 percent of the Nation's $15.6 trillion GDP.

The transportation sector is one of the largest generators of high-paying jobs, accounting for 11.4 million jobs in 2011. The transportation sector has helped generations of Americans secure a middle-class life for themselves and their families.

But our transportation system is aging. Much of it was built more than 50 years ago, and in some cases more than 100 years ago, and it is in need of investment, innovation, increased efficiency, and new technologies.

Our economic competitors in Europe and Asia continue to invest significantly more in maintaining, modernizing, and expanding their transportation networks. In 2012, the World Economic Forum rated the competitiveness of U.S. infrastructure as 14th in the world, below Canada, the United Arab Emirates, and Korea.

Beginning with the State of the Union address 2 weeks ago and continuing with his proposal released last week, President Obama called for $50 billion in increased infrastructure investment to create jobs and spur economic growth. The President proposed a "Fix-It First" Program that would direct $40 billion towards reducing the backlog of deferred maintenance on highways, bridges, transit systems, and airports nationwide, along with $10 billion for innovative transportation investments.

The President also proposed a Partnership to Rebuild America to attract private capital to upgrade what our businesses need most: efficient roads, rails, mass transit systems, waterways, and ports to move people and goods, and safe, modern energy, water, and telecommunications systems.

The proposals that the President recently made build on the Administration's work over the past 4 years to strengthen the Nation's transportation infrastructure. The administration worked with Congress to pass the American Recovery and Reinvestment Act in 2009. And it is true, Senator, it was a small portion on transportation, but it was the most significant transportation public works program since the New Deal. The Recovery Act funded in the transportation sector 15,000 transportation jobs across the country and created tens of thousands of jobs.

We are also grateful that Congress recently passed the Moving Ahead for Progress in the 21st Century Act (MAP–21). It has provided predictable surface transportation funding for States and localities, and it has been a major priority for the Department. The bill makes great progress in improving safety, especially in transit, expanding the TIFIA credit program to get more private sector involvement in our transportation system, focusing on freight policy, better planning, and moving us towards a more performance-driven system.

While we are implementing the bill, we also know that part of how we ensure we have the best infrastructure is improving how we do project delivery. The Department is working with States and localities to produce better economic analysis to ensure that every public dollar is well spent.

We are working with our sister agencies to reduce the Federal permitting review process timeline by 50 percent for project sponsors, giving them tremendous savings of time and money. We are also encouraging cost-effective innovation and creative new approaches to construction, operations, and project delivery.

On the aviation side, the Federal Aviation Administration is moving forward aggressively with the NextGen satellite navigation program, which will provide tremendous economic returns by improving the safety, efficiency, capacity, and reducing the environmental impacts of travel.

MAP–21 and NextGen are important first steps in rebuilding and modernizing our transportation system, but the demands on our Nation's infrastructure will only increase in coming years. By 2050, the U.S. population is expected to grow by approximately 100 million people. Many of them will live in already congested metropolitan areas.

Last year, the Highway Trust Fund collected only $40 billion in revenue but spent close to $50 billion. This is not a new problem. The Highway Trust Fund has had a funding shortfall every year for the last 5 years.

By the end of MAP–21 in 2014, Congress will have transferred almost $54 billion in general funds into the Highway Trust Fund to keep the surface transportation program afloat. This is of growing concern as we seek to address our Nation's fiscal challenges.

As Federal dollars have grown scarcer, many States and localities have attempted to make up the shortfall, often by taking on significant debt.

We clearly need political consensus on how to sustainably fund surface transportation in this time of severe budgetary challenges. The President has proposed to pay for our investments in surface transportation through savings from winding down our contingency operations overseas. We believe this is the right course because it will allow us to move forward with critical investments in transportation infrastructure now while working together on a bipartisan basis to address the longer-term fiscal challenges the Highway Trust Fund faces.

Thank you and I am happy to answer any questions you have.

[The prepared statement of Ms. Trottenberg follows:]

STATEMENT OF
POLLY TROTTENBERG
UNDER SECRETARY FOR POLICY
U.S. DEPARTMENT OF TRANSPORTATION
BEFORE THE
COMMITTEE ON THE BUDGET
U.S. SENATE

February 26, 2013

The Impact of Federal Investments on People, Communities, and Long-term Economic Growth

Chairman Murray, Ranking Member Sessions, Members of the Committee:

Thank you for inviting me here today to speak on behalf of the Obama Administration about the importance of transportation investments and their impacts on our Nation's economy, our States and local communities, and the traveling public.

The U.S. boasts a transportation system that is among the strongest and safest in the world and has benefitted from the investments of previous generations of Americans.

From waterways to railroads, highways, airways and transit, our transportation system has been critical to our Nation's economic success, providing remarkable mobility and opportunity to our citizens and their families, and fueling the prosperity of our businesses, factories and farms.

But our transportation system is aging. Much of it was built more than 50 years ago and in some cases more than 100 years ago, and is in need of investment, innovation, and new technologies.

Transportation is one of the largest sectors of the U.S. economy, with transportation-related goods and services including vehicles, fuel, auto insurance, structures, and equipment representing nearly 10 percent of the Nation's gross domestic product (GDP) -- \$1.5 trillion out of \$15.6 trillion in 2011.

The transportation sector is one of the largest generators of high-paying jobs, accounting for 11.4 million jobs in 2011, according to the Bureau of Labor Statistics, including 2.3 million truck drivers, 144,000 highway maintenance workers, and 87,000 flight attendants.

Beginning with the State of the Union address two weeks ago, and continuing with his proposal released last week, President Obama called for \$50 billion in increased infrastructure investment to spur economic growth. The President proposed a "Fix-It-First" Program that would direct \$40 billion towards reducing the backlog of deferred maintenance on highways, bridges, transit systems, and airports nationwide and put U.S. workers on the job, along with \$10 billion for innovative transportation investments.

President Obama also proposed a Partnership to Rebuild America to attract private capital to upgrade what our businesses need most: efficient roads, rails, mass transit systems, waterways, and ports to move people and goods, and safe, modern energy, and telecommunications systems.

The President's proposals build on the Administration's work over the past four years to strengthen the Nation's transportation infrastructure. The Administration worked with Congress to pass the American Recovery and Reinvestment Act in 2009, the most significant transportation public works program since the New Deal.

The Recovery Act funded major projects all across the country, including the CREATE freight rail project in Chicago, the I-244 Bridge in Tulsa, and rebuilding the Presidio Parkway connecting San Francisco to the Golden Gate bridge. Through the Recovery Act and core infrastructure funds, U.S. workers have improved over 350,000 miles of U.S. roads, and repaired or replaced over 20,000 bridges, including the Milton-Madison Bridge connecting Kentucky and Indiana, and the South Park Bridge in Seattle.

Since the President took office, the Department's investments are helping communities build or improve more than 6,000 miles of intercity rail corridors and 40 train stations, such as Union Station in St. Paul and Moynihan Station in New York, and purchase approximately 260 passenger rail cars and 105 locomotives, and make significant investments in 25 ports across the U.S.

In addition, the Obama Administration has made an unprecedented commitment to strengthen public transportation across the United States, investing in more than 350 miles of new light and heavy rail, streetcars, and bus rapid transit, in cities from Los Angeles to Cleveland to Atlanta, and helping to revitalize the American manufacturing industry by investing in 45,621 buses and 5,545 rail cars.

We are grateful that Congress passed the Moving Ahead for Progress in the 21st Century Act (MAP-21) in June 2012, and provided two years of predictable surface transportation funding for States and localities. Since enactment, MAP-21 has been a major priority for the Department, and I am proud of how quickly we have been able to implement its key provisions and get guidance out to the States, Metropolitan Planning Organizations, local communities and transit agencies.

MAP-21 makes great progress in improving safety, especially in transit, expanding the TIFIA credit program, focusing on freight policy, better planning, and moving us towards a more performance-driven system.

In fact, we consider MAP-21's focus on performance one of the most exciting parts of the legislation. We are working with our stakeholders to develop performance measures in key areas such as safety, pavement and bridge condition, system performance, congestion and freight. Setting these performance measures is an important step in creating a more efficient outcome-based transportation system.

Part of ensuring our nation has the world's best infrastructure, which is essential to our continued economic success, is improving how we deliver transportation projects. The Department is working with states and localities to produce better economic analysis to ensure that every public dollar is well spent.

We are working with our sister agencies to reduce the Federal permitting review process timeline by 50 percent for project sponsors, giving them tremendous savings of time and money. We are also encouraging cost-effective innovation and creative new approaches to construction, operations and project delivery.

MAP-21 also provided DOT with unprecedented opportunities to improve freight movement throughout our nation. This is an area where we have already made great progress.

Last summer, Secretary LaHood announced the creation of our Freight Policy Council. The Council, which is chaired by Deputy Secretary Porcari, brings together senior leadership, modal administrators, as well as policy, budget, economic and research experts -- to oversee the implementation of MAP-21's freight provisions, including development of the National Freight Strategic Plan.

And last week, the Department announced the establishment of the National Freight Advisory Committee to engage a variety of public and private sector stakeholders in the implementation of the MAP-21 freight provisions. As the Federal Register notice outlines, the Department is accepting nominations for committee members until March 21.

On the aviation side, the Federal Aviation Administration (FAA) is moving forward aggressively with the NextGen satellite navigation program, which will provide tremendous economic returns by improving the safety, efficiency, and capacity of air travel. NextGen will ultimately save hundreds of dollars per flight for our Nation's airlines, and millions of hours of travel time for the public.

In 2009, the FAA estimated airline operations alone generated $300 billion in economic output to the GDP and supplied more than two million jobs. Making air travel more convenient, dependable, safe, and efficient has far-reaching implications for the nation's economy.

MAP-21 and NextGen are important first steps to rebuilding our transportation system, but the demands on our Nation's transportation infrastructure will only increase. By 2050, the U.S. population is expected to grow by approximately 100 million people, with many of them projected to live in already congested metropolitan areas.

In 2008, Federal, State, and local governments spent approximately a combined $182 billion in total on highways and bridges, of which $91 billion was spent on capital improvements. However, the 2010 Conditions and Performance Report, which DOT publishes biennially, estimated that maintaining the Nation's highway system, and improving it to meet future demand, requires that all levels of government combined increase capital investments from $91 billion currently spent to $170 billion annually over a 20-year period.

On the transit side, Federal, State, and local governments spent a total of about $52.5 billion, of which $11 billion was spent on capital improvements. Yet the same 2010 report estimates that achieving a state of good repair for the nation's transit systems, while accommodating future ridership growth over a 20-year period, requires an annual increase in capital investments from $11 billion to between $21 billion and $25 billion.

Both of these investment need estimates do not take into account operations and maintenance costs, and are based on 2008 data. The Department is currently preparing a new Conditions and Performance report which will contain updated investment need figures.

Moving people will not be the only challenge. Currently, the U.S. freight system moves 57 tons of freight per person per year. The addition of approximately 100 million people will result in nearly six billion tons of additional freight that the Nation will need to move through our often congested roadways, rails, airports and ports. We have to find ways to move those goods more efficiently.

Last year, the Highway Trust Fund (HTF) collected only $40 billion in revenue, but spent close to $50 billion. This is not a new problem. The HTF has had a funding shortfall every year for the past five years.

By the end of MAP-21 in 2014, Congress will have transferred almost $54 billion in General Funds into the HTF to keep the surface transportation program afloat, which is of growing concern as we seek to address our Nation's fiscal challenges.

As Federal dollars have grown scarcer, many States and localities have attempted to make up the shortfall, often by taking on significant debt. The Federal Highway Administration reported that, in 2010, States owed a combined $154 billion in road bond debt, nearly triple the $56 billion they owed in 1995. On the transit side, local transit agencies also amassed tens of billions of dollars in debt, in some cases threatening their ability to fund annual maintenance and capital needs.

Meanwhile, our economic competitors in Europe and Asia continue to invest significantly more in maintaining, modernizing, and expanding their transportation networks. In 2012, the World Economic Forum rated the competitiveness of U.S. infrastructure as 14th in the world, below Canada, the United Arab Emirates, Spain, and Korea.

But we also need political consensus on how to sustainably fund surface transportation in this time of severe budgetary challenges so that States and localities can plan for and build long-term projects. The President has proposed to pay for our investments in surface transportation through the savings from winding down our contingency operations overseas. We believe this is the right course because it would allow us to move forward with critical investments in our transportation infrastructure now while working together to consider the fiscal challenges the Highway Trust Fund faces. Others may have different proposals. I know that is one of the many important issues that the leaders on this Committee and throughout Congress will be grappling with in the months to come and the Administration looks forward to seeking a shared solution.

We owe it to future generations of Americans to provide them with a transportation system as remarkable, safe, and productive as the one our parents and grandparents built for us.

Thank you and I am happy to answer any questions you may have.

Chairman MURRAY. Thank you very much.
Dr. RAWLINGS.

STATEMENT OF HUNTER R. RAWLINGS III, PH.D., PRESIDENT, ASSOCIATION OF AMERICAN UNIVERSITIES

Mr. RAWLINGS. Chairman Murray, Ranking Member Sessions, members of the Committee, it is a pleasure and an honor to be here to talk to you about this important challenge facing America. My name is Hunter Rawlings, president of the Association of American Universities, who are 60 of the leading research universities in the United States.

We believe the sequester is terrible policy in the short and the long term, and that is what I would like to speak with you briefly about this morning.

We need to address budget deficits, as you all have said, and our long-term debt. But so far, discretionary funding, especially nondefense discretionary spending, which represents only 17 percent of the budget, has borne the brunt of the cuts. It includes vital investments in education and innovation as well as infrastructure. The sequester will force additional cuts, equivalent to nearly 10 percent for the remainder of this year and more in future years. This is the part of the Federal budget where our future lies. It is not the way to solve the Nation's deficit problem. It is very stupid policy.

Faculty members and the next generation of researchers are already feeling the effects of the sequester as agencies hold back funds for concern about the sequester's effect. The sequester could cause vast problems in our research enterprise and could also cause a low-income undergraduate student to lose up to $876 a year in Federal financial aid. It will cut work-study and other financial aid and increase student loan borrowing costs. Why penalize young students working their way through college? What kind of message does that send? It is not a message of opportunity.

All of these cuts will have even greater impact on the longer term, the economy, and the Nation that we leave to our children and grandchildren.

The Federal Government invests approximately $29 billion in research at the Nation's colleges and universities, mostly in basic research. Private sector R&D is primarily for the purpose of developing products; businesses cannot afford riskier, long-term basic research. That is why there has long been a bipartisan consensus that this is primarily a responsibility of the Federal Government, and the Federal Government has made great decisions in the past to support research, which has led to enormous economic advantages for this country.

As Senator Lamar Alexander and I wrote in an op-ed very recently, scientific research is a high-yield investment. Economists estimate—and this is a critical fact—that at least half of GDP growth since World War II has come from technological advances, almost none of which would be possible without federally funded innovation. This research gave us the technology behind Google, as the Chairman noted, Cisco, and Genentech and entire new industries. And the NIH's Human Genome Project has spurred not only advances in human health but nearly $800 billion in economic growth. That is an enormous return on investment.

Why is this so important? Well, let me just hold up a smartphone. Every one of you has one of these, and you use it now constantly. It is wonderful that we have companies that make these fantastic instruments. But they would not work, they could not be built, they would not have been thought of without federally funded research.

Why is that? Because the GPS that guides you to your destination was made possible by the federally funded research that produced the atomic clock. The touch screen came directly from innovation funded by the National Science Foundation. The liquid crystal display, the LCD monitor used on these phones, came from research funded by NIH, the National Science Foundation, and the Defense Department. The rechargeable lithium ion batteries that run these phones came out of basic research funded by the Department of Energy. The integrated circuit, which you find in practically all electronic equipment today, benefitted from federally funded research. And, finally, the Internet and the World Wide Web, which we spend so much time on with these devices, are results of federally funded research along with private sector innovation.

Why would we reduce the part of the Federal budget that generates these returns in science, innovation, and economics just at the time when the rest of the world is investing heavily in precisely those areas? I do not want the next Google to come from China. I want it to come from here. And the only way to make sure that is going to happen is if we continue to be the leader in science and technology internationally.

We face a challenge, a big challenge to our leadership in these fields today. It is not an exaggeration to say that the Chinese and other countries are now borrowing our model, spending heavily on research as we reduce research. Why would we cut when they are increasing their investment?

To conclude, the sequester is dangerous. Please do not let it happen. Universities have repeatedly urged Congress and the President to stop the sequester and address our fiscal problems in a balanced, sensible way that preserves investment in the future.

Thank you for this opportunity.

[The prepared statement of Mr. Rawlings follows:]

Testimony of Hunter R. Rawlings III

President, Association of American Universities

Before the United States Senate Committee on the Budget

February 26, 2013

Chairwoman Murray, Ranking Member Sessions, and members of the committee, thank you for the opportunity to testify today about the impact of budget sequestration on federal investments in research and higher education. I am Hunter Rawlings, president of the Association of American Universities, which represents 60 of the nation's leading public and private research universities. We believe the sequester is terrible policy in the short and long term. My testimony will focus on two critical areas of federal spending that generate enormous returns on investment – university research and student financial aid, both of which will suffer significantly under sequestration with consequences not only for scientists, engineers, and students, but also for our nation's innovation enterprise and economy.

One of the greatest challenges facing the nation is the need to address federal budget deficits and our long-term debt. Unfortunately, deficit reduction efforts to date have focused primarily on the part of the federal budget where America's future lies – discretionary spending. Discretionary spending, which constitutes only one-third of the federal budget, has had to carry the vast majority of the deficit reduction load and will carry even more under sequestration. In particular, nondefense discretionary spending, which is only 17 percent of the budget, includes vital investments in education and innovation, as well as infrastructure needs. As a result of the tough discretionary spending caps established by the Budget Control Act, non-defense discretionary spending, even in the absence of sequestration, will decline within 10 years to its lowest level relative to GDP since 1962.

Federal support for research and student financial aid laid the foundation for the dramatic expansion of the 20th century U.S. economy and can do the same in the 21st century. These investments produce the educated people and the ideas that lead to new products, new businesses, and entire new industries, as well as to the jobs that go with them. Cutting these investments in our future is not the way to solve our nation's deficit problem. Such cuts would undermine economic growth that is essential to deficit reduction. Yet that is exactly what the sequester will do. To put it kindly, this is an irrational approach to deficit reduction. To put it not so kindly, it is just plain stupid.

Members of both political parties believe that a long-term deficit reduction agreement should specifically incorporate such investments. For example, the majority report of the bipartisan Bowles-Simpson Commission stated, "we must invest in education, infrastructure, and high-value research and development to help our economy grow, keep us globally competitive, and make it easier for businesses to create jobs." And the new Bowles-Simpson deficit-reduction plan also calls for "preserving high-value investments."

Faculty members and the next generation of researchers at our universities are already feeling the effects of the potential sequester. Well before the March 1 deadline, federal science agencies began withholding funding and postponing research awards because they did not know how much funding they would ultimately have for grants. Michael Purugganan, the Dean of Science at New York University (NYU), wrote in an op-ed last month that just the mere threat of sequestration is taking its toll. He and his research collaborators are working on a new way to map genes in plant genomes which could help pave the way for new crop varieties able to withstand environmental stress. But they have delayed their work for months while waiting for a resolution to this budget mess. Purugganan is not alone in feeling the effects. AAU universities inform us that the threat of sequester is affecting hiring decisions for research scientists and postdoctoral researchers (those who have received doctoral degrees and hold temporary jobs in hope of attaining permanent positions). It is also causing great uncertainty for graduate students who do not know if they will continue to be supported by research grants.

The sequester will also hurt students from low-income families through cuts in student financial aid. If Congress allows the mandated cuts to go forward, students who receive federal aid could lose up to $876 a year according to the Student Aid Alliance. The sequester will cut work-study and other financial aid programs and increase student loan borrowing costs at the very time we are seeking to ensure greater access and improve college completion so as to have the educated citizenry and highly skilled workforce we need to grow our economy. Why would we penalize young Americans working their way through college? Why would we reduce access to higher education when other nations are improving access? What kind of message does that send to current and future college students and their families? It is not a message of opportunity.

The impact of these cuts is even more significant in the long term for research, the economy, and the nation that we will leave to our children, grandchildren, and great-grandchildren.

The sequester will cut university innovation that is critical to health, quality of life, and economic and national security of future generations, just as past research has provided these benefits to us. Research in all of the disciplines is how we, as a nation, come up with medical advances that save lives and ultimately reduce the cost of health care, advance our economy, figure out cleaner forms of energy, and develop the technologies that defend our country and make our fighting men and women safer. We have also leveraged these research investments to educate and train the next generation of scientists and engineers, who are most often supported by research grants.

To get an idea of the sequester's likely impact on these activities, I would encourage you to visit www.ScienceWorksForUS.org, a website established by AAU, the Association of Public and Land-grant Universities, and The Science Coalition to show the impact of the sequester on university research. There you will find useful state-by-state data and a series of brief videos of university presidents, administrators, faculty members, and postdoctoral researchers describing their work and how it could be affected.

The federal government invests approximately $29 billion each year in research at the nation's colleges and universities, most of this in basic research. While the private sector invests in R&D, its investment is primarily in development of products; businesses cannot afford to make investments in the riskier, long-term basic scientific research that produces the breakthrough discoveries essential to innovation. As the Congressional Joint Economic Committee has stated, "Despite its value to society as a whole, basic research is underfunded by private firms precisely because it is performed with no specific commercial applications in mind." That is why there has long been a bipartisan consensus that funding basic research is primarily the responsibility of the federal government.

As Senator Lamar Alexander and I wrote in a joint op-ed last year, scientific research is a high-yield investment. More than half of economic growth since World War II has resulted from technological advances, almost none of which would have been possible without federally funded innovations. For example, federally funded research at the university level gave us the technology behind companies like Google, Cisco, and Genentech and has resulted in entire new industrial sectors that few would even have imagined, such as those in information and biotechnology.

A recent study by United for Medical Research demonstrates the extraordinary return on investment by scientific research, showing that government funding through the National Institutes of Health (NIH) in 2012 alone supported nearly half a million jobs and $58 billion in economic activity nationwide. The long-term impact is far greater. One single project supported by NIH – the Human Genome Project – has spurred more than $796 billion in economic growth. This is a 141-fold return on investment, in addition to the extraordinary advances in human health which it has only begun to make possible.

Two weeks ago at a press conference on the issue of the sequester, I provided a concrete example of the fruits of federal investments in scientific research that I think is worth my repeating here to illustrate what is at stake.

All of us have an iPhone, Android phone, or some other smartphone in our pockets nearly all of the time. That phone would not exist were it not for federally funded research. Here are just a few examples of why:

- The global positioning system (GPS) that enables your device to guide you to your destination would not exist without the federally funded research that produced the atomic clock.

- The amazing touch screen came directly from research funded by the National Science Foundation (NSF).

- The liquid crystal display, or LCD, monitor used on these phones comes from research funded by NIH, NSF, and the Defense Department.

- The rechargeable lithium-ion batteries that run these phones came out of basic research funded by the Department of Energy.

- The integrated circuit, which you find in practically all electronic equipment, also benefited from federally funded research, as well as great skill by industry.

- And finally the Internet and World Wide Web, which we spend so much time on with these devices, are results of federally funded research and private sector innovation.

I commend to you a video of a briefing provided by the Task Force on American Innovation entitled "Deconstructing the iPad," in which scientists describe the history of some of these amazing technologies.

These great products that we take for granted each day cannot keep coming if the nation fails to adequately invest in scientific research. More than half a century ago, our nation's leaders made a wise decision to fund university research and graduate education. And when the launch of Sputnik posed a challenge to our technological leadership from abroad, it spurred us to extraordinary investments in these areas.

Today we face a similar challenge to our leadership from overseas. Let me assure you that if the U.S. government falls short in its investments in education and research, other nations will be there to take our leadership position. At the very time we as a nation are squabbling about how much further to cut investments in research and education, Singapore, China, and South Korea are increasing their spending in these areas. Why are they doing this? Because they are smart. They are imitating the model we created decades ago that has led to unrivaled wealth creation, economic prosperity, and quality of life.

We should all be clear: our competitors are watching closely to see how we respond to their challenge, and are fully prepared to take advantage of our mistakes. For example, over the last 10 years, R&D expenditures as a share of economic output have remained nearly constant in the U.S. but have increased by nearly 50 percent in South Korea and nearly 90 percent in China. (Source: NSF S&E Indicators 2012) Also, according to Organisation for Economic Co-operation and Development (OECD) figures, government R&D spending between 2000 and 2009 increased by 250 percent in South Korea and 330 percent in China, while U.S. government R&D spending increased by about 45 percent. I commend to you a recent report by the Task Force on American Innovation entitled: American Exceptionalism, American Decline? This report illustrates that despite a strong history of being the world leader in research and discovery, the United States has failed to sufficiently heed indications that our advantage is diminishing and that we may soon be overtaken by other nations in these areas, which are critical to economic growth and job creation.

Now, let me share with you four examples of what will happen if sequestration is fully implemented in FY13 and beyond.

First, a recent analysis by the Information Technology & Innovation Foundation finds that sequestration will shrink federal R&D by nearly nine percent from 2011 spending levels over nine years, reducing the gross domestic product by anywhere from $203 billion to $860 billion over that period. As the report states, this is equivalent to "taking away all the new motor vehicles purchased by U.S. consumers over the last six months [or] all their airline travel over the last two years."

The second example is perhaps even more sobering. The sequester would damage the nation's security efforts by cutting research funding for cyber security. NSF, the Department of Homeland Security's (DHS) Science and Technology Directorate, and the Department of Defense all would experience across-the-board cuts to cyber security research in FY13. According to a report released recently by the House Appropriations Committee minority, cyber security at DHS would be cut by 30 percent. These spending cuts could not come at a worse time. Just last week, we learned that hackers in China are engaged in prolific cyber espionage against the United States government and some of America's largest companies. America's cyber infrastructure needs to be protected, and the best way to do that is to support critical cyber security research and educate and train the next generation of cyber security experts. Yet here we are cutting this funding.

The impact of sequestration will not only reduce funding of federal research agencies, it will have a direct impact on those who conduct basic research at the nation's colleges and universities. The sequester seriously undermines opportunities for young, talented graduate students and postdoctoral researchers to train with world-renowned researchers, and to conduct cutting-edge scientific research. In a recent Marketplace Morning Report, Dr. Jennifer Elisseeff of Johns Hopkins University said that many in her lab are suffering from "sequester-stress." Dr. Elisseeff leads a 25-person laboratory that conducts research on re-growing tissue that can later be attached to scaffolding and be placed in a human body. This is vital research that will be harmed if cuts to the NIH and Defense Department budgets come to pass. And the first to feel that impact will be the graduate students and postdoctoral researchers working in her lab.

Finally, these cuts will have a detrimental impact upon our ability to fully leverage wise investments that the nation has already made in large-scale, world-class scientific research facilities and tools located at both universities and our national laboratories. If the sequester is allowed to move forward, operations of major scientific user facilities will have to be significantly curtailed and thereby adversely affect many of the more than 25,000 researchers and students who rely on these research tools to advance basic science and to develop advance commercial technologies. Department of Energy national laboratory personnel who help to operate these facilities may be furloughed and laid off, and university and industrial access to these facilities will be reduced.

In summary, let me state this as plainly as possible: the sequester is dangerous. You should not let it happen. It undermines both immediate and long-term support for the nation's education and research enterprise. It jeopardizes our nation's economy now and for years to come. We in the university community have repeatedly urged Congress and the President to stop the sequester and address our fiscal challenges in a balanced, sensible way that preserves our nation's ability to continue to invest in areas that will lead to sustained economic growth. I do so again here today.

Thank you for this opportunity to share my views.

Chairman MURRAY. Thank you.
Dr. CARNEVALE.

STATEMENT OF ANTHONY P. CARNEVALE, PH.D., DIRECTOR AND RESEARCH PROFESSOR GEORGETOWN UNIVERSITY CENTER ON EDUCATION AND THE WORKFORCE

Mr. CARNEVALE. Thank you, Madam Chairman and Ranking Member Sessions, for inviting me here. I have a fairly simple story to tell, and that is that in these times, and really beginning in the early 1980s and moving toward these times, we have become a Nation where, if you are going to get a good middle-class job, you have to have some kind of postsecondary education and training, not necessarily a B.A. or graduate degree but some kind of postsecondary education and training. And that was not always so. A lot of people find this difficult to understand because they remember an economy where that was not true. I do. And it was not that long ago.

In 1973, at the end of the great American post-war boom, 72 percent of American workers had high school or less; 35 to 40 percent were high school dropouts. When we look at those people retrospectively, we find that the majority of them, almost 65 percent, earn more than $35,000 a year in current dollars and on up from there. It really was a high school economy, especially for blue-collar males.

What changed was somewhat mysterious at first. Actually, in the 1970s, the value of a college education went down relative to the value of high school, and everybody was worried about that. Books were written, one by a famous economist called "The Overeducated American." We were all worried. And then in 1980–81, we had the Volcker recession, which crashed the economy and reduced and all but killed off inflation. And after that, the economy began to reorganize very rapidly. What drove it was computer-based technology. And what happened and has been happening ever since is that computer-based technology automates any task in a job that is repetitive, and more and more it automates whole sets of tasks.

As a result of that, the tasks that were left over were nonrepetitive and required higher skill. In America, the only way we could get higher skill, because the only institution we had available was higher education or postsecondary education—it could have been done otherwise. But here, when we wanted more skill, we shifted demand upward to higher education. The population went first. Economists debated for a decade about what was going on. But Americans started going to college in very great numbers, such that between 1983 and 2002 most analysis agrees that the supply of college-educated workers went up by about 1 percent, the demand by employers went up by 3 percent per annum.

As a result of that, we created a huge wage premium for college. It went all the way to 74 percent, advantage for people with some college or better.

As a result of that as well—this is a major part of the story about the growing income disparity in America, apart from minimum wages and all the rest of it—we are really divided now into a Nation of postsecondary haves and postsecondary have-nots.

There are two things that have come from this that are very clear. One is the increasing value of college. As you said in the beginning, if you go to high school, you will make about 900 grand over a career. If you get a high school degree, you will make about a million three. If you get an A.A. degree, you will make about a million seven. If you get a B.A., about $2,300,000. If you get a graduate degree, you can make anywhere from $3.1 million to $3.7 million. So the demand for college grew, and the cost of college grew.

But there was a second effect that is even more important, I think, from a policy perspective, and that is, the variation in the value of degrees grew even more. So it is now true that a worker with a certificate of one year in heating, ventilation, and air conditioning can make more than 25 percent of people with B.A.s. Thirty percent of people with associate's degrees make more than people with bachelor's degrees. Forty-four percent of people with bachelor's degrees make more than people with graduate degrees.

What that is telling us is that the field of study is what is driving the value of education, not the degree level, not the institution. And so the system is now driven by a relationship between college majors, fields of studies, and programs, and the access they give individuals to occupations.

And so in the end, what this says to me and it said to many others is that we need to begin to make the higher education system more transparent. We need to let students know, administrators know, and policymakers know what the value of different degrees are, give them choices, in the hopes that ultimately it will increase efficiency in the system, because beyond the sequester, what we are going to need is efficiency in policy with whatever money we have left over.

Thank you.

[The prepared statement of Mr. Carnevale follows:]

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U.S. Senate
Committee On The Budget
February 26, 2013

Hearing On
The Impact of Federal Investment on People, Communites
and
Long Term Economic Growth

Testimony
By
Anthony P. Carnevale
Director
The Georgetown University
Center on Education and The Workforce

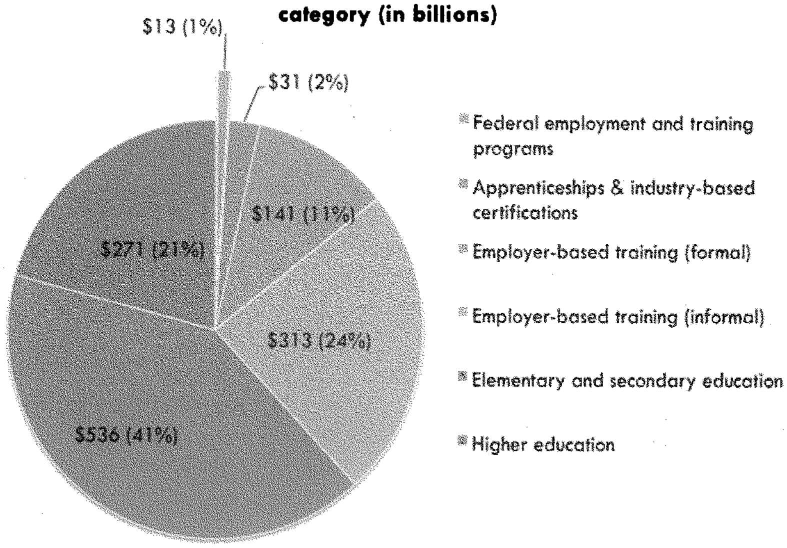
Good morning, Madam Chairman and esteemed Members of the Budget Committee. Thank you for the opportunity to speak with you today about the effects of investing in education and job training for individual opportunity and our long-term economic growth.

I am the Director of the Georgetown University Center on Education and the Workforce, a nonpartisan, research center at Georgetown University that focuses on higher education policy from a workforce and global competitiveness perspective.

The U.S. spends $1.4 trillion on human capital development annually in the private and public sectors, an amount that is roughly 10 percent of GDP. K-12 and postsecondary programs make up 41 percent of that spending and formal and informal employer-based training account for most of the other 59 percent. In addition to its spending on K-12 and postsecondary education and training, the federal government spends $13 billion annually on 47 employment and training programs, which represents one percent of the national investment in human capital.[1] By comparison, the private sector spends approximately $110 billion each year on staffing and recruitment services alone, six-times what the federal government spends on employment and training programs.[2]

The U.S. invests roughly $1.4 trillion in human capital development each year.

Public and private spending on human capital development by category (in billions)



SOURCE: CEW analysis using data from the U.S. Department of Education's Integrated Postsecondary Education Data System (IPEDS), the U.S. Department of Labor's Employment and Training Administration (DOLETA), the American Association of Community Colleges (AACC), the U.S. Education Department's Office of Vocational and Adult Education (OVAE), Survey of Employer Provided Training (DOL), and Bureau of Labor Statistics (BLS).

Educational attainment beyond high school has become an increasingly significant driver of long-run economic growth and productivity.

Education promotes economic growth by making workers more productive. For example, education contributed one-third of the productivity gains between 1950 and 2000. Between the 1950s and 1980s

[1] GAO. *Multiple Employment and Training Programs: Providing Information on Collocating Services and Consolidating Administrative Structures Could Promote Efficiencies*, GAO-11-92, January 2011.
[2] American Staffing Association (ASA), Structural Shift?: Annual Economic Analysis Explores Data and Trends in Flexible Workforce Management, *Staffing Success*, 2012.

increasing high school attainment was the principle source of education's contribution to economic growth and productivity improvements. But as improvement in high school graduation rates plateaued in the early eighties, the marginal contributions of education to growth shifted toward increasing postsecondary attainment.

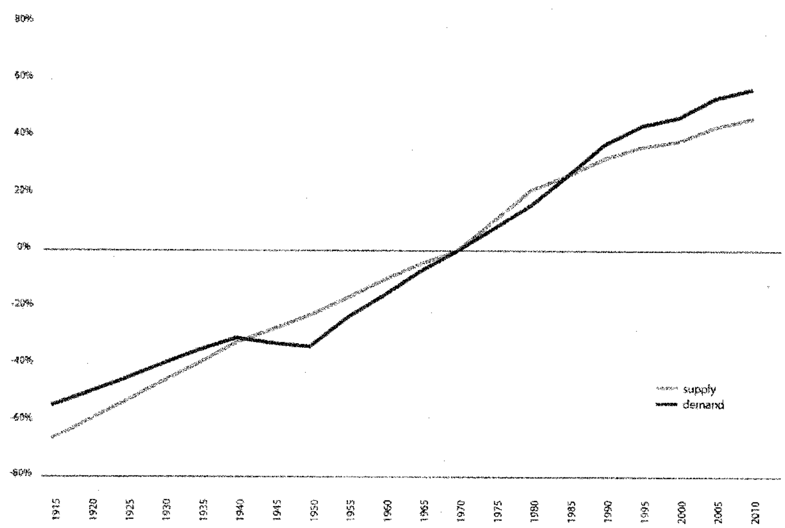
The payoff of investments in education in terms of economic growth and tax revenue is substantial. We estimate that an extra year of schooling beyond high school for all Americans by 2025 would increase GDP growth by between $500 billion and $1 trillion, providing an additional $150 billion in state, local, and federal taxes.

The supply of educated workers has not kept up with economic demand since the eighties.

Since the end of the 1980 -81 recession the U.S. economy has been undergoing rapid structural change. This evolution has been driven by what economists call skill-biased technological change. Since the early eighties, technology, led by computing technology, has been automating repetitive tasks and activities in jobs. As a result, more and more jobs, tasks, and activities left to people at work are non-repetitive and require skills beyond high school. The resultant increasing entry level skill requirements for work have made postsecondary education and training the gatekeeper for access to training on the job and state of the art technology. The synergy between postsecondary preparation and formal and informal learning on the job account for a growing major share of the ingredients in the recipe for U.S. economic growth. Consequently, postsecondary education and training has become more important than ever in today's economy.

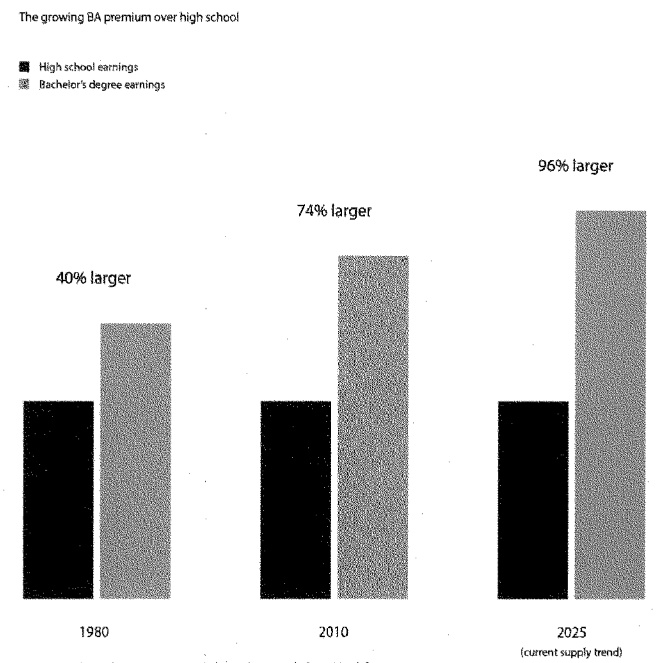
Since 1983, the supply of college-educated workers hasn't kept up with demand. Demand has grown at an average annual rate of 3 percent, while supply has grown by 1 percent annually. As a consequence, the college wage premium over high school increased from 40 percent to 74 percent over this time period.

Since 1983, the supply of college-educated workers has grown by 1% annually, while demand has grown by 3%.



Source: Goldin and Katz (2008)

The college wage premium over high school grew from 40 percent in 1980 to 74 percent in 2010, and will grow to 96 percent in 2025.



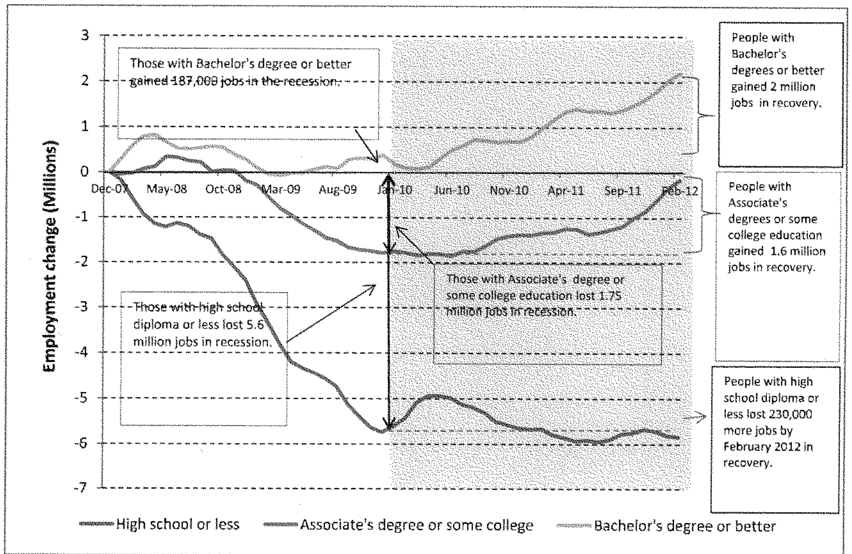
SOURCE: Georgetown University Center on Education and the Workforce

The failure to provide the U.S. workforce with enough postsecondary education and training to keep up with the demands of the information economy is one of the principal causes of the growth in wage inequality since the early 1980s. In 1970, workers with a high school education or less captured 63 percent of national wages. In 2007, they captured only 27 percent.

Since the beginning of the 2007-09 recession, historically high unemployment among recent college graduates has hidden the continued structural shift from an economy that provided good jobs for high school-educated workers to an economy in which the vast majority of good jobs require at least some postsecondary education.

What is clear in this recession, as in the last several recessions, is that most of the jobs lost that required high school or less are gone are not coming back, while jobs that require at least some college will recover and grow as a share of all jobs.

Almost half of the jobs lost in the recession have been recovered and virtually all of those jobs recovered required some form of postsecondary education.



SOURCE: Georgetown University Center on Education and the Workforce, *The College Advantage*, 2012

Wages declined for all workers since the beginning of the recession, but college-educated workers' wage advantage over high school-educated workers has remained high and has held mostly stable since the recession began.

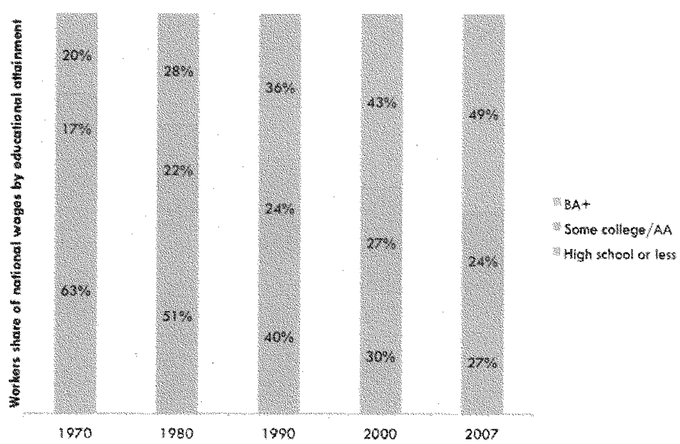
The peak unemployment rate for college-educated workers in the Great Recession was 5.1 percent compared to 15.7 percent for high school dropouts. The current unemployment rate for college-educated workers is 3.7 percent, compared to 12 percent for high school dropouts.

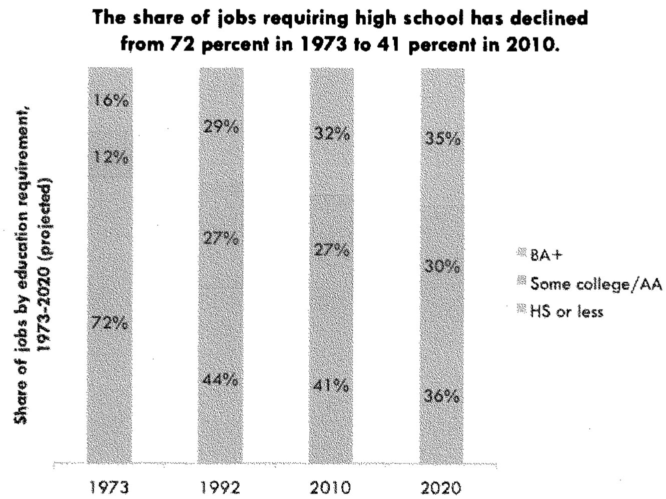
Although the unemployment rate for all college-educated workers has been low, it has been a tough job market for <u>new</u> college graduates but far worse for those without a college education. In 2012, 7 percent of <u>new</u> college graduates are still unemployed and another 14 percent are underemployed in jobs beneath their skill levels. By comparison, the unemployment rate for new high school graduates is 24 percent and 42 percent for those underemployed.

Jobs that require BAs have been the big winner, increasing by 2.2 million jobs since the recession began. Those jobs that required some college or an AA declined by 1.8 million in the recession but have regained 1.6 million of those job losses since the recovery began in 2010. At the same time 5.8 million jobs for those with high school or less have been lost since the recession began.

Education and training beyond high school, once the preferred pathway to middle-class earnings, has become the most well traveled pathway to the middle class. Whereas in 1973, more than half of workers with high school or less were in the middle class, only two in five were in the middle class in 2007.

From 1970 to 2007, college-educated workers' share of national wages increased from 20 to 49 percent, while the share for workers with high school or less fell from 63 to 27 percent.





SOURCE: Current Population Survey

Since the 1980s, college-educated workers' earnings have grown relative to those with no college credentials, especially those with graduate or professional degrees. Obtaining a postsecondary credential is almost always worth it, as evidenced by higher earnings over a lifetime: the higher the level of educational attainment, the greater the payoff. What's more, the gap is widening. In 2002, a BA-holder could expect to earn 75 percent more over a lifetime than someone with only a high school diploma. Today, that premium is 84 percent.

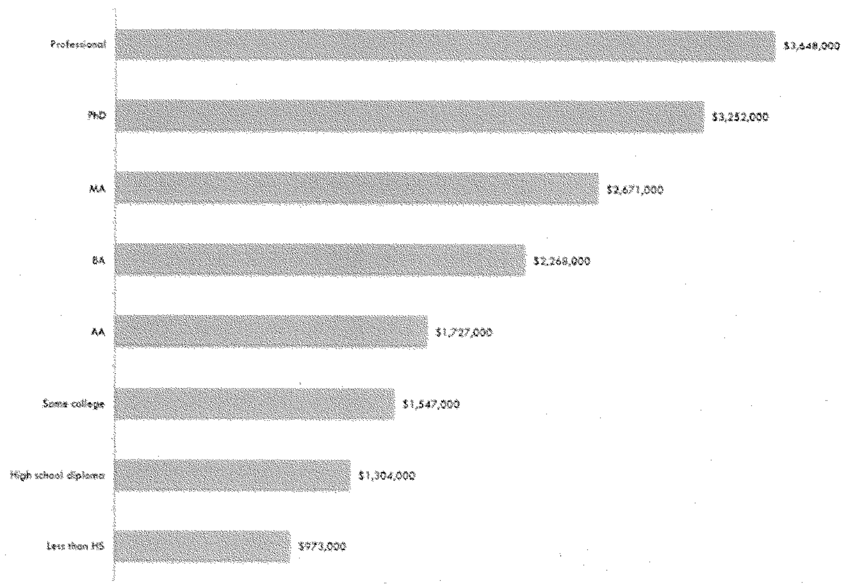
On average:

- High school dropouts earn $973,000 over a lifetime.
- High school-educated workers earn $1.3 million over a lifetime.
- Workers with some college credit earn $1.5 million over a lifetime.
- AA-holders earn $1.7 million over a lifetime.
- BA-holders earns $2.3 million over a lifetime.

Graduate degrees confer even higher earnings:

- MA-holders earn $2.7 million over a lifetime.
- PhD-holders earn $3.3 million over a lifetime.
- Professional degree-holders earn $3.6 million over a lifetime.

Lifetime earnings by educational attainment (in 2009$)



Higher level degrees are worth more than lower level degrees on average. But averages are deceiving. The other major trend since the 1980s is that employability and earnings increasingly depend on individuals' field of study in postsecondary programs.

What you make depends more and more on what you take. Oftentimes, lower-level programs can outperform higher-level programs. For example, some workers with one-year certificates in fields like information technology, electronics, and drafting earn more than a substantial share of people with AAs and BAs.

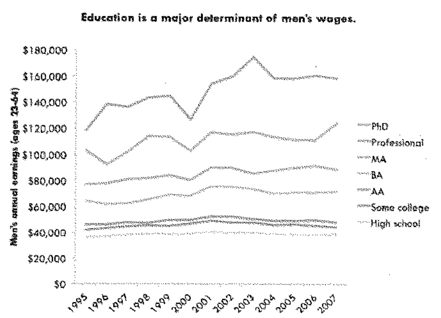
There are significant earnings variations between different levels of educational attainment depending on postsecondary fields of study.

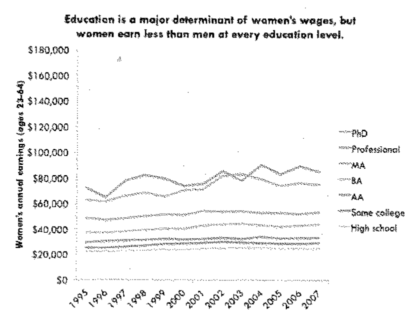
- 31 percent of high school dropouts earn more than the median earnings of workers with high school diplomas;

- 37 percent of high school-educated workers earn more than the median worker with some college credit, but no degree;
- 42 percent of people with some college credit, but no degree earn more than the median AA-holder;
- 28 percent of AA-holders earn more than the median BA-holder;
- 40 percent of BA-holders earn more than the median MA-holder;
- 36 percent of MA-holders earn more than the median PhD-holder;
- 37 percent of PhD-holders earn more than the median professional degree-holder.

While education has become the arbiter of opportunity, access to opportunity has been unequal between men and women. Education confers a large wage premium for both men and women, but men earn more than women at every education level, in large part due to differences in fields of study and college majors.

Education brings an enormous benefit to both men and women, but men still earn more than women at every level of education.



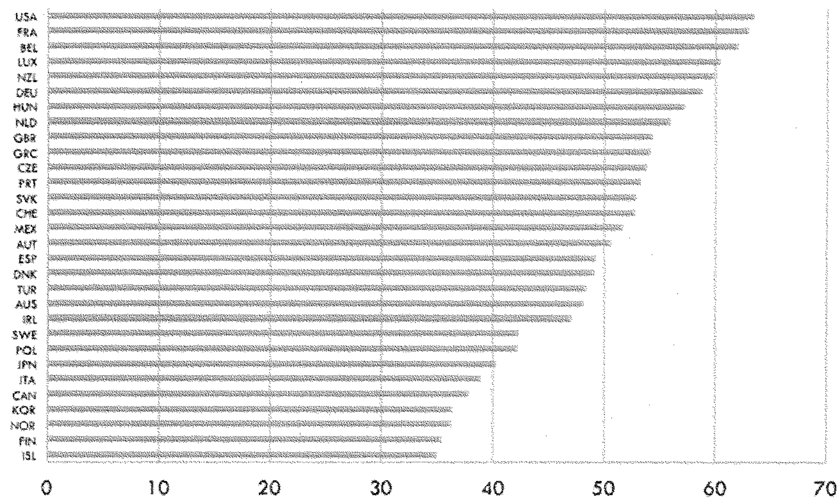


SOURCE: Current Population Survey

In the U.S., compared to other countries, the circumstances you are born into play a greater role in where you end up as an adult. The U.S. ranks first in the extent to which parental education determines individual's future educational attainment.

As access to postsecondary education determines earnings, college completion is a major source of the intergenerational transfer of privilege.

Parental background has a stronger influence on educational attainment in the U.S. than in other developed countries.



Influence of parental background
(socio-economic influence taking cross-country distributional differences into account)

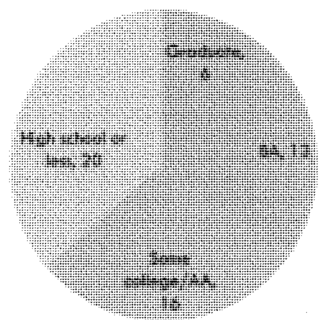
SOURCE: Calculations based on the 2006 OECD PISA database

The future promises continued growth in the demand for postsecondary education and training.

Our projections over the next ten years show, if the recovery continues, that there will be 55 million job openings — 24 million new jobs and 31 million openings from Baby Boomer retirements. Two-thirds of these openings, or 36 million, will require some education beyond high school, but we will not have enough workers to fill those jobs — we will fall short by 5 million.

Two-thirds of the job openings between 2010 and 2020 will require some postsecondary education.

Job openings by education requirement (in millions), 2010-2020

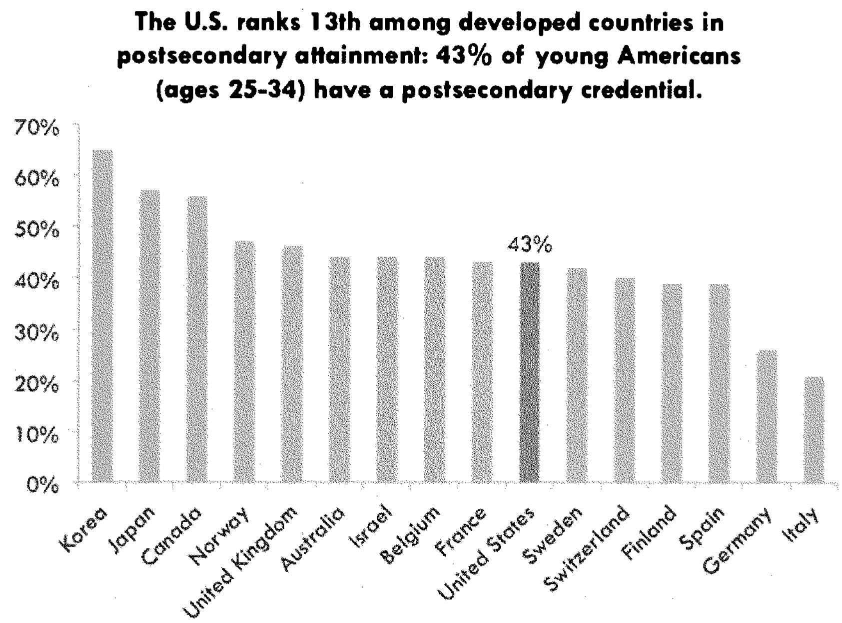


SOURCE: Georgetown University Center on Education and the Workforce Projections

Our workforce is struggling to compete internationally in postsecondary completion.

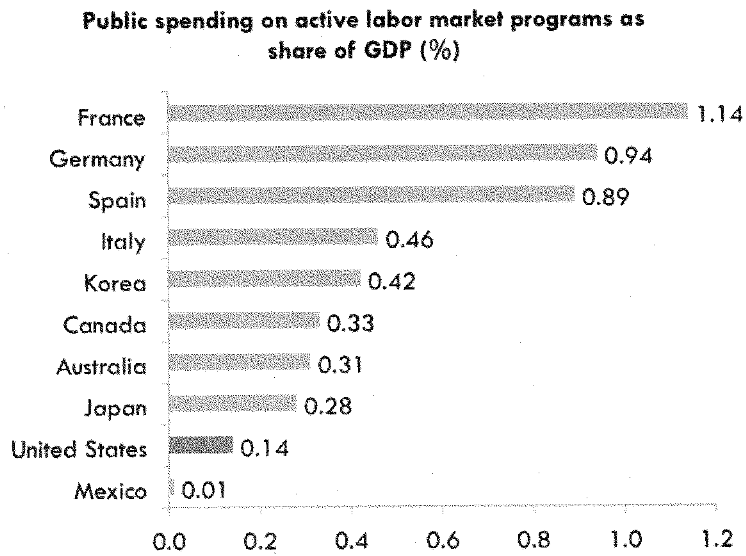
After leading the way in college attainment through the early-1990's, United States now ranks 13th in young workers with a postsecondary credential. Since 1997, postsecondary attainment has been growing by 1 percent each year, compared to 4 percent in other industrialized countries.

South Korea, Japan, Canada, Norway, Britain, Australia, and France are outperforming us at preparing young people for the 21st century economy.



We have the second lowest public spending on active labor market programs, with only Mexico devoting a lower share of its GDP to these programs. Major European countries, for example, spend seven to eight times more on employment and training programs than we do.

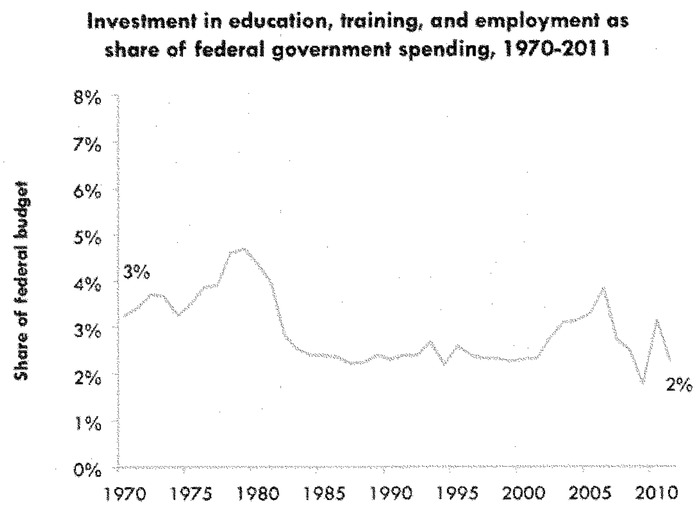
Public spending on employment and training programs is far below other countries.



SOURCE: OECD, Public expenditure of LMP by main categories, *Employment Outlook, 2012*.

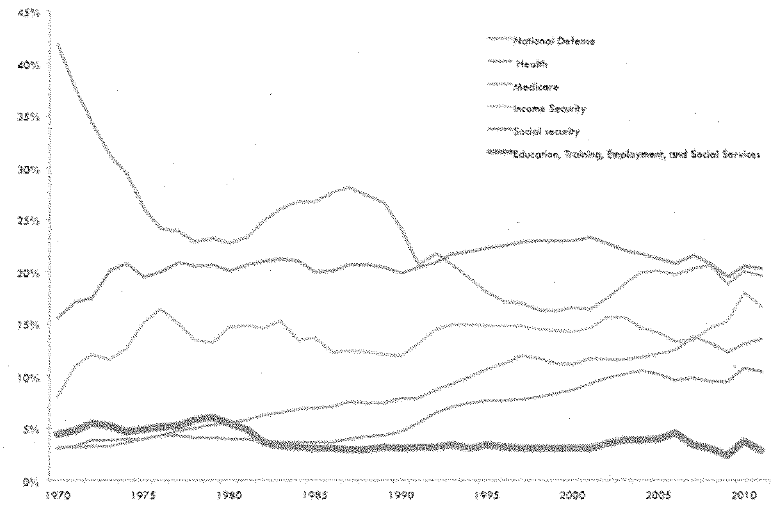
While the value of education and training has increased significantly in the modern economy, as evidenced by the growing college wage premium, the increasing demand from employers, and the rising share of high-skill occupations, the share of government spending invested in these human capital development functions has remained roughly flat over the past 40 years, and is currently at a historically low level.

Federal investment in human capital development declined from 3 percent of the budget in 1970 to 2 percent in 2011.



SOURCE: Office of Management and Budget (OMB), Outlays by Function and Subfunction: 1962-2017, Historical Tables (Table 3.2).

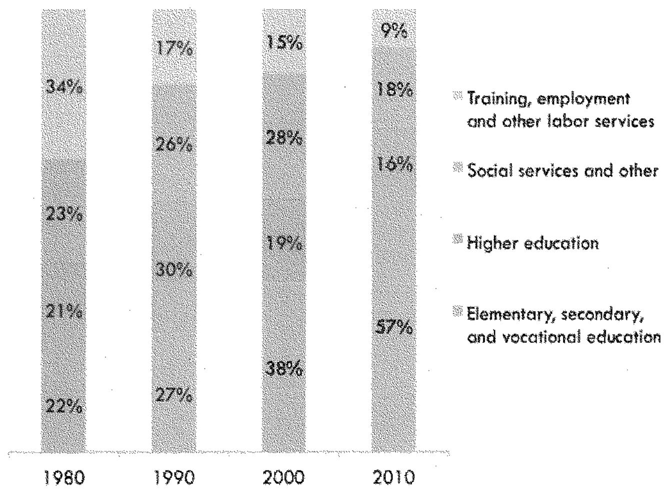
Historically, human capital development has represented a small share of the federal budget.



SOURCE: Office of Management and Budget (OMB), Outlays by Function and Subfunction: 1962-2017, Historical Tables (Table 3.2).

Employment and training programs, such as WIA, have declined as a share of federal spending on human capital development. WIA and Employment Services (ES) provide irreplaceable training, support, and labor market services that connect education and training to real jobs. Yet these services continue to be devalued by the federal government. In 1980, 34 percent of human capital investments by the federal government were spent on job training and employment services; by 2010, that share had decreased to 9 percent. This is a substantial loss in employment and training services programs.

Distribution of Function 500 (Education, Training, Employment and Social Services) Spending by Subfunction category, 1990-2010



SOURCE: Office of Management and Budget (OMB), Outlays by Function and Subfunction: 1962-2017, Historical Tables (Table 3.2).

Reforming education and training programs

As this committee is painfully aware we have entered an age of austerity in the use of public resources. At current productivity rates in many of our public institutions we cannot afford all the public services we need to support a thriving republic and a thriving opportunity-based economy. This is particularly true in education and healthcare, the only two American industries with negative productivity rates.

The bottom line seems to be that we need more efficiency in our public programs, including our education, employment, and training programs. We are, by our back of the envelope calculations at the Georgetown University Center on Education and the Workforce, at least $150 billion short of the revenues necessary to meet the President's educational goal of making us number one in global postsecondary completions. And we are able to provide employment training services to only a small portion of the tens of millions of Americans who apply for unemployment insurance every year.

The surest way to efficiency and maximum choice without interference in complex institutional and consumer-driven decisions is transparency in measured outcomes. This is the essential lesson of the private sector productivity and quality improvements since the eighties. The top-down hierarchies of Big Business in manufacturing, for example, have been displaced by complex global networks that allow us to assemble and sell cars by coordinating the work of thousands of parts' suppliers and sellers. There are more independent institutions in these complex manufacturing networks, not fewer, and they all work to measured standards of cost, quality, customization, timeliness and customer service.

These fundamental changes in outcomes-driven networks have moved well beyond manufacturing into many private sector services and growing array of governmental services. Education and healthcare have become the last frontiers in the spread of this fundamental shift from top down hierarchies to complex networks driven by common outcomes standards.

The fledgling movement toward higher education reform reflects these trends. Affordability, debt and default issues have fostered a growing interest in measured outcomes that gauge costs and completion rates at education and training institutions. In my view, cost and completion are good outcome metrics, but they beg the question of economic value. Cost only makes sense in the context of economic benefit as measured by employability and earnings. And completion metrics need to be disciplined by employment and earnings standards. Consider, for example, that one quarter of men who complete one- or two-year postsecondary certificates earn more than the average worker who completes a four-year BA.

We also need to be concerned about equity. If postsecondary institutions focus exclusively on cost and completion, they will do so by catering to the most advantaged students who typically attend full-time and pay full cost. Moreover, in the current system, higher education institutions are already separate and unequal. White students from advantaged background are concentrated in four-year colleges and universities, especially those with selective admissions, while minorities and students from low-income families are concentrated in open-admission community colleges. Race- and class-based stratification in higher education is especially troubling when you consider that four-year colleges spend twice as much per student annually as community colleges and have significantly higher graduation rates, even among equally qualified students.

While costs and completion outcomes can be usefully, if not fully, measured at the institutional level, economic outcomes need to be measured at the program level. The institutional cost and completion metrics are useful because cost and completion are largely institutional variables. However, as you can see in the data above, employment and earnings outcomes are less about institutions and more about fields of study and majors: Both whether you get a job and what you make depends on what you take. This is the essential wisdom of the "gainful employment metrics." Employment and earnings effects of postsecondary education and training operate at the program level. Teachers are similarly employed and compensated, regardless of whether they attended Harvard or,an open-admissions college.

Recently, there have been efforts to consolidate the 47 employment and training programs. It's hard to argue with consolidation efforts. Surely eliminating duplication can encourage efficiency. But too much standardization can reduce quality from the program participant point of view. Many of these programs are tailored toward targeted populations. While efforts to consolidate programs may result in some administrative savings, the government would not achieve real efficiency gains or contain costs simply by shifting around the program boxes, and could potentially undermine program efficacy that arises from the specialized knowledge and familiarity targeted programs have developed with the populations they serve.

Program consolidation can bring efficiencies but can also interfere with customization for the particular needs of distinctive populations and policy purposes. In addition to the rationalization of administrative structures, I would recommend that you consider integrating diverse programs by using common outcomes standards that apply to one degree or another in all publically funded education and training programs. Common metrics that cut across all programs can be very effective in promoting accountability and informed student choices. Information can help education and training markets work better. By adding information into the transactions between students and providers we can increase returns to our public education investments.

Using outcome metrics can accomplish much of what programs consolidation sets out to do, with much less political and administrative fuss. It can also increase the efficacy of program consolidation. And I would argue that the most common metrics — which apply to virtually all federal postsecondary education and training programs — are measures of common labor market outcomes, such as earnings, employment, and working in field.[3]

At current productivity rates in education and training, we cannot afford all the postsecondary education and training we need. The first step toward higher productivity in the postsecondary system is greater transparency in the alignment between postsecondary programs and labor market outcomes. Greater transparency in the relationship between postsecondary education and training curricula and careers is a relatively cost-free, self-regulating way to get more bang for our educational buck.

Choosing a postsecondary program is the first big investment decision made by young people, especially the majority of students who will finance their postsecondary programs with loans. They need to understand the risks and rewards associated with their choice of colleges and fields of study. As the cost of particular certificates and degrees grows and the labor market returns shift, prospective students need more information to guide their choices and to ensure high-returns on their investments.

Aligning education more closely with careers is also the best way to encourage student success. People with some sense of where they are gong are more likely to get there. A student's choice of career is the primary motivation for going to college. Helping students connect their college studies with their future careers captures this motivation and increases graduation rates.

The basic elements of a college and career information system already exist (including the Department of Education's College Navigator system); we just need to connect the dots. All the necessary data exists we just need to move it from the nation's statistical warehouses to the kitchen tables where college and career choices are made. Ultimately, we need to make the connection between postsecondary costs, completion and gainful employment at the institutional and program levels. Cost and completion data are more and more available in states and at the national level. The most important missing piece of the puzzle to current information systems is publicly available data on employment and earnings attached to particular postsecondary programs. Most states have made the effort to connect programs with labor markets in their internal data systems but have not developed usable formats for students, policy makers, or postsecondary administrators. Senators Ron Wyden (D-Ore.) and Marco Rubio (R-Fla.) have

[3] I.e., working in the same occupational field the individual received education and training in.

introduced the *Student Right to Know Before You Go Act,* which would take the next step in developing these state systems in useable formats. Similar bipartisan legislation, H.R. 4282, has been introduced in the House.

As an advocate of better data on the relationships between postsecondary programs and careers, we want to be careful not to slight the non-economic purposes of postsecondary education and training programs. Employment and career building is not the only purpose of federal education and training programs. In a republic such as ours the general purpose of education, especially college education is to allow individual to live fully in their time. But in a work-based society such as ours, it is very difficult to live fully as a private individual or a citizen without a job. Ultimately the economic role of postsecondary education, especially its role in preparing American youth for work and helping adults stay abreast of economic change, is central. The inescapable reality is that ours is a society based on work. Those who are not equipped with the knowledge and skills necessary to get, and keep, good jobs are denied full social inclusion and tend to drop out of the mainstream culture, polity, and economy. In the worst cases, they are drawn into alternative cultures, political movements, and economic activities that are a threat to mainstream American life.

Hence, if secondary and postsecondary educators and trainers cannot fulfill their economic mission to help grow the economy and help youths and adults become successful workers, they also will fail in their cultural and political missions to create good neighbors and good citizens. And increasing the economic relevance of education should, if done properly, extend the educator's ability to empower Americans to do work on the world, rather than retreat from it.

As we strive to deal with the budgetary challenges, we must not lose sight of our most important investments, those that promote competitiveness, ingenuity, and resourcefulness of American people.

Chairman MURRAY. Thank you very much.
Mr. Ferguson?

STATEMENT OF STEPHEN L. FERGUSON, CHAIRMAN, COOK GROUP, INC.

Mr. FERGUSON. Thank you, Chairman Murray and Ranking Member Sessions and members of the Committee. We appreciate the opportunity to testify here today. My name is Steve Ferguson. I am chairman of the board of Cook. I am pleased to be representing and speaking on behalf of the medical device industry today.

My message is not just about a company. It is about employees, jobs, and patients.

I have nearly five decades of experience in the medical device industry. Recently, I was approached by an employee who said, "Your company has now saved two lives in my family." She told me her father had been diagnosed with an aortic aneurysm and traditional surgery was not an option. However, the new stent graft saved her father's life.

She then spoke of her step-daughter who benefitted from a device which stops the bleeding of mothers after birth. The doctors said the device saved her step-daughter's life.

When someone tells you personal stories about medical technology that saved lives, it drives home how important our mission is at Cook and how important our industry is to the people of this country.

In 1963, our company started in the spare bedroom of Bill and Gayle Cook's apartment with those two as the only employees. Cook is the largest family-owned medical device manufacturer in the world today. We have manufacturing facilities in Indiana, Illinois, Pennsylvania, North Carolina, and California. We also have plants in Ireland, Denmark, and Australia.

While 57 percent of our sales are outside the United States, more than 80 percent of our 14,000 products are manufactured in this country. We employ about 7,500 in the United States and 10,000 worldwide.

The U.S. medical technology industry has been a global leader in the medical revolution that has taken place over the last 50 years. That has led to increased longevity and treatments for conditions and illnesses that were not even dreamed of in my father's generation.

We are an industry of thousands of companies; 98 percent of them have fewer than 500 employees. The industry is directly responsible for 2 million American jobs and generates $5.4 billion in trade surplus.

As chairman of Cook, not a month goes by without a representative of a foreign nation coming to Cook headquarters to recruit jobs to their country. The device excise tax has been the latest recruiting tool.

Our company, like nearly all medical device companies, is facing road blocks to growing jobs in the U.S. The most significant barrier to future job growth is the 2.3 percent medical device excise tax that became effective January 1. While this does not seem like much, it is a tax on gross revenue. It comes off the top, not on earnings, and it is huge. Whether a manufacturer makes a profit or not, it pays the excise tax.

For a company like ours, which pays about 33 percent of our U.S. earnings in Federal and State corporate taxes, the excise tax will increase our effective rate to more than 42 percent. This is more than a 25-percent increase. Ernst & Young projects that the Federal tax liability of the medical device industry will increase 29 percent as a result of the tax.

Policymakers on both sides of the aisle have stated a key component to turning our economy around is to invest in high technology and manufacturing, and they are is right. To create jobs you would not impose a special tax on the fastest-growing and most innovative industry. The med tech industry is the type of industry we want to stay in this country.

In order to offset big expenses like the excise tax, a company can only look to reduce employees, research and development, and capital investment. Those are your three big items. Everything else is minor, the cost of materials, et cetera. Cook has never had a layoff in 50 years, and we do not intend to start now. However, we must make hard choices. Cook will start important new projects outside the United States as we already have employees there. Our previous plans to open five new manufacturing facilities in American towns are now on hold.

The impact of this tax falls squarely on patients and employees. Make no mistake about it. Cuts in research and development will adversely impact patient care. The tax will drive manufacturing outside the United States. It is a shame that potential Cook employees who can compete with any place in the world based on their productivity are now going to be denied the chance because of Government action.

Fortunately, Congress can act to repeal the tax. We hope that you deliberate further about ways to encourage innovation and investment in long-term economic growth and that you will support the repeal of the medical device excise tax. The country needs your leadership. We must do everything we can to create an environment so that the next Bill and Gayle Cook can begin their journey to improve patient care in the United States.

Thank you very much.

[The prepared statement of Mr. Ferguson follows:]

Testimony of
Stephen L. Ferguson
Chairman, Cook Group, Inc.

Before the U.S. Senate Budget Committee

February 26, 2013

Chairman Murray, Ranking Member Sessions and Members of the Committee, thank you for the opportunity to testify at today's hearing on "The Impact of Federal Investments on People, Communities, and Long-Term Care Economic Growth." I am pleased to be here representing the medical device industry.

I am testifying today as the Chairman of Cook and appreciate the opportunity to tell you a bit about our company, Cook, and about the impact we and thousands of companies like us have had on patients, communities and the economic health of our nation.

Today, my message is not just about a company, but employees, jobs, and patients. I have nearly five decades of experience in the medical device industry, so I've seen and heard a lot, but more often than I'd ever imagine, I'm told a story that stops me in my tracks. Two years ago, I was approached by an employee who said she wanted to stop and thank me. She said to me, "A second member of my family is alive today thanks to a Cook product. Your company has now saved two lives in my family." Months before, I was talking with her in the sundry store where she worked and she told me about her father who had been diagnosed with an aortic aneurysm. I contacted the Cleveland Clinic and asked them to expect a call. Her father could not survive traditional surgery but our new stent graft that had just been approved was a possible alternative. He was admitted and received the new device saving her father's life. The second involved technology that was approved in the U.S. in 2005. This time, it was a Bakri Balloon, a device that stops potentially fatal bleeding for mothers after they give birth. The doctors told her this device saved her step-daughter's life. When somebody tells you about medical technologies that save lives, it drives home just how important our mission is at Cook.

History of Cook

Since 1963, the company has grown from its birth in a spare bedroom in Bill and Gayle Cook's apartment to a world leader in advancing medical care for patients worldwide. There were many setbacks and countless challenges that threatened the success of Cook as our founder, Bill Cook, sought to build an innovative American company that would improve patient care. But Bill was resilient and had the same entrepreneurial spirit that makes this country so unique. These traits, combined with his focus on the patient, are the foundation of Cook's success. The company has been the first to introduce new medical devices in more than 70 procedures.

Today, Cook is the largest, family-owned medical device manufacturer in the world. We are best known as a pioneer in the field of interventional medicine. Our products benefit patients by providing doctors with a means of diagnosis and intervention using minimally invasive techniques, as well as by providing innovative products for surgical applications. Cook sells more than 14,000 different products with 13,600 of these products serving markets of $1 million or less worldwide. The other 400 are large market technologies. These devices are used by physicians in the more than 40 medical disciplines and range from simple wire guides, needles and catheters, to grafts, drug-eluting stents and tissue engineering.

Cook is headquartered in Bloomington, Indiana with its U.S. manufacturing plants in Indiana, Pennsylvania, North Carolina, Illinois and California. We also have manufacturing facilities in Ireland, Denmark and Australia. We have direct sales in most of the world where the health care system is developed. Our company employs about 10,000 people around the world with approximately 7,500 of these employees based in the United States. While more than 57 percent of our sales are outside the United States, more than 80 percent of the devices are manufactured in this country.

It has been my privilege to be associated with Cook for 45 years.

The Medical Device Industry

a) Contributing to Improved Patient Health

Over the years, improvements in medical technology have led to significant advances in the health of patients. Today, patients are living healthier, more productive and independent lives. Many of these advances are due to the development of minimally invasive medical technologies that make it easier to diagnose and treat patient problems. These advances have resulted in improved patient outcomes with fewer complications. Since 1950, the life expectancy for American men and women has increased nearly 10 years. We have also seen significant results from 1980 to 2000:

- 15 percent decline in annual mortality
- 50 percent decline in the overall mortality rate from heart attack
- 25 percent decline in disability rates
- 56 percent reduction in hospital stays.

b) Contributing to Increases in Jobs, Payroll and the Economy

In addition to patient health, the medical technology industry has been a strong and vibrant contributor to the U.S. economy. The medical technology industry is responsible directly and indirectly for two million U.S jobs. As we strive for policies that improve our economy, policymakers on both sides of the aisle have stated that a key component to turning our economy around is to invest in high technology, manufacturing, and growth industries of the future. I agree whole-heartedly and that is why we must do everything we can to ensure the U.S. maintains its leadership position in medical technology, innovation and manufacturing.

Our company is not alone when it comes to that sort of impact. According to the National American Industry Classification System (NAICS), 80 percent of the 16,424 medical device companies in the nation have fewer than 50 employees. It is an industry dominated by small companies. Cook is relatively large in the device industry, but small compared with the drug companies.

The medical device industry is one of the few U.S. industries that enjoy a net trade surplus exporting more than we import. The U.S. is the only net exporter of medical devices in the world -- the U.S. medical technology industry generates a $5.4 billion trade surplus. It is the envy of the world, and make no mistake, we hear repeatedly from countries around the world that they want to compete with the U.S. for this market share and actively recruit companies in the U.S.

c) Contributing to Advances in Medical Innovation

While the medical technology industry has helped to fuel our fragile economy in recent years, its position as a global leader may erode over the next decade. This will no doubt affect the ability of Americans to access future break-through medical advancements, and the growth of U.S. jobs. A recent study found that in the future, China, India and Brazil will experience the strongest gains in developing next-generation lifesaving products. Without changes to U.S. policies, capital, jobs and research will move away from the U.S. and toward these markets. (PwC, "*Medical Technology Innovation Scorecard; The Race for Global Leadership,*" January 2011.)

What effectively spurs medical innovation in this country is the association and talents of American doctors, engineers and innovators who are dedicated to discovering new treatments and therapies for patients. This requires an atmosphere that encourages innovation and a dynamic market that does not impede job creation but encourages it. Our company, like nearly all medical device companies, is facing road blocks to growing jobs in the U.S.

Policy Challenges

a) The Medical Device Excise

The most significant barrier to our future U.S. job growth is the medical device excise tax. The Affordable Care Act of 2010 (ACA) contained a revenue provision that placed an excise tax of 2.3 percent on the sale of medical devices in the U.S. beginning January 1, 2013. While that does not sound like much it is a tax on gross revenue. It comes off the top and not on earnings, and it is huge. Further, whether a manufacturer makes a profit or not, the excise tax applies. **For a company like ours, which pays about 33 percent of our U.S. earnings in federal and state corporate income taxes, the excise tax will increase our effective rate on those U.S. earnings to 42 percent - this is more than a 25 percent increase.** It is true that imported goods are subject to the excise tax when sold in the U.S.; however, corporate tax rates on manufacturing income earned outside the U.S. are much lower. It is also important to note that there is not a state corporate tax on top of the federal corporate tax in countries such as Ireland (at 12.5 percent).

Since its enactment, there have been frequent announcements about device companies freezing capital expenditures, reducing research and development, expanding overseas rather than in the U.S., and/or in many instances, laying off employees due to the excise tax. It makes no sense to encourage manufacturing in the U.S. and at the same time impose an excise tax on one of the few industries that exports more products than it imports. Why would we want to impose an excise tax on one of our fastest growing and most innovative industries - medical technology - that increases the federal tax burden on medical device manufacturers by 29 percent? (Ernst & Young, *Effect of the Medical Device Excise Tax on the Federal Tax Liability of the Medical Device Industry*, November 2012).

Myths About the Device Excise Tax

1) Device manufacturers will pass along the amount of the tax - False.

Some say that a new 2.3 percent tax will only lead device manufacturers to pass on the cost of the new excise tax to purchasers (generally hospitals). That simply is not true for most companies. Hospitals are under tremendous cost pressure today with 40 percent of hospitals operating in the red. The hospitals and group purchasing organizations are saying no. This is a very competitive industry and customers have many suppliers.

Furthermore, our company, like most in our industry, has experienced significant increases in operational costs: health care costs for employees, salaries and wages, utilities, raw materials, regulatory costs, etc. We have seen the unemployment insurance tax increase along with other state, local and property taxes. The vast majority of companies simply cannot pass all those costs on, let alone a 2.3 percent tax on gross sales.

Finally, we have existing contracts of 3 to 5 years with prices already negotiated. Even if we did not face other restraints in passing along the costs, we simply would be unable to do so because of existing contracts.

2) Device manufacturers will have an increased market of new patients as the uninsured now become insured and therefore seek out new treatments – False.

Many believe that the ACA will add more patients and device companies will make more money as a result. This, too, is a myth for the vast majority of device companies. According to The U.S. Department of Health and Human Services (HHS), 71 percent of the "new insured" are younger than 45 years, a great majority of whom will not need our technologies. I have seen no credible studies that indicate an increase in sales and our research and other studies demonstrate that there will not be an increase in the sales of medical devices and no windfall profits.

I must also point out that a 2012 Roth Capital survey of companies showed that their experience in Massachusetts after universal health care was enacted showed no increase in the rate of growth compared to the increase in growth of rest of the nation. Indeed, Cook's growth rate in Massachusetts trends slightly behind the national growth.

<u>Device Company Investment in the Community</u>

Let me tell you a bit more about the vision of our late founder and my good friend, Bill Cook. Bill believed in giving back to the community and investing in America. He believed that companies should create technologies that benefit patients, but also that the companies themselves should create jobs that benefit not just individuals and families but communities as well. Bill grew up in the small town of Canton, Illinois. A few years ago, before the excise tax, Bill decided to open up a manufacturing plant in the small community of Canton. At the time, unemployment in Canton was very high and the International Harvester plant, which employed so many, had closed. Bill made the decision for Cook to invest in Canton and today we have two new factories where 140 people now work. More than 1,000 applicants applied for the initial 30 jobs at that factory, which makes catheters. The plant will employ 300 when we are at peak capacity. This growth has had a ripple effect as the local community also invested resulting in further growth. Canton is a model of what we would like to replicate in many other mid-western towns, but unfortunately this tax has forced us to shelve plans to build a similar factory every year for the next five years.

<u>Impact of the Device Excise Tax on Cook</u>

In order to offset a big expense like the excise tax, a company can only look to employees, research and development or capital. Cook has never had to lay-off an employee in our 50 years of business, and we will not start now. However, we must make hard choices.

Cook has made the difficult decision that without repeal, we will move important new product lines outside of the U.S. Our previous plans to open up five new manufacturing facilities in American towns are now on hold as we use capital intended for these projects to pay the excise tax.

The impact of this tax is squarely on U.S. jobs. Cook will adjust, but those that will be most affected by the device excise tax will be the potential future employees. Make no mistake about it: we want to develop and manufacture in the U.S. but this tax is preventing our growth in this country. It is a shame that potential employees in Indiana, Illinois, Pennsylvania, California and North Carolina can compete with any place in the world based on their productivity, but are going to be denied the chance by government.

Over time, we will see an acceleration of companies manufacturing outside the U.S. to lower the costs of goods sold in an effort to offset the impact of the tax. I emphasize that this is not about labor costs. Our industry needs an educated, skilled labor force wherever we locate.

This migration of manufacturing, coupled with the fact that most clinical studies are now being conducted outside the U.S. will result in new, self-sustaining medical technology clusters that will threaten the U.S.'s global leadership position in medical technology, innovation and manufacturing. This migration will result in delays and in some cases barriers for American patients and their providers who need innovative technology to ensure quality care.

Impact of Device Tax on Other Device Companies

Cook is not alone in feeling the adverse impact of the device tax. A 25 to 30 percent increase federal taxes will dramatically change this industry. Remember that this is an industry of small companies and the industry profit margin is between 6 and 10 percent.

A good example is Orthopediatrics, a Warsaw, Indiana company whose President and CEO Mark Throdal, says his company has shelved research and mothballed developing product lines that would help disabled children walk again. He needs to devote that R&D funding to pay this medical device tax. Listen to what others say, executives who came to the Web site www.no2point3.com to urge lawmakers to repeal this tax. Dozens of founders and senior executives replied. Here are a few of their comments.

> *We have lower net profit margins than competitors solely due to our choice to keep prices competitive while keeping 100% of sourcing and*

production domestic. For one of the products we'll be releasing for 2013 my domestic cost per unit runs in the high 40s per unit. My total cost in having it manufactured offshore, including logistics, runs about 18 per piece. That cost goes even lower if production runs become larger. By doing nothing but moving my production offshore we immediately see around a 65% savings per unit - which becomes all profit margin. There needs to be a distinction between those manufacturing domestically, paying decent wages, employment taxes, providing benefits for their workers, etc., and those who bypass our system by offshoring production. From Michael Shaffer, president of Atlanta-based Vendition Partners

Or this from Dr. Stephen R. Kerr of Pullyalup, Washington:

I am a surgeon and surgical device developer in Puyallup. I have a surgical device that I am now in the process of marketing to the major surgical device manufacturers in the US. i had the fortune...or should I say, eventual misfortune, of having dinner with the VP of sales and member of the board of directors of one of our country's major medical device manufacturers. The purpose of the dinner was for him to evaluate my new medical device. The upshot of the meeting, he loved the idea, and thought it was a significant improvement not only over what their company had available, but better than any of the other competitive devices as well. Sounds promising. He then proceeded to tell me that, unfortunately, due to the looming new medical device tax, that they would not be investing in any new medical device technology anytime soon. Regarding manufacturing of their current medical device portfolio, he informed me that their company, which does the majority of their manufacturing in the US, was now building new plants overseas and would be shifting their manufacturing there permanently. In order to offset the costs associated with the medical device tax. The president has stated that the ACA will increase the number of patients available and thereby increase their sales to make up for that. Unfortunately, as a surgeon, i can tell you with utmost certainty that this reasoning is flawed. Not once in my career did I not use, or downgrade the quality of the medical technology or devices that I use due to a lack of insurance. NEVER. I implore you to further examine the 2.3% medical device tax and its negative effects on medical innovators.

Perhaps John Micek of Buford, Georgia, has the most sobering perspective: *"I have lost my job due to this tax. So have 50 to 60 other people at Remington Medical, Inc. My past employer is moving to the Dominican Republic."*

<u>Senate Legislation to Repeal the Medical Device Excise Tax – S. 232</u>

But before this happens Congress can act to repeal this onerous excise tax. We are grateful to the 29 sponsors of S. 232, a bill introduced by

Senators Hatch and Klobuchar, as well as our home-state Senators Burr, Casey, Coats, Donnelly and Toomey, to repeal the medical device excise tax. In fact, many Senators serving on this committee have cosponsored this legislation or expressed support for either a delay or repeal of this tax, and we are grateful for your acknowledgment that this excise tax will have serious, unintended consequences. We hope as you deliberate further about ways to encourage medical innovation and investment in long-term economic growth you will consider advancing the repeal legislation.

b) Other Important Steps to Maintain Leadership in the Development and Manufacture of Medical Devices.

It is important to note that the medical technology industry faces other challenges from the federal government. The U.S. has been able to put a man on the moon and ought to be able to have the best system for the approval of safe and effective medical devices. Today, we have good people working hard at the FDA, but Americans access to the latest technology is behind those outside the U.S. **Congress needs to support changes in the system (not lower standards) to give American patients access to the latest technology. Cook historically has introduced all of its devices in the U.S. Now, almost 100 percent are first introduced outside the U.S.**

I also would like to mention the broader issue of taxation. The U.S. medical device industry conducts most of its manufacturing and invests the majority of its research and development dollars within the U.S. but as mentioned previously this trend is changing. Both Congress and the Administration recognize the importance of creating a climate to retain and expand these jobs. **Passing legislation to enact a manufacturing tax credit and a permanent research and development tax credit are two steps toward making this happen.** The current manufacturing deduction should be replaced with a manufacturing tax credit that results in qualifying manufacturing income being taxed at 20 percent. The research and development tax credit should be made permanent because a credit that continually expires and is reinstated does not provide the necessary predictability when companies are planning to conduct research and development in 3, 5 or 10 years.

Not many years ago, 75 percent of Cook device sales were in the U.S. Now, 57 percent of Cook sales are outside the U.S. while more than 80 percent of Cook devices are manufactured in the U.S. International markets are growing much faster than domestic markets. Thus, for U.S. companies to grow and prosper, their products must be sold internationally. This requires having operations outside the U.S. to cultivate these markets. In the medical device industry, it is necessary to have employees close to our customers to demonstrate products to health care professionals and to be able to deliver products for next day procedures. With the current U.S. tax system, companies are effectively locked out from repatriating earnings from these operations located outside the United States due to the incremental U.S. tax cost. Thus, **a repatriation incentive should be created to allow these funds to be returned to the U.S. at a minimal incremental cost with appropriate safeguards to ensure the funds create jobs.** During the prior repatriation holiday in 2004-2005, Cook invested repatriated funds in 2 start-up companies that currently employ a total of 500 people – up from a total of 73 prior to the repatriation. Another example of the use of repatriated funds at Cook was to allow for expansion at another of its subsidiaries by purchasing and renovating a larger building. This allowed the company to increase employment from 104 to 224 employees.

Closing

I come to you today as the Chairman of the Board of a multi-national medical device company. I shared with you quotes from other device companies to demonstrate the breadth of concern in the industry and am happy to assist you in reaching out to these companies if helpful to you. But today, I also sit here and speak to you not jut as a Chairman of Cook, but as a husband, father, grandfather, patient, and, finally, as an employee myself.

I spoke earlier of our catheter plant and what we've done in Canton, Illinois, and in closing I want to tell you a story about the first person hired at the new plant which opened two years. I heard this story on a tour given to a new Congresswoman representing our district: "When I was hired I was a single mother on welfare and lived in a small, subsidized apartment in Canton. I could not afford to get married and lose my benefits. Now, I have health care, I am married, and I just purchased a home because I got the job at Cook." Like more than 1,000 others from her town, she applied for a job at Cook and she got that job, she has a 401(k), she has profit-sharing, along with health insurance and steady income. Getting off welfare enabled her to finally get married to her boyfriend. She no longer needed access to government care. She just bought a house. This job, she will willingly tell you, has changed her life - brought her and her young family self-reliance and hope for a better future.

The country needs your leadership on this issue – your statesmanship – and we need it now. I urge every Member of this Committee and beyond to put partisanship aside and do what's right: protect families and patients. Repeal this medical device excise tax. Future generations are counting on it.

Thank you.

Chairman MURRAY. Thank you very much.

Mr. MALPASS.

STATEMENT OF DAVID R. MALPASS, PRESIDENT, ENCIMA GLOBAL LLC

Mr. MALPASS. Thank you, Chairman Murray, Senator Sessions, and members of the Committee. Thank you for the invitation to discuss the impact of Federal spending on economic growth.

I welcomed the Chairman's introduction on the need to tackle the debt and deficit and to cut spending responsibly. That is the spirit of my statement today, which I will summarize.

By way of background, my company is Encima Global. We provide economic research to a variety of financial firms.

My view is that reducing the path of Federal spending would cause faster economic growth and more jobs. To have a positive impact on growth, it is important to convince the private sector that the Government will create a continuous process of spending restraint and downsizing. The best way to convince the private sector is to make a responsible reductions now.

The debt limit should be rewritten, in my view, to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, which, if exceeded, forces Washington to cut spending.

A process to restrain spending growth is all the more urgent because the economic recovery continues to be much slower than normal. The unemployment rate is still 7.9 percent, and the growth in the Nation's prime working-age population has stalled. I am going to refer to a few of the graphs in my prepared statement.

On the graph on page 2, we can see that we have fewer workers in the prime working-age population. Apart from recessions, 2012 was the weakest nominal growth rate since World War II. The real median household income—and there is a graph of that on page 3—has fallen over the last 13 years, and especially in the last 5 years. Current policies, which I will characterize as spending more, raising taxes and relying on the Federal Reserve to provide the funding, are simply not working, as shown in the graph on the top of page 3.

CBO has had to repeatedly lower its forecasts, at the bottom of page 3, and the Federal Reserve, on page 4, has also had to lower its forecasts repeatedly as the effect of the policies became clear on the economy.

In my view, the inability to control spending is hurting growth. That includes the expansion of entitlement spending; the lack of a Senate budget in 2010, 2011, and again in 2012; the routine sidestepping of the PAYGO scorecard; and the decision not to offset spending increases with restraint elsewhere in the budget. Those have slowed GDP growth and job creation. The result is a policy that will require much higher future debt and taxes, discouraging business investment.

Government spending causes the private sector to expect more taxes and Government debt issuance. That causes it to reduce investment and hiring. The converse is also true. A convincing reduction in the long-term growth of Government spending would encourage private sector investment and hiring, and I will refer you to the graph on page 6 to show the problem.

CBO's projections of spending are that in the out-years they go up faster than the economy. That is daunting to the private sector. It looks at that graph, spending going up even faster than the economy, and decides not to invest, and that is what we have been facing.

The picture facing the private sector is even worse than the CBO baseline because it is based on two rosy assumptions. CBO is assuming that interest rates stay very low by historical standards despite the high levels of debt; and they are also assuming—and I refer you to the graph on page 7—that discretionary spending plunges from 8 percent of GDP now down to 5.5 percent of GDP by 2023. It is highly unlikely that we will see that level of spending restraint, nor would that be beneficial to economic growth if we did that. And yet that is the baseline assumption that CBO is operating on.

In making budget decisions, one of the confusing issues is whether austerity is bad for growth. The confusion is that austerity or "fiscal consolidation" encompasses two separate economic policies: Government downsizing on the one hand, which I think causes more growth; and private sector downsizing on the other hand, which causes recessions.

Many of the reform programs underway in Europe are harmful because they are built on austerity aimed at the private sector. In general, the unsuccessful programs provide minimal reductions in the size of Government, few labor reforms, and minimal asset sales. The Greek Government, for example, sold no assets in 2012 despite the austerity that they were under.

I see my time has expired, so, in conclusion, I would like to emphasize the urgency of this Committee's work in restraining spending growth and making decisions on a better composition of spending. Private sector investment is very responsive to future Government spending and taxation, so cutting Government spending, downsizing Government, helps growth by encouraging private sector investment and hiring.

Thank you very much, Madam Chairman.

[The prepared statement of Mr. Malpass follows:]

Statement of
David R. Malpass before the
Senate Budget Committee
February 26, 2013

Chairman Murray, Senator Sessions, members of the Committee, thank you for the invitation to testify on the impact of federal spending on economic growth.

My view is that reducing the path of federal spending would cause faster economic growth and more jobs. The private sector would celebrate. Government spending is a drain on the private sector because it has to provide the funding to the government through either taxes or loans. If you want more growth and jobs, you should convince the private sector that you will begin restraining spending. The best way to do this is to announce a few cutbacks today. The more convincing you can be in lowering the path of spending, the more the private sector will respond by investing and hiring workers.

Before continuing, I'd like to provide a little of my background. I am president of Encima Global, which I founded in 2008. We provide economic research to a variety of firms primarily in the financial industry. I also write a regular column in Forbes magazine with historians Paul Johnson and Amity Shlaes and Lee Kuan Yew of Singapore. I served at Treasury and State in the Reagan and Bush-41 Administrations and, prior to that, was the tax analyst on this Committee's staff during the development of the 1986 tax reform. I was a CPA before that and have a long-standing interest improving the federal budget. I live in New York with my wife Adele who was also worked on the staff of this Committee.

I was privileged to testify before this committee two years ago on the fiscal crisis. My February 1, 2011 statement recommended an upheaval in our federal spending and budgeting culture and made policy recommendations which I think would improve growth and jobs creation. I would like to repeat those recommendations today and hope that you will consider them:

- The expiration of the continuing resolution on March 4, 2011 (and on March 27, 2013) should be used as an opportunity to make numerous spending cuts now -- to put Washington on a diet where it shrinks day by day. Waiting for a deficit reduction package ducks responsibility and is a recipe for continued out-of-control deficit spending.

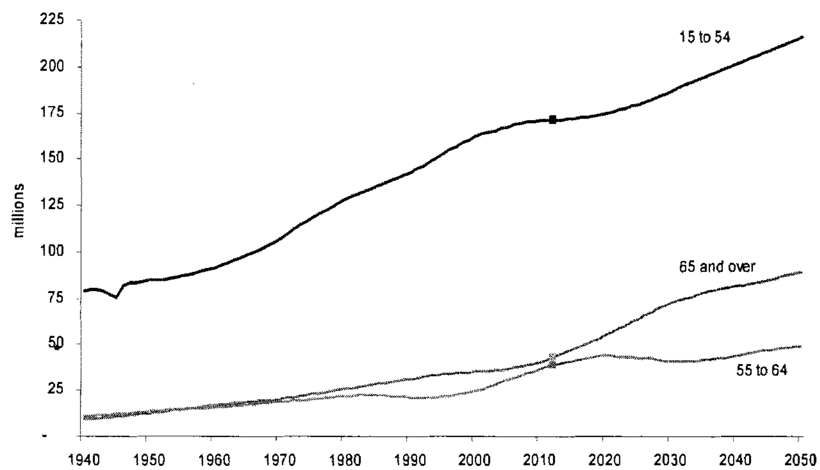
- The debt limit increase should be used to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, enforced by escalating penalties on Washington. There should also be a minimum maturity for the debt to stop the government from artificially lowering near-term interest costs.

- By buying long-term assets, the Federal Reserve is conducting fiscal policy. QE2 should be wound down. It is shortening the effective maturity of the national debt and is causing substantial market distortions.

- I believe these policy approaches would give new confidence to American businesses and financial markets, causing an inflow of capital and jobs to the U.S. private sector. (The above is an extract from my 2/1/2011 statement.)

Most of the issues you face are the same as they were in 2011, with the added urgency that the economic recovery continues to be much slower than normal, the unemployment rate is still 7.9% and the growth in the nation's prime working age population has stalled. The demographic climate points to weakness in payroll and income taxes, especially given high unemployment, at a time when federal outlays on the elderly will be increasing.

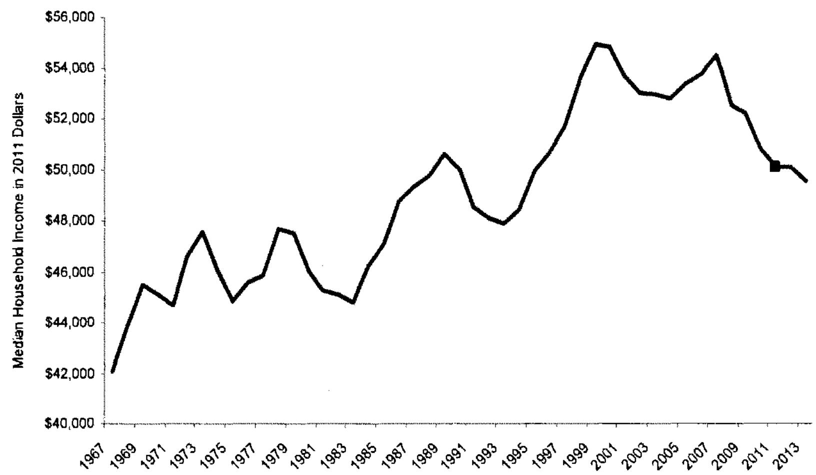
U.S. Population by Age Groups (last obs. 2012, projected to 2050)



Source: Census Bureau; Encima Global

In nominal terms, our economic growth of 3.3% in 2012 was even weaker than in 2010 or 2011. **Apart from recessions, 2012 was the weakest nominal four quarter growth rate since World War II.** The real median household income has fallen over the last 13 years, and especially in the last 5 years, a dismal economic performance.

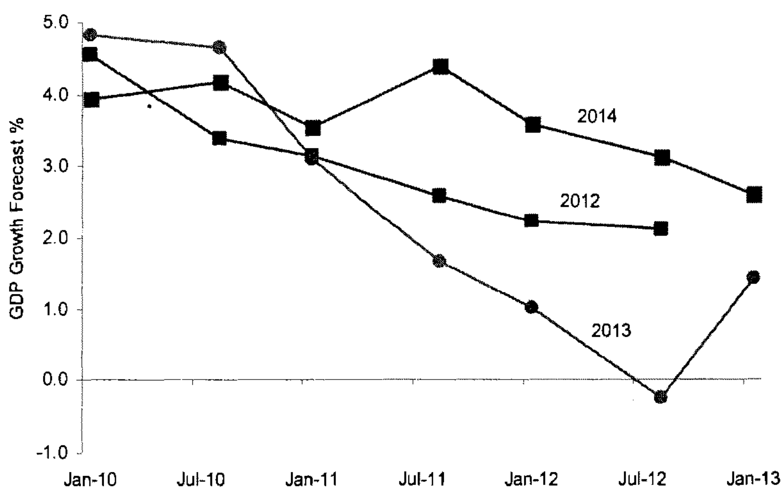
Real Median Household Income (last obs. 2011, estimates to 2013)



Source: Census Bureau; Encima Global

- CBO's growth forecasts have been overly optimistic and been reduced.

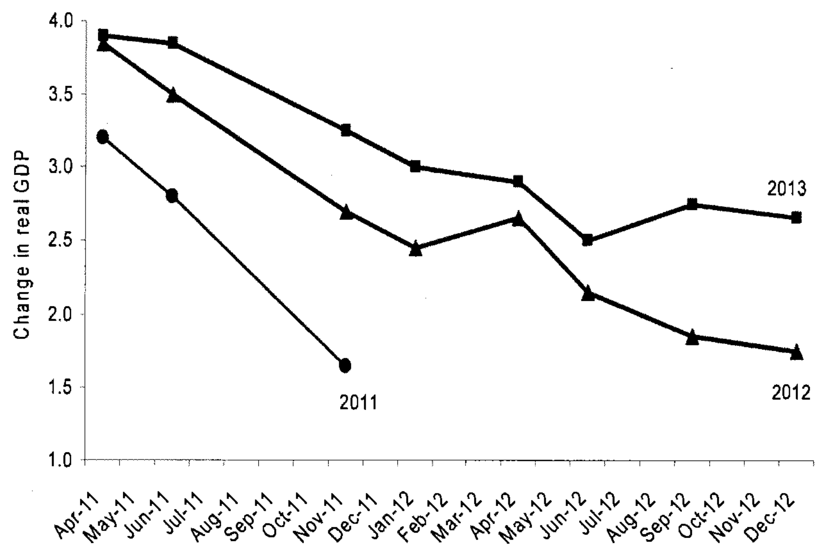
CBO Declining Growth Rate Forecasts for '12, '13 and '14 (last obs. 2-5-13)



Source: CBO; Encima Global

- Similarly, the Federal Reserve's original growth projections for 2011, 2012 and 2013 were too optimistic.

Fed Projected Real GDP Growth Rates (last obs. December 12, 2012)



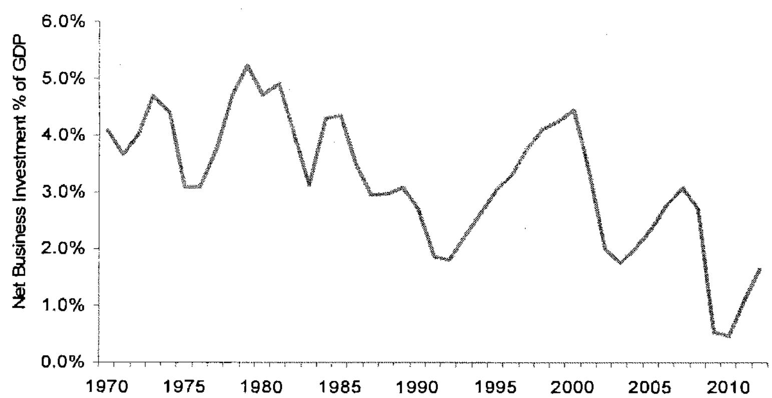
Source: Federal Reserve; Encima Global

Spending and Debt Contribute to Weak Growth

Current spending policies contribute to our economic weakness. In rough terms, the current policy consists of the federal government spending $3.6 trillion per year, 50% greater than the tax revenues of $2.4 trillion. The inability to control spending is hurting growth -- including the expansion of entitlement spending, the lack of a Senate budget in 2010, 2011 and 2012, the routine side-stepping of the pay-go scorecard and the decision not to offset spending increases with restraint elsewhere in the budget. **The result is a policy that will require much higher future debt and taxes, discouraging business investment.**

- Net business investment (gross non-residential fixed investment less depreciation) was only 1.1% of GDP in 2011 and an estimated 1.7% in 2012.

Net Business Investment as a % of GDP (last obs. 2011, estimated for 2012)



Source: Bureau of Economic Analysis; Encima Global

Milton Friedman explained that government spending has the effect of a tax. In a 2000 Media Research Center essay, he argued it this way: "An increase in government spending clearly benefits the individuals who receive the additional spending. Considered by itself, it looks as if the additional spending is a stimulus to the economy... But that is hardly the end of the story. We have to ask where the government gets the money it spends." He concludes that: "Government spending crowds out private investment."

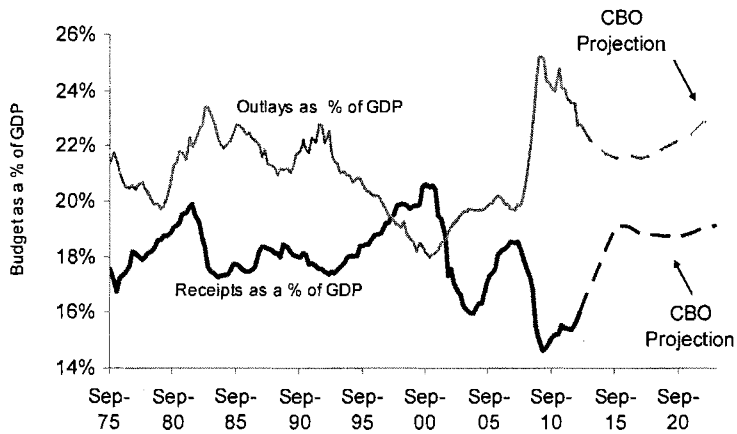
In CBO's discussion of this problem, its recent study on alternative budget paths finds that "larger deficits would reduce national saving and 'crowd out' domestic investment (as savings that would otherwise fund private investment were instead used to purchase government debt), lowering output."

The issue before the Committee, as I understand it, is how much the government should spend in trying to encourage growth and jobs. **The short answer is that you should spend much less if you want a stronger economy and, if possible, you should make spending reductions now rather than putting them off.** Government spending causes the private sector to expect more taxes and government debt issuance, causing it to reduce investment and hiring.

Again quoting Friedman: "Japan provides a dramatic recent example. During the 1990s, the Japanese economy was depressed. The government tried repeated fiscals stimulus packages, each involving increases in government spending financed by borrowing. Yet -- or maybe therefore -- the Japanese economy remained depressed."

The converse is also true. **A convincing reduction in the long-term growth of government spending would encourage private sector investment and hiring.** Looking at CBO spending forecasts on the graph below, the economic growth problem is clear – government spending per GDP is high and goes up in the out years, confronting the private sector with the prospect of paying more taxes and lending more to the government rather than to the private sector.

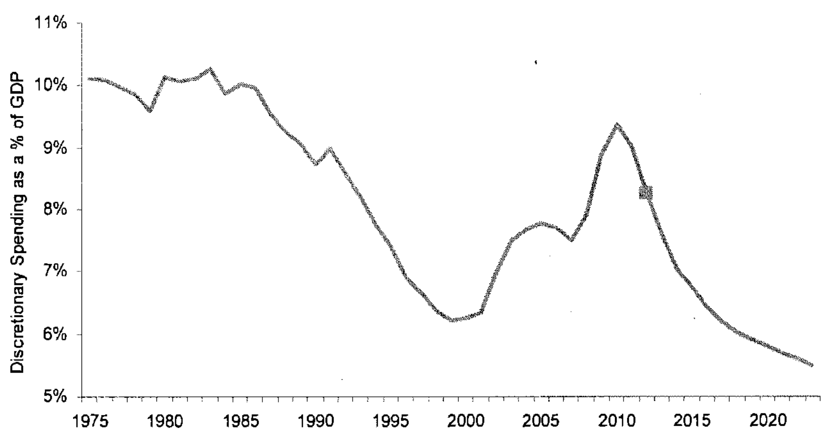
CBO Baseline: Federal Receipts and Outlays as pct of GDP (last obs. Q4 2012)



Source: CBO; Encima Global

- The picture facing the private sector is even worse than CBO's baseline forecasts because they are based on two rosy assumptions: that interest rates stay very low by historical standards despite high debt levels and the assumption of faster growth; and that discretionary spending plunges from 8% of GDP now to 5.5% of GDP by 2023, a highly unlikely degree of spending restraint.

CBO Baseline: Discretionary Spending as pct of GDP (last obs. 2012, est. to 2023)



Source: CBO; Encima Global

In making budget decisions, one of the confusing issues is whether austerity is bad for growth. The confusion is that austerity or "fiscal consolidation" encompasses two separate economic policies, government downsizing on the one hand, which I think causes more growth; and private sector downsizing on the other hand, which causes recessions.

Many of the reform programs underway in Europe are harmful because they are built on austerity aimed at the private sector. The austerity often takes the form of higher value-added taxes, wealth taxes, reductions in transfer payments to private sector retirees and increases in government fees for its monopolies. In the Asian and Latin American crises that I worked on, the austerity included currency devaluations, while the European programs are relying on "internal devaluations," primarily cuts in private sector wages, in an effort to respond to high unemployment and low productivity. This type of austerity has repeatedly failed.

In general, the unsuccessful programs provide minimal reductions in the size of government, few labor reforms, and minimal asset sales (the Greek government sold no assets in 2012 despite a severe cash shortage). I discussed the different forms of austerity in two Wall Street Journal articles: The Crisis Winner Is Government on 12-16-11 and Greece's False Austerity on 5-24-12.

This is of course a hotly contested field in macro-economics because it gets to the heart of whether governments should spend less, or more. A 2009 study by Harvard's Alberto Alesina and Silvia Ardagna concluded that fiscal adjustments based on spending cuts tend to be successful whereas fiscal adjustments that involved tax increases tend to be unsuccessful. Kevin Hassett of AEI and others have repeated the Alesina research and reached similar conclusions. This coincides with my experience working on several dozen country programs beginning with a review of Central American reform programs in 1984 for this Committee.

In contrast, the Congressional Research Service's Jane Gravelle reviewed the economic literature in January 2013 and concluded that the studies showing that spending cuts help economic growth "are generally inconsistent with the mainstream view of fiscal policy where short-term multipliers for spending decreases are negative and also tend to be larger in absolute value than those for tax cuts." The reference to multipliers means that spending cuts tend to hurt growth more than tax cuts help growth. Extending this logic, it might follow that spending increases help growth more than tax increases hurt growth, supporting an expansion of government.

The IMF issued a study in October 2012 prior to the G20 meeting supporting this mainstream government view. The study connected fiscal consolidation (i.e. smaller fiscal deficits) to slower-than-expected growth rates. It showed that countries which widened their deficits or reduced their fiscal surpluses grew faster-than-expected. This supported the French government's arguments to Germany that Germany should stop pushing so hard on austerity.

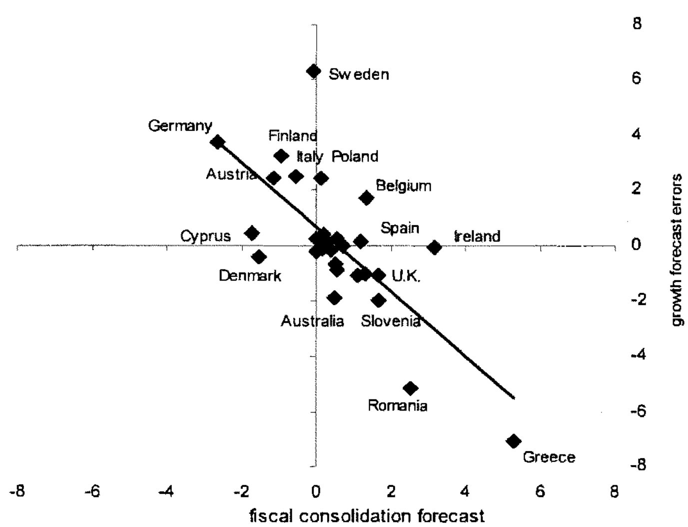
- This mainstream IMF view is lumping together two separate types of fiscal consolidation. Greece and the UK both imposed major tax increases as part of their consolidation, helping explain the deterioration in their growth forecasts during the IMF study.

- In contrast, Germany decided against tax increases, allowing the fiscal balance to move from a surplus of 0.2% of GDP in 2007 to a deficit of 4.1% of GDP in 2010 during the timeframe of the IMF study.

- It is clear to me from my experience in numerous countries that reforms that add to growth include labor mobility, restraint on government spending, asset sales and tax reform aimed at simplification and lower rates; whereas reforms that subtract from growth, as are often required in IMF programs, include value-added tax increases, wealth taxes and increased fees for government services.

- Whatever the conclusions from the various studies of government spending, the connection between spending and growth also depends on the level of debt. Spending increases will not be as damaging to growth (or spending cuts as helpful to growth) if the debt level is low, whereas spending increases will damage growth (and spending cuts help growth) when debt levels are high.

Fiscal Consolidation vs. Growth Forecast Error (IMF est. for 2010-2011)



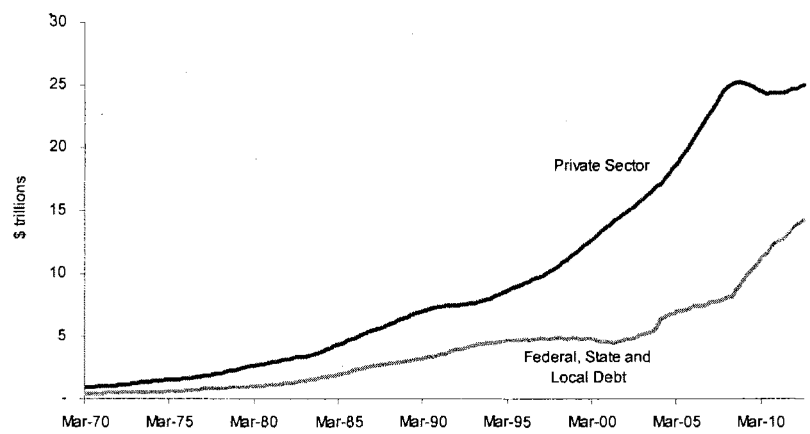
Source: IMF; Encima Global

Too Much Debt

The high and rising level of the U.S. national debt should be a key concern facing the Committee. It's clear from a variety of studies that the high federal debt burden slows growth. A key characteristic of our current economic policy is the rapid rise in government debt. When I testified here in 2011, federal debt was 64% of GDP. It's now 73% of GDP, very near the red flag levels established in recent economic studies. Including state and local debt, the IMF now puts our net debt level at 84% of GDP. While our debt probably won't go up as much in the next two years as it did in the last two, the current massive level of government borrowing undercuts the financial system's ability and desire to provide credit to the private sector.

- Credit to the government has been growing much faster than credit to the private sector, slowing growth. In effect, there's been a diversion of credit from the private sector to the government. This shows up in weak private sector investment which in turn has caused weak growth in labor productivity and GDP.

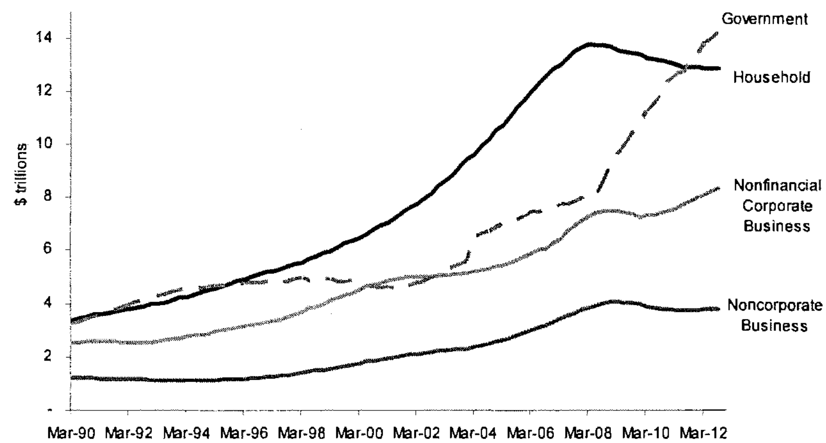
Credit to the Private Sector Vs. Government (last obs. Q3 2012)



Source: Federal Reserve; Encima Global

With the government borrowing huge amounts, the credit available to households and unincorporated businesses, which tend to be small, job-rich enterprises, has gone down, not up as it should. The Fed's flow of funds data makes clear the dramatic reallocation of credit to governments and corporations. In the year ending September 30, credit to the government was up 8.9% to $14.3 trillion (including federal, state and local marketable debt). Private sector credit was up only 1.9% year-over-year to $25 trillion. Credit to corporations was up 6.3% to $8.4 trillion, but non-corporate credit was up only 1% to $3.8 trillion and credit to households was down 0.5% to $12.8 trillion. The December 31 data, due from the Fed on March 7, is likely to show an extension of these trends. The economic result of the dramatic increase in government debt has been weak growth in jobs and GDP because small and new businesses have lagged.

Debt by Major Sectors (last obs. Q3 2012)



Source: Federal Reserve; Encima Global

Studies by Reinhart and Rogoff show that countries with debt levels approaching 90% begin to grow more slowly. A study by the BIS's Stephen Cecchetti found that each 10% increase in the debt-to-GDP ratio tended to cause a 0.2% decrease in subsequent growth rates once debt reaches excessive levels. Using different methodology, an IMF working paper by Kumar and Woo found about the same sensitivity – that growth slows by 0.2% for each 10% increase in debt, once debt levels exceed 90%, a direction we are heading.

There's a lot at stake as the U.S. debt-to-GDP ratio continues its rapid rise. Translating the growth impact from the high level of U.S. government debt into the impact on the employment rate, we may already be seeing a 0.5% increase in unemployment due to debt.

Federal Reserve's Role

In a change from past fiscal practices, the Federal Reserve is now providing much of the government's incremental borrowing capacity by borrowing from commercial banks to indirectly provide the funding for government spending.

The Fed's overnight IOUs to banks will soon reach $2 trillion, reminding me of the famous quote attributed to John Paul Getty: "If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem." The Fed will owe banks 20,000 times that amount and has plans to borrow another 10,000 times the Getty amount in 2013 alone. This will create a huge $3 trillion distortion in the composition of commercial bank assets, which are increasingly invested in the U.S. government through the Fed.

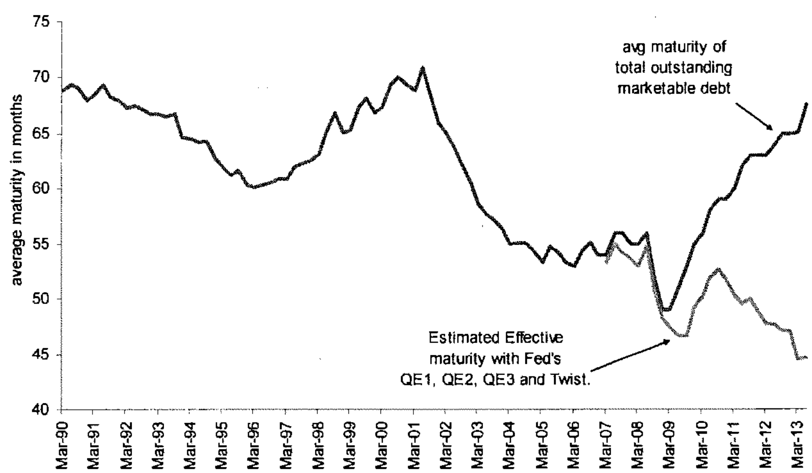
One goal of good financing policy is to lengthen the maturity of the debt. The U.S. is doing the opposite. This is a major risk in the event that interest rates rise, adding to the uncertainty in the business community from the expectation of higher taxes due to high levels of government spending.

The maturity of the U.S. national debt issued by Treasury is 65 months, only a little below the average maturity in the 1980s and 1990s.

- However, the Federal Reserve's large buyback of longer-dated Treasury notes and bonds, paid for by over-night loans from commercial banks, has substantially shortened the effective maturity of the U.S. national debt – to roughly 47 months -- which is near the crisis point of the 1970s.

- In addition to Treasury bonds, the Fed holds $1.1 trillion of long-maturity MBS and GSE agency notes financed overnight, an added exposure for the taxpayer in the event markets require higher interest rates -- as they did in the 1970s when the debt maturity was also short.

Maturity of Public Debt (last obs. Q3 2012, estimated through Q2 2013)



Source: Treasury Dept and Federal Reserve; Encima Global

Thus, the policy mix – high spending levels at a time of high debt levels, with funding provided by a wholly new financing scheme based on trillions of dollars in short-term Fed borrowing from commercial banks -- creates uncertainty about future interest rates and the dollar, further discouraging investment. This uncertainty is compounded by the short effective maturity of the national debt held by the private sector.

Not Worth the Risk

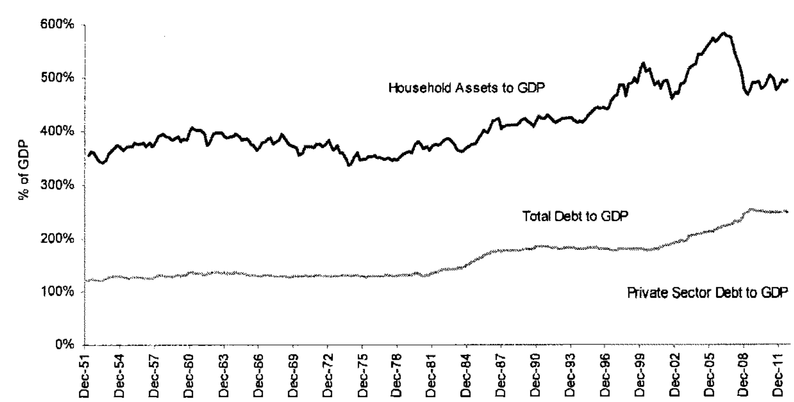
In evaluating the U.S. debt problem versus other countries, I look at the current debt burden relative to GDP (ours is now high); the rate of growth of the debt burden (ours is fast, given the fiscal deficit); the foreign currency exposure (ours is minimal); the nation's offsetting assets (ours have fallen, but are still very high); and the maturity of the debt (ours is way too short).

- On the positive side, very little of the U.S. national debt is non-dollar. Crises in Asia and Russia in the late 1990s and Mexico in 1994 involved foreign currency debts that mushroomed during their devaluations.

- U.S. household assets are the largest in the world by far ($78 trillion or 495% of GDP).

- By these metrics, the U.S. is in a less precarious debt position than several European countries, arguing against a near-term federal crisis.

Household Assets and Total Debt / GDP (last obs. Q3 2012)



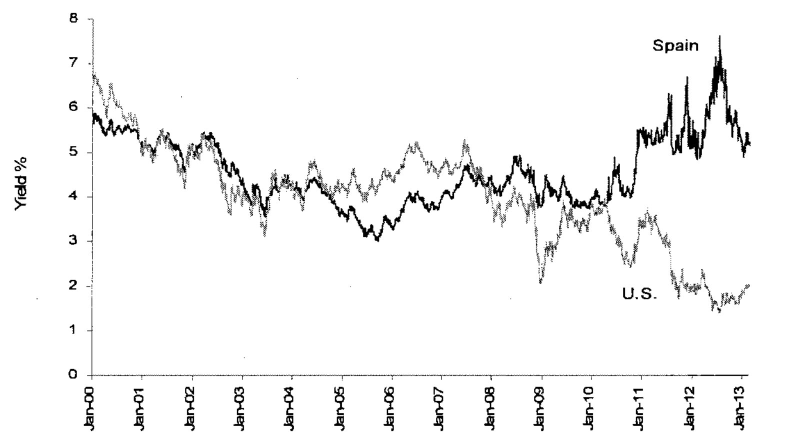
Source: Federal Reserve; BEA; Encima Global

No one knows whether the U.S. will hit a tipping point where creditors stop buying our debt. Such a problem would be catastrophic, so responsible public policy should be aimed at lowering the risk.

- Spain thought it was in good shape until early 2011 when its bond yields jumped and it found itself in deep fiscal trouble almost overnight. Unemployment is now

27%. One of the triggering events was the government's admission that the fiscal deficit was worse than it expected and the debt-to-GDP ratio was going to surge – it's now 90% of GDP and rising fast versus 107% for U.S gross general goverment debt under similar IMF methodology.

Spain and U.S. 10 Year Gov't Yields (last obs. February 22, 2013)



Source: Bloomberg; Encima Global

In conclusion, I would like to emphasize the urgency of this Committee's work in restraining spending growth and making decisions on a better composition of spending. Many government programs run on auto-pilot with little review of whether current spending levels are necessary in light of the huge national debt.

Much attention has been focused on the U.S. entitlement problem and the underfunding of the social security and Medicare trust funds. From an economic perspective, I think there's no real difference between dollars spent on entitlements and those spent on discretionary programs. Under our current system, all spending ends up being funded on a pay-as-you-go basis whether accounted for as an entitlement with a trust fund (like Social Security) or as discretionary spending (like defense.) In this way, all government programs are a commitment of future spending, though some will be harder to restrain than others. Rather than separate the categories of restraint between discretionary spending and entitlements, I think it is more important to agree that much more spending restraint is necessary and would be pro-growth, and then to get started on it.

Reducing the path of federal spending would cause faster economic growth and more jobs. The private sector would celebrate. Even though some economic models contend that cuts in government spending hurt GDP, the reality is that private sector investment is very responsive to future government spending and taxation – so cutting government spending helps growth by encouraging private sector investment and hiring.

Chairman MURRAY. Absolutely, and thank you to all of you for your testimony. We will now go to 5-minute rounds for all of our Senators for asking questions.

Ms. Trottenberg, I want to start with you. There has been a steady stream of studies in recent years highlighting a perceived investment gap in the Nation's transportation infrastructure. Certainly the public is very sensitive to the worsening congestion on our roads and at our airports and throughout our infrastructure.

Can you talk a little bit about what the economic consequences associated with an aging infrastructure are?

Ms. TROTTENBERG. Yes, there have been a lot of studies in that regard, and at DOT we put out a Conditions and Performance Report every few years, and we have seen that just to maintain the current state of good repair—which is essential for our economy to function efficiently—we would need in both the highway and transit context to basically double what we are investing now in capital investments.

If we look at our economic competitors, I think they are doing a better job of the economic analysis of looking at where investments will bring us the highest return, and we have started to do more of that at DOT. The TIGER grants gave us a really good opportunity to start that process. And I will just mention a few areas where I think there are tremendous economic returns to be realized.

I will start with NextGen. We are still using a 1950s ground-based navigation system. This gentleman held up his smartphone. We need to get to a satellite-based system. The economic returns on those investments are tremendous. They modernize our aviation system. They will save airlines fuel costs. They will make more capacity in our skyways. They will have tremendous benefits.

There are a lot of key areas like that. We discovered in TIGER, in our freight system in particular, there are a lot of areas where, with a good combination of very modest public sector investment, you can leverage a lot of private investment, 5, 6, 7 times as much public investment, and get tremendous public and private benefits.

Chairman MURRAY. Thank you.

Let me ask all of our panelists a broader question. America has always been known for building large projects— Hoover Dam, Interstate Highway System, investing in innovative technologies, as Dr. Rawlings talked about, producing the Internet and communication industries, educating our students, working to support these efforts.

You know, historically, investments in education, infrastructure, and research and development have really had strong bipartisan support. Eisenhower built our highways. Republicans in Congress worked with President Roosevelt on the Montgomery GI bill. The COMPETES Act passed Congress on a bipartisan basis. It was actually signed into law by both President Bush and President Obama.

I am worried about some signals on the horizon. Last year, after very long negotiations with the House, we were only able to pass a two-year transportation bill instead of a five-year bill. The Elementary and Secondary Education Act, and the Workforce Investment Act, both have not been reauthorized.

I wanted to ask all of you what you think is behind that trend and what are the long-term consequences of failing to invest in these programs.

Ms. TROTTENBERG. I can start on the transportation front.

Chairman MURRAY. Great.

Ms. TROTTENBERG. It is true MAP–21 was only a 2-year bill. We are grateful that Congress did come together, and obviously it was a bipartisan bill, led by Senators Boxer and Inhofe here in the Senate.

I think on the transportation front, we have had an extraordinary tradition in this country of bipartisan consensus. In part that is because, the funding mechanism we have used for the past 60 years, the Federal gas tax, has risen pretty regularly, and Congress has actually only had to raise it a few times. And because of the amount of mileage that Americans are driving has increased every year, we had a pretty good stream of revenue, and that enabled us, to build a stable program and achieve political consensus.

Obviously, now we have not had the gas tax raised in 20 years, and we have been searching for a way to achieve consensus on how to fund the program going forward. We have put a lot of general funds into the program, something that we started doing about 5 years ago and had not done prior to that at all. Obviously I think a lot of us worry that that is not fiscally and politically sustainable. As Senator Sessions was saying, that is adding to the debt future generations are going to have to pay to keep the program going.

So for us, we clearly need consensus on a long-term, sustainable funding path.

Chairman MURRAY. How about on the education and research side?

Mr. RAWLINGS. What I would cite there is the following: NIH has great bipartisan support. Republicans and Democrats support NIH, and that is terrific. It has helped us build great biomedical research in this country.

But because of what has been happening to the budget, with the steady squeeze on the domestic discretionary side of the budget, appropriations for NIH actually decreased over the last two years. Down, not up. And in terms of its purchasing power, it is down 20 percent over the past 10 years. That is a big number. It affects the University of Alabama at Birmingham, which is a great research institution in biomedical research. It affects the University of Washington, another great one. Both stand to lose tens of millions of dollars because of NIH reductions, which are already occurring, because NIH, worried about the sequester, is holding back research grants.

So the estimate at Birmingham is a $25 million loss. At UW it is $75 to $100 million. And the new president at Birmingham, Ray Watts, devoted most of his first public address to the danger of the sequester specifically for his institution in Alabama. So that is how it hurts.

Chairman MURRAY. Okay. Unfortunately, I am out of time. I am going to keep us all to 5 minutes, so I am going to turn to Senator Sessions at this point.

Senator SESSIONS. Thank you. We are proud of the University of Alabama at Birmingham, and they get about $300 million from the

Federal Government, and that is so important to a lot of the good work they do. And a $25 million reduction is significant, and it is a bit troubling through the sequester where the cuts falls are not as smart as they need to be. We did double NIH funding in the early part of 2000, but it is an important matter.

With regard to highway funding and the sequester, the sequester does not impact Federal highway spending, does it?

Ms. TROTTENBERG. Correct.

Senator SESSIONS. So we hear a lot of talk, you know, they go around and poll, I guess, and figure what is most important to the American people. They like roads and bridges. They like improved transportation. And we sort of imply that roads are getting cut, and in this program it is one of the things that is exempt, as is food stamps, as is Medicaid, as is many of the Pell Grant programs that are entitlement programs.

Mr. Ferguson, you mentioned something I have seen from talking to real business people, and you are one of those. You were actually solicited to move some of your manufacturing out of America to foreign countries because you could avoid the increase in the medical device tax. And that was an argument I guess some of the people asking you to consider that made. Do you think other companies may succumb to that argument?

Mr. FERGUSON. Well, I think you can see by the reports and releases that companies are making that decision every day to move outside the country.

Senator SESSIONS. So as a result, this tax would accelerate job loss in America.

Mr. FERGUSON. Yes. The answer to that question is yes. Ireland, Canada, and other nations constantly recruit U.S. companies to come locate in their countries.

Senator SESSIONS. Well, thank you for sharing that real-life perspective.

Mr. Malpass, with regard to the debt and Government size and spending, this is really important. I think all of us have to be honest. It is not all win-win, that somebody comes up with a plan and they say it is going to produce al these benefits, and if we would just tax a little more or borrow a little more and fund this program, it is going to make America better. But you are raising the question that it is not always so.

Would you share a little more with us on that?

Mr. MALPASS. Yes, Senator. As the debt grows, the private sector has to assume that that debt is going to be paid. So as the Government spends more, the borrowing has to come from the private sector or else taxes come from the private sector.

To the Chairman's point about why is it that we are having trouble making long-term investments, I would answer that we have so much debt, and each time you do a budget, you find that the entitlements and the annual spending are, in effect, crowding out. If you have a budget horizon that is 10 years and you say, well, the first thing we have to do is fund all the entitlements and then we have to fund the necessary discretionary expenditures, it does not—

Senator SESSIONS. Well, second, we fund the interest on the debt.

Mr. MALPASS. Yes, the interest on the debt, it does not leave much room for the longer-term projects that are going to create future growth. So, in my view, the best way to address that problem would be to make choices on all of these areas starting now, meaning you have to make spending choices, responsible spending choices, today.

Senator SESSIONS. Well, we know that recovery is slow. They are saying it was because there was a financial recession and other excuses. However, just a few years ago, 2, 3 years, after we were coming out of the recession, after we were out of it, the projections for economic growth that were expected last year and this year and next year made a couple of years ago are not being met. Is that not correct?

Mr. MALPASS. That is right. And I think we have tried the idea of having the Government spend more money to see if that causes growth, and we have the answer definitively. It absolutely does not cause growth. And Japan tried this. Japan has tried over and over again to have big spending increases and see if it gets the economy going. And each time the private sector reacts by reducing investment, which hurts jobs.

Senator SESSIONS. Well, it is so important, and I appreciate your testimony. My time has expired.

Chairman MURRAY. Thank you.

Senator Baldwin?

Senator BALDWIN. Thank you, Chairman Murray and Ranking Member Sessions. Today's hearing is especially timely given the across-the-board sequestration that is scheduled to take effect this Friday. These arbitrary and indiscriminate across-the-board cuts will reduce, according to many economists, expected GDP growth by as much as half at a time when we need to be focused on growing our economy. And it is another in a series of what I would describe as "self-inflicted wounds" that congressional gridlock is really responsible for.

We have to do better. We have an obligation to come together to find a balanced solution to avoid sequester and get back to the regular order of annual budgeting.

Our budget is about choices, and it is about values. And this week the Senate Democrats will offer a balanced solution to remove the sequester for a year by safeguarding investments that we need to grow our economy and cutting spending and closing tax loopholes that we can no longer afford.

Here are some of the choices that I see as we move forward. In my home State, do we kick 900 Wisconsin children out of Head Start? Or do we close oil and gas tax loopholes for one of the world's most profitable set of companies?

Do we ensure that 23,000 Wisconsinites continue to get job search assistance to get them back on their feet? Or do we continue with tax breaks for companies who ship American jobs overseas?

Do we provide nutrition assistance for our most vulnerable Wisconsin seniors? Or do we continue with billions of dollars of wasteful direct payment subsidies to large corporate farmers?

These are just some of the choices that we are facing that demand our action.

I want to focus my questions on two areas— infrastructure investments and workforce development—and I would start with a question about ports for Ms. Trottenberg. Wisconsin is home to one of the largest ports on the Great Lakes, the port of Duluth-Superior, and I had some time this past week to visit with residents of Superior, Wisconsin, about the topic of harbor maintenance.

As you may know, Senators Levin and Isakson have introduced the Harbor Maintenance Act, which would ensure that all fees charged to shippers through the Harbor Maintenance Trust Fund, which amounted to $1.7 billion for fiscal year 2013, are spent on harbor maintenance and operations. Presently, only half that amount is actually spent on those activities. And I am happy to say my colleague from Wisconsin and I are both cosponsors of this legislation.

Ms. Trottenberg, could you discuss what kind of economic impact the doubling of investments we make in harbor maintenance would have on communities like Superior, Wisconsin? Green Bay also has a big harbor.

Ms. TROTTENBERG. Yes, I would be happy to, Senator Baldwin, and certainly ports is another area where at the Department we get a lot of interest, and they are clearly a key focus for our administration in terms of investment.

Again, having to do four rounds of the TIGER grant program, we were able to put investments into 25 ports around the country. It was pretty unprecedented. And with a lot of those projects, the economic analysis showed benefits that greatly surpassed the investments. And, again, a lot of these projects were public-private partnerships where there was a lot of private investment being leveraged. Clearly, there are a lot of ports around the country that are interested in accessing more of the Harbor Maintenance Trust Funds. There are great dredging needs. There are great both port infrastructure needs and transportation needs linking to the ports— roadways, railways, et cetera.

There is no question, through the economic analysis our Department has done, there is great economic value to be unlocked in investing in our Nation's ports, and clearly, as we anticipate less of an issue in the Great Lakes but certainly in the southeast as we anticipating the widening of the Panama Canal, our Department is right now undertaking an analysis to see exactly what the potential impacts of that are going to be and how we can best target investments to make sure our country remains competitive in the global economy.

Ms. BALDWIN. Thank you.

Chairman MURRAY. Thank you.

Senator Johnson?

Senator JOHNSON. Thank you, Chairwoman Murray.

The Chairwoman in her opening statement said that the goal here is to help our economy grow and keep us globally competitive. I just want to ask any member of the panel, is there any tax increase that you know of that helps our economy grow or keeps us competitively globally? Any? Anybody want to volunteer? I will take that as a no.

Mr. FERGUSON. Well, I would say that the device tax, makes it more difficult for the U.S. to compete globally.

Senator JOHNSON. Exactly.

Mr. FERGUSON. And the private side exceeds the public side in investment in R&D. And so when you have a tax and businesses have only three places to cut—employees and R&D and captial—and this tax has a strong impact.

Senator JOHNSON. I think my point has been made. There are no tax increases that are going to help our economy grow.

We have also heard a number of times—and really over the number of weeks—people talking about the sequester devastating our economy; $85 billion on $16 trillion, or sixteen thousand billion, is about 0.5 percent. Is a 0.5-percent reduction in spending by one component of the economy going to be devastating to any economy? Is that an accurate term?

Mr. MALPASS. I do not think it is devastating. I think it is correct to say this is not the best way to make your spending decisions. So as the Chairwoman opened the hearing, the goal is to find responsible ways to restrain spending, and that would be very pro-growth.

One concern I have on the sequester itself is this. If it is perceived as a one-time cut, then it will not have the positive impact that you would get from a continuous process of spending restraint. The private sector has seen one-time temporary tax cuts. For example, in May of 2008, there was a Bush tax rebate that did not work. And in 2011 and 2012, we had the payroll tax cut that, again, did not provide stimulus. We have seen the economy actually slow.

So it is the same with the sequester. If it is perceived as a one-time cut rather than a continuous process of cutting, I do not think we will get the benefits that we would get from continuous spending restraint.

Senator JOHNSON. Okay. I believe the whole point of sequester is to lower the baseline and that is why you would get about 1.2 trillion.

Dr. Rawlings, you asked why would we possibly want to reduce this. You know, quite honestly, I do not want to reduce infrastructure spending or basic science and research. But here is why we have to reduce something in the Federal Government, is because we have taken 65 percent of our Federal budget off budget, so that all of these cuts are falling on a very small sliver. And the other reason we have to do this is from 1970 to 1999 the average interest rate we paid on our debt was 5.3 percent. We have been keeping that interest rate artificially low. If we revert to that average when global competitors say we are not going to loan you this money, not at that rate, we could add $600 billion per year to our interest expense. That is 60 percent of discretionary spending. That is why we have to address this.

Dr. Carnevale—

Mr. RAWLINGS. Could I just say something?

Senator JOHNSON. Sure.

Mr. RAWLINGS. Those are very good points, Senator, and I certainly do not disagree. The problem here, of course, is that all the cuts are falling on this tiny piece of the budget where we—

Senator JOHNSON. So don't you think we need to expand and take a look at all of the budget? And that is part of the problem. You know, certainly on this side of the aisle, we actually want to save those other programs for future generations. It seems like the other side is always taking them off the table, and that is the real problem here, all these cuts are disproportionately falling on a small sliver of—

Mr. RAWLINGS. I think that is a big part of the problem, and it does seem to me that we need a much better balanced approach.

Senator JOHNSON. Yes. But the balanced approach, if you increase taxes, it is going to harm economic growth, so the balanced approach you are talking about then was why don't we actually address Social Security, Medicare, other mandatory spending programs that are really the bulk of our long-term deficit drivers. Correct?

Mr. RAWLINGS. If we protect the vulnerable, which I strongly believe in, then it seems to me that people like me could indeed suffer—

Senator JOHNSON. And we all want a strong social safety net. We are a very compassionate society.

Dr. Carnevale, you mentioned the escalating costs of higher education. I agree. In the 1960s, room, board, and tuition of a 4-year college was about $1,000. Had that just grown by the rate of inflation, today college room and board for a year would be about $7,400. But, in fact, it is about $18,000.

Can you explain what is so different about higher education that it would grow in its cost at 2.4 times the rate of inflation and make, quite honestly, higher education less accessible?

Mr. CARNEVALE. In the end, a lot of the growth really is—and I understand your point. You are right. The cost of higher education has gone up. But a fair amount of it is quality. The question is: Can we afford the quality? That really is—and can we afford spending 18 to 20 grand a student for 65 percent of—

Senator JOHNSON. In business, all the time, quality has dramatically improved. I mean, we pulled this thing out. Quality is dramatically improving as the price is decreasing. So, again, so what is it? What is higher in quality in education that you cannot also squeeze out economies?

Mr. CARNEVALE. Oh, sure, you can squeeze out economies. I agree with that completely. Not only that, we are going to have to squeeze out economies. I do not think there is any alternative here. We simply cannot educate 65 percent of us at the postsecondary level at the current productivity rate in higher education. It is not possible.

Senator JOHNSON. We have enticed our children to incur collectively $1 trillion of debt in higher education. Fifty percent are unemployed or underemployed recent college graduates. And we have poured Federal support into those programs. I guess I am just kind of wondering if maybe that is one of the reasons higher education has increased 2.4 times the rate of inflation, the money we have poured into it?

Mr. RAWLINGS. If I could just respond quickly, what is happening is a really dire problem, and part of it is because States have cut so much back on their support for public higher education. So, in Oregon, for example, repeated cuts in State funding have led, as you say, to increases in tuition. We cannot just keep doing that, and the result is that right now budgets just keep going down, down, down. So—

Senator JOHNSON. But the cost has gone up, up, up—

Chairman MURRAY. Senator Johnson—

Senator JOHNSON. I am sorry.

Chairman MURRAY. I hate to interrupt you, but we have a lot of Senators and a vote coming.

Senator Warner?

Senator WARNER. Thank you, Madam Chairman.

I do want to follow up, though, from where Senator Johnson was. I agree that entitlement reform has to be part of the mix. One of the things I find interesting, though, is, you know, our revenue as a percent of our GDP is at a historic low. Having been involved in a variety of the effort to try to find that common ground, all of them have had substantial amounts of revenue increases to try to get us back towards our historic levels, what we did on New Year's Eve was less than half of what everything from Simpson-Bowles to every other plan had out there.

So the notion that we are going to somehow do this without having revenues as part of the mix, as somebody who has read—I will match my capitalist credentials against anybody at this dais and job creation credentials against anybody on this dais, you know, and can read a balance sheet, you know, it has to have a balance.

I do want to come back to the sequestration issue, which I have been running back and forth, along with some of my colleagues, with Chairman Bernanke downstairs, you know, everybody concurs, you take this hit, and in a way that was set up to be the stupidest way possible, you are going to have at least a 750,000 job hit.

What I pressed Chairman Bernanke on was how deep was your analysis, was it just, you know, taking this much money out, this many jobs, and he acknowledged that is only as deep as it went. It did not go to the point of where—and I think the American public will be even more outraged as we kind of go down the line. How stupid this was set up where in many cases we will be costing the taxpayer money under the guise of savings. Let me cite three examples, and one, Dr. Rawlings, I would like your comment on, where like any volume purchaser we buy more tanks, bullets, guns, planes, you get a volume discount. We will be breaking volume discount contracts because of this—taking the Navy, 975 separate line items. They are not all of equal value to the taxpayer, but they are all going to take a whack.

The idea of furloughing a meat inspector or a poultry inspector, where you can take that cost of that individual's job, what has not been factored into the analysis is what happens when not as much food gets to the marketplace and, consequently, food prices go up overall?

And, Dr. Rawlings, I had—my good friend Tim Kaine has one of our university presidents in today, and I have heard this from a number of them, as well as folks at NIH, where— and you may want to comment on this—where because of this kind of arbitrary, non—and I agree with actually Senator Toomey, lack of discretion, and even with discretion you are still going to have bad outcomes, you will have cases, isn't it true, where you may have multiple years of research where you need that last year to finish the research to get valid results, where you will not be able to issue that last year contract and consequently will literally flush from a scientific standpoint the prior year workings. Is that not correct, sir?

Mr. RAWLINGS. That is correct, and with that scientific loss goes something else. Think of most of these researchers on NIH grants as running small businesses— because that is what they do. They are not like me. I teach ancient Greek. I do not have a small business. I do not drive the economy. But these researchers on NIH grants do. So some of them have four-person companies. Think of it that way. Some of them have 12-person companies, some of them have 25-person companies doing grant work.

So what do you do when you get this cut in the fourth or fifth year of your research? You let go your workers because you cannot pay them any longer. So the grad students and the post docs fall off the research team, and the research team cuts back. But worst of all is not knowing.

I had one professor tell me that his lab is now suffering from sequester fatigue before the sequester begins because NIH has held back on the grants.

Senator WARNER. Well, again, my point being that I very much believe you have to have a balanced approach, revenues, I do believe entitlement reform has to be part of this mix. But I think when we look at this kind of top-line number, we are looking at the top-line number as if it was as rational set of cuts, when in effect this was set up to be the most irrational—I use the "Blazing Saddles" analogy when the sheriff comes up and puts the gun to his head. You know, no rational group of folks would allow this to happen, yet we are 3 days from allowing this to happen.

I know I am down to 35 seconds. I want to move to another subject, Ms. Trottenberg. There are a number of us, bipartisan—Senator Kerry and Senator Hutchison, who have since moved on to other careers, but Senator Lindsey Graham and I looked at the notion of how you better leverage our declining revenues for infrastructure, on any historic basis, again, our percent of GDP investing in infrastructure is pitifully small. So we have looked at a public-private combination of an infrastructure investment bank, and with my few remaining seconds, I would like to get your comments on that.

Ms. TROTTENBERG. Yes, and—

Senator WARNER. And let me add, one that on the Senate side did not have direct loans but—did not have direct grants, but was much more loans, loan guarantees, married a model much after the Export-Import Bank, which has never lost a public dollar ever.

Ms. TROTTENBERG. And we have sort of a prototype model of an infrastructure bank right now at USDOT, which is the TIFIA loan program, which Congress greatly increased the funding we have for that program in MAP–21. And I can tell you, the program has been very, very successful. It does leverage tremendous amounts of private dollars. I think it brings a lot of private sector efficiencies into transportation investments. It requires project sponsors, I think, to do the kind of due diligence that, particularly when you have some real skin in the game, you see very good work there.

There is one thing we have to acknowledge, though. Those types of programs do require some sorts of revenues to pay back the loans, and typically in transportation that has been tolling or a sales tax or something like an availability payment, which is a guaranteed revenue stream from a State or local government.

So I think those bring tremendous efficiencies and can unlock all kinds of private capital that is waiting to get into the infrastructure investment space. But they do need some sort of a revenue stream, obviously, to pay back the loan.

Senator WARNER. Thank you.

Chairman MURRAY. Thank you very much.

Senator Ayotte?

Senator AYOTTE. Thank you, Madam Chair.

I wanted to ask Mr. Ferguson, I have been very concerned about this medical device tax. In fact, in New Hampshire, we have approximately 50 medical device companies employing almost 3,800 people, and that was just in 2008. It has really been a growth industry for me. I have visited many of them, both when I campaigned and also since I have been a Senator. And I know you are a larger company, Cook. What does this do to startups, the medical device tax?

Mr. FERGUSON. It hurts them very badly. There is a startup that I know in Warsaw, Indiana, called OrthoPediatrics, which builds orthopedic devices for kids and makes them able to walk when they cannot. They have about $19 million in revenue. They are not profitable. This tax drops to the bottom line. They had to cut two R&D projects that would have helped kids walk.

Senator AYOTTE. Is that because this tax is also a tax on revenue as opposed to profit and, therefore, when you are a startup, you do not generally make a profit so your revenue is reinvested in research and running your company?

Mr. FERGUSON. It does, for what you say, since it is a gross tax, it drops directly to the bottom. You have to remember, out of the public companies that are publicly traded, over half of them lost money last year. So it is dropping directly to the bottom, and they are having to make decisions between employees, and R&D, and capital. So it is not just the small companies. It is big companies, too.

Senator AYOTTE. Who is ultimately going to pay this tax? You know, we are really concerned about health care costs increasing. What does this do to health care costs?

Mr. FERGUSON. I think patients pay the price for this tax, because they will not have the latest technology. I think U.S. employees and R&D will pay the price. Ultimately patients will pay the buggest price. I think that is where it falls.

Senator AYOTTE. Will it ultimately drive up health care costs as well? I mean, these costs—you can only sustain so much in terms of what you can—what will not be able to pass—will some of it be passed through to the consumer?

Mr. FERGUSON. Well, you know, in our cases, you raise wages 4 percent, you have a 10-, 13-percent increase in health care costs, you had other expenses every year. The hospitals are under tremendous pressure. The GPOs are saying you cannot pass it on to us. We have a lot more expenses than we could possibly pass on, so we have to look at the other side, which is how to reduce your costs, and that is the reason I say it is going to go to the employees and patients.

Senator AYOTTE. You were going to open up five new facilities or plants, as I think you described in recently testimony, here in the United States. What kind of jobs were you talking about there?

Mr. FERGUSON. We had just opened a plant in Canton, Illinois. We started out—and it was interesting. Our new Representative, the Congresswoman from that area, took a tour, and she introduced herself to our employees. One young lady stood up and said, "You know, before Cook I was on welfare. I could not get married because I could not give up the benefits. I was living in subsidized housing. Now I have health care. I just bought a house. I got married," et cetera.

We had 1,000 people apply for the first 30 jobs. We are going to have 300 employed there. We wanted to build five more plants like that so we could employ 300 per plant, about 1,500 more people who are productive, who work, who want to work, who need the jobs, and we want to do it in the United States.

Senator AYOTTE. And also, do you see this, if this tax remains in place, that we will see more investment in medical device innovation overseas?

Mr. FERGUSON. Absolutely. I think you can see that right now by what is happening. I hope that you act quickly to try and turn this. You know, we are an American company. We want to stay here. We want to build jobs. I think this industry does, too. But you are going to have to take action quickly to keep the momentum.

Senator AYOTTE. Mr. Malpass, I wanted to ask you, is there another way we could grow revenue other than increasing taxes? What will the growth in economic—growth in the private sector in terms of growth there do to increased revenue to our Government?

Mr. MALPASS. Yes, I think we can grow revenues. In 1986 we lowered the rate and broadened the base, and that was very stimulative to the private sector. The private sector sees that coming and begins to invest more.

The same happened in 2003 and 2004 with the Bush tax cut, which was very successful in terms of causing more revenues to come into the Government, even though the rates were lower.

As you look at tax provisions, tax reform that makes the code more logical or less illogical would be a big step forward. This medical device tax, by taxing gross revenues, is a stupid tax. We are using that term about the sequester, but we are doing it also on the revenue side. It is a bad way to raise revenues.

Senator AYOTTE. Thank you all for being here. I appreciate it.

Chairman MURRAY. We have four Senators remaining: King, Toomey, Kaine, and Wyden. Senator King?

Senator KING. Thank you, Madam Chairman.

Madam Chairman and Ranking Member, this has been a very interesting hearing, and I want to thank you for setting it up.

Mr. Malpass, a couple of questions. I was fascinated by your testimony. I think one of the issues that really has not come out explicitly in this hearing is that all Federal spending is not created equal, and that there are areas that certainly need to be cut and restrained, and there are other areas that are legitimate investments. Would you agree that that is the case?

Mr. MALPASS. Yes. I think what is important is that the United States be perceived as a Government that has a process to restrain spending and to make logical choices. I was listening with interest to the other statements today and agreed with most everything. The projects that are put forward sound like good projects. Within the same Departments, for example, the Department of Transportation, it would be very useful to have areas of restraint where there is a process that the business community can see, the private sector can see, and that would spur growth.

Senator KING. Well, one of the ironies about the sequester—and Senator Johnson pointed this out—is that it is aimed at the areas of the budget which, if you look historically, are flat or actually declining. Nondiscretionary difference is at the lowest percentage of GDP it has been in about 40 years. And the real driver of the deficit over time is health care. And there is nothing in the sequester or—I mean, we have to talk about health care, we have to talk about entitlements, because that is the long-term driver. So I agree with Senator Johnson on that.

One other sort of mega question, and I do not have an answer to this, I am interested in all of your answers, but particularly you, Mr. Malpass, because you are talking about it. By the way, when I first heard your name, I thought it was "Malthus," and I thought how ironic.

Mr. MALPASS. I have tried to live that down.

Senator KING. That is too poetic for the Federal Government, I think.

What is the appropriate level of Federal spending as a percentage of GDP? Historically, it has been between 20 and 22 percent. What is the appropriate level of taxes, revenues, as a percent of GDP? Historically, it has been between about 17 and 18 or 19. What is the right number? If we can figure out what those numbers should be, then it gives us targets that we can then talk about in terms of budgets and revenues. Do you have a theory about where that number should be?

Mr. MALPASS. My view is that there is no one magic number, but the ranges you cited would be very pro-growth. So if this Committee decided that that was going to be the objective, to have spending in the historical range, you would see businesses across the country begin hiring workers.

The problem is, as I showed in the graph, the CBO baseline has much more spending than that. It has tax revenues going up to nearly 20 percent of GDP, which we have never been able to achieve. So there are already plenty of taxes in the budget, but just way too much spending, and so the private sector responds negatively.

Senator KING. Well, I would point out that revenues right now are about a point below the 40-year average in terms of percent of GDP, so there is some upward space for revenues.

Mr. MALPASS. And CBO has that in the baseline that revenues we go up. The assumption in the current law baseline is that revenues are going to go up and actually exceed historical averages with the current taxes. So there is no real room for more taxes. There is room for less spending.

Senator KING. Would you distinguish between raising—I notice you like the 1986 act because it lowered rates and broadened the base. If we are talking about revenues, shouldn't that be where we are looking, tax expenditures, broadening the base, rather than rate increases? Simpson-Bowles says we can actually lower rates if we significantly cut back on tax expenditures.

Mr. MALPASS. That is true, and I think, again, if the Committee in forming a budget were to seek that as a goal, that would cause immediate reaction in the private sector with people hiring. It would mean that the U.S. Government has a goal of having tax reform, which streamlines the Tax Code, is less horrible than our current Code, with lower rates and a broader base. The private sector reaction would be huge to that.

Senator KING. I would agree with that. I think the most stimulative thing we could do is make a deal, a long-term, sustainable deal.

Mr. MALPASS. And in my testimony, and 2 years ago when I testified here under the same circumstances, the key point is to make some small cuts now on the idea that there is a desire to have restraint. The impression across the country is that Washington wants to have more spending and more taxes, and so that is what is holding back the business community. There is plenty of cash out there, but people just are not investing it under these conditions.

Senator KING. And we need to unleash that.

Mr. MALPASS. Yes.

Senator KING. The only other, the final—I realize I am over time, but the percentages, going back to whether the right number is 20 or 21 or 22, we also, when we are figuring that out, have to take into account the effect of the aging of the population.

Mr. MALPASS. That is right, and that actually is a very tough question. And Senator Wyden is an expert. I showed earlier in my testimony the demographics changing. Even if you went to the high end of those ranges that you specified, that would still be a huge surprise to the country and would be very pro-growth if it were achieved.

Senator KING. Thank you very much.

Chairman MURRAY. Thank you very much.

Senator Toomey?

Senator TOOMEY. Thank you very much, Madam Chairman.

Just to follow up on this, my own perspective on the question that Senator King posed is that the optimal size of Government depends in part on how much growth you want to have. I think the evidence is overwhelmingly clear. Societies that have government expenditures smaller as a percentage of their economy have a higher standard of living. They have higher growth, higher income, higher wages, and greater wealth. And countries that have the government occupying a larger segment of the economy, they have slower growth, fewer jobs, lower standards of living, and lower incomes. So a big part of this comes down to how much prosperity do we want. If we want more, we will spend less. And it makes sense not only because the Government spends money through a political process that is not following the kind of economic incentives that the markets use, but also it has to be paid for. This spending always ultimately gets paid for by confiscating it from the more productive private sector, which brings me to the sequester, which I just want to stress for the record that, despite the description, the apocalyptic descriptions about this, this is really small in the context of total spending and the economy, where the Federal Government has doubled its spending in the last 10 years, and we are talking about a 2.5-percent reduction in spending from that 100-percent growth. And, by the way, that is budget authority. Actual outlays for this year, it is about 1–1/4 percent. That is one-quarter of 1 percent of GDP. This is not some kind of severe austerity plan.

Now, I think it could be done more wisely, and I wanted to see if there was any disagreement on the idea that since the current law forces the across-the-board cuts with no opportunity to exercise any discretion with respect to those spending areas that have more merit and those that have less, could you comment on whether you think it makes sense for us to, in the event that the sequester goes forward, grant to OMB and the Defense Department in their responsive areas the flexibility to make these cuts in a more thoughtful fashion? Does that make sense to anybody?

Mr. MALPASS. The short answer is yes, very much so, and I think the private sector response would be huge because it would show Washington trying. Rather than trying to maximize the damage from the sequester, it would be trying to reduce the damage or make it less onerous than Washington has made it out to be.

Senator TOOMEY. Any other thoughts on that?

Mr. RAWLINGS. Yes, I would disagree with that comment because, while it sounds better to make flexibility, in fact, if what it means is we are going to stick with the cuts at the level of the sequester and then leave it up to NIH and NSF to make the cuts in a slightly better fashion, they can do that. But if that becomes the new baseline, all you have done is succeeded in cutting NIH and NSF, letting them figure out—

Senator TOOMEY. Let me just interrupt for a second because it is not—depending on how you formulate this, it is not necessarily the case that NIH per se has to take the cut.

Mr. RAWLINGS. Right.

Senator TOOMEY. If the administration has the discretion across all nondefense categories, they might decide that, building new taxiways on a seldom-used airport somewhere should be a lower priority than NIH.

Mr. RAWLINGS. The problem is it is going to look like a good solution, everyone is going to say, great, now they can make their own decisions. But the bottom line is going to be cuts in the areas where we need investment because our competitors are investing and we are reducing.

Senator TOOMEY. Okay. But that sounds like an argument that we cannot cut anywhere, and when we have had a Government that has doubled in size in the last 10 years, to think that we cannot find, a little over one penny on every dollar anywhere throughout this Government strikes me as not very appropriate.

Let me ask a specific question, if I could, of Mr. Ferguson because I know you touched on the medical device tax, and as you may know, there is bipartisan concern that this is a really egregiously, badly designed tax. That happens to be my view, in part because it applies to sales, irrespective of whether a company is making any money. And if I understood your testimony correctly, am I right in understanding that because of the medical device tax and if it stays in effect, you will forgo expanding production in the United States of medical device manufacturing?

Mr. FERGUSON. Yes, and our future growth will have to be in Ireland or Denmark or Australia.

Senator TOOMEY. So this medical device tax, in your view is this a pretty direct incentive to go overseas, go offshore, create jobs somewhere else?

Mr. FERGUSON. When combined with other issues, the answer is yes, it is the straw that broke the camel's back. But the other thing is it falls directly on R&D because when you look at the size of this type of tax and it is an expense, then the only places you have to cut are employees or R&D, or you have to go look for cost savings someplace else.

Senator TOOMEY. Thank you very much.

Chairman MURRAY. Thank you very much.

Senator Kaine?

Senator KAINE. Thank you. Just three quick follow-ups.

We built a Federal Interstate Highway System largely off of a Federal excise tax on gasoline. Do any of you believe that that tax and the way it was spent was harmful to economic growth? Would you all agree that the construction of an Interstate Highway System was helpful to economic growth?

Mr. FERGUSON. Absolutely.

Senator KAINE. All right. Thank you.

The second question I want to ask is a follow-up on Senator Warner's discussion. As he indicated and as did Senator King, we are now—we have a balance sheet problem. That is what we are wrestling with as a Budget Committee. We spend more than historic averages. We are taking in less than historic averages.

To the new guy on the block, it seems like there are three ways we can fix it: we can fix it all on the revenue side, more revenue; we can fix it all on the expense side, cut expenses; or we can find—and the details are important—or we can find some kind of a balanced approach that looks at expenditure reductions and revenues.

Which of you favor fixing it all on one side of the balance sheet, either all through expense reductions or all through revenue increases?

And which of you feel like we need to fix it by, if we are going to fix the balance sheet, trying to find some fixes on both sides of the balance sheet?

Okay. The last thing, I worry about this medical device tax, too, and I want to drill into it a minute to find out what is the right contour of the fix. The first piece, talking about the international competition, it was my understanding that the device tax does apply to foreign manufactured devices that are sold in the United States. So a foreign manufacturer gains no edge over a U.S. manufacturer. If they are selling devices in the United States, the excise tax applies to those sales as well. Is that right, Mr. Ferguson?

Mr. FERGUSON.It increases their ability to compete with us because they are starting with a lower base and cost. For instance, coming from Ireland, the Federal tax rate is 12.5 percent versus 35 percent in the U.S., plus we have State taxes on top of it. So when you look at it, what this has done is just exacerbated the difference between being an American manufacturer and manufacturing overseas.

The thing to remember is a lot of times people say that the problem is because personnel costs. That is absolutely not true.

Senator KAINE. So the differential between the countries is not the excise tax, which gets applied regardless of where the device is manufactured, but it is other tax policies that create a differential?

Mr. FERGUSON. Well, it is really the excise tax that makes the differential. When you add a 30-percent bottom-line tax in this country, then it makes the differential. And so it is the marginal differential that this tax imposes that makes the international versus the U.S. tax such a large—

Senator KAINE. So just the real simple question, because I have to make sure I am right on this. The excise tax is applied to foreign manufactured items if they are sold in the United States.

Mr. FERGUSON. Yes, it does.

Senator KAINE. Okay. The other questions, I just want to make sure, for medical device manufacturers, many of the revenues that come into medical device manufacturers are revenues that come in through Medicaid or Medicare reimbursements. Isn't that correct?

Mr. FERGUSON. Yes, indirectly, but through our customers.

Senator KAINE. Okay. I do not have any other questions, Madam Chair. Thank you all very much.

Chairman MURRAY. Senator Kaine, thank you very much.

A vote has been called. Senator Sessions and I need to go vote.

Senator Wyden wants to return to ask his questions, so I am going to leave the hearing open and put us in a small recess and let him close this out today, if you all would not mind staying. Senator Sessions, if you do not object to that.

I would just let all of our colleagues know that I think this was a really good hearing, and I want to just say I am really committed to a budget that reflects the values and priorities, and today's hearing I think was really important in helping us create a path to future successes.

I would remind all of our colleagues that additional statements need to be in today by 6 o'clock p.m. Senator Wyden will gavel us out shortly as soon as he returns, and with that I will just put us into a short recess.

Senator SESSIONS. Well, could I just thank the panel? It was, I think, a very good discussion. We learned some things, and it helps us wrestle with the great choices we are being forced to make. When you are borrowing 36 cents out of every dollar you spend, you are on an unsustainable course. We have to confront that and make the tough choices. So thank you for helping us.

Chairman MURRAY. Thank you. I agree. Thank you very much to all of our panelists, and we will give you a moment's respite here, and Senator Wyden will return in just a minute.

[Recess.]

Senator WYDEN. [Presiding.] Thank you all very much for your patience. This is a hectic day, even by standards of the United States Senate.

I have questions for each of you. Let me start with you, Dr. Carnevale, and I will profess right at the outset to have long been an admirer of your work and the scholarship you have done in the education field. I would like to ask you a question in a sense about where we are in terms of higher education policy because I believe we are in something of a fork in the road. Higher education policy has always been about access, and I certainly do not take a back seat to anybody in terms of access, and particularly ensuring that our young people can get access to Pell grants and Stafford loans and the array of programs that ensure that they get in the door, that they can actually get into college.

I think, however, that we are now moving to a day when we are going to look at a policy that I in effect call access plus so that we also say it is extraordinarily important that students get more value for their education, because this is going to be, after buying a house, their second biggest expenditure. And Senator Rubio and I have introduced a bipartisan piece of legislation. There are other approaches that in many respects are similar. And we have been able to get support across the political spectrum, from very progressive groups to conservative organizations. And my understanding is you are a long-time advocate for transparency. We have said young people should be able to find out about graduation rates and remedial education and particularly be in a position to get some sense of what they would be likely to earn when they got a degree from a particular school.

In advocating for transparency, what have you seen as the primary opposition over the years, and what are the principal arguments to counter that?

Mr. CARNEVALE. I agree with you we have hit a fork in the road here. Part of it has to do with fiscal constraint—that is, we do not have any money—and the other part has to do with the fact that the role of higher education has changed. It is now our workforce development system. And that has a real economic history, beginning in 1983, when it all began to accelerate very rapidly.

The opposition to the notion of transparency, of telling people, as your bill says, giving people the right to know before they go what the outcome is likely to be of their program, the opposition comes at a value level, a normative level, and it is the most difficult piece of it because higher education leadership sees itself as an institution that is supposed to help people live more fully in their time, a very broad goal. I doubt many of us disagree with that.

But the reality now is that in order to get a decent job, you have to get some higher education, and whether or not you get a decent job or how good the job is depends on what you take. And given increasing prices and loans and all the rest of it, I think we need to start telling people this.

In the end, my bias is that in this culture and economy you cannot live more fully in your time if you are living under a bridge and out of a shopping cart. That is, people need to know that their education is going to give them gainful employment at the end of the day. It does not mean they should not take English or study the role of feminism in the French Revolution. It just means that they need to know what they are going to do with that after they graduate because they are going to be doing that for the next 45 years of their life after breakfast every day.

Senator WYDEN. Well said. I would ask you more questions if I had more time, but thank you again. We are going to be working very closely with you, and staff is very appreciative as well.

Ms. Trottenberg, welcome, and you will not be surprised that I want to talk about infrastructure spending, and particularly about new approaches that can support a bigger role for the private sector. For literally a decade, I worked with a number of Republicans to put in place the Build America Bonds program, and the night of the debate about the Recovery Act, Senator Grassley and Senator Baucus, who I think as much as anything had heard me talk about this so often, they said, well, let us look at this because Ron has been bringing this up, you know, for eons. They said, "Well, so what is going to happen with Build America Bonds?" I said, "Well, we have maybe a year and a half. We might generate $4 or $5 billion worth of investment." And everybody said, "Oh, my goodness. We have never done bonding at the Federal level before. And you think this will get $4 or $5 billion worth? That sounds terrific."

As you know, Build America Bonds in a year and a half generated $180 billion worth of investment, a 30-fold increase beyond anything that was projected. And I just think that given the fact we have all of this work that needs to be done, and you cannot have a Big League period of economic growth with Little League transportation systems, that we are going to keep coming back to what are the effective ways to fund infrastructure.

Now, Senator Hoeven and I have teamed up on an approach that really is quite similar. We call it "TRIP bonds" to, in effect, have Federal tax credit bonding to leverage private dollars for investment in infrastructure. And I do not know of any other approach that will drive down the costs more and increase the private sector role in transportation than this particular concept. And we have talked to you all many times, and I am encouraged that you all seem to be moving in that direction as well.

The American Fast Forward Bond program it seems to me sort of tracks the bipartisan efforts up here in terms of trying to look at these kinds of approaches. Am I reading this right or what is your sense of it?

Ms. TROTTENBERG. Absolutely. Thank you for your leadership on the Build America Bonds. As you pointed out, it was wildly successful and brought in an enormous new class—

Senator WYDEN. I think that, by the way—excuse me for interrupting. I think Alan Krueger deserves a lot of credit for this because, as you know, there was a lot of pushback early on, and he really prosecuted the case. Excuse me for interrupting.

Ms. TROTTENBERG. And brought in, tremendous new classes of investors who could not benefit from traditional municipal bonds.

We in the Department now have several programs which are somewhat along those lines. We have the private activity bonds where essentially we use them to incentivize the private sector to develop projects which have very clear public benefits. We are looking for ways to increase the use of that program, and as Congress has given us the expanded TIFIA funds, we are finding more and more that project sponsors are coming to the Department wanting to make use of both of those programs in concert. We are well familiar with your TRIP program, Senator Wyden, and I think we are very keen to work with you, and we are thrilled there is so much bipartisan support here in Congress on how we can continue to broaden the pool of investors that want to come in and invest in infrastructure. Obviously, from the Treasury's point of view, make sure we do it in the way that is the most efficient, and I know that is—you know, one question that we have is how we set the subsidies, the interest rates, whatever it would be, so that we are using the taxpayer dollar as efficiently as possible. But, clearly, we are going to need to bring in much greater private sector investment and participation to close the gap on what we need in terms of infrastructure.

Senator WYDEN. Well, I am going to look forward to following up with you, Ms. Trottenberg, on it because I think particularly when you look at something that can attract private sector support, it has significant support from labor union groups, Doug Holtz-Eakin, as you know, has said dollar for dollar he thinks this is the attractive approach in the transportation field. Given the President's comments in the State of the Union—and I thought he was spot on in terms of talking about infrastructure and roads and bridges and rails—I really hope that this is an area that can become a prime focus of your work because I may be missing something, but I just look around and there are no rallies outside my office calling for increases in the gas tax, you know, for example. It is going to be increasingly difficult to find approaches that are substantively sound and politically viable. And I think that this concept that we are talking about in terms of trying particularly to look at tax credit bonding is something that holds the tariff down on the Federal side—and I noted your comments earlier with respect to infrastructure—and is the one that the private sector is saying looks flexible and appealing. So I am anxious to work with you on it.

Let me talk a little bit about health care and taxes, and we will kind of go into your area, Mr. Malpass, and I have followed your comments as well. Suffice it to say the debate about the sequester, when you really strip it down, has largely been because there has not been agreement in health care and taxes. Those are the two kind of driving kinds of areas. And my sense is—let us take them separately. I just came from the Finance Committee where we were talking mostly about the health care issue, and I may be able to get back to talk about tax reform. But, again, there are some opportunities to bring people together.

For example, the latest evidence on Medicare—which the costs have gone down a little bit here recently, we are pleased to see, but I think we all understand the demographic tsunami that we are dealing with—70 percent of the Medicare spending goes to treat those with three or more chronic conditions. So you get into a strategy that will promote quality of care that the seniors deserve with a strategy that will hold down costs. You go a long way to trying to address the agenda for Medicare reform.

The accountable care organizations are clearly a step in the right direction. We had them in our part of the world long before anybody thought about them at the Federal level. But what is your sense in terms of particularly looking at chronic care as a key element of Medicare reform and also creating incentives for those on the program for holding costs down as well?

Mr. MALPASS. Thank you, Senator. I am not going to be able to respond as an expert on the chronic care issue, and will look to colleagues on the panel for that if they have comments. Your point is excellent about how do we find a way to make reasonable choices within the Medicare program and that it has a massive impact on the budget.

Right now we are in this impasse where we end up with a sequester. Republicans are not claiming invention of that idea. You have been a leader in trying to find ways to work across the aisle, to find a way to break the impasse.

My own view is that we are at a point where there needs to be some spending restraint, some agreement that there could be some spending restraint, and that might then break the logjam on taxes and on revenues and on health care. But right now the Nation is waiting for Washington to find a single program that it thinks could be downsized. That would be the starting point for the debate and discussion.

Senator WYDEN. Let me do this, because staff tells me that we have to wrap up and get out the door here. On tax reform, I will pose this to you in writing. One of the things that we are asking experts in the field is to identify the tax expenditures, which is, of course, spending in any kind of literal sense, that they think ought to be either altered or removed altogether as a way to generate the opportunity for tax reform. I have had an approach with Senator Coats and Senator Begich and Senator Gregg and others over the years. I think we all understand, after what we were dealing with in terms of the special committee and also Bowles-Simpson, that much of this is the challenge of modernizing what a big group of Democrats and Ronald Reagan agreed to in the 1980s. It created millions of jobs and psychologically gave a big boost to the economy.

So I would ask you more questions if time allowed, but I will put in writing to you a question asking you on the basis of your expertise to identify the tax expenditures that you think ought to be changed.

Mr. MALPASS. And if I may, just one point. If any savings on the tax credits could be used to reduce the overall rate, let us say, on the corporate side, if that were proposed and became a concept, it would be hugely pro-growth.

Senator WYDEN. Very good. With that, the Budget Committee is adjourned.

[Whereupon, at 12:31 p.m., the Committee was adjourned.]

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RON WYDEN
United States Senator

Question for the Record
from
Senator Ron Wyden
for
David Malpass

"The Impact of Federal Investments on People, Communities, and Long-term Economic Growth"

February 26, 2013

Committee on the Budget

United States Senate

- In the *Wall Street Journal* last week, Dr. Martin Feldstein wrote: "Republicans want to reduce the deficit by cutting government spending while Democrats insist that raising revenue must be part of the solution. Yet the distinction between spending cuts and revenue increases breaks down if one considers tax expenditures. Here are some examples. If I buy a solar panel for my house, a hybrid car, or an energy-efficient refrigerator, the government pays me. But instead of sending me a check, it gives me a tax credit or a tax deduction. There are dozens of such examples that increase the annual budget deficit by billions of dollars. Congress should review these tax expenditures and eliminate those that the country cannot afford."

- Dr. Feldstein has also written that "tax expenditures are the single largest source of wasteful and low-priority spending in the federal budget and one of the first places policymakers should go to restrain spending."

- CBO Director Douglas Elmendorf, in testimony before the House Budget Committee, made a similar point when he stated that tax expenditures "are really best viewed as a form of government spending because they are directed at particular people or entities or designed to subsidize particular activities," almost precisely analogous to other government spending.

- Alan Greenspan has suggested that tax expenditures represent just as great a threat to a sustainable budget path as any other spending, including entitlements.

- **With that background, what, in your view, are some of the least economically efficient and/or justifiable tax expenditures? What economic effects—positive or negative—would you expect from their repeal? How would you propose we mitigate those effects?**

- **In a similar vein, there is a great debate among Republicans and Democrats as to what we should do with any additional revenue generated by rolling back or reducing tax expenditures, also commonly referred to as closing loopholes. On the one hand, some would have us use any additional revenue to buy down marginal tax rates, while, on the other, some would have us use the revenue for deficit reduction or other investments. Weighing in on that debate, Martin Sullivan, a widely read commentator on tax policy, suggested that perhaps the best solution was to devote half of any resulting revenues to reducing rates and half to reducing the deficit. Do you feel that Sullivan has the ratio about right? Or would you suggest a different allocation of revenue and why?**

The thrust of my testimony is that Congress, in the interest of growth and jobs, should continuously pursue spending restraint, restraint on tax credits, tax rate reduction and tax simplification. I advocate a stronger debt limit that would encourage Congress in pursuing these. This discipline is vital to achieving faster growth, more job creation and a higher median income.

It is important that Congress start each of these processes now, even if it means small steps. For example, tax simplification would have a huge payoff for the economy, so Congress could start by agreeing each month to a small bipartisan simplification bill repairing the most egregious inefficiencies in the tax code. Similarly, spending has grown to such large amounts, with inadequate trade-offs among programs, that Congress should agree each month on a small bipartisan spending reduction bill to save money and show leadership.

A growth-oriented approach to tax reform is to lower rates while broadening the base. The ideal would be to start that process tomorrow. Many of the tax expenditures narrow the base and are expensive and inefficient. A general approach is to try to reduce their size and scope as part of the tax rate reduction effort.

Given the difficulty of coordinating the two processes – reducing the expenditures and agreeing on which tax rates to lower – I think it might be useful for Congress to explore ways to allow tax expenditure reductions to be "banked" and applied to a subsequent rate-reduction effort. There would have to be a clear agreement that tax rate reduction was a near-term goal and that tax expenditure reductions would be used to reduce tax rates.

Regarding the inefficiency of various tax expenditures, my view is that most are inefficient in the sense that their cost isn't worth the higher tax rates needed to pay for them. There are many publications on this. My view is that Congress should work out compromises within a budget that reduces the growth in spending and applies reductions in tax expenditures to tax rate reduction.

Reducing or repealing tax expenditures would cause dislocations for those dependent on the tax credit, but the resulting tax rate reduction would have a substantially larger benefit for the overall economy. The question asked how to mitigate the negative effects for those dependent on the tax expenditure. I think Congress could address ways to mitigate the dislocations within its budget just as it does in considering ways to mitigate spending restraint or trade liberalization as part of the budget. I note that tax deductions and exclusions benefit those in high tax brackets the most, so most of the harm from reducing them would fall on higher incomes, perhaps reducing the need for targeted mitigation. In a similar vein, non-refundable tax credits can only be used to the extent of taxable income. This applies to a diminishing portion of the population, reducing the cost of mitigation. I emphasize the magnitude of the beneficial effects on growth and jobs from proceeding with tax expenditure reductions applied to tax rate reductions.

Regarding the percentage of tax expenditure reductions that could be applied to tax reform versus deficit reduction, my view is that tax revenues have been growing rapidly and would increase with the extra growth generated by applying tax expenditure reduction to tax reform. I think it would be growth-maximizing to apply all of the savings from reduced tax expenditures to improving the tax code. That would add to economic growth, providing deficit reduction.

Some have advocated using reductions in tax expenditures to increase appropriations. Given the overgrown size of current and projected expenditures, I don't think this approach should be pursued.

In conclusion, tax reform is urgent. Congress has a tendency to put off individual decisions with the idea of achieving a grand compromise that never comes to fruition. As discussed in my testimony, Congress should start today with achievable steps to restrain spending. I think it would also be helpful to make small improvements in the tax code on a regular basis, with the idea that reductions in tax expenditures could be used to reduce tax rates. This approach would generate a large payoff in terms of jobs and a higher median income.

Sincerely,
David Malpass
Encima Global
212-876-4400

REDUCING THE DEFICIT BY ELIMINATING WASTEFUL SPENDING IN THE TAX CODE

TUESDAY, MARCH 5, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Committee met, pursuant to notice, at 10:31 a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, Chairman of the Committee, presiding.

Present: Senators Murray, Wyden, Stabenow, Sanders, Whitehouse, Warner, Merkley, Baldwin, King, Sessions, Grassley, Crapo, Johnson, and Ayotte.

Staff Present: Evan T. Schatz, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. Good morning. This hearing will come to order.

I want to thank all of our witnesses, who I will introduce in just a moment. And Ranking Member Senator Sessions and all of our colleagues who are here today, thank you for joining us.

Over the next few weeks, both chambers of Congress will be debating fundamental choices about our country's direction and what kind of nation we will leave to our next generation. We will lay out proposals that reflect very different approaches to the many challenges we face.

One central question that we are looking at is: How can we bring down our debt and deficits while putting the middle class and broad-based economic growth first? Today's hearing will focus on how cutting wasteful spending from our Tax Code can help us meet this challenge.

As we have looked for ways to reduce our deficits and debt, we have heard a lot of outrage about waste and excess in Government programs. My Republican colleagues, in particular, tend to focus on cutting programs the most vulnerable families depend on to get back on their feet. They say spending on food stamps is out of control and we cannot afford so many education and job training programs and unemployment benefits are driving up the deficit.

Now, there is no question that we do need to look at Government programs carefully so we can make fair, responsible cuts that put families and our economy first. But a big source of spending, and one that deserves to be just as closely examined, is expenditures in our Tax Code. While we do not often think of tax expenditures as a form of spending, they require us to make the same kinds of tradeoffs that other forms of Government spending would, and lots of them.

Tax expenditures have grown over the last 20 years to become one of the largest impacts on our deficits and debt. Just this year, the Treasury will lose $1.3 trillion to tax expenditures. That is more than we will spend on either Social Security or Medicare.

But unlike funding for Government programs like Pell grants or Head Start or road repairs, which is limited and reviewed regularly, tax expenditures have flown largely under the radar. Since they generally do not need to be reauthorized, they receive much less scrutiny than programs that do need to be reauthorized. That is why Alan Greenspan once called them “tax entitlements.”

But here is a big difference: When we think of entitlements, we typically think of Social Security and Medicare, which keep our promises to seniors, or nutrition assistance for families who have fallen on hard times. These programs allow our country to fulfill its part of the bargain with those who have already done their share and enable us to give those most in need some relief.

However, for the vast majority of tax expenditures, about 70 percent of them, it is the other way around. For that 70 percent of tax expenditures, the higher your income, the more you benefit. So the wealthiest households benefit the most while middle-class families receive much smaller benefits, and many of our most vulnerable do not qualify at all. The less you need, the more you get. And we all pay for it.

In 2012, on average, the top 1 percent of income earners saw their after-tax income increase by nearly $250,000 as a result of tax expenditures. But middle-class families received an average benefit of only about $3,500, which means that when we talk about big Government welfare, maybe we should not always jump to cut spending for those who are most in need. Maybe we should think about what we are spending on those who are least in need.

The skewed nature of tax breaks like these has helped drive the amount the wealthiest Americans pay in taxes to historically low levels as a share of their income. IRS data show that the effective tax rate for the 400 wealthiest taxpayers has fallen from almost 30 percent in 1995 to only 19.9 percent in 2009. This is less than the rate paid by many middle-class families. And meanwhile, over the same time period, the average income for the 400 wealthiest taxpayers rose five-fold. That is probably why some tax expenditures are often called “back-door spending” or “special-interest earmarks” for the largest corporations and wealthiest Americans.

Of course, not all expenditures in the Tax Code are wasteful. Many help hard-working families reach goals like sending a child to college, which helps them, their child, and the economy. But many, too many, are inefficient and unfair.

There is no good reason, for example, that taxpayers currently subsidize millionaires more when they purchase a second home or a yacht than they do middle-class families purchasing their first home. And why should a hedge fund manager pay a lower tax rate on his income than a soldier or a police officer or a teacher?

We have some clear opportunities to cut wasteful spending and make our tax system work better for middle-class families. And at a time when there is far too much we disagree on in Washington, there does seem to be some acknowledgment by leaders on both sides of the aisle that we should seize these opportunities.

Senator Tom Coburn said, and I quote, "Masquerading as tax cuts, many of these programs are no different from any other Federal program that spends taxpayer money."

Speaker Boehner recently proposed to raise $800 billion in new revenue by closing what he termed "special-interest loopholes and deductions." Even House Budget Committee Chairman Paul Ryan has noted that many preferences in our tax system are "patently unfair" and "mainly used by a relatively small group of mostly higher-income individuals."

I appreciate Senator Coburn, the Speaker, and Chairman Ryan for making these arguments and pointing out that these loopholes help special interests succeed, but do very little to help middle-class families succeed. I, like many of my Democratic colleagues, would like to know when Republicans will be willing to sit down with us and start looking strategically at which wasteful provisions we can eliminate.

Experts across the political spectrum have also proposed eliminating wasteful spending in our Tax Code as a way to reduce our deficit. Discussing options for major deficit reduction, Ronald Reagan's chief economist Martin Feldstein recently said, "The distinction between spending cuts and revenue increases breaks down if one considers tax expenditures." Today we will hear from experts who have studied this issue at length.

Professor Edward Kleinbard has noted that we spend twice as much on tax expenditures as we do through discretionary investments, like education, infrastructure, and research. But many of these subsidies are both poorly targeted and skewed to unfairly benefit high-income Americans more than low-income Americans.

Economist Jared Bernstein recently explained that by reducing unfair tax expenditures we can essentially raise revenue by cutting spending. That sounds like a form of deficit reduction Democrats and Republicans should be able to agree on.

I look forward to hearing their testimony, as well as the testimony from Mr. Roberts of the Hoover Institution, who Senator Sessions will introduce.

If we agree there is wasteful spending in the Tax Code—and I think it is clear there is—the next question is: How should those savings be used?

Many of my Republican colleagues would prefer to use every dollar of new revenue to dramatically lower tax rates rather than making critical investments in our competitiveness or paying down the debt. But that approach is more of the same.

It would very likely make it easier for the wealthy to get even further ahead of middle-class families while making paths to opportunity for the middle class, through student loans or workforce training or job-creating research and innovation, more narrow.

If the goal of our budget plan is to strengthen the middle class and work towards broad-based economic growth, finding savings from unfair tax provisions is an opportunity to responsibly reduce our deficit and invest in our future.

And let us remember that all of the bipartisan groups— Simpson-Bowles, Gang of Six—agreed. They all recommended using a significant portion of the revenue from eliminating tax breaks to reduce the deficit.

As Democrats and Republicans both know, responsible deficit reduction is essential to our long-term prosperity. But that is not all we have to do.

Just as we have to bring down our deficits and debt, we have to make sure we are educating our workforce for the 21st century. We need to repair our roads and bridges and airways so businesses can move their people and products efficiently. And we need to invest in research and development so we can continue growing new industries in the United States rather than ceding those new industries, and the jobs that come with them, to China or India.

That is why proposals from nonpartisan experts include new revenue for deficit reduction and point out the need to continue making investments in our long-term economic well-being. The Simpson-Bowles plan, for example, described infrastructure, higher education, and research and development as "high-priority investments America will need to stay competitive."

And we have seen time and time again that the American people agree. The American people think we should get rid of inefficient, unfair tax breaks skewed towards the wealthiest Americans and corporations. In fact, a recent poll showed 57 percent of respondents strongly agreed we should eliminate the loophole that allows hedge fund managers to pay lower tax rates than the middle class. Fifty-eight percent strongly agreed with closing loopholes that will allow wealthy Americans and corporations to shift income overseas. And Americans want to see that new revenue used to lower the deficit and make crucial investments in our future rather than lowering tax rates for those who are already doing just fine.

I am looking forward to today's conversation because it seems that cutting wasteful spending in our Tax Code would help us move forward on a number of challenges.

We know there is wasteful spending in our Tax Code. Chairman Ryan was absolutely correct; much of it is skewed towards the wealthiest Americans.

So at a time when we absolutely must cut where we can, looking at ways we can close special tax breaks that are not targeted to help the middle class or the economy makes sense, especially when, by making those adjustments, we can stop giving an unfair advantage to those who are already doing far better than most Americans, and instead focus on making crucial investments in our future while cutting our deficit in a fair way.

So, again, I want to thank all of our witnesses and colleagues who are here today. I hope this can be a very productive discussion. And with that, I will turn it over to Ranking Member, Senator Sessions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Madam Chairman. I will offer my written remarks for the record and would note that the title of the hearing, "Reducing the Deficit by Eliminating Wasteful Spending in the Tax Code," really suggests how much disconnect we have as we analyze the problems facing America today.

When you allow a person to keep money that they have earned because of a certain deduction for charitable or mortgage or health care payments, I do not believe that is spending by the United States Treasury. It is not spending. And we certainly have problems in our deductions, and there are some loopholes which are abuses of legitimate deductions, and there are things we can do to make our Tax Code flatter and simpler and more growth-oriented. Senator Crapo, Senator Warner, and others have worked really hard on some excellent ideas to try to move in that direction, and it is not so that Republicans have not sat down with Democrats to discuss these issues. They have spent months—years, working on these issues.

We are facing a real debt crisis, a very real debt crisis. John Cochrane, a University of Chicago professor, wrote in the Wall Street Journal yesterday about the surge in interest we will be paying. He reminds us that the resumption of normal interest rates by the Federal Reserve, which Professor Cochrane said was all but inevitable in the next few years, this resumption of normal rates "could raise this Government's outlays for interest on the debt up to $900 billion per year," or twice current levels, more than the Defense Department, more than Social Security, more than Medicare.

So I think we do have a serious crisis. Dr. Elmendorf, CBO Director, testified just a couple of weeks ago that we cannot continue to sustain spending increases at a greater rate than the economy grows. You cannot have spending increase at 6 percent a year while the economy is growing at 2 and 3 percent a year. That is unsustainable. That is the very definition of unsustainability, and that is why spending is the critical factor. It has to be in line with the growth we can expect in the economy.

Actually, David Malpass last week noted that the slow growth that we are having now proves that the stimulus that we have gone through has not been effective.

So I think we just need to return to common sense and analyze our financial situation in a fair way. And, look, eliminating tax exemptions is a tax increase. You cannot spin it any other way. And I have heard it said recently— and it is troubling to me—that, well, we can pay for the sequester, we will not have to have these cuts in growth, we will not have to have that happen, because we will just eliminate these loopholes. But that is not going to happen, colleagues. You need to know this. That will not happen, it cannot happen, because we agreed in August of 2011 we were on a path to increase spending over the next 10 years from $37 trillion to $49 trillion. We agreed to reduce that growth to $47 trillion by raising the debt ceiling $2.1 trillion and reducing spending over 10 years $2.1 trillion. There were no tax increases in that. The President signed that. Many of you voted for it. Senator Reid voted for it, and the House and Senate both passed it. And that was the agreement. So we are not now going to raise taxes in order to increase spending above the baseline that we are now on, which would be still a substantial increase in spending over the next 10 years. That is what we are talking about. It is just not going to happen and should not happen. It would be a retreat from the promises we made to the American people.

We said, American people, we voted to raise the debt ceiling, but we promise to cut spending over the next 10 years by $2.1 trillion. And the President, of course, got a tax increase in January, some $650 billion to the Treasury.

So this is not going to happen. I hope it will help—we have to get this straight as we discuss the difficult choices we face.

Now, the CRS sent us a report in December that lists the so-called tax expenditures or tax deductions that are out there, and they list the top ten:

Exclusion for employers for Medicare payments, $109 billion, the largest one;

Second was exclusion of contributions to retirement plans, the fact that that is not taxable, that is the second biggest one, $105 billion.

Reduced tax rates on dividends and long-term capital gains, instead of taxing at earned income rates, you get a less rate for dividends. That is $90 billion.

The fourth one is mortgage interest, $77 billion.

Earned income tax credit for the poor, $59 billion.

Exclusion from Medicare benefits—that is an exclusion. Medicare should be really income. They do not pay income tax on it.

Child tax credit is next, and so forth.

There are about $750 billion in the top ten expenditures, about 70 percent of those expenditures.

So I just would say to my colleagues, I doubt that we are going to agree to eliminate all of that. And if we do, we have to ask ourselves, Can the economy sustain such a massive sucking out of its wealth? Should not it be part of what Senator Crapo and Senator Warner and the Debt Commission talked about—reducing rates and simplifying the Tax Code and not just using this money to increase spending? And if we do increase taxes, should not we be absolutely sure that that money goes to paying down the deficit, not funding new spending programs, as the President has repeatedly asked?

Professor Roberts, thank you for being with us. He is from Stanford's Hoover Institution, and he will talk to us about the importance of a better functioning tax system. We can agree on that. We can improve fairness, and we can improve growth.

So let me just conclude and say we cannot—I do not feel like I can sit silent while this Committee describes tax deductions which allow people to keep wealth that they have earned as wasteful Government spending in the Tax Code. So we have a disagreement on that. But there is potential for agreement, Madam Chairman. I thank you for having the hearing. This is a very important issue. If we work at it, I am sure we can learn something today and maybe reach some agreements in the future.

Chairman MURRAY. Thank you very much.

With that, I am going to turn it over to our panel. Professor Kleinbard, we are going to start with you and just move across.

STATEMENT OF EDWARD D. KLEINBARD, PROFESSOR OF LAW, UNIVERSITY OF SOUTHERN CALIFORNIA GOULD SCHOOL OF LAW

Mr. KLEINBARD. Thank you for inviting me to testify.

You know, actually, I agree with the Ranking Member that the long-term fiscal policies of the United States are unsustainable. Something must be done. But I have reluctantly concluded that this "something" means higher taxes.

Personally, I do not want to pay higher taxes every year, but there is no practical alternative. But as it turns out, there is a way to do this that actually leads to smaller Government, not a bigger one.

I emphasize tax revenues for five reasons:

First, our budget deficits over the next decade are mostly the result of forgone tax revenues. As a result of the Great Recession, we lost about $2 trillion in tax revenue relative to our historic rate of tax collections. And looking forward, the fiscal cliff tax deal with reduce tax revenues by an additional $4 trillion. To a large extent, both sequestration and the 2011 budget caps are efforts to recoup on the spending side monies that have been forgone on the revenue side.

Second, in the short term, there is no crisis in financing the national debt; Treasury borrowing rates are at near-record lows. The short-term crisis is about jobs. Yet the CBO projects that further cuts to Government spending through the sequester will put 700,000 more Americans out of work.

Third, our biggest spending problem is health care. The United States today spends much more on health care— public and private combined—per capita than does any other developed country in the world. If we were to spend per capita what Norway, which is the second place country, does on health care, our aggregate health care spending would immediately decline by some $880 billion a year. But our citizens' expectations and our health care delivery institutions are built around current policies. Change must be phased in slowly.

Fourth, nondefense discretionary spending is modest by world norms, and both defense and nondefense discretionary spending already are on a path to reach their lowest levels in 50 years. Even if we were to eliminate the entirety of our nondefense discretionary spending, the CBO projects that we would still run deficits in 2023.

And, fifth, the number of Americans age 65 or older will increase by more than one-third over the next 10 years. This has obvious adverse implications for Government spending.

These points imply that revenue, not spending, must be the driver of medium-term deficit reduction. Whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues. We therefore have no practical choice but to raise the level of tax collections in the medium term to the range of 21 percent of GDP rather than the 19-percent level currently projected.

Fortunately, the United States is an extraordinarily low-tax country by world norms. In fact, in 2012, we were the lowest taxed country in the OECD as a percentage of GDP, and that includes Federal, State, and local combined. The United States can afford to increase the total taxes it collects. A little more than a decade ago, we ran budget surpluses and enjoyed a robust economy and job growth while tax collections exceeded 20 percent of GDP.

Now, ironically, the smart way to raise revenues actually is to cut spending, but a special kind of hidden Government spending baked into the Tax Code, which is to say tax expenditures. Of the $1.3 trillion of annual tax expenditures, I believe that the most important to address first are the personal itemized deductions. These subsidize homeownership, charitable contributions, State and local taxes, and the like. They are extraordinarily costly Government subsidy programs of personal expenses, about $250 billion a year in forgone tax revenues in subsidizing personal consumption decisions. They are inefficient in that they lead to major economic misallocations. They are poorly targeted in that the subsidies go to individuals who would have behaved the same without them. And they are unfair in that they are upside down. They subsidize high-income Americans more than low-income ones.

I therefore recommend that we replace the personal itemized deductions with 15-percent tax credits. My preliminary estimate is that by doing so, we could raise as much as $1.5 trillion in revenues over the next 10-years. A 15-percent credit preserves about one-half the aggregate current economic value of personal itemized deductions, but does so in a way that adds to the progressivity of the Tax Code.

Look, I fully recognize that the home mortgage interest deduction and the other personal itemized deductions invariably are described as "sacred cows." But they are sacred cows that we simply can no longer afford to maintain. Either we corral these sacred cows or we will allow them to stampede over us.

[The prepared statement of Mr. Kleinbard follows:]

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United States Senate

Statement for the Record
from Senator Angus S. King, Jr.
Reducing the Deficit by Eliminating Wasteful Spending in the Tax Code
March 5, 2013
Senate Budget Committee

I would like to submit this commentary from Harlem Children's Zone CEO Geoffrey Canada on his behalf.

March 5, 2013
Mr. Geoffrey Canada, President and CEO, Harlem Children's Zone

In today's Senate Budget Committee Hearing at 10:30am, Mr. Russell Roberts provided testimony for Ranking Member Senator Jeff Sessions. Mr. Roberts mentioned my work at the Harlem Children's Zone as an example of private philanthropy succeeding where government could not. He advocated for less government spending on similar programs.

At the Harlem Children's Zone, we run our programs with a rich mix of federal, state, and local funding as well as private dollars. Both public and private funds are essential to our work. Private dollars often act as the "glue" that brings many funding streams together to provide a seamless pipeline of services and supports for our community.

We are accountable not just to our funders, but to the children and families we serve, and it is for this reason that we track hundreds of goals and indicators at the student level to carefully monitor our results. Like us, Promise Neighborhoods operating around the country with federal dollars are required to report on a common set of strict indicators and outcomes. The accountability piece of the Promise Neighborhoods program is part of what makes it so strong. The Federal dollars awarded in competitive grants to these communities help incentivize more private and public spending and bring much needed resources into struggling rural, suburban, urban, and tribal areas around the country.

TESTIMONY OF PROF. EDWARD D. KLEINBARD

HEARING TITLED

"REDUCING THE DEFICIT BY ELIMINATING WASTEFUL SPENDING IN THE TAX CODE"

U.S. Senate Committee on the Budget

March 5, 2013

Chairman Murray, Ranking Member Sessions, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard and I am a Professor of Law at the University of Southern California's Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress's Joint Committee on Taxation.

I. SUMMARY OF TESTIMONY.

- There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. The CBO projects that the January 2013 fiscal cliff tax deal will triple our deficits over the next 10 years, relative to what deficits would have been had all the 2001-03 tax cuts expired.
- To a surprising extent, our adverse budget deficit picture over the next decade is the result of forgone tax revenues. As a result of the Great Recession, we lost about $2 trillion in revenue over the last few years, relative to our historic rate of tax collections as a percentage of GDP. Looking ahead, the fiscal cliff tax deal will reduce future tax revenues by $4 trillion, relative to what CBO had projected under its 2012 baseline. Together, these past and future forgone revenues amount to a roughly $7 trillion contribution to our deficits from 2008 – 2023 (including interest costs on increased borrowings). To a large extent, both sequestration and the budget caps of the 2011 Budget Control Act are efforts to recoup on the spending side monies that were forgone from the revenue side.

- There is no short-term crisis in financing the national debt; Treasury borrowing rates are at near-record lows. Nor is there a general crisis in the availability or cost of capital for the private sector. The short-term crisis is about jobs; the CBO projects that 2014 will be the first time since the Great Depression that unemployment remains over 7.5 percent for six consecutive years. But deficit reduction through eliminating wasteful tax expenditures can offer little short-term help here.

- The long-term problem is entitlements spending, particularly spending on healthcare. For that matter, healthcare is our biggest *immediate* spending problem as well. The United States today spends much more on healthcare (public and private) per capita than does any other developed economy in the world. *If the United States were to expend per capita what Norway (the second place country) does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some $880 billion/year.*

- While long-term entitlement spending reform is critical, we must "boil the frog slowly," to borrow a phrase from Senate Finance Committee Chairman Baucus. Both our citizens' expectations and our healthcare delivery institutions are built around current policies. Change must follow a predictable path that starts in the near future, phases in slowly, and comes to rest with new institutions that will serve the needs of Americans for decades to come. The requirement that we boil the frog slowly in turn has important implications for tax revenues over the medium term.

- Defense discretionary spending is the other great outlier in U.S. government spending policies. *By one estimate, the United States spends as much on its military as do the next 14 countries combined – 41 percent of the entire world's military expenditures.*

- Current levels of nondefense discretionary spending are modest by world norms. This "spending" includes some items, like infrastructure, that are bona fide investments with long-term economic benefits. And both defense and nondefense discretionary spending already are on downward paths to reach their lowest levels in 50 years. This unrealistically aggressive assumption is baked into the CBO's 2013 deficit projections.

- The number of Americans age 65 or older will increase by more than 1/3 over the next 10 years. This has obvious implications for healthcare, social security and other government spending programs.

- All these points imply that spending cuts cannot by themselves fund all of our deficit reduction requirements in the medium term. Whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.

- The United States is an extraordinarily low-taxed country by world norms – in fact, *in 2012 we were the lowest taxed country in the OECD, as a percentage of GDP*. And even by our own standards we have been collecting historically low levels of tax. This level of revenues cannot be reconciled with our outsized spending on healthcare and defense, and our rapidly aging population.

- By all measures, the United States can afford to increase the total taxes it collects as a fraction of GDP. Just a decade ago, the country ran budget surpluses and enjoyed both a robust economy and job growth, while tax collections exceeded 20 percent of GDP.

- We therefore have no practical choice but to raise the level of tax collections in the medium term to the range of 21 percent of GDP, rather than the 19 percent figure projected by the 2013 CBO baseline.

- Economists prefer to raise additional tax revenues, when necessary, through broadening the tax base, rather than raising marginal rates. Unlike 1986, when the tax system overflowed with unintended tax shelters that could be cleaned up and traded off against lower rates, this means directly tackling some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.

- Of all current law's tax expenditures, the most important to address in tax reform are the personal itemized deductions, such as the deductions for home mortgage interest, charitable contributions and state and local taxes. They are extraordinarily costly subsidies – about $250 billion/year in forgone tax revenues. They are inefficient, in that they lead to major misallocations of economic resources, particularly with respect to housing. They are poorly targeted, in that the government subsidies go to individuals who would have behaved the same without the subsidies. And they are unfair, in that they are "upside down" subsidies – they subsidize high-income Americans more than low-income ones.

- I recommend that we replace the personal itemized deductions (and the standard deduction) with 15 percent tax credits. *My preliminary estimate is that doing so will raise about $1.5 trillion in revenues over the next 10 years* (without taking into account any transition relief).

- My suggestion would still preserve about one-half the aggregate current economic value of personal itemized deductions, but would do so in a way that adds to the progressivity of the tax code. Nonetheless, the scale-back in the value of the personal itemized deductions should be phased in over several years.

- I fully recognize that the home mortgage interest deduction and other personal itemized deductions invariably are described as "sacred cows." *But they are sacred cows that we can no longer afford to maintain.* Either we corral these sacred cows, or we allow them to stampede over us.

II. THINKING ABOUT THE DEFICIT.

A. There is No Immediate Fiscal Crisis.

There is no short-term crisis in financing the national debt; Treasury borrowing rates are at near-record lows. (Indeed, a strong case can be made that this is an ideal time for the federal government to stretch out the average maturity of its debt, to lock in today's very favorable rates.) Nor is there a general crisis in the availability or cost of capital for the private sector.[1] (Of course small or less creditworthy firms may continue to

[1] See, e.g., Bain & Co., Inc., *A World Awash in Money: Capital Trends Through 2020* ("Our

experience difficulties in borrowing at reasonable rates.) We can see the plentiful supply of credit for strong borrowers in the recent boom in debt-financed mergers and acquisitions, such as the recently-announced leveraged acquisition of H.J. Heinz Corporation.

The United States, is, however, mired in an immense jobs crisis. The 2013 edition of the Congressional Budget Office's *Annual Budget and Economic Outlook* points out that the United States is on track to record by 2014 unemployment rates exceeding 7.5 percent for the sixth consecutive year, for the first time since the Great Depression.[2] This topic is desperately important to millions of Americans, but is far afield from my understanding of the purpose of today's hearing, and tax reform would have little immediate impact on this problem.

B. <u>The Long-Term Fiscal Problem is Real</u>.

While the federal government is able to finance its deficits at very low rates today, there is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. The 2013 edition of the Congressional Budget Office's *Annual Budget and Economic Outlook* predicts that, under the CBO's relatively optimistic baseline assumptions, federal debt held by the public will amount to roughly 77 percent of GDP in 2023 (comparable to its 2013 level), and will be trending upwards. Under plausible alternative assumptions, the 2023 ratio would be 87 percent.[3]

The Congressional Budget Office further predicts that our projected deficits over the next 10 years will "lead to lower output and income later in the decade than would have occurred under prior law. The [fiscal cliff] legislation lowers tax rates for many people—thereby boosting output—but it also expands budget deficits—which will reduce

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[2] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, at 1 (Feb. 2013).

[3] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, at 4 (Feb. 2013).

national saving and lower the stock of productive capital, thereby reducing output relative to what would have occurred under prior law."[4]

There is no generally-accepted theory in public finance economics of what constitutes a country's optimal debt-to-GDP ratio. Nonetheless, most observers would agree that these projections are troubling, because (i) they leave very little room to absorb unexpected economic or national security calamities in the coming decade, (ii) they imply that even within the next decade the economy will be adversely affected by the crowding out of private investment by government borrowing, and (iii) the adverse projected trend in the debt-to-GDP ratio continues to accelerate in the decades that follow.

Against this background, it is understandable that this Committee would be concerned about the fiscal path on which our country is pointed. I therefore wish to make only a few brief observations about our overall deficit trends. I do so to focus the discussion on the relative contributions to deficit reduction that we should expect from spending cuts, on the one hand, or revenue increases, on the other.

C. Forgone Revenues Tell the Underlying Story.

The CBO's February 2013 10-year deficit projections are much more dire than were those contained in the CBO 2012 baseline, for the simple reason that, as required by law, the CBO 2012 baseline assumed the expiration of all the 2001-2003 tax cuts, as well as the lapse of other temporary tax provisions. The recent "fiscal cliff" tax deal (the American Taxpayer Relief Act of 2012) essentially gives *every* taxpayer an income tax discount relative to what would have been the case had those temporary tax cuts fully expired. (Even the highest-income taxpayer filing a joint return enjoys the benefit of the lower tax rates on his first $450,000 of income.) As a result, the fiscal cliff tax deal is projected to add $4.6 trillion to our accumulated deficits over the next 10 years, which represents a *tripling* in the size of the 10-year projected deficit compared with the 2012 baseline.

Post-fiscal cliff revenues are expected to climb over the next few years to about 19 percent of GDP, and then to stabilize there for the rest of the coming decade. By

[4] http://www.cbo.gov/publication/43835

contrast, the 2012 baseline, which by law assumed the expiration of all the 2001-03 tax cuts, projected that tax revenues would rise to 21 percent of GDP by 2022. As a result, the 2012 baseline also projected that the country's fiscal crises would be largely resolved, at least for a considerable period. Deficits were projected to average only 1.5 percent of GDP for the entire 2012 – 2022 period, and debt held by the public was projected to decline to 62 percent of GDP by 2022 – a full 15 percentage points lower than the relatively optimistic base case in the 2013 projections.

Forgone revenues also figure into the federal government's deficits looking back over the last several years. The country is slowly climbing out of the worst financial and economic crisis since the Great Depression. To address the crisis required some extraordinary new spending measures and temporary tax reductions. But in addition to these new legislative measures, the Great Recession led to a collapse in existing federal tax revenues and a surge in certain income security spending programs, particularly unemployment insurance and the Supplemental Nutrition Assistance Program (food stamps, colloquially). These consequences are known as "automatic stabilizers" – just by the design of these programs, they operate without any new legislative interventions to mitigate the consequences of a recession, by leading to smaller tax bills and more payments to individuals who qualify for some modest assistance towards meeting current living expenses.[5] Of course, the automatic stabilizers also generate deficits until the economy recovers and the programs in question return to normal levels. Because we have not endured an economic collapse of this magnitude in the living memory of most Americans, we have generally underappreciated the role that automatic stabilizers played in our surge in national debt.

A quick review of tax revenues during the 2008-2013 period illustrates this point. For the decades leading up to the crisis, federal tax revenues averaged 18.3 percent of GDP.[6] (This of course does not mean that revenues approximated this number each year;

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[5] For a discussion of how automatic stabilizers operate, see, e.g., Congressional Budget Office, *The Budget and Economic Outlook, Fiscal Years 2012-2022* (Jan. 2012), Appendix C.

[6] More specifically, using CBO data, I calculated that the unweighted average debt-to-GDP ratio for the 20 years 1988-2007, and for the 30-year period 1978-2007, was 18.3 percent. For the 40-year period 1968-2007, it was 18.2 percent.

revenues topped out at 20.6 percent of GDP at the end of the Clinton administration, for example, and revenues fell significantly in earlier recessions.) During the current crisis years, by contrast, federal revenues have fallen precipitously, to about 15.1 percent of GDP in 2009 and 2010, for example. To be fair, not all of this decline in revenue was the result of the automatic stabilization properties of the income tax, as Congress implemented new temporary tax reductions to stimulate the economy, but a significant portion was attributable to the automatic stabilization function.

To make this more concrete, I calculated what the federal government's tax revenues would have been in the 2008-2013 period, if revenues each year totaled 18.3 percent of that year's GDP, and compared those hypothetical revenue figures to the revenues actually collected (or in the case of 2013, the revenues that are projected to be collected). *The difference is a gap of $2.1 trillion* – without regard to the increased interest costs incurred to finance this contribution to the deficit.

In short, forgone revenues (compared to historical norms) are a large part of the story of where our most recent deficit problems have arisen. In past years (e.g., the 1990's) we used years of strong economic performance to pay back this "missing" revenue, by allowing tax revenues to rise above the long-term average. After all, 18.3 percent of GDP could not have been the average revenues collected over many years if some years fell below that number, and no year rose above it.

Summing up the two streams, and removing any double counting for 2013, leads to the following observation: if the federal government had collected its historic average of 18.3 percent of revenue during the 2008-2012 period, and then switched to the higher revenue levels contemplated by the 2012 CBO baseline (i.e, the expiration in particular of the 2001-03 tax cuts in their entirety) for 2013-2023, total deficits would have been on the order of $7 trillion lower (taking into account debt service savings).[7]

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[7] My calculation of forgone revenues in the 2008-2012 period is not a general equilibrium calculation; that is, it does not take into account the effect on GDP of collecting higher taxes in a recession.

So both looking forward to projected revenues after the fiscal cliff tax deal, and looking back to the revenues forgone through the automatic stabilization function of the income tax (as well as various temporary tax relief measures), we see a consistent story of missing revenues that to a large extent explain our worrisome fiscal trends. And to be clear, the 2012 CBO baseline numbers contemplated revenue collections at levels not very different from those that prevailed at the end of the Clinton administration; these are levels that are not beyond our wildest contemplation. To a large extent, both sequestration and the budget caps of the 2011 Budget Control Act are efforts to recoup on the spending side monies that might have been collected on the revenue side.

D. Explicit Spending.

This section II.D. discusses government spending that is presented as such in standard budget presentations. Section IV, below, discusses disguised government spending baked into our tax code – what specialists call "tax expenditures."

Over a longer horizon than the 10-year window considered above, our country does have a spending problem, driven to a surprisingly large degree by one paramount issue: healthcare spending, and to a much lesser extent by Social Security.[8] The Congressional Budget Office has projected that government spending on Social Security and the major healthcare programs will amount to 11.7 percent of GDP in 2023. In 2007 that figure was 8.2 percent, and in 1970 3.8 percent.

These adverse spending trends reflect among other factors the inescapable demographic fact that our population is growing older, and doing so rapidly.[9] The Congressional Budget Office reminds us that the number of Americans age 65 or older will increase by 1/3 in the next decade. That fact in turn has direct implications for the

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[8] For a recent discussion of some Social Security policy options, see Thomas L. Hungerford, *Increasing the Social Security Payroll Tax Base: Options and Effects on Tax Burdens*, Congressional Research Service publication RL33943 (Feb. 5, 2013).

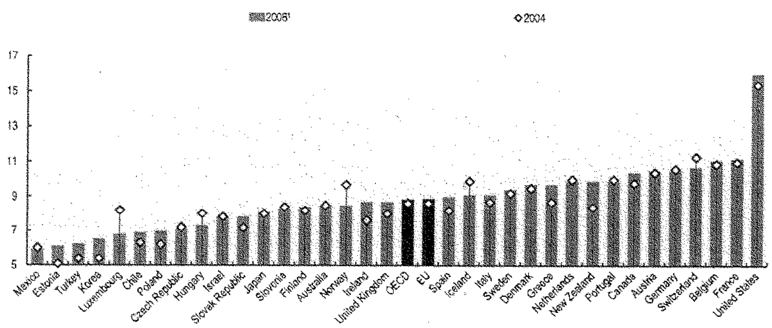
[9] This of course is a universal phenomenon in developed countries. See, e.g., OECD, *OECD in Figures 2009*, at 6-7.

level of tax revenues required to provide basic services to an aging population, and also to the design of these entitlements programs. Phrasing things more directly, it is simply unreasonable to expect that we can maintain tax revenues at pre-crisis average levels while at the same time the number of elderly Americans increases so rapidly.

Healthcare actually is a large-scale current fiscal problem, because our healthcare spending is so large, and so disproportionate to the value we receive, that it imposes large economic efficiency losses on all of us. Here, OECD data are extremely useful in helping us to see just what an outlier the United States is *today* in respect of healthcare costs.

The United States today spends much more on healthcare than does any other developed economy in the world, whether measured as a percentage of GDP or as per capita healthcare spending. Applying consistent OECD metrics, in 2010, the United States spent 17.6 percent of GDP on healthcare; the next most profligate country, the Netherlands, spent 12.0 percent.[10] *If the United States spent the same percentage of GDP on healthcare as did the Netherlands, our total public and private healthcare spending would have been $812 billion lower.*

Figure 3.23. **Health expenditure**
Percentage of GDP



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.
1. 2007 for Australia, Denmark, Greece and Japan; 2006 for Portugal.
Source: OECD (2010), *Health Database*.
StatLink http://dx.doi.org/10.1787/888932373514

(Source: OECD, *Economic Policy Reforms: Going for Growth 2011* at 174.)

[10] http://www.oecd-ilibrary.org/social-issues-migration-health/total-expenditure-on-health_20758480-table1

It also is true when measured as dollars spent per capita. In 2010, the United States spent $8,233 per capita on healthcare, by far the highest in the world; the next most profligate country, Norway, spent $5,388 per capita.[11] *If the United States were to spend per capita what Norway does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some $880 billion/year.*

More remarkably, the United States today is second in the world (only to Norway) in *government* spending per capita on healthcare.[12] In 2010, U.S. federal, state and local governments spent more per capita on healthcare than did the governments of Germany, Denmark, Switzerland, France or Canada. Our extraordinary profligacy in government spending on healthcare has nothing whatsoever to do with the Patient Protection and Affordable Care Act, which had no impact on 2010 healthcare spending (the year covered by the data), and which in fact is projected by the CBO to mitigate somewhat the accelerating path of government healthcare spending.

And of course, in return for this profligate spending on healthcare, the United States enjoys poor health outcomes; our life expectancy, for example, is at the bottom end of the OECD, well below that of the countries mentioned above.

In short, the government's long-term *fiscal* health depends directly on grappling much more fundamentally than we have to date with how we provide healthcare services to our citizens.[13] But change in this area will be challenging, and as Chairman Baucus of the Senate Finance Committee has pointed out, in such situations it is important that you "boil the frog slowly."[14] This means that we must rely on long transition periods to move from where we are to where we need to be without unfairly upsetting settled expectations

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[11] OECD Health Data: Health expenditure and financing: OECD Health Statistics (database), *http://dx.doi.org/10.1787/hlthxp-cap-table-2012-2-en.*

[12] http://www.oecd-ilibrary.org/social-issues-migration-health/public-expenditure-on-health-per-capita_pubexhltcap-table-en.

[13] Congressional Budget Office, *2011 Long-Term Budget Outlook* at 45-47 (June 2011).

[14] Cf. http://en.wikipedia.org/wiki/Boiling_frog.

and modes of healthcare delivery systems. *In the meantime, however, the resulting costs must be financed.*

Government discretionary spending has been on a decades-long downward trend, interrupted only by the emergency spending to deal with the Great Recession. Regardless of what one thinks about the efficacy of those programs, they were in fact temporary and will not contribute further to the deficit in future years. As the figure below shows, this downwards trend is true regardless of the application of the sequester and the 2011 Budget Control Act's caps on discretionary spending. As the Congressional Budget Office noted in its 2013 annual *Budget and Economic Outlook*:

> With funding as assumed in the baseline [i.e., including 2011 BCA caps and the sequester], discretionary outlays would fall to 5.5 percent of GDP by 2023, more than 3 percentage points below their average from 1973 to 2012. Specifically, defense outlays in 2023 would equal 2.8 percent of GDP, compared with a 40-year average of 4.7 percent, and nondefense outlays in 2023 would equal 2.7 percent of GDP, compared with a 40-year average of 4.0 percent.[15]

These are wholly unrealistic projected levels of spending. As Martin Feldstein, a prominent conservative economist, recently concluded in an op-ed in the Wall Street Journal that "The truth is that federal finances cannot be stabilized by reducing discretionary outlays alone."[16]

Put another way, the Congressional Budget Office's 2013 annual *Budget and Economic Outlook* projects that the federal government in 2023 will spend 2.7 percent of GDP on all nondefense discretionary spending, but will run a deficit of 3.8 percent of GDP. This means that the federal government would run a significant deficit in that year even if it were to spend *zero* on all nondefense discretionary spending programs.

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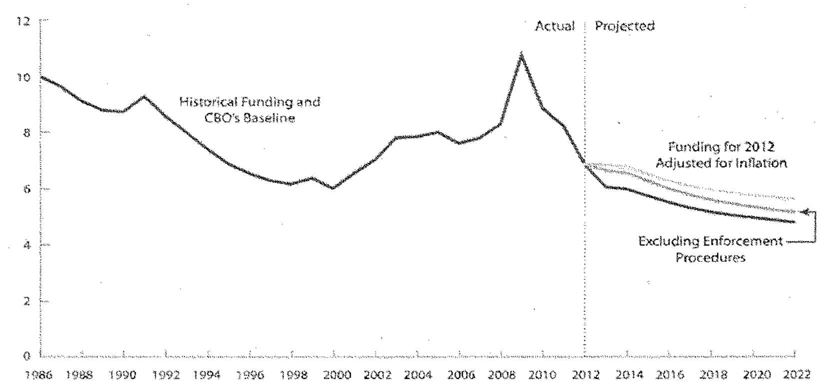
[15] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, at 25 (Feb. 2013).

[16] Martin Feldstein, *A Simple Route to Major Deficit Reduction,* Wall St. J., Feb. 21, 2013, at A-15.

Total Discretionary Budget Authority Excluding War Funding, Disaster Relief, and Program Integrity Initiatives

(Percentage of GDP)



The caps on discretionary spending—either with the required automatic reductions (as in CBO's baseline) or without them (as in the alternative fiscal scenario)—will necessitate a reduction in the real resources available for many government programs, compared with the funding provided for 2012. If, instead, funding was allowed to grow at the rate of inflation, it would be 17 percent higher in 2022 than the amounts projected in the baseline.

In general, our nondefense discretionary spending today is modest by world standards.[17] Moreover, our standard budget presentation of discretionary "spending" is a hopeless muddle, because it mixes what in a private business would be treated as current expenses (salary for government employees, for example) with items that a private firm would properly characterize, not as an expense, but as the purchase of an asset. In effect, we confuse income statement and balance sheet items. In doing so, we overstate government nondefense discretionary spending.

By contrast, the U.S. military budget is a discretionary spending outlier. We all are proud of our Armed Forces and are grateful for their work in keeping our country secure, but I nonetheless suspect that it would come as a surprise to many Americans to learn that, by at least one third-party estimate, we spend almost exactly as much on our military services as do the next 14 largest militaries *combined* (in fact, 41 percent of the

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[17] This is particularly the case if veterans' benefits and services are properly recharacterized as a component of defense spending, rather than as nondefense discretionary spending (the current budget presentation).

world's total military expenditures), and more per capita than does Israel, for which existential threats are arguably much more immediate.[18]

OECD data that combine *all* national and subnational government spending, both mandatory and discretionary (including social security), confirm that the United States is not the victim of government spending run amok. Of the 31 OECD member countries, the United States ranks 6th from the bottom in total government spending as a percentage of GDP.[19] Given our outsized military and healthcare spending, this implies that the United States is a very parsimonious government spender in all other respects, when compared with our world peers.

Finally, when difficult decisions about taxing and spending must be made, some find it tempting to think that the place to cut back is on government programs designed to alleviate poverty. The federal government's income security programs include the Supplemental Nutrition Assistance Program, Supplemental Security Income, unemployment insurance, the earned income and child tax credits, family support, child nutrition, foster care, and miscellaneous tax credits.[20] Impressive though this list may sound, our government's total outlays for all of these programs combined is much smaller than many observers realize. More specifically, the Congressional Budget Office projections contained in the 2013 annual *Budget and Economic Outlook* contemplate that government outlays for income security programs will decline as a percentage of GDP from 2.0% in 2014 to 1.3% by 2023.[21] I do not believe that, for the largest and most successful economy in the world, this level of support for Americans struggling with unemployment or in poverty can in any way be described as lavish.

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[18] Stockholm International Peace Research Institute, http://www.sipri.org/research/armaments/milex/resultoutput/milex_15/the-15-countries-with-the-highest-military-expenditure-in-2011-table/view, and *Yearbook 2012*, at 183.

[19] OECD Economic Outlook Annex Table 25, available at http://www.oecd.org/eco/outlook/economicoutlookannextables.htm.

[20] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years* 2013 TO 2023, 16, 24 (2013).

[21] *Id.* at 24.

All this suggests to me that further cuts to explicit discretionary spending will make at most only a modest impact on the federal budget deficit in the medium term. And if one further accepts the maxim that one must boil the entitlements spending frog slowly, our worrying fiscal trends over the next decade will not be addressed within that time frame by revisions to mandatory spending programs. That leaves larger tax revenues (which includes eliminating hidden spending in the form of tax expenditures) as the only means of financing the policies to which we largely are committed.

III. WHY TAX REVENUES MUST RISE.

The previous discussion has demonstrated that the gap between projected federal government spending and tax revenues will have measurable adverse consequences in reduced economic output and greater fiscal fragility within a decade. But at the same time, federal government discretionary spending already is projected to reach unsustainably low levels, and reforms to mandatory spending programs (which in some cases may not necessarily be good policy) would in all events require long transition rules.

This leaves tax revenues as the only way to finance our transition from here to there. It is for this reason that bipartisan majorities on deficit reduction panels (for example, the Bowles-Simpson and Rivlin-Domenici commissions), major nonpartisan studies (for example, the Peterson-Pew Commission on Budget Reform's report), the staff of the OECD, thoughtful budget experts like Robert Greenstein at the Center for Budget and Policy Priorities and prominent economists like Alan Greenspan and Martin Feldstein have all agreed that tax revenues must rise from their current levels in order to finance our government.

Bluntly, there is no rational alternative. The need to repay the revenue shortfalls of the Great Recession, the rapid increase in the number of elderly Americans, the continuing needs of the many Americans who are unemployed or in poverty, our oversized and inefficient healthcare system, our large military expenditures, and the costs of supervising the world's largest, most complex and most sophisticated economy collectively require government revenues greater than those we currently are on track to collect.

Fortunately, we begin with such an extraordinarily low level of tax collections in the United States that it is feasible to raise tax collections over the next several years without unduly disrupting the U.S. economy. The United States is an extraordinarily low-tax country by world norms, and of course in recent years the automatic stabilization properties of the income tax have mitigated even those modest levels of tax burdens.

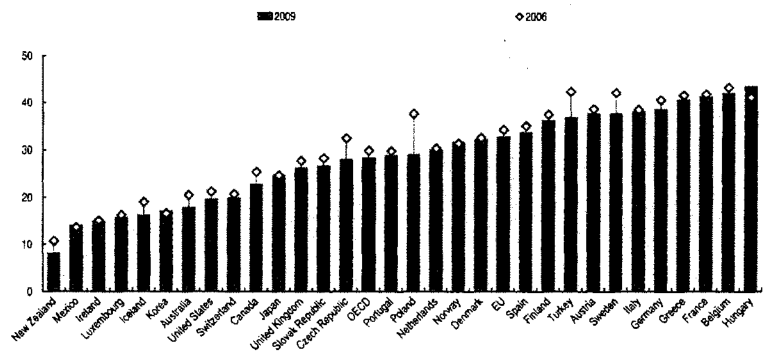
Here OECD comparative data (which combine national and subnational taxes) are again extremely helpful. ***Those data show that for 2012, the United States had the lowest total tax collections as a percentage of GDP of any country in the OECD.***[22]

Yet at the same time, we finance a military as big as that of the next 14 countries combined, and the most expensive and inefficient healthcare system in the world. Why are we then surprised that we are running budget deficits?

Another way of getting a sense of our modest current tax burdens is to look at the "tax wedge" on labor – the difference between what an employer pays (including social security contributions) and what an employee takes home as after-tax wages. Here again OECD data demonstrate that the United States is at the low end of developed country norms:

[22] OECD Economic Outlook Annex Table 26, available at http://www.oecd.org/eco/outlook/economicoutlookannextables.htm.

Average Tax Wedge on Labor (As Percentage of Compensation)
(Couple with 100% of Average Earnings and 2 Children)



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.
1. Measured as the difference between total labour compensation paid by the employer and the net take-home pay of employees, as a ratio of total labour compensation. It therefore includes both employer and employee social security contributions.
2. Average of three situations regarding the wage of the second earner.

Source: OECD (2010), *Taxing Wages Database*.

StatLink http://dx.doi.org/10.1787/888932373134

The conclusion that tax revenues must rise sits badly with some. They like to point out that high taxes impede economic growth and job creation. These sorts of nostrums have as much policy utility as the old adage that, all other things being equal, it is better to be rich and healthy than poor and sick. Tax revenues need to increase not because higher taxes are desirable as an independent goal, but because there is no other choice.

Others object that we should look to reducing mandatory spending programs before thinking of raising overall tax revenues. Again, I fully recognize the need to rethink healthcare spending in America, in particular, but whatever the shape of the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.

Realizing that any mention of one Administration can be perceived as politically charged, the undeniable facts are that in the 1992-2000 period the economy grew much faster than it has since that time, and that the economy did so notwithstanding the burdens of tax rates that did not reflect the application of the 2001-03 tax discounts. All other things being equal, lower taxes are better than higher taxes (just as being rich and healthy beats being poor and sick), but whether viewed from the perspective of world norms or our own recent history, it is simply not credible to argue that the U.S. economy cannot sustain higher levels of tax collections than the historically low levels of the last few years, or even slightly higher levels than historical averages.

A close reading of the 2013 CBO annual *Budget and Economic Outlook* in conjunction with the same report for 2012 gives a clear picture of what we need by way of additional federal revenues. The 2013 baseline projection predicts that federal government revenues will reach about 19 percent of GDP during the coming 10 years; as previously explained, this level appears to be too low for optimal fiscal health. Conversely, the 2012 CBO baseline projection contemplated that revenues slowly would climb to about 21 percent of GDP; this level enabled a significant paydown of the national debt.

This is the bid-ask spread, to put things into a Wall Street jargon. The closer we can get over the next 10 years to a revenue base on the order of 21 percent of GDP, the stronger our fiscal health will be. And again, for all the reasons developed above, I do not think it particularly credible to argue that a phased step up to tax revenues at this level will choke our economy or erode our fundamental liberties.

IV. REDUCING THE DEFICIT THROUGH CURBING TAX EXPENDITURES.

A. How Should Revenues Be Raised?

Acknowledging that tax revenues must rise is the first step on the road to fiscal healing, but of course that leaves open how exactly to do so, and to whom should it be done?

Let us consider the second question – on whom should incremental tax burdens fall – first. Here it is important to clarify some widespread confusion about how different taxes relate to each other, because from the perspective of a taxpayer what matters is how many dollars are removed from her personal resources to pay for government, not what the name of the tax is, or even which level of government is doing the removal. For example, it often is observed that 47 percent (or thereabouts) of taxpayers pay no federal income tax. But this is an incomplete and ultimately misleading observation, because it ignores the fact that payroll taxes are paid from the first dollar of wages, and that other taxes (e.g. Federal excise taxes or state sales taxes) also are highly regressive.

Citizens for Tax Justice is the only organization of which I am aware that prepares a comprehensive and regularly updated calculation of the total tax burdens (federal, state and local) imposed on Americans of different income levels.[23] Their analysis shows how important it is to look at the entire suite of taxes to which individuals are subject when making claims about how tax burdens are shared:

Incomes and Federal, State & Local Taxes in 2011

		Shares of		TAXES AS A % OF INCOME		
	Average cash income	Total income	Total taxes	Federal taxes	State & local taxes	Total taxes
Lowest 20%	$ 13,000	3.4%	2.1%	5.0%	12.3%	**17.4%**
Second 20%	26,100	7.0%	5.3%	9.5%	11.7%	**21.2%**
Middle 20%	42,000	11.4%	10.3%	13.9%	11.3%	**25.2%**
Fourth 20%	68,700	18.7%	19.0%	17.1%	11.2%	**28.3%**
Next 10%	105,000	14.2%	15.0%	18.5%	11.0%	**29.5%**
Next 5%	147,000	10.1%	11.0%	19.7%	10.7%	**30.3%**
Next 4%	254,000	14.3%	15.5%	20.6%	9.9%	**30.4%**
Top 1%	1,371,000	21.0%	21.6%	21.1%	7.9%	**29.0%**
ALL	$ 71,600	100.0%	100.0%	17.6%	10.3%	**27.9%**
Addendum:						
Bottom 99%	$ 58,500	79.1%	78.3%	16.5%	11.0%	27.5%

Notes:
a. Taxes include all federal, state & local taxes (personal and corporate income, payroll, property, sales, excise, estate etc.).
b. For calculations of income shares and taxes as a % of income, income includes employer-paid FICA taxes and corporate profits net of taxable dividends, neither of which is included in the average cash income figures shown.

Source: Institute on Taxation and Economic Policy Tax Model, April 2012

Citizens for Tax Justice, April 2012

(Source: Citizens for Tax Justice, *Who Pays Taxes in America?*, April 4, 2012)

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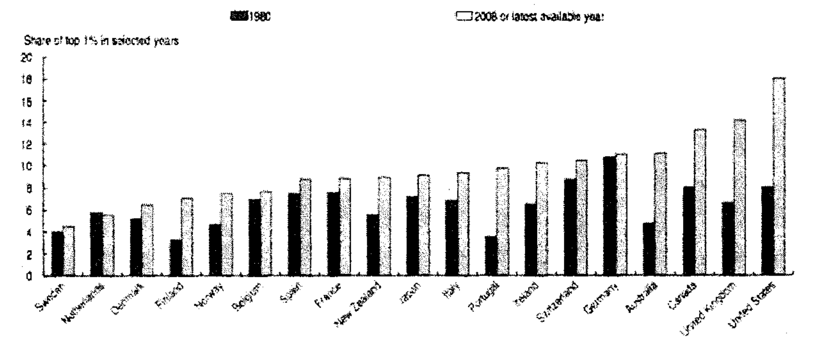
[23] The Staff of the Joint Committee on Taxation has in the past prepared distribution tables showing the distribution of the tax burdens of all *federal* taxes other than the corporate income tax. See, e.g., Staff of the Joint Committee on Taxation, JCX-19-10, Table 11 (March 22, 2010).

From the other direction, and as widely covered in the press, the academic work of Emmanuel Saez and others has demonstrated that income inequality in the United States has risen dramatically in recent decades. I cannot review all the literature here, but a chart from the OECD I think helps to illustrate that, while growth in income inequality is a phenomenon with global reach, the United States is a real outlier in this regard:

Figure 5.5. **Share of the top 1% of earners in total taxable income, 1980 and 2008**



Note: The pre-tax income data exclude capital gains for all countries except Australia and Finland. The data are based on tax returns.

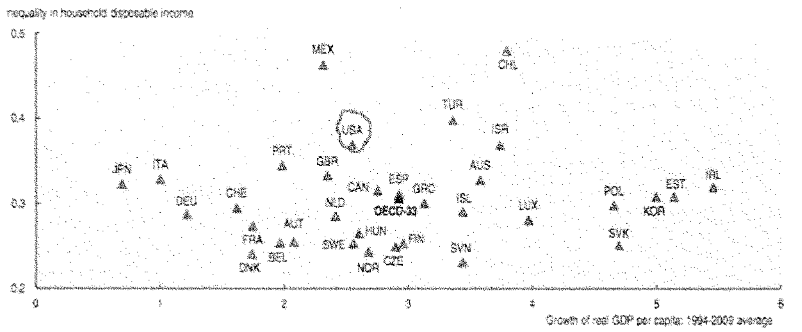
Source: Alvaredo, F. et al. (2011), *The Top Incomes Database*, *www.parisschoolofeconomics.eu/en/news/the-top-incomes-database-new-website/*; Matthews, S. (2011), "Trends in Top Incomes and their Tax Policy Implications", *OECD Taxation Working Papers*, No. 4, OECD Publishing.

StatLink http://dx.doi.org/10.1787/888932566554

(Source: OECD, *Economic Policy Reforms 2012: Going for Growth*, at 188.)

What is more, it does not follow that our greater income inequality has fueled faster economic growth, as this OECD chart shows:

Figure 5.9. **There is no simple link between inequality and growth**



Note: Inequality in household disposable income is measured by the Gini index. The inequality measures refer to the late 2000s, except for France and Ireland for which they refer to the mid-2000s.

Source: OECD Income Distribution and Poverty, OECD *Social Expenditure Statistics* (Database); OECD *Economic Outlook: Statistics and Projections* (Database).

StatLink http://dx.doi.org/10.1787/888932566611

(Source: OECD, *Economic Policy Reforms 2012: Going for Growth*, at 194.)

I believe that these data support the view that most Americans pay significant taxes, and that additional tax revenues should be raised in a progressive manner. But at the same time, I am sympathetic to the view that the very highest marginal tax rate, once one factors in the new 3.8 percent Medicare tax and the effects of section 68 of the tax code ("Pease"), has reached a level that should not be increased at this time.

It can fairly be argued that certain new taxes (e.g. a carbon tax) can have a long-term positive impact on the country, by addressing "externalities" and the like, but I am not aware of any broad sentiment on this Committee in favor of entirely new taxes. I therefore conclude that the increased tax revenues that we require should come from the income tax, but, for the reasons developed above, should be raised in a way that adds to rather than subtracts from the progressive structure of the Internal Revenue Code.

Finally, I think that significant increases in tax revenues necessarily will come from the personal income tax. The reason is simply that the corporate income tax's statutory rate of 35 percent is today far outside world norms. The rate needs to come down, but at the same time we cannot afford to lose revenue. I therefore conceive of corporate tax reform as a roughly revenue neutral undertaking, in which the corporate tax base will be broadened through closing business tax expenditures and loopholes, and the resulting revenues used to "pay down" the corporate rate.

The straightforward goals of an incremental reform of the personal income tax should be (1) to raise the targeted level of revenues with (2) the desired distributional consequences while (3) keeping marginal tax rates – the tax imposed on your last dollar of income – as low as possible. The intuition here is simple: people are more sensitive to the tax rate imposed on their last dollar of income than to their average tax burden. The deadweight loss of taxation can be minimized by keeping marginal tax rates as low as possible, consistent with the other two goals.

Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-03 tax discounts) requires broadening the tax base. Unlike 1986, the individual income tax today has not been eroded through suspect tax shelters or other schemes to avoid the tax system that Congress anticipated when drafting the tax code. (There are of course exceptions, but they are not significant to the overall revenue picture.) *This means that the only way to raise significant revenues without raising marginal tax rates is to tackle directly some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.*

Tax expenditures, particularly those that can be phrased as "tax subsidies," are a form of government spending, not tax reductions.[24] As such, they are the economic equivalents of cash entitlements programs, but ones that in many cases are poorly targeted, economically wasteful, and awarded to those taxpayers who need subsidies the least. The United States prides itself on being a market-based economy, where market prices, not central planners, determine the allocations of goods and services. All too often, however, tax expenditures undercut this premise, and in fact represent a government thumb on the scale of market prices – with all the inefficiencies that this implies.

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[24] The history and theory of tax expenditure analysis is developed at length in the Staff of the Joint Committee on Taxation's publication, *A Reconsideration of Tax Expenditure Analysis,* JCX-37-08 (May 12, 2008).

The magnitude of hidden spending baked into our tax code is staggering: the federal government spends today almost twice as much through tax expenditures as we do through old-fashioned explicit non-defense discretionary spending programs. In fact, we spend more in tax expenditures than we collect in cash through the personal income tax – about $1.2 trillion/year. This spending is divided roughly 90 percent on personal tax expenditures and 10 percent on business tax expenditures. It is as if our tax base were twice as large as it appears, and then we gave half or so of those revenues back through various ersatz subsidies that in many cases are poorly targeted and result in misallocations of economic activity.

Because tax expenditures are so large, and because so many are poorly targeted ersatz subsidies, it is perfectly feasible to envision raising very large sums of money – perhaps on the order of $1.5 to $2 trillion – over 10 years without raising tax rates. I offer a specific suggestion to this effect at the end of this Section IV.

B. The Central Importance of Tax Expenditures.[25]

Tax expenditures dissolve the boundaries between government revenues and government spending. As a result, they reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government. To see how, consider a little example involving the small but self-reliant country of Freedonia. Its economy is comprised of 10 fruit and vegetable growers, each earning $1,000 pre-tax, for a total gross domestic product of $10,000. Each grower pays income tax to support the Freedonian army at a flat rate of 15 percent, for total tax revenues of $1,500.

Freedonia's sole kumquat producer is particularly resourceful. Armed with scientific reports showing the many health benefits of kumquat consumption, he convinces the Freedonian legislature that kumquat production deserves tax incentives, to bring kumquats within the reach of every Freedonian family. The legislature responds by

[25] Some of this subsection is abstracted from Edward Kleinbard, *The Hidden Hand of Government Spending*, Regulation (Cato Inst., pub.), Fall 2010, at 18.

effectively exempting kumquat production from its income tax through an innovative kumquat production tax credit.

But Freedonia is not a profligate state, and it believes in fiscal discipline in the form of pay-as-you-go budget rules. Therefore, to keep the kumquat credit revenue-neutral, the legislature pairs the new preference with an 11.1 percent tax hike on the other producers, to maintain tax revenues at $1,500. (Freedonian tax policy allows for rounding error.) That means that the other fruit and vegetable farmers will each pay $167 (instead of $150) in tax on their $1,000 of income.

In a world without tax expenditure analysis, Freedonian legislators can argue that nothing has changed: government revenues are constant, and there is no increase in government spending or borrowing. But this is plainly wrong; things have changed, in both the private and public sectors.

First, the tax incentive increases kumquat production and consumption. The equilibrium price and quantities sold of kumquats will be different relative to other fruits and vegetables after the tax incentive. Economists believe that, in the absence of some identifiable market failure, markets set prices better than legislatures do, but the kumquat credit alters the quantity of kumquats sold relative to the case in which the tax burden of all fruit and vegetable growers was equal. Unless the health of Freedonians really is improved by the kumquat credit (perhaps due to prior rampant borderline scurvy among the population), the result will be a less efficient allocation of our collective resources.

Second, the introduction of the kumquat credit in an apparently virtuous "revenue neutral" fashion has another profound economic effect: tax rate increases on the incomes of all the fruit and vegetable producers who do not receive targeted tax relief. All taxes, no matter how beautifully implemented, impose "deadweight losses." That is, some transactions that are rational in a world without taxes become too expensive in a world with those taxes and do not take place. And deadweight loss increases faster than the tax rate — in standard presentations, in fact, at the square of the tax rate.

What all this means is that, by virtue of granting "revenue neutral targeted tax relief," the Freedonian government may raise the same aggregate revenues as it did previously, but impose more deadweight loss on the remaining taxable Freedonian private sector. This result is one of the great ironies of many tax expenditures, particularly those that fall into the category of business incentives — once the incentive's impact on tax burdens *for others* is considered, it impoverishes the country even more than it enriches the beneficiaries of the legislative largesse. (Deadweight loss of course cannot be avoided for long by electing "targeted tax relief" without revenue offsets. Unfortunately, recent U.S. tax history has some of this flavor.)

Third, by virtue of its new kumquat credit, the Freedonian government just got bigger, even though aggregate nominal tax revenues remain constant. The best way to analogize the new kumquat credit to a uniform 11.1 percent tax hike on all of Freedonia's fruit and vegetable producers, followed by a $167 kumquat crop farm subsidy payment to the kumquat producer. By recasting the tax expenditure in this way, as a constant tax burden and a separate transfer payment, the two different functions of government are restored to their customary formal presentation, and the words "revenue" and "spending" can be applied consistently to economically identical (but formally different) modes of implementation. As so recast, it is easy to see that Freedonia's economic handprint on the private sector is no longer $1,500 in tax revenues, but rather $1,667 in economic terms. The government is bigger in every meaningful sense of the word.

C. <u>Tax Expenditures Must Be Evaluated on the Merits</u>.

Tax expenditures serve many different purposes. Some (the earned income tax credit, the special tax rates on long-term capital gains) might be viewed as adjustments to the tax rate tables; others (the child credit, the refundable portion of the EITC) serve important social and distributional goals; still others (pension plan contributions) can be explained as moves towards a consumption rather than an income tax. But many fall into the category of well-intentioned but ultimately inadvisable instances of Congressional meddling with our market economy, by subsidizing different forms of personal consumption or business activity. These latter sorts of tax expenditures typically introduce economic inefficiencies, miss the target of their intended beneficiaries, and waste a great deal of money.

Every tax expenditure therefore must be evaluated on its own merits. Nonetheless, when one does perform this sort of evaluation, many tax expenditures, including some of the most expensive ones, fail miserably: that is, they represent extraordinarily costly government spending programs that do not deliver commensurate social welfare benefits.

In 2008 the Staff of the Joint Committee on Taxation undertook a comprehensive review of tax expenditure analysis in a pamphlet titled *A Reconsideration of Tax Expenditure Analysis*. Its purpose was to assist policymakers in using tax expenditure analysis "as an effective and neutral analytical tool" to analyze tax proposals.[26] One of the principal contributions of *A Reconsideration of Tax Expenditure Analysis* was to urge that tax expenditures be grouped into different conceptual buckets, so that each could fairly be analyzed in accordance with its overall purpose, and compared to other expenditures serving a similar overall purpose. To my regret, the Staff of the Joint Committee on Taxation later retreated from the presentation recommended in this pamphlet. I think that this reversal unfortunately weakened the utility of tax expenditure analysis in general.

Tax expenditure analysis traditionally has identified "tax expenditures" as those provisions of the tax code that are said to deviate from a hypothetical "normal tax" system. The fundamental problem, however, is that the "normal tax" system is itself a normative assertion, rather than an economic fact. To mitigate the importance of the "normal tax" concept, *A Reconsideration of Tax Expenditure Analysis* recommended that items traditionally labeled as tax expenditures be divided into two main groups: tax subsidies and tax-induced structural distortions. The former category contained the majority of tax expenditures; it comprised those items that a fair reading of the Internal Revenue Code would suggest were exceptions, not to some hypothetical ideal called the normal tax, but rather to the general rules visible on the face of the Code itself. Tax-

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[26] Staff of the Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08 (May 12, 2008). Since that date the Staff of the Joint Committee on Taxation has retreated from the analysis proposed therein to its traditional presentations of tax expenditure analysis. I think that this is a mistake, because reverting to an excessive reliance on a "normal tax" as the analytical starting point weakens the case for bipartisan agreement on the central importance of tax expenditure reform.

induced structural distortions comprised important tax provisions traditionally categorized as tax expenditures, but where the general rules of the Code were not clearly visible, so that it was impossible to say which was the exception and which the rule. The treatment of the international income of U.S. multinational corporations is a perfect example of an economically important tax provision that cannot fairly be described as a simple exception to a general rule of the Internal Revenue Code.

A Reconsideration of Tax Expenditure Analysis further recommended that the world of tax subsidies (which again comprised the vast bulk of tax expenditures) be subdivided into three conceptual buckets: Tax Transfers (refundable credits); Social Spending (tax subsidies unrelated to the production of business income, which are intended to subsidize or incentivize non-business behaviors, such as the subsidy for charitable giving); and Business Synthetic Spending. Tax expenditures that fall into the last category in particular in my view are inherently suspect, as they represent direct Congressional meddling in the operation of our marketplace economy.

A Reconsideration of Tax Expenditure Analysis showed how tax expenditures could be analyzed under traditional tax considerations of equity, efficiency and ease of administration. These considerations weigh differently across the different conceptual buckets described above. For example, one might expect a Business Synthetic Spending tax expenditure to be justifiable primarily on efficiency grounds, while equity considerations in general dominate the design of Tax Transfers.

Finally, *A Reconsideration of Tax Expenditure Analysis* offered some insights into how best to design a tax expenditure, once the decision to offer a tax subsidy had been made through the political process. The pamphlet emphasized the goals of designing subsidies that are transparent (so that costs are easily identifiable, and the identity of beneficiaries made clear), well-targeted (so that the subsidy goes to change behavior in the direction that policymakers intend, and not to reward people who would have engaged in the activity in any event), and certain (so that intended beneficiaries know that they qualify, and can plan accordingly).

Here is an excerpt from the report that applied some of these principles to the vexing question of our very large government subsidies for owner-occupied housing:

To take a well-known example, the Federal income tax today contains several large subsidies (incentives) for home ownership. Most economists would agree that these tax subsidies are welfare-diminishing. The tax expenditures can be described as introducing inequality of after-tax treatment between otherwise similarly-situated home owners and home renters. The incentives can also be seen as introducing inequities in another sense, by virtue of what Stanley Surrey called their "upside down" design – that is, the fact that these tax expenditures, by being structured as tax deductions, give proportionately greater government subsidies to taxpayers with higher incomes (because the value of a tax deduction is determined by the taxpayer's marginal tax rate). Housing tax subsidies can also be viewed as inefficient, in at least three respects. First, they encourage private capital to be diverted into the housing sector from other investments that would have been made in a world without such incentives, thereby raising the cost of capital for the rest of the economy. Second, the revenues forgone by providing these tax subsidies must be made up by raising marginal tax rates, and those higher tax rates by themselves introduce distortions in behavior. Finally, current law's housing incentives certainly add significant complexity to our tax system.

Nonetheless, the political process has concluded that subsidizing home ownership is desirable. This conclusion can be explained as reflecting factors other than efficiency – for example, "externalities" such as the possible advantages to society of having its citizens feel more "invested" in their communities, and committed to the larger political system, that might stem from home ownership. Moreover, a simple application of tax expenditure analysis along the lines summarized above might be criticized in this context (when one is reviewing a longstanding tax expenditure) for assuming a world where decisions had not been distorted for many decades by these incentives; the technical analysis of what to do with those tax expenditures in light of that past history, or in light (in this case) of the market dislocations that this sector of the economy currently is suffering, might be completely different from the analysis that would be applied to a completely new proposed tax expenditure.

To conclude this example, tax expenditure analysis can shed helpful light on the costs (in the broad sense, including, as noted above, environmental costs and similar externalities) of tax subsidies associated with owner-occupied housing, or can propose ways of rethinking the subsidies that might reduce their costs (for example, the replacement of housing-related tax deductions with tax credits). The ultimate decision as to the net societal welfare to be gained by subsidizing home ownership, however, can only be resolved through the political process.[27]

[27] *A Reconsideration of Tax Expenditure Analysis* at 49-50.

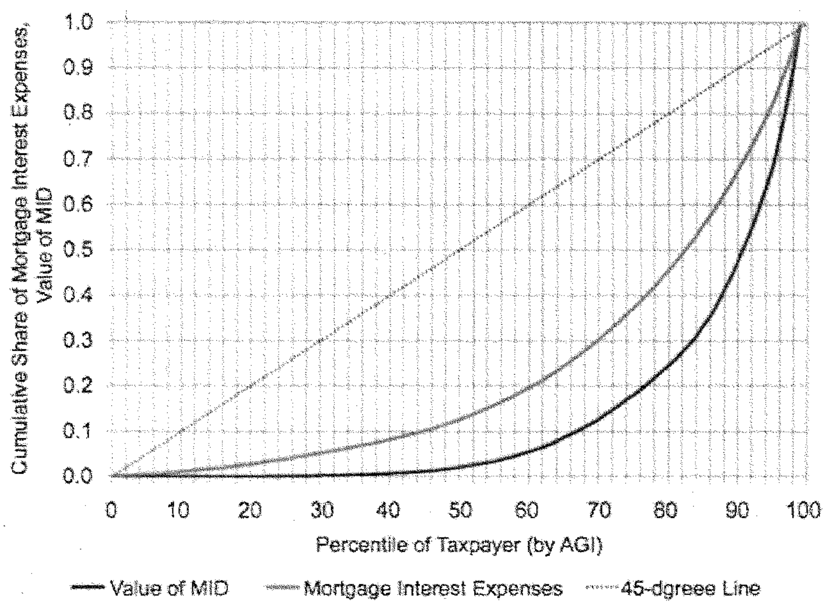
As it happens, I believe that the opponents of this subsidy have by far the better of the argument. The subsidy is inefficient, because it induces Americans systematically to overinvest their capital in homes, rather than in productive business investments; the subsidy is inequitable, in that its benefits go primarily to the highest-income Americans (the "upside down" subsidy problem associated with any subsidy that takes the form of a tax deduction); and the subsidy is poorly targeted, in that its benefits in many cases go to individuals who would have bought a home in any event.

The poor design of our large tax subsidies is neatly captured in the following chart, from an article by Adam Cole, Geoffrey Gee and Nicholas Turner.[28] It shows how the benefits of the home mortgage interest deduction in fact are distributed across Americans of different incomes. What the authors' research tells us is that roughly the top quintile of Americans by income get 80 percent of the value of this government subsidy, and the top 10 percent get over half its value.

[28] Adam J. Cole, Geoffrey Gee and Nicholas Turner, *The Distributional and Revenue Consequences of Reforming the Mortgage Interest Deduction*, 64 National Tax J. 977 (2011).

Figure 3

Cumulative Shares of the Value of the Mortgage Interest Deduction and Mortgage Interest Expenses by AGI Percentile, 2007



Note: Non-filers are excluded from this sample.
Source: Authors' calculations based on data from the SOI Division of the IRS.

(Source: Adam J. Cole, Geoffrey Gee and Nicholas Turner, *The Distributional and Revenue Consequences of Reforming the Mortgage Interest Deduction,* 64 National Tax J. 977 (2011))

Can anyone imagine proposing to Congress in this difficult fiscal environment the creation of a gigantic cash subsidy – totaling *$379 billion* in forgone tax revenues over the next five years, according to the Staff of the Joint Committee on Taxation[29] – the purpose of which is to put roughly $200 billion directly into the pockets of the most

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[29] Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, Feb. 1, 2013, at 33.

affluent 10 percent of Americans? Yet this is exactly what we have done with this one tax expenditure.

In practice, we do not focus on the enormous expense, the deadweight loss or bizarre targeting of the government's subsidy of home mortgage interest in the same way Congress and the public do when Congress considers the Farm Bill. The reasons are that the home mortgage interest deduction is invisible in our standard government accounts, as just another feature of the tax law that leads to a certain level of tax revenues, and because the deduction functions as an entitlement – a permanent feature of the law that people claim if they are qualified, without annual appropriations by Congress. The home mortgage interest deduction and other similar tax expenditures rely to a large extent on this relative invisibility, not on their economic or equity merits, to survive.

As another quick example of the muddle in which we find ourselves, consider that we use the tax system today both to subsidize alternative energy sources, and to subsidize the fossil fuels that those alternative energy sources are designed to supplant. [30] Together the two efforts counteract each other, by incentivizing production and consumption of what amount to competing products.[31] If the policy behind subsidies for alternative energy is to increase the likelihood of consumers using those sources, the subsidy on fossil fuels is directly in opposition to that policy by incentivizing producers and consumers to continue their existing use of fossil fuels.[32]

It is important to stress that not all tax expenditures are wasteful. The earned income tax credit, for example, is a great success story, to the point where it has been copied in countries around the world, under the general rubric of "making work pay."

[30] In 2009, tax expenditures supporting fossil fuels totaled $3.2 billion, compared to $1.47 billion for alternative energy. SUBSIDY SCOPE, *Tax Expenditures in the Energy Sector*, PEW CHARITABLE TRUSTS (Sep. 9, 2010), *available at* subsidyscope.org/energy/tax-expenditures.

[31] Diane Cardwell, *Renewable Energy Industries Push for New Financing Options*, N.Y. TIMES (Jan. 30 2013), *available at* dealbook.nytimes.com/2013/01/30/renewable-energy-industries-push-for-new-financing-options.

[32] *Id.*

Over 20 million Americans claim the benefits of the EITC each year. The EITC has lowered the barriers to entry into the job market for these millions of Americans. There are very large costs associated with moving from unemployed status to one's first job – child care, uniforms or tools, commuting expenses, and so on. These are not taxes in a formal sense, but in practice operate effectively as very high marginal taxes on an individual's first dollar of wage income.

The EITC helps to overcome these sorts of barriers, and to enable individuals to develop the skills and work habits that will enable them to move up the income ladder, until they 'graduate' from EITC.[33] For this reason, most EITC recipients in practice receive EITCs only for only one or two years in a row.[34] The EITC thus solves a fundamental economic problem in the labor markets (the very high implicit tax on entering the workforce), thereby increasing the labor supply, our national wealth and our collective social welfare.[35]

Some observers emphasize the possibility of fraud in taxpayers' claiming the EITC, to the exclusion of considering the credit's demonstrated labor market benefits. The IRS is well aware of this risk, and applies much more rigorous vetting procedures to every return claiming the EITC than it does, for example with the home mortgage interest deduction. The IRS checks the social security number of each taxpayer and of each child

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33 Molly Dahl, Thomas Deleire, and Johathan Schwabish. *Stepping Stone or Dead End? The Effect of the EITC on Earnings Growth*, 62 National Tax J. 329 (2009) (Jobs that single mothers took because of the incentives from the EITC were not dead-end jobs, but rather jobs with the potential of earnings growth).

34 Tim Dowd and John B. Horowitz, *Income Mobility and the Earned Income Tax Credit: Short-Term Safety Net or Long-Term Income Support*, 39 Pub. Fin Rev. 619 (Sept. 2011) (61 percent of taxpayers claiming the EITC do so for no more than two consecutive years). Some taxpayers with children, in particular, receive EITC benefits for longer periods. Id. The authors conclude: "Therefore, for some taxpayers, the EITC acts as a temporary safety net during periods of either anticipated or unanticipated income or family structure shocks. But the EITC also acts as a long-term mechanism of providing assistance to taxpayers with children who are entrenched in the lowest-income brackets."

35 See e.g. Jeffrey Grogger, *Welfare Transitions in the 1990s: The Economy, Welfare Policy, and the EITC*, 23 J. of Policy Analysis and Management 671 (2004); Timothy Dowd, *Distinguishing Between Short-Term and Long-Term Recipients of the Earned Income Tax Credit*, 58 National Tax J. 807 (2005).

claimed against other government databases. If the IRS finds a problem, it will not give the EITC portion of the refund until after audit. The IRS further uses a variety of automated algorithms to detect suspect EITC filings. And relying in part on section 6695(g) of the Internal Revenue Code, added specifically to increase compliance among paid return preparers, the IRS reviews the returns submitted by commercial tax preparers and looks with more scrutiny at preparers who have submitted erroneous claims in past.

D. <u>Healthcare Tax Expenditures.</u>

The two largest clusters of tax expenditures are those for healthcare and those for owner-occupied housing. Each has had a large and profoundly negative allocative effect on the economy – that is, each has distorted what goods and services we all purchase, by changing relative prices through hidden government subsidies. Each also is poorly targeted, in the sense that the subsidy often goes to taxpayers who would have purchased those goods or services without the help of the subsidy.

The most important healthcare tax subsidy is the treatment of wages paid by an employer in the form of healthcare benefits (whether called insurance or out of pocket reimbursements) as tax-exempt in the hands of an employee. This "exclusion" from employees' incomes of wages paid in the form employer-provided healthcare will cost some $132 billion in forgone income taxes in 2013 alone (and $760 billion over the five years 2013-2017),[36] but even these enormous costs understate the true picture, because they do not include the payroll tax revenues forgone by the exclusion. In 2008, the JCT Staff estimated these payroll tax costs at some $100 billion for one year alone.[37]

In short, the total value of this government subsidy for one mode·of healthcare delivery is on the order of $250/billion year. Yet precisely because this subsidy is delivered as an income "exclusion," its recipients are largely unaware that they are the

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[36] Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, Feb. 1, 2013, at 38.

[37] Staff of the Joint Committee on Taxation, *Tax Expenditures for Healthcare*, JCX-66-08 (July 2008).

beneficiaries of a hidden government handout. The result is a terrible distortion in public discourse, as seen in the debate surrounding the Patient Protection and Affordable Care Act. Many Americans believed that the Act represented an unprecedented government intrusion into the private sector, but were unaware that the government had long been subsidizing their healthcare (but not necessarily those of other Americans with different employers). This is why in my academic writing I have emphasized the corrosive effects of tax expenditures on our ability to conceptualize the role of government in our lives.[38]

Substantively, the subsidy for employer-sponsored distorts our spending patterns, by encouraging us to take compensation in the form of generous healthcare programs (its allocative consequences), does so inefficiently (by subsidizing higher-income Americans more, since tax-exemption is more valuable to them – the classic "upside down" subsidy pattern of many tax expenditures), and does so unfairly (because its availability depends on the programs offered by your employer, not consistent national standards available to everyone).

For these reasons, every health economist of whom I am aware believes that the tax subsidy for employer-sponsored health insurance is both unaffordable and bad policy. Many I believe were acutely disappointed that the Patient Protection and Affordable Care Act left the subsidy largely intact (except for certain "Cadillac" plans).

The difficulty is not with this ultimate conclusion, but rather with the frog boiling procedure. The tax subsidy for employer-provided healthcare is so deeply engrained in the healthcare delivery system that it cannot be removed except through a carefully thought-out transition to a different system. Whether the Patient Protection and Affordable Care Act is that system, or only a steppingstone to a more comprehensive rewriting of how healthcare is delivered in the United States, is a complex question, but the unwinding of the tax subsidy for employer-sponsored healthcare should take place in the context of a plan that assures Americans that healthcare will not become less available or wholly unaffordable.

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[38] E.g., Edward Kleinbard, *The Congress Within a Congress: How Tax Expenditures Distort Our Budget and Our Political Process*, 36 Ohio Northern L. Rev. 1 (2010).

E. <u>The Sacred Tax Cows of Personal Itemized Deductions – It's Them or Us</u>

Employer-provided healthcare is the largest single government subsidy program delivered through the tax system. As a group, however, the personal itemized deductions –in particular, the deductions we claim that subsidize our homes (the home mortgage interest deduction, the deduction for property taxes, etc.), our charitable contributions, our state and local income taxes, and so on – are even larger. *The Staff of the Joint Committee on Taxation has estimated that our tax subsidies for home ownership, charitable contributions, and state and local taxes together will cost $1.2 trillion in forgone federal tax revenues over the next five years.*

Following the recommendations developed in an article I co-authored with Joseph Rosenberg of the Tax Policy Center,[39] I urge that these deductions be converted into nonrefundable tax credits at a 15 percent tax benefit rate: that is, a $100 deduction would be converted into a $15 cash equivalent, in the form of a tax credit. [40] The result will be that these activities still will be subsidized, but to a much smaller degree, and the subsidy no longer will be "upside down." In other words, all taxpayers who itemize will get the same $15 tax benefit from a $100 charitable contribution (or whatever), rather than getting a bigger subsidy if they are in a higher tax bracket. To ease the pain for those taxpayers living in particular at the margin of affordability of their homes, the new principles should be phased in over a few years.

This same principle can even be extended to the standard deduction (with adjustments to deal with the 10 percent tax rate bracket). The standard deduction invariably gets a free pass when tax expenditures are examined, but the standard deduction has all the same ''upside-down'' subsidy characteristics that itemized deductions do and no greater justification as a normative income tax matter. Converting the standard deduction to a 15 percent credit (with an adjustment for income in the 10

[39]Edward Kleinbard and Joseph Rosenberg, *The Better Base Case,* 135 Tax Notes 1237 (2012).

[40] *See also* Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stanford L. Rev. 23, 44-48 (2006). Batchelder and her co-authors recommended that credits be refundable; for revenue reasons, I am proposing that they would not be.

percent bracket) raises substantial revenues and addresses the upside down subsidy problem.

I do not have a complete revenue estimate for the revenues that this proposal will raise under the new tax rate brackets adopted as part of the fiscal cliff tax deal, but *my preliminary estimate is that this proposal alone will raise about $1.5 trillion over the 10-year budget window* (ignoring any staged transition rule to minimize the pain of adjusting to the new principles). At the same time, a 15 percent tax credit leaves in place about one-half the aggregate value of the personal itemized deductions, which mitigates some of the transition concerns.

There is a widespread *bipartisan* consensus that the current personal itemized deductions are perverse, inefficient, and unaffordable.[41] In his Presidential campaign, Governor Romney urged that tax expenditures be scaled back, and of course President Obama has proposed a 28 percent cap on the value of personal itemized deductions. The difference between the parties is not, I think, with regard to the merits of scaling back the value of personal itemized deductions, but rather whether the resulting revenues should be used to fund government, or to "buy down" tax rates.

A powerful argument can be made that the personal itemized deductions should be entirely eliminated. My proposal does not go that far, but it is possible to imagine that subsequent Congresses could choose to phase out the personal itemized deductions starting at some later date by reducing the tax benefit of the deductions by, say, 1 percent each year for 15 years.

I recognize that the personal itemized items are frequently described as political "sacred cows," but they are simply unaffordable luxuries in the current environment. Either we eliminate these sacred cows, or they will stampede us.

By scaling back the value of personal itemized deductions, we can not only raise a very large amount of revenue, but we do so efficiently. We can raise this incremental

[41] *See, e.g.*, Michael M. Gleeson and Michael Beller, ''Ryan Budget Calls for Top Tax Rates of 25 Percent,'' *Tax Notes*, Mar. 26, 2012, p. 1595. For example, both Rep. Paul Ryan, R-Wis., and Rep. Patrick J. Tiberi, R-Ohio, have argued that tax expenditures must be scaled back.

revenue *without* raising marginal tax rates. The elimination of the tax preferences for these items also will add to the progressivity of the tax system, because itemizers generally have higher pretax incomes than do taxpayers claiming the standard deduction.[42] (Only about one-third of tax filers itemize their deductions today.)

Moreover, by eliminating these sacred tax cows we directly address a fundamental misallocation of capital in the private sector, which is our overinvestment in single-family homes compared to other forms of capital investment.[43] We also will eliminate the inefficiencies by which we provide these subsidies to those who would have bought their homes (or made charitable contributions, or chosen to live in high-tax states) regardless of the tax incentives.[44]

At bottom, the personal itemized deductions, as the name implies, are all *personal* expenses. Their replacement by a 15 percent credit would make the tax system more progressive, more efficient, less distortive and simpler. Doing so also would raise great deal of money without adding unduly to the deadweight loss from taxation, and raising a great deal of tax revenue in general is something that we have no choice but to embrace.

The reason to convert *all* the personal itemized deductions to a 15 percent credit is that it is impossible to choose among them. Each can be defended as an incentive for one desirable goal or another. Our only practical hope is to round up and eliminate all these tax sacred cows at once.

Martin Feldstein has made a somewhat similar proposal, which he describes as a 2 percent cap on the tax benefits that an individual taxpayer can claim from tax

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[42] See, e.g., Testimony of Robert Greenstein Before the Senate Committee on Budget, March 9, 2011, Table 1 (listing distributional consequences of itemized deductions by income quintiles).

[43] Robert Carroll, John F. O'Hare and Phillip L. Swagel, *Costs and Benefits of Housing Tax Subsidies*, Pew Charitable Trusts (June 2011); Evridiki Tsounta, *Home Sweet Home: Government's Role in Reaching the American Dream,* International Monetary Fund Working Paper Wp/11/191 (August 2011).

[44] For example, Tsounta, supra n. 43, finds (Table 8 at 28) that Canada's tax subsidies for home ownership are perhaps 1/5 as large as a percentage of GDP as those of the United States, yet Canada has a higher rate of home ownership.

expenditures.[45] Feldstein proposes that taxpayers can claim any combination that they wish of the personal itemized deductions and two income exclusions (described below) that are caught by his proposed rule, provided that in doing so taxpayers cannot reduce their tax bills by more than 2 percent of their adjusted gross incomes. (For example, if a hypothetical taxpayer had $100,000 in adjusted gross income, that taxpayer would be limited in claiming deductions and exclusions to an amount that translated into a $2,000 cash tax savings. At a hypothetical flat 25 percent tax rate, this would mean that the taxpayer could claim a total of $8,000 in deductions and exclusions, because 25 percent of $8,000 is $2,000 of cash taxes saved.) Marty and I share a common emphasis on the importance of addressing tax expenditures as the right way to raise revenue, but I do not agree with his specific recommendation.

First, the Feldstein proposal would be extremely complex to implement, much more so than suggested by op-ed I reference in a note. Second, Feldstein proposes to include in his list of tax subsidies subject to the 2 percent cap excludible tax-exempt bond interest. At least as written this does not appear to be economically sensible, because investors in tax-exempt bonds already suffer an implicit tax in the form of lower coupons. (The idea of the exclusion for interest on state and local government debt is not to subsidize investors, but rather the state and local governments that issue the securities.)

Third, whether by design or not, the Feldstein proposal appears to impose very large tax burdens on many middle class Americans. The reason is that he includes in his list of tax subsidies subject to the new 2 percent cap the income exclusion for employer-provided healthcare insurance, subject to an $8,000 allowance. This allowance sounds very generous, and in fact would fully protect most single taxpayers, but if (as I think is intended) Feldstein gives only one $8,000 allowance to a family filing a joint return, then millions of working Americans with employer-provided health insurance would find that much of their previously-excludible health benefits had become taxable. I understand completely the impulse to dismantle the tax subsidy for employer-provided healthcare,

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45 The most recent iteration of this proposal is Martin Feldstein, *A Simple Route to Major Deficit Reduction,* Wall St. J., Feb. 21, 2013, at A-15.

but as I emphasized earlier, we should do so only in the context of a completely secure path to a superior healthcare delivery system that is still affordable.

Fourth, the Feldstein proposal has the odd effect of giving two affluent taxpayers completely different answers, depending on whether their incomes are derived from labor (taxed at the maximum marginal rates) or capital gains taxed at 20 percent. Taxpayers whose income comprised entirely capital gains would get essentially twice as many personal itemized deductions as would high-income wage earners.

Finally, Feldstein excuses charitable contributions from the reach of his proposal. While I understand the impulse to protect charitable giving, I do not agree with this recommendation. Charitable giving is very top-weighted by incomes, and leaving it protected vitiates much of the progressivity of the proposal. Moreover, charitable giving is rife with questionable practices (for example, donor-advised funds or the aggressive use of charitable remainder unitrusts) that have little to do with the eleemosynary purposes for which the charitable contribution deduction was intended.

Chairman MURRAY. Dr. Bernstein?

STATEMENT OF JARED BERNSTEIN, PH.D., SENIOR FELLOW, CENTER FOR BOARD OF GOVERNORS AND POLICY PRIORITIES

Mr. BERNSTEIN. Thank you for the opportunity to testify today.

These are uniquely challenging times for fiscal policy. Our national economy continues to face a series of self-imposed fiscal deadlines in the forms of cliffs, ceilings, and, most recently, sequestration. This latter automatic cut, if it remains in place, is estimated to shave half a percent off of real GDP growth this year and cost the labor market over half a million jobs.

While I understand that there are often principled stands behind these deadlines, operationally they have consistently and needlessly damaged an economic recovery that needs your support, not the fiscal drag and uncertainty that they are causing.

In that spirit, my testimony argues that repealing or reducing some of our tax expenditures offers a promising way forward.

First, compromise on a deficit reduction package is clearly blocked by seemingly intractable disagreements about the composition of such a package. Republicans argue for a "spending cuts only" approach while and Democrats and the President argue for a package that balances spending cuts and tax increases.

Tax expenditures sit astride both of these categories because while they are administered through the Tax Code, many serve the same function as spending programs. For example, Pell grants and subsidized child care are both spending programs that help low- and moderate-income families afford college and child care. But 529 accounts— those are tax-deferred savings accounts for college—and the child care tax credit are tax expenditures that serve the same purposes for higher-income families. Thus, if you believe we have a spending problem, you should also believe we have a tax expenditure problem.

At the same time, since tax expenditures currently forgo over $1 trillion in revenue each year that would otherwise be in the tax base, their reform offers significant contributions to a balanced deal. Such balance is essential.

Chairman Murray has pointed out that the original Simpson-Bowles plan and the Senate's Gang of Six plan had ratios of spending cuts to tax increases of roughly 1:1. But given the spending cuts legislated in the Budget Control Act and the tax increases in the fiscal cliff deal, that ratio today stands at $2.30 of spending cuts for every $1 of tax increases.

Now, of course, every spending program should not be cut, and neither should all tax expenditures be repealed or reduced. I recommend three criteria to evaluate the utility of tax expenditures: revenue forgone, efficiency, and fairness. Members will not be at all surprised to find that it is far too easy to find many tax expenditures that are trifectas. They forgo significant revenue, induce inefficiencies, and return most of their benefits to the wealthiest households, boosting after-tax inequality and failing on the fairness criterion.

For example, the carried interest loophole allows equity fund managers to pay taxes on their earnings at half the normal rate, violating the fairness criterions. Far more revenue is forgone through the ability of multinational corporations to defer taxation on profits earned by foreign subsidiaries, a privilege domestic firms lack. Since most firms with overseas operations can hold their profits abroad for as long as they want without paying U.S. taxes, this break gives them a strong incentive to both reinvest their income abroad and/or shift their operations, or at least their profits, to low-tax havens. Deferral in this case violates all three criteria. It is inefficient for firms to make investment and location choices based on tax savings versus production or sales efficiencies. Considerable revenue is forgone, and since small businesses and domestic firms do not face this option, it provides multinationals with a strong comparative advantage over domestic firms and, thus, fails on fairness grounds as well.

Of course, no matter how reasonable the criteria, picking which tax expenditures should be curtailed amounts to a huge political challenge. In that regard, capping most deductions at a lower rate—the President has suggested 28 percent—for taxpayers above a certain income level also scores highly on the three criteria noted above: raising significant revenue, reducing both inefficiencies and the upside down subsidies embedded in the current system.

In sum, tax expenditure reform offers an excellent option to reduce wasteful spending through the tax system while helping to meet our fiscal challenges in ways that will simultaneously improve our deficit outlook, increase economic efficiency, and add much-needed fairness back into the Tax Code.

Thank you.

[The prepared statement of Mr. Bernstein follows:]

Tax Expenditures: How Cutting Spending Through the Tax Code Can Lower the Deficit, Improve Efficiency, and Boost Fairness in the US Tax Code

Testimony Before the Senate Budget Committee, Sen. Patty Murray, Chairman

3/5/2013

Jared Bernstein

Senior Fellow, Center on Budget and Policy Priorities

Introduction

Chairman Murray, ranking member Sessions, I thank you for the opportunity to testify today.

These are uniquely challenging times for fiscal policy. Our national economy continues to face a series of self-imposed fiscal deadlines in the forms of cliffs, ceilings, and most recently, sequestration. Various independent analyses find that if these automatic cuts remain in place, they will shave around 0.5% off of 2013 real Gross Domestic Product (GDP) growth and cost our labor market between 500,000 and one million jobs. While I understand that there are often principled stands behind these deadlines, operationally, they have consistently and needlessly damaged an economic recovery that needs your support, not the fiscal drag and uncertainty caused by these manufactured crises.

In that spirit, a significant part of this testimony develops recent bipartisan suggestions that some of our tax expenditures be repealed or reduced. There are numerous rationales for this. First, it is clear that compromise on a deficit-reduction package is blocked by seemingly intractable disagreements about the composition of such a package. Republicans have argued for a "spending-cuts-only" approach while the Presidents and Democrats in this chamber have argued for a package that balances spending cuts *and* tax increases.

Tax expenditures sit astride both of these categories, because while they are administered through the tax code, many serve the same function as spending programs. Thus, those who believe we have a spending problem should also believe we have a tax expenditure problem. At the same time, since tax expenditures currently forgo over $1 trillion in revenue each year that would otherwise be in the tax base, their reform offers significant contributions to a balanced deal.

Of course, just as not every spending program should be cut, neither should all tax expenditures be repealed or reduced. In discussing examples below, I use three criteria to evaluate the utility of tax expenditures: revenue forgone, efficiency, and fairness. Members will not be surprised that it is far too easy to find many tax expenditures that are "trifectas": they forego significant revenue, they induce inefficiencies, and they return most of their benefits to the wealthiest households, boosting after-tax inequality and failing on the fairness criterion.

I cannot overemphasize the importance of this last point regarding fairness. As I point out below, not only do we have record high levels of income and wealth inequality in America, but changes in our tax code over the last decade have often exacerbated those inequalities with certain tax expenditures, like favorable treatment for capital gains and opportunities to defer taxation on appreciated assets, contributing to that outcome. These issues took center stage in the last election and President Obama frequently cited a fairer tax code as a central part of his agenda.

In my own work on these issues, I've raised concerns about how taxpayers view the legitimacy of the American tax system. If the average taxpayer feels like the privileged can get a much better deal out of the tax code than they can, that system's legitimacy is at risk, and this is a serious concern for a democracy. In that sense, these revenue issues are not merely about cash flow and budget balancing. They are existential.

My testimony begins by establishing the importance of new tax revenues as part of forthcoming budget deals, then turns to why reforming tax expenditures offers a rich set of opportunities to raise revenues while reducing inefficient spending through the tax code. I then offer numerous examples of tax expenditures that I urge the committee to consider for reform. Finally, I discuss an important dimension of the fairness part of this debate: linkages between the growth of tax expenditures and the growth of income inequality.

Tax Revenues Must Be Part of Ongoing Fiscal Deals

As Chairman Murray emphasized in her budget memo from a few weeks back, Congress and the Administration worked together to achieve around $2.4 trillion in deficit savings, 2013-2022, including (with interest savings) $1.7 trillion in spending cuts and $700 billion in tax increases. Thus, using just the policy changes (leaving off interest savings) in this recent round of deficit reduction, Congress has so far legislated $2.40 of spending cuts for every one dollar of tax increases (note that these numbers reflect neither the sequester nor savings from reduced war spending).

My Center on Budget and Policy Priorities colleague Richard Kogan has updated these estimates for the most recent budget window, 2014-2023, and also added what it would take to stabilize the ratio of debt-to-GDP (the debt ratio) over that window, an accomplishment I would consider the first step to getting the nation on a sustainable fiscal path. The results shown in Table 1 reveal that it would take another $1.5 trillion in savings over this period to stabilize the debt at 73% of GDP.

Table 1
Deficit Reduction to Stabilize the Debt
Cumulative totals, 2014-2023, in billions

	Policy savings	Interest savings	Total deficit reduction
Discretionary savings from cuts in 2011 funding and caps imposed by the BCA	1,576	336	1,912
Savings from the ATRA	732	117	850
Further savings to stabilize debt at 73% of GDP	1,327	202	1,529
TOTAL	3,636	655	4,290

Notes: BCA stands for the Budget Control Act, August 2011; ATRA stands for the American Taxpayer Relief Act, January 2013; all savings measured relative to current policy (see Appendix I)
Source: Center on Budget and Policy Priorities based on Congressional Budget Office and Joint Committee on Taxation data.

Source: Kogan, 2013

Over the longer term, more savings will need to be generated to lower the debt ratio further and achieve more lasting fiscal stability, a point that is well-appreciated by analysts from all sides of the debate. But policymakers' initial focus should be to implement the savings needed to stop the nation's stock of debt from growing faster than the economy (GDP growth) and to do so in a balanced way including new revenues and new spending cuts.

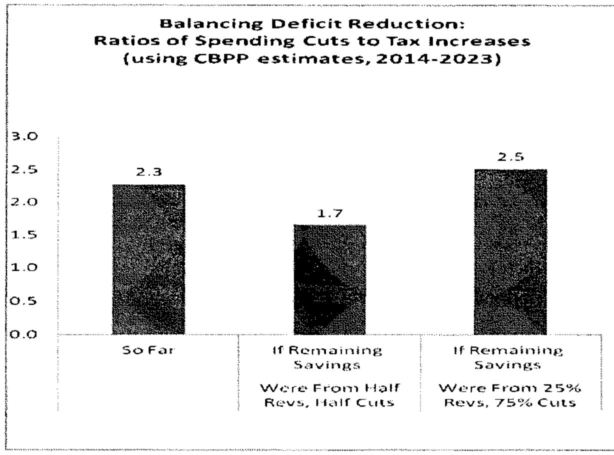
As this committee well knows given the ongoing debate over the sequester, this raises the question as to how best to raise this next $1.5 trillion. The same Chairman's memo noted above makes the following point regarding bipartisan plans, including the original Simpson-Bowles plan and the Senate's "Gang of Six":

> These bipartisan frameworks include significant new revenue and have far more balance between spending cuts and revenue increases than the deficit reduction measures we've enacted to date. For instance, the President's Fiscal Commission and the Senate's Gang of Six each proposed roughly $4.8 trillion in deficit reduction over the 2012-2021 period with over $2 trillion coming in the form of new revenue. Excluding the interest savings of roughly $800 billion, the two bipartisan efforts proposed a roughly 1:1 ratio of spending and revenue savings...
>
> Further, measured over the same ten-year window used to estimate the effects of the ATRA legislation (2013-2022), the two bipartisan efforts each provide for revenue of between $2.4 trillion and $2.5 trillion, or roughly four times the amount of new revenue to be generated by the year-end deal [ATRA].

Figure 1 shows that ratio of cuts to revenues prevailing so far and the ratio if Congress were to split the needed $1.5 trillion between both budget categories (using data from Table 1, i.e., CBPP's update to 2014-2023). An even split at this point would still not reach the roughly 1:1 ratio proposed by the earlier commissions, but it would narrow the ratio some, bringing it to 1.7 to 1.[1] On the other hand, a 75/25 split (cuts to revenues) would result in a less balanced split than the current ratio.

Figure 1

[1] The $732 billion in ATRA savings in Table 1 include $29 billion in program cuts (as opposed to tax increases); I've adjusted the numbers accordingly in the figure.



Source: Table 1 above

It is also notable that in recent fiscal negotiations, revenue offers from both the White House and Speaker Boehner were all considerably higher than the enacted revenue increases in ATRA of $560 billion. These offers ranged from $800 billion to $1 trillion offered by the speaker, to $1.2 to $1.6 trillion offered by the President (all for 2013-2022).[2]

Thus, a balanced plan requires new revenues as part of the deal. I recognize that this flies in the face of a recent partisan position that essentially maintains "we've already raised taxes and we won't do it again." I believe that the analysis above, using standard, widely-accepted estimates, reveals that position to make no more sense than were partisans on the other side were to say "we've already cut spending, we're not going to do it again." Achieving our medium-term goal of debt stabilization will require compromise, which in practice implies both new revenues and new spending cuts.

Tax Expenditure Reform

The above analysis raises the question as to how new revenues should be raised. As President Obama has suggested, and many members of Congress from both parties have at various times agreed, the right place to start is by reducing or repealing certain tax expenditures.

There are good, substantive reasons for the bipartisan appeal of tax expenditure reform. First, it is increasingly recognized by experts including President Reagan's former chief economist Martin Feldstein and current CBO director Doug Elmendorf that in many cases, tax expenditures are simply ways of

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[2] See this piece by Chye-Ching Huang, http://www.offthechartsblog.org/both-sides-have-offered-higher-revenues-than-those-in-fiscal-cliff-deal/.

spending through the tax code.[3] Marr et al (2013) point out that child care assistance and education supports are provided both through spending programs and through tax expenditures, but the distinctions are substantively meaningless. For example, Pell Grants and subsidized child care are both spending programs that help low- and moderate-income families afford college and child care, respectively; "529 accounts" (tax deferred savings for college) and the child care tax credit are tax expenditures that serve the same purposes for higher-income families.

All of these programs provide help acquiring services that Congress has deemed to be worthy. Why should the difference in their delivery mechanisms — the tax code on one side or direct spending from general outlays on the other — determine which ones get cut in the service of deficit reduction? In that regard, policymakers who believe we have a spending problem must also believe we have a tax expenditure problem.

For other policymakers seeking a balanced approach to deficit reduction, cutting regressive tax expenditures that have little economic rationale makes obvious sense, especially given that the Treasury now forgoes more than $1 trillion in revenues from tax expenditures each year and, as emphasized below, most of their benefits flow to those at the top of the income scale, thus exacerbating the problem of high and growing income inequality.

Finally, economists agree that some of the tax expenditures have distortionary economic effects, distorting price signals and providing inefficient subsidies.

So, reforming — as in restructuring, cutting back, or repealing — certain tax expenditures has three very important benefits right now: they offer a balanced path to deficit reduction, they cut spending through the tax code, and their reduction can add both fairness and efficiency to the tax code. The next sections demonstrate these points.

--*Tax Expenditures Now Cost the Treasury Over $1 Trillion in Annual Revenue Forgone*: as Figure 2 below, from Marr et al (2013), shows, tax expenditures are now greater than these other major spending categories of the budget. As a share of GDP, total tax expenditures were cut significantly in the 1986 tax reform, but "subsequently re-bounded, recovering more than half their decline from tax reform GDP," and now are worth about 7% of GDP.[4] As noted above, many of these expenditures through the tax code are economically indistinguishable from spending through the mandatory or discretionary sides of the budget. And as Figure 2 reveals, if tax expenditures were classified as spending, they'd be the largest category in the budget.

Figure 2

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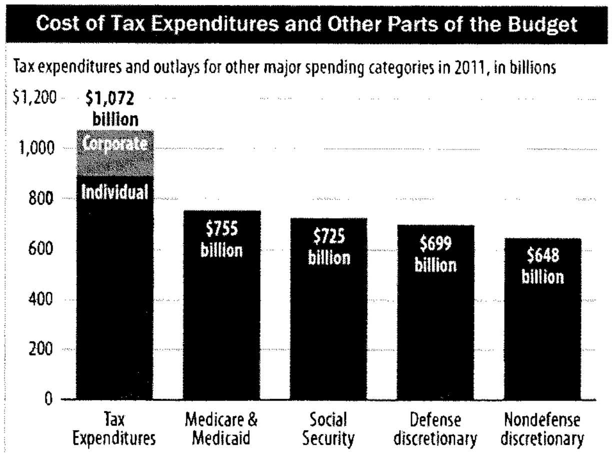
[3] See recent testimony by Robert Greenstein on these points: http://www.cbpp.org/cms/index.cfm?fa=view&id=3908.

[4] See http://www.taxpolicycenter.org/UploadedPDF/412404-Tax-Expenditure-Trends.pdf.



Notes: Tax expenditure estimates do not account for interaction effects; estimate does not include outlays.
Source: Office of Management and Budget, Historical Tables 8.5 and 8.7 and Analytical Perspectives Table 17-2.

--*Tax Expenditures Disproportionately Benefit the Well Off*: as discussed in greater detail in the next section, most, though certainly not all, of the benefits of tax expenditures flow to households at the top of the household income distribution. One reason for this skewed outcome is that the majority of individual tax expenditures (around 70%) take the form of tax deductions or exemptions whose value increases with tax brackets and thus with household income. As Marr et al point out:

> As a result, these tax expenditures provide their largest subsidies to high-income people even though those are the individuals least likely to need a financial incentive to engage in the activities that tax incentives are generally designed to promote, such as buying a home, sending a child to college, or saving for retirement. Meanwhile, middle-class families receive considerably smaller tax-expenditure benefits for engaging in these activities. In this regard, these tax expenditures are "upside down," which makes them less efficient, as well as less equitable.

These authors also provide the following example, using the mortgage interest deduction, a tax expenditure that cost the Treasury over $600 billion (2013-17) in forgone revenue:

> Consider how the deduction for home mortgage interest affects two households' decisions to buy a home. An investment banker making $675,000 who has a $1 million mortgage and pays $40,000 in mortgage interest each year receives a housing subsidy of about $14,000 annually from the mortgage interest deduction. By contrast, a middle-class family led by a nurse making

> $60,000, and paying $10,000 a year in mortgage interest on a more modest home, receives a housing subsidy worth $1,500 annually. Not only does the mortgage interest deduction provide the high-income banker with a larger total subsidy (in dollar terms) than the nurse, but the subsidy also represents a greater share of the banker's mortgage interest expenses. In fact, the proportion of the banker's mortgage interest expense covered by the subsidy is more than twice as large as the percentage subsidy that the nurse receives.

--*Tax Expenditures Are Often Inefficient*: the regressive aspect of many tax expenditures just noted also makes them inefficient. By disproportionately subsidizing higher-income households that are relatively less income constrained, these tax breaks help offset the costs of economic activities that would likely have occurred even without the subsidy. Both theory and evidence support the view that to be most effective in incentivizing desired behaviors, whether that's home ownership, saving, work, or investment, tax policies must reach those most likely to respond to the incentive.

Here, the "upside down" design of the credits contributes to their inefficiency. Since wealthier households are more likely to purchase a home, save, invest in capital assets, send their kids to college, and so on, without any incentives relative to lower-income households, tax expenditures that disproportionately reach the wealthy, as most do (see Figure 3 below), are inefficiently targeted.

Tax expenditures are also inefficient in that they can distort prices and production in sectors of the market where they channel significant tax breaks. The mortgage interest deduction again provides a good example of the impact of these inefficiencies on the housing market. Analysts widely agree that in its current structure it subsidizes home purchases that would be made anyway, and thus leads to an inefficient subsidy that artificially inflates both the market prices and the size of home purchases, particularly among the most well off.

Another example, one that is perhaps underappreciated relative to the mortgage interest deduction, is the large variation tax expenditures generate in tax rates across industries leading to the misallocation of capital and dampening innovation and growth. Recent Treasury Department analysis shows that due to the variation of tax expenditures across industries, average tax rates ranged from 14% to 31% (around a mean of 26%) and importantly in terms of investment behavior, effective *marginal* rates (as opposed to average rates) differed widely as well:[5]

> "For example, because of accelerated depreciation and other features of the tax code, in 2005 income from a typical investment in structures for oil and gas faced an effective total marginal tax rate (including corporate and investor level taxes) of about 9 percent as compared to a 32 percent rate for manufacturing buildings."

Other examples of distortionary tax breaks are not categorized as tax expenditures but work in much the same way, privileging a certain type of income or activity in ways that lose significant revenue while violating efficiency and fairness criteria. For example, by allowing the deduction of interest expenses,

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[5] See http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.

our tax code heavily favors debt financing over equity financing (the effective rate on debt financing is, in fact, negative). This incentivizes financial leverage which both helps inflate debt bubbles and leaves the economy more vulnerable to shocks when those bubbles burst. A 2009 International Monetary Fund report concluded that large biases toward debt financing in the tax code is "hard to justify given the potential impact on financial stability" and that "one lesson of the [recent financial] crisis may be that the benefits from mitigating [these biases] are far greater than previously thought."[6]

Another example is the incentive of corporations to structure themselves as so-called "S corporations" in order to pass corporate profits through to the individual side of the tax code. Thirty years ago, pass-through entities accounted for around a quarter of business income; recent data from the late 2000s show that they now account for about 70%.[7]

Here again, such restructuring is not done in pursuit of economic efficiencies, but in pursuit of tax advantages, leading to inefficient allocation and lost revenue. As the Treasury report states: "By allowing large pass-through entities preferential treatment, the tax code distorts choices of organizational form, which can lead to losses in economic efficiency; business managers should make choices about organizational form based on criteria other than tax treatment."

--*Specific Tax Expenditures Worth Reducing or Repealing:* along with the ones noted above, here are a few other examples of tax expenditures that policymakers should take a critical look at from the three perspectives I've highlighted throughout: forgone revenues, fairness, and equity (this section borrows heavily from Marr et al, 2013).

Carried Interest Loophole: a common and often distortionary problem with tax expenditures involves privileging one type of income over another, creating an incentive for taxpayers to redefine their income to meet the favored definition. A potent current example of this is the carried interest loophole which allows managers of investment funds to redefine their earnings as capital gains, allowing them to pay a top tax rate of 20% — the capital gains rate — instead of almost 40%.

Many of these managers are paid 20% of the profits on the funds they manage and even though they may have none of their own capital in the fund, this part of their compensation is taxed at the lower capital gains rate. Closing this loophole would raise around $15 billion in revenue currently forgone over the next decade (and if fund managers happened to have some of their own capital in the fund, once this loophole is closed, their realized gains would be taxed at the lower rate).

Various Types of Deferrals: I still recall from a line from my public finance textbook from many decades back: *taxes deferred are taxes saved.* To the extent that tax expenditures shield various types of income — foreign earnings, bequests to heirs, debt-financing — from taxation, revenue is lost, inefficiencies can be generated, and fairness is violated.

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[6] International Monetary Fund, "Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy," June 12, 2009, www.imf.org/external/np/pp/eng/2009/061209.pdf.

[7] This trend towards S corporation income continued even through the Clinton era, when, like today, the statutory corporate rate was set below the top marginal individual tax rate.

For example, a sale of property that gained value since it was acquired would normally trigger a capital gains tax liability. But if the property is exchanged for a "like-kind" property (or business), the tax liability is deferred. Originally, like-kind exchanges protected small farmers trading acreage or barter transactions from taxation, but it has grown into a major tax avoidance scheme for sellers of large assets such as commercial real estate or oil wells. Moreover, Marr et al point out that "...if the owner passes the property to an heir instead of selling it, capital gains tax is not just deferred but permanently eliminated, since capital gains become exempt from taxation once the individual who owns the asset dies." These authors also note that full repeal of this tax expenditure would raise about $18 billion over 10 years.

A much larger amount of revenue forgone comes from the ability of multinational corporations to defer taxation on profits earned by foreign subsidiaries, a privilege domestic firms lack. Since most firms with overseas operations can, in practice, defer repatriation of their profits (at which point they'd be taxed as corporate income) for as long as they want, they have a strong incentive to both reinvest their income abroad and/or shift their operations, or at least their profits, to low-tax havens.

Deferral in this case thus violates all three criteria: it is inefficient for firms to make investment and location choices based on tax savings versus production or sales efficiencies, considerable revenue is forgone, and since small businesses and domestic firms don't face this option, it provides multinationals with a strong comparative advantage over domestic firms and thus fails on fairness grounds as well. It is notable that as regards two of these criteria, the non-partisan Congressional Budget Office (CBO) recently noted that "...eliminating or curtailing deferral of U.S. taxes on income earned abroad... would dampen incentives to shift investment or reported income on the basis of concerns about tax liability. As a result, those options would generally lead to more economically efficient business investment and increase corporate tax revenues from firms that remained incorporated in the United States."

CBO goes on, however, to warn that this change has the potential to incentivize more firms to incorporate abroad to avoid US corporate taxation. Even so, they judge that "[o]n balance...eliminating deferral would boost both efficiency and tax revenues. In fact, eliminating deferral entirely would boost U.S. tax revenues by more than $100 billion over a 10-year period, according to an estimate by the staff of the Joint Committee on Taxation (JCT)."

Tax Expenditures and Inequality

Extensive research from disparate sources reveals that income inequality, both before and after tax, is at historically high levels. Prior to the recent recession, pre-tax market income inequality (i.e., without transfers; with realized capital gains) had grown to levels of concentration not seen since the Great Depression.[8] For example, the share of income going to the top 1% was about 10% in the late 1970s,

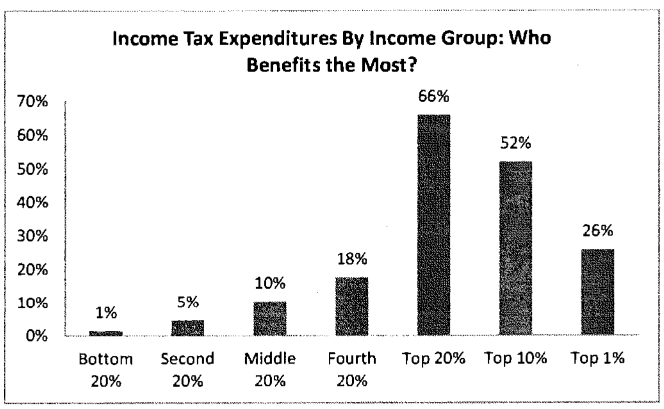
[8] See, for example, this recent analysis by Emmanuel Saez: http://elsa.berkeley.edu/~saez/saez-UStopincomes-2011.pdf.

but had doubled by the end of the 2000s expansion, and now stands at 19.8%. Wealth holdings are even more concentrated than income.[9]

Is there any relation between tax expenditures and this increase in inequality? In fact, as research by economist Thomas Hungerford has shown, "by far, the largest contributor to [the increase in after-tax income inequality from 1991 to 2006] was changes in income from capital gains and dividends" income sources that are consistently favored through the tax code across this period. As capital gains, interest income, and dividends increased have become a larger share of the income of the wealthiest households, this is among the factors that have pushed down their effective tax rates (of course, cuts in top tax rates, such as those in the 2001 and 2003, also played a role). IRS data on the 400 taxpayers with the highest incomes show effective rates falling from 26% in 1992 to 20% in 2009.[10]

Figure 3, using data from the non-partisan Tax Policy Center, shows how individual income tax expenditures can amplify pretax trends toward higher income inequality, as their benefits flow disproportionately to those at the top of income scale. Fully two-thirds of the benefits go to households in the top fifth of the income scale, half go the top 10%, and 26% of the benefits go to households in the top 1%, whose average income is about $2 million.[11]

Figure 3



Source: Tax Policy Center, Table T11-0087 (Note: analysis uses 2012 tax law and thus does not incorporate changes under ATRA. However, ATRA is unlikely to have changed the overall regressivity of tax expenditures; the reinstatement of Pease may

[9] Research by the Economic Policy Institute finds that in 2010, the top 1% held 17% of household income but 35% of household wealth (net worth). See http://stateofworkingamerica.org/files/book/Chapter6-Wealth.pdf, table 6.1.

[10] See http://www.irs.gov/pub/irs-soi/09intop400.pdf.

[11] These data are for 2015 but reflect 2012 federal tax law. Thus, they do not reflect changes under ATRA, but those changes would not alter the results much at all.

have somewhat reduced the total value of itemized deductions for some high-income filers, however the return of the top tax rates to Clinton-era levels for some taxpayers will increase the value of deductions and exemptions for high-income filers.)

In what specific ways do tax expenditures contribute to this problem of growing income inequality, and more specifically, diminished income mobility? As noted, one way is through providing favorable tax treatment to forms of income that are concentrated at the top of the scale, such as realized capital gains and dividend payouts. Another is through protecting appreciated wealth holdings from taxation when they are transferred between generations. For example, heirs who inherit wealth from a deceased relative do not have to pay capital gains taxes because of the "stepped-up basis" exemption, which exempts any accrued gains from taxation. Similarly, by transferring family assets to a family limited partnership and restricting access to the partnership for a few years, parents can transfer their wealth to their children at a highly discounted value. Once the restriction period is over and heirs claim the assets, such "valuation discounts" enable them to benefit from the full value of the asset while incurring a minimal wealth tax liability.

It should also be noted that permanent changes recently enacted in wealth taxation already make this part of the tax code less progressive. Under the tax deal passed to resolve the fiscal cliff, wealthy couples face zero taxes on wealth transfers up to $10.5 million. According to TPC estimates, this cutoff shields all but the top 0.14% estates from any liability, and the small number that do face the tax pay an effective rate of only 17%.[12] This increased regressivity now locked into the tax code is all the more reason to close tax expenditure loopholes which further protect wealth transfers from taxation.

Conclusion

As we meet today, our already-too-weak economy is taking a hit from a mindless set of across-the-board spending cuts that neither party endorses. Yet compromise on the components of a deficit-reduction package to offset the sequester has been elusive as members continue to disagree on whether the package should be balanced between revenues and spending cuts, or just have spending cuts alone.

Tax expenditure reform should offer a solution palatable to both sides. Though they operate through the tax code, many of these programs are indistinguishable from spending programs. In that regard, policymakers who believe the federal government has a spending problem should thus also believe it has a tax expenditure problem. Moreover, many tax expenditures fail on both efficiency and fairness criteria. Finally, as I have pointed out throughout, tax expenditures forgo significant revenue and thus could handily be part of a balanced deal.

In fact, in light of this logic, policymakers of both parties have advocated for reducing or repealing tax expenditures. Yet, even ones that are widely agreed to be quite egregious, like the carried interest loophole discussed above, remain in place. Clearly, politics makes it a serious challenge for would-be reformers to pick and choose who wins and who loses when it comes to tax expenditure reform.

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[12] Tax Policy Center table T13-0020.

That's why part of the way forward may well be to cap most deductions for taxpayers above a certain income level. This solution scores highly on the three criteria I've stressed throughout. President Obama has proposed to limit the value of itemized deductions and certain other tax expenditures to 28 cents on the dollar, which would raise about $500 billion in revenue, otherwise forgone, over the next decade. Regarding the fairness criterion, it reduces the "upside down" problem, by partially closing the gap between the value of deductions claimed by those with the highest incomes relative to lower income tax units. And while the lower deduction amount reduces incentives at the margin, such incentives still exist, a feature which distinguishes this approach to reform tax expenditures to those which cap expenditures at a certain dollar amount or at a set percentage of income. Under those approaches, no marginal incentives exist above the cap.

Still, such a cap would miss other tax expenditures that are also ripe for reform, including carried interest, like-kind exchanges, and some of the other deferral loopholes noted above.

In sum, tax expenditure reform offers an excellent option to reduce wasteful spending through the tax system, while helping to meet our fiscal challenges in ways that will simultaneously improve our deficit outlook, increase economic efficiency, and add much-needed fairness back into the code.

I thank Grace Leeper, Chye-Ching Huang, and Nate Frentz for help in preparing this testimony, though any mistakes are my own. The testimony borrows heavily from the recent CBPP paper "Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction" by Chuck Marr, Chye-Ching Huang, and Joel Friedman.

Chairman MURRAY. Dr. Roberts.

STATEMENT OF RUSSELL ROBERTS, PH.D., RESEARCH FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY

Mr. ROBERTS. Chairman Murray, Ranking Member Sessions, and distinguished members of the Committee, I am wildly enthusiastic about eliminating wasteful spending in the Tax Code.

Our tax system should be more transparent, simpler, and fair. We should get rid of special exemptions for the rich, for parents, farmers, homeowners, and all the other ways that the Tax Code panders to special interests.

But how we finance Government—the structure of the tax system and the mix between taxes and borrowing—is rarely as important as whether Government spends money wisely. It is not just that we spend more than we take in. We spend too much, and much of it we spend poorly. Raising taxes does not solve that problem.

In recent years we have ignored the size of Government spending because it is tempting to believe that all spending stimulates the economy during times of recession. But economists do not agree on the effects of the 2009 stimulus package. Even the Congressional Budget Office has conceded it is unable to separate out the impact of Government spending independently of the changes that occur at the same time.

And it is tempting to see Government expanding as an inevitable force for good—more help for children, the disadvantaged, the poor, and the elderly. Who is against helping children, disadvantaged, the poor, and the elderly? No one.

The problem is that a lot of spending goes to people who are merely politically important—rich financial executives, rich farmers, rich old people who do not need a Government retirement program. And much spending is ineffective because it is spent poorly. Sometimes less is more.

What would happen if Government actually got smaller? Not just a reduction in the rate of growth, but real cuts? There would be more private spending. But we do not just spend our own money on ourselves as consumers buying more stuff. We are also givers. We give our time and our money to causes and communities that we cherish.

Consider the Harlem Children Zone—a $75 million charitable organization that has transformed the lives of 10,000 children. Roughly two-thirds of their money comes from private donations. Those donations have been made because the public programs we are forced to pay for through taxation have failed those children. We need more Harlem Children Zones. But they are not easy to reproduce. They cannot be replicated from the top down simply by spending money, even if that money goes to the same activities.

Great organizations have to be grown. The incentives are the soil that allows them to thrive. The freedom people have to donate to organizations that work and to stop donating to organizations that do not. The founder and head of the Harlem Children Zone is Geoffrey Canada. To keep his organization alive, he has to make the case he is doing a good job with his donors' money. He earns the money that people give him.

When Government gets smaller, you create more room for private organizations to thrive, for civil society, for schools that actually educate the poor, programs for the elderly that give meaning to their lives, training programs that work, soup kitchens that do not just feed the homeless but find them jobs. If Government spent less, great organizations would find it easier to raise the money to do more.

The alternative to Government spending is not selfish spending by our own individual selves. The alternative to Government is voluntary cooperation instead of forced cooperation through the tax system.

As the Hayek character says in "Fight of the Century," my rap video on the stimulus debate written with John Papola: "Give us a chance so we can discover, the most valuable ways to serve one another." Let entrepreneurs of all kinds emerge from the competition for investors and donors, entrepreneurs who get others to cooperate and produce something so much greater than themselves, not just entrepreneurs like Steve Jobs or Jeffrey Bezos, but social entrepreneurs like Geoffrey Canada.

The Talmud says, "In a place where there are no men, strive to be a man." To put it in modern language, in a place where people have no principles, remember yours. In a place where everyone is a coward, be brave. Principles and courage are scarce here in the Nation's capital. We have charted an unsustainable fiscal course—our promises cannot be kept.

Brave men and women of principle of both political parties need to stand up and chart a different course. We need to focus Government spending on those activities Government does better than the private sector, not just those activities that are politically expedient.

So, please, stop spending our money on bankers and rich farmers and rich retirees. But the world might be a better place if you spent less on even the best of causes. Give us a chance so we can discover the most valuable ways to serve one another.

Thank you very much.

[The prepared statement of Mr. Roberts follows:]

Cutting Spending vs. Raising Taxes

TESTIMONY

by

Russ Roberts
Research Fellow
Hoover Institution
Stanford University

Senate Budget Committee Hearing entitled
"Reducing the Deficit by Eliminating
Wasteful Spending in the Tax Code"
Tuesday, March 5, 2013 10:30 am
SD-608 Dirksen Senate Office Building

Russ Roberts is a research fellow at Stanford University's Hoover Institution. He is the author of three books on market processes and hosts the award-winning weekly podcast EconTalk. His Ph. D. is from the University of Chicago.

Chairman Murray, Ranking Member Sessions, and distinguished members of the Committee:

I am wildly enthusiastic about eliminating wasteful spending in the tax code.

Our tax system should be more transparent, simpler, and fair. We should get rid of special exemptions for the rich, for people with children, for farmers, home owners, and all the other ways that the tax code panders to special interests.

But how we finance government--the structure of the tax system and the mix between taxes and borrowing--is rarely as important as whether government spends money wisely.

It's not just that we spend more than we take in. We spend too much and much of it we spend poorly. Raising taxes doesn't solve that problem--it turns it into the status quo.

In recent years we've ignored the size of government spending because it's tempting to believe that all spending stimulates the economy during times of recession. We're like the alcoholic who thinks that if one glass of red wine a day is good for your heart, then a bottle is even better.

But there's no irrefutable evidence that stimulus spending works. First-rate economists on different sides of the issue cannot convince the other side. Even the Congressional Budget Office has confessed that it's unable to separate out the impact of government spending independently of the changes that occur at the same time.

And it's tempting to see expanding government as an inevitable force for good--more help for children, the disadvantaged, the poor, and the elderly. Who's against helping children, disadvantaged, the poor, and the elderly?

No one. The problem is that a lot of spending goes to people who are merely politically important--rich financial executives, rich farmers, rich old people who don't need a government retirement program. And much spending is ineffective because it's spent poorly. Spending on education, for example, is not the same as more education. Don't we actually want to help children rather than giving the appearance of helping them?

Sometimes less is more. What would happen if government actually got smaller? Not just a reduction in the rate of growth, but real cuts?

If government spending were to fall, there would be more private spending. But private spending on what? It's natural to think that smaller government means we'll then have more money to spend on ourselves. But we don't just spend our own money on ourselves, as consumers, buying more stuff.

We are also givers. We give our time and money to the causes and communities we cherish.

Consider the Harlem's Children Zone--a $75 million charitable organization that has transformed the lives of 10,000 children. Roughly 2/3 of their money comes from private donations. Those donations have been made because the public programs we are forced to pay for through taxation have failed those 10,000 children.

We need more Harlem Children Zones. But they're not easy to reproduce. They cannot be replicated simply by spending money, even if that money goes to the exact same activities done by the Harlem's Children Zone. That's like drawing an eagle and expecting your drawing to fly. Wings alone are not enough. Something vital is missing.

Great organizations can't be replicated from the top down. They have to be **grown**. The incentives are the soil that allows an enterprise like the Harlem Children's Zone to thrive. The freedom people have to donate to organizations that work and to stop donating to organizations that don't work.

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The alternative to government isn't selfishness. The alternative to government is voluntary cooperation instead of forced cooperation through the tax system.

Make government smaller and you get more private enterprise and more entrepreneurs. But the enterprises that will spring up aren't just commercial enterprises. There will be organizations that help others.

As the Hayek character says in Fight of the Century, my rap video on the stimulus debate written with John Papola:

> Give us a chance so we can discover, the most valuable ways to serve one another.

That's what we try to do when we're given the chance. If you're Jeffrey Bezos, you serve others by creating the Kindle. If you're Geoffrey Canada you serve others by creating the Harlem Children's Zone. Both Bezos and Canada are entrepreneurs who get others to cooperate and produce something so much greater than themselves.

The Talmud says in a place where there are no men, strive to be a man. To put it in modern language, in a place where people have no principles, remember yours. In a place where everyone is a coward, be brave. Principles and courage are scare here in the nation's capital. We have charted an unsustainable fiscal course--our promises cannot be kept.

Brave men and women of principle of both political parties need to stand up and chart a different course. We can't have everything we want. We can't keep living beyond our means. We have to learn to say no. We need to focus government spending on those activities government does better than the private sector, not just those activities that are politically expedient.

So please stop spending our money on banks and rich farmers, and rich retirees. But the world might be a better place if you spent less on even the best of causes.

Give is a chance so we can discover the most valuable ways to serve one another.

Chairman MURRAY. Thank you, to all three of you, for your testimony.

We are now going to turn to opening rounds of questions, and, Dr. Bernstein, let me start with you. As you noted in your testimony, in general, tax expenditures are very regressive, meaning, of course, that the benefit of these special tax breaks flow to high-income individuals.

You also mentioned that by giving special tax treatment to certain activities, investments and industries, our Tax Code creates—and I am quoting you—"misallocation of capital," which you said is bad for economic growth.

As an economist, can you explain in layman's terms how this misallocation of capital occurs and why exactly it is not good for the economy?

Mr. BERNSTEIN. Sure. Let me begin by referring those to Figure 3 in my written testimony, which shows the distribution of tax expenditures through the income code, and it is a point that all three of us made, including Russ here to my left.

Mr. ROBERTS. Enjoy it.

Mr. BERNSTEIN. You know what I mean.

Mr. ROBERTS. Yes.

Mr. BERNSTEIN. Where 66 percent of the benefits of these expenditures go to the top fifth and 26 percent go to the top 1 percent of households.

Look, because of these tax expenditures, the effective tax rates on corporations, if you divide them into their industries, range from about 14 percent to about 30 percent. That is a very large range for effective tax rates, and right there, Chairman Murray, you get a sense of the answer to your question. We are clearly incentivizing investments in some industries over others. Oil and gas faces an effective marginal rate of something like 10 percent. Manufacturing faces an effective marginal rate of something like 30 percent. When you have those kinds of differences in the Tax Code, you are influencing which industries investors will invest in because their after-tax returns will be higher, not based on any economic criteria, like we need more of this and less of that to make the economy grow better, but because I will get faster after-tax returns because my write-offs will be bigger in Industry A versus Industry B.

Secondly—and I will stop after this point—as I mentioned in my spoken testimony, because multinationals with foreign subsidiaries abroad are able to defer the income that they earn, relative to domestic firms, it is actually cheaper from the perspective of the Tax Code to build a factory in Singapore or China than it is in Illinois. And, again, those kinds of location decisions made not because here is the best place for me to produce geographically in an economic sense, but are being made because here is the place where, if I produce there, I can get the biggest tax breaks. That is the kind of inefficiencies that undermines economic growth and creates those differentials between industries.

Chairman MURRAY. Okay. And on another point, because our Tax Code so often gives outsized subsidies to high-income Americans as compared to families in the middle class, are we not essentially providing tax breaks to folks who very likely might engage in tax-favored activities even without an incentive?

Mr. BERNSTEIN. Very much so. I mean, again, if I may quote my colleague Russ, perhaps somewhat surprisingly, he pointed out that too much spending goes to people who do not need it.

Now, again, from a perspective of fairness, that is wrong. But your point is well taken. From a perspective of inefficiency, that is another big problem.

One of the things you do not want to do with subsidies—and not all subsidies are bad. You named some, Chairman Murray, in your introduction that actually score high on efficiency criteria: food stamps; the earned income tax credit, which incentivizes work; the child tax credit, which incentivizes work. Those are tax credits that are very important to create positive incentives for low-income people.

But when you give a subsidy to someone who would have done it anyway, not only are you wasting much-needed revenue, but you are overincentivizing a particular activity at the cost of efficiency and optimal decision making.

Chairman MURRAY. Well, thank you. And I am going to retain the balance of my time. We have a lot of members here and a vote at 12:15. I want to make sure everybody has a chance, so I will turn it over to Senator Sessions.

Senator SESSIONS. Thank you. Well, we certainly all believe and share the view there is a great opportunity for bipartisanship in simplifying this Tax Code and making it more productive and creating more growth, creating, therefore, more jobs and better wages for working Americans, who are not doing very well and have not done well for some time, in my view.

With regard to the "tax expenditures," a phrase I am not comfortable with—however, it is used—we have the exclusion for employer-provided health insurance, Dr. Roberts. That represents 13 percent of that. Do not a lot of lower- and middle-class families benefit from that?

Mr. ROBERTS. Sure, they do.

Senator SESSIONS. And with regard to lower- and middle-class families, we had a witness here a couple of weeks ago from Pennsylvania, their welfare system, that low-income people receive as much as $29,000 a year from the Government in support through multiple programs that benefit them. So it is not really fair to say that poor people are paying in more than their fair share or less than their fair share. I think we just need to analyze the system and see how it all works out.

The home mortgage interest deduction is the second largest or one of the largest. It is 9 percent of all expenditures. Over 70 percent of the benefit goes to taxpayers with incomes under $200,000. Eliminating that deduction would be a major tax increase, Dr. Roberts, would it not, on middle-class America?

Mr. ROBERTS. Sure.

Senator SESSIONS. And is it not fair to say, Dr. Roberts, that while we ought to simplify the system, the big question for us is, if you eliminate some of the exclusions, deductions, and loopholes that are out there, if you eliminate those, you bring in a lot more revenue, you have created a tax increase? And the question is: What do we do with it? Would you have a suggestion that it should be utilized to fund more spending, or should we utilize it in other ways that would be better for the country?

Mr. ROBERTS. Well, it will definitely bring in more spending. I think the challenge we have is, as you say, what do we do with that extra opportunity. Do we allow people to keep more of their money in more effective ways, say with lower rates? Should we lower spending as a result to close the gap that is still going to exist possibly after you have changed that tax policy?

I think the biggest problem with tax expenditures we have not talked about today—and although I use the phrase, I am also a little bit uneasy with that phrase, but let us call it "special deductions." Although I am uneasy with the phrase "tax expenditures," "special deductions"—maybe a better phrase—have a different problem that we have not talked about, which is it encourages people to come to you and ask for special treatment. And it is a long line. And I think that is lovely for you, but it is not so good for me.

Senator SESSIONS. It is not so lovely for us, really. But it is true—

Mr. ROBERTS. Well, it has costs, I understand. It can be frustrating and annoying, and it is hard to say no. But in economics, we call it "rent seeking." It is people trying to get their share to get at the trough and elbow others aside. And I think that is a terrible waste of resources, both the time and energy, plus the behavior that then is incentivized by the Tax Code is often not healthy, not good. We have named a bunch of things that sound good. We talked about education. Everybody here is in favor of education. But the question is: Is the continual subsidy of education—which benefits me, by the way—is that continual subsidy a healthy way to improve the education system and the well-being of the people of the United States? Are you at risk of creating another bubble like we had in the housing market that is going to cause a very unhealthy situation where people find themselves, first of all, unable to find work to pay back their subsidized loans, the tuition rates that have skyrocketed as a result of that subsidy, an unintended consequence, which helps fund my salary? That is all lovely for the education sector. It is not necessarily so good for education.

So I think we have to be extremely careful when we take specific examples of things that sound good but that in practice turn out to be fairly destructive.

Senator SESSIONS. Dr. Roberts, is it not true that if these deductions, exclusions, or whatever you choose to call them, were to be eliminated, we would have a substantial tax increase on the middle class? Middle-class and lower-middle-class people would pay more in taxes to the Government?

Mr. ROBERTS. If we got rid of all of them, we certainly would. And I think then we would have to have a choice about whether we should then lower rates, which would be my personal choice, but more importantly, to lower spending so that we could afford what we actually do, which I think is the responsible adult behavior that I wish we could do more of.

Senator SESSIONS. Well, thank you so much.

Madam Chairman, I think, if I could just have a second—do we have this chart on the screen? I would like to look at this chart when we talk about taxes. It was part of the front-page article in

Barron's a couple of weeks ago, and the three lines represent this: the blue line represents what the debt would be in 2043 under the CBO estimate; the second would be under the CBO estimate, if the wealthy paid 50 percent, not the higher rate that we just passed at 40 but go to 50 percent, if they paid 50 percent; and then the third line was a CBO estimate with the wealthy paying 50 percent and all the Bush tax cuts were eliminated.

So I would suggest that this gives further credence to the argument that we have a difficult—we are not going to get very far, getting our way out of the unsustainable debt course by raising taxes. It is just not there. The growth of spending is greater than the growth of the economy, and spending has to—cannot rise consistently higher than the economy grows.

Thank you, Madam Chairman.

Chairman MURRAY. Senator Wyden.

Senator WYDEN. Thank you, Madam Chair.

Mr. Kleinbard, the lead story in this morning's New York Times highlights what to me is a growing abuse in the Tax Code, and that is the matter of tax-exempt bond finance. And if I might summarize, I think there is a general kind of sense in the Congress and in the country that tax-exempt bonds ought to be used for projects like roads and bridges, but not skyscrapers. And what this article essentially outlines in great detail is that the really increasing use of these tax-exempt bonds goes increasingly to these very powerful private interests who seem to be straying from a public purpose.

What we do in our bipartisan tax reform bill—it started with Senator Gregg and Senator Coats and Senator Begich and myself—is more to a tax credit approach, so there would be a role in order to try to promote these public investments. But how serious an abuse is this? And would you favor something like that?

Mr. KLEINBARD. The private activity bond rules in the Code today are fundamentally, in my view, inexcusable. They represent Government subsidies for particular private investments. They are the hand of Government distorting private behavior in ways that are simply not justifiable on anybody's theory of what the economy of the United States is all about. And we are talking about tens of billions of dollars a year in Federal subsidies to individual firms to build factories or hotels, or whatever, that they would have done in any event. So it is just wasted money delivered through the Tax Code in the form of permitting these private firms to capture the benefits of tax-exempt financing.

Senator, as you say, tax-exempt financing ought to be about general obligation bonds. It ought to be about the needs of the States to finance infrastructure and the like, and this is a terrible distortion.

The second problem that we have with all tax-exempt financing is that the object of the subsidy is or should be the States and localities. It is about subsidizing the issuer, not the investor. But there are so many tax-exempt bonds chasing so many investors that high-income investors, in fact, are getting a spillover of that subsidy. They are capturing part of the subsidy that was never really intended for them, and that is not right.

By switching to a tax credit structure, like the Build America bonds, by switching to that kind of a structure, you can target the

Federal subsidy to the people you mean it to, which are the States and local governments. So it is a much more efficient way of delivering the same subsidy.

Senator WYDEN. You have just delivered a teach-in on the whole bond issue, and I thank you for it.

Mr. Roberts, let me ask you a question about the charitable deduction, which I think was one of our big challenges in putting together the legislation. And I have come to the general conclusion that the charitable deduction is a lot more of a lifeline than a loophole, and I want to ask you your view about one particular point that we hear from philanthropists quite frequently.

Philanthropists have basically told us that they believe people do not make a contribution to charity just to get a break. So you start with that as the proposition. But the philanthropists often say that they think people are giving more because there is the charitable deduction and the loss of that would be harmful.

What is your sense of that?

Mr. ROBERTS. Well, it is half—I think what they say is basically correct. Almost no one donates, quote, just to get the deduction because you have to lose money to get the deduction. You have to make an actual contribution. So it is a question of how much more or less people would give if we got rid of that deduction.

If we got rid of that deduction, the effective price of charity for people in high tax brackets goes up quite a bit. They would still give. They would give less, though, presumably. And whether that extra amount less would be decisive or important would depend on what charity you are in and how it happened to your collections. I think we would raise less money from the charitable deduction—for the charitable sector if we got rid of the charitable deduction.

Now, I think the charitable deduction is one of the best loopholes in the Tax Code, but I could argue equally well that maybe it is not appropriate that you have to subsidize the charities that I think are worth donating to. The return argument is, yes, but then you subsidize mine and I subsidize yours. That is not to me a very effective way to do things.

There is a great economic argument for the charitable deduction. There is a great economic argument for almost every deduction we have in the Code. Again, the question is how prone are they to abuse once you open that Pandora's box to skyscraper abuse and others.

Senator WYDEN. My time is up, Madam Chair. I would just say we are going to have to make some tough calls in this. I think the kind of thing we saw on the front page of the New York Times is a little bit different than a deduction to loaves and fishes in Portland, Oregon, where we are trying to help seniors who are walking on an economic tightrope. But we will be working with you.

Thank you, Madam Chair.

Chairman MURRAY. Senator Grassley.

Senator GRASSLEY. Let me say what I think is frustrating about this whole issue of raising taxes either to spend more or to reduce the deficit, whatever the motive is, particularly in a time of such high unemployment we have now and the longest period of unemployment I guess since the 1930s.

The President in 2008 ran on a platform of increasing taxes. Before he was sworn in, he made an announcement that during a time of such high unemployment—and it was not even 10 percent then; it eventually got to be 10 percent—you should not raise taxes in that period of time. The only thing that has changed since then, it is down to 7.9 now, but the President re-emphasized not raising taxes at least twice since he has been in office—not lately, of course, but in 2009 and 2010 he said that the economy had not improved enough to increase—or that we ought to increase taxes.

Now, obviously it is different now because there is a $612 billion tax increase that we voted as a result of his last election. But it is kind of difficult for me to believe that we are raising taxes to reduce the deficit because last week we had the bill up by the majority to preempt sequester, and it raised taxes. But I also believe that the bill added $5 billion to the national debt instead of reducing the national debt.

So the frustration comes, after 4 years we still hear about higher taxes because we need a balanced approach or we need a fair share. But I never see any definition of what is balanced. I never see any definition of "fair share." And I think we ought to start policy making, whether it is at the White House or whether it is here in the Congress, based upon certain principles of taxation.

Now, you may not like the principles of taxation that my party has had for a couple decades, but it is that after 50 years, about 18 percent of the gross national product has come in for us to decide how to divvy up, and the other 82 percent has stayed in the pockets of the taxpayers because it turns over in the economy more often than if Government turns it over. You may not like that principle of taxation, but what is the principle of taxation? What is the policy of other people in this town of what the taxation policy is? Except just every time there is a crisis here in town, we have to be fair and we have to be balanced.

The principles of taxation ought to be spelled out for us and then make a decision based upon the level of taxation on what those principles are. But if you do not have a definition of "fair share" or what "balanced" is, you really have nothing except just on a whim we are going to raise taxes. Well, when are taxes high enough to satisfy the level of people in this Congress to spend money, or any Congress, for that matter? So I beg for that sort of principle to be expressed.

I probably only have time for one question now, and that would be to Mr. Kleinbard. I want to first express a concern I have about the focus of the hearing as evidenced by the title. There appears to be an assumption that tax expenditures are an untapped revenue source that can be used to finance more spending on other programs. This view could frustrate or replace comprehensive tax reform efforts. Mr. Kleinbard, your testimony correctly recognizes that our current corporate tax rate is out of line with the rest of the world, and am I correct in reading your testimony to say that reductions or eliminate of corporate tax expenditures should be used to reduce corporate tax rates and not as a source of new revenue?

Mr. KLEINBARD. Yes, sir. I believe very strongly in benchmarking of the U.S. against other countries as a general matter. When you benchmark the United States, our statutory corporate tax rate is well out of line. The corporate tax rate needs to come down to the mid-20s. At the same time, our tax revenues from business generally are on the low side because we have so many tax expenditures, which are particularly pernicious in the business world. We do not have Soviet-style 5-year plans for how to run the economy except through the tax system where we do exactly that, where we favor this industry or that industry.

So I believe quite strongly we should get Government out of the business of business by reducing the marginal tax rate on U.S. corporations to something in the mid-20s and to pay for that through the elimination of business tax subsidies. And by my estimates, in fact, the numbers work. You can do that.

So I see business as a separate silo from the individual tax system, and the business tax reform, the lead item should be corporate tax rates in the mid-20s, pay for that by getting rid of the hand of Government that is distorting business behavior, and let business be business.

Senator GRASSLEY. Thank you, Madam Chairwoman.

Chairman MURRAY. Thank you.

Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Madam Chair.

Dr. Bernstein, let me take you through where I think we are, and if you could double check the numbers for me so that I am in the right place. As we try to solve a $4 trillion deficit problem, we have looked at the spending side, and we have already agreed to spending cuts of $1.7 trillion. We have looked at increasing tax rates, and because we took back the Bush tax cuts for families making over $450,000 a year and went to Clinton era tax rates for families making over $450,000 a year, we raised $0.7 trillion in new taxes if you count the associated interest in both cases, which takes us to having gotten $2.4 trillion towards solving our $4 trillion problem. And by my math, that leaves $1.6 trillion that we still need to agree on in order to get to that goal.

Now, we have looked at spending cuts. We have looked at tax rates. The one place we have not looked at is tax expenditures. And that is not a term we made up. That is Martin Feldstein's term for this, Reagan's Economic Chairman. That is Republican Alan Greenspan's term for this. This is tax expenditures. And they add up, in my calculation, over a 10-year budget period to $13 trillion, roughly—$13 trillion in a 10-year budget period.

So to the Ranking Member's point that we might "eliminate" all of that, we do not need to come close to eliminating all of that. We could do the entire remainder of what we need to do to get to $4 trillion out of this $13 trillion by only taking 12 percent of it back. And that probably understates it, because when you include the corporate piece in this, if you look at the personal side, the individual income side, for every dollar that the Government actually collects in revenue, it is about 99 cents that goes back out to people through the Tax Code. It is about a one for one. When you look at the corporate side, it is $181 billion that actually comes through in revenue and $157 billion that goes out to corporations through tax deductions, loopholes, gimmicks, various things.

My understanding is that the 181 and the 157 do not count the tricks that corporations use to hide offshore revenues. So it is actually way worse than that in terms of corporate collection, and Chairman Conrad used to show us the picture of that house in the Cayman Islands that had, you know, 17,000 companies pretending to do business in it in order to hide their revenue offshore. We have seen companies that have moved their intellectual property to Ireland in order to hide it from paying taxes, and as a result, corporations pay $1 in tax for every $6 that human beings spend, and a couple of decades ago, it was one for one. So they have really slipped out of the taxpaying picture in America.

So I think those are the right numbers. You have been sort of nodding and following me. Have I been on base with the numbers so far?

Mr. BERNSTEIN. Yes. In Table 1 of my testimony, we have updated those numbers because the budget window has moved 1 year, but they amount to very close to what you said. At this point it would take $1.5 trillion over 10 years to stabilize the debt as a share of GDP.

Senator WHITEHOUSE. Okay, not 1.6, so even less.

Mr. BERNSTEIN. Correct.

Senator WHITEHOUSE. So out of the $13 trillion in tax expenditures, it is even a smaller percentage than I have suggested. And when you look at some of the stuff that is in this mess of tax expenditures, some of it, frankly, just seems slimy. I mean, the idea that a hedge fund billionaire pays a lower tax rate than a hospital orderly or a firefighter or a bricklayer, that is just—I mean, you do not need to be looking for revenue to find out that that is wrong. That is just plain wrong on its merits. If you have big oil companies that I think have made $1 trillion in profits in the last—I think it is 5 years, if I am not mistaken, maybe it is 10—$1 trillion in profits, and they are still coming to the American taxpayers' pockets for subsidies? There is something wrong with that whether or not you need the revenue. And all the incentives for American businesses to offshore all the tax incentives they get when they move jobs overseas or hide revenue overseas, all of that, that is just wrong. And you mentioned, the top 400 taxpayers. You know, it is not just—we heard about Mitt Romney paying, what was it, 11 percent? He had to gimmick his taxes to get them up to 13 percent. It is not just him, though. It is the whole top 400 paying about 20 percent, which is about what a bricklayer makes in Rhode Island. And it is about a third, if I remember correctly, of people making over $1 million who pay lower than what 10 million middle-class taxpayers pay.

So we have a huge problem in our supposedly progressive health care system in that the lobbyists have been at it, the special interests have been at it. They have carved all these special interest loopholes in there. And so my position—I am sorry. I have gone over my time. My position would be this is stuff we should be cutting out of our Tax Code on moral and fairness reasons anyway, and to use it to avoid cuts to Head Start and special education and Medicare is a smart move.

Chairman MURRAY. Thank you.

Senator JOHNSON.

Senator JOHNSON. Thank you, Madam Chair.

You know, what is wrong is we have this monstrosity of a Tax Code that costs $200 to $300 billion a year to comply with. I will go on the record, I would like to scrap the entire thing, rebuild the tax system on pretty basic principles: raise the revenue you need, do no economic harm. We need to stop socially and economically engineering through the Tax Code, but we are a long ways from that. Right now we are just trying to nibble around the edges.

Let me start with a basic question. What is the maximum marginal tax rate that each one of you thinks the Federal Government should charge on the next dollar of income? Maximum marginal tax rate. Professor?

Mr. KLEINBARD. The maximum marginal tax rate that I would be comfortable with would be about 45 percent. That is what it is in the U.K. now.

Senator JOHNSON. Okay. Good.

Dr. Bernstein?

Mr. BERNSTEIN. Well, it is a good time to ask that question because there has recently been research by scholars in the field, recent papers by Peter Diamond and Emmanuel Saez that I commend you—

Senator JOHNSON. Just give me a number.

Mr. BERNSTEIN. Yes, so they come up with numbers that are way above what Professor Kleinbard said.

Senator JOHNSON. Well, I am asking you.

Mr. BERNSTEIN. 60, 70 percent. I am more comfortable 45, 55, in that range.

Senator JOHNSON. Okay. Dr. Roberts?

Mr. ROBERTS. I do not have an answer for you, but I would say that if Government were the size it should be, meaning if Government only did the things that it does better than the private sector, I think it would be a fraction of its current size, and the goal of the tax system is not to maximize how much revenue we create, which a lot of these academic exercises are about how big could it be and we would still collect a lot of money. That is not my goal. My goal would be what is the right size of Government, and the answer to that is what Government does well, particularly what it does better than the private sector, and then I would have a fairly flat tax system with minimal deductions and minimize that compliance cost. And my guess is that that number is somewhere in the 10 to 20 percent range for the tax rate. And I would have a broad base rather than the system we have now, where millions of Americans pay zero in income tax, and because they think their payroll tax is saved for them for their retirement, they see extra Government spending as being a free lunch. And that is a destructive political incentive.

Senator JOHNSON. I just kind of have a common-sense notion that the way you really strengthen the middle class is have a strong economy, and you have businesses that have the incentive to risk their capital. And I guess I am just kind of scratching my head, when you have a top Federal tax rate of 40 to 50 percent, you are not allowing that entrepreneur, that risk taker, much from the standpoint of keeping the fruits of their labor.

Professor Kleinbard, you mentioned that we obviously have a revenue problem. The fact is in the latest CBO estimate, the spending over 10 years is 22.1 percent, which is 1.9 points higher than the 50-year average up to 2007; whereas, revenue is 18.9, which is 0.8 points higher than the 18.1 percent. So the problem is we are just spending a lot more than we ever did. So I would just dispute that we have a tax problem.

And here is my point: In 68 years, from 1944 to the present time, only 10 times have we generated revenue that exceeded 19 percent of GDP, 3 times over 20 percent. What makes you think that we can actually generate—no matter what the top marginal tax rate is—by the way, the top marginal tax rate during that period was 91 percent, then 70 percent, then 50 percent. You know, what makes anybody think that we can actually generate more than that 18.1 percent?

Mr. KLEINBARD. Oh, so I have a couple of answers to you. We know we can generate more. We have generated more. We know—

Senator JOHNSON. Only infrequently.

Mr. KLEINBARD. Because you have chosen to reduce rates. If you, in fact, look at our OECD peer countries, we are the lowest-taxed country. We are the best economy in the world; we are the most flexible, robust economy in the world. But we have the lowest rates. Those two are not necessarily causative, but they do indicate that we can have a tiny bit higher rate, a 21-percent rate, without destroying the economy.

Senator JOHNSON. Let me ask the question I asked during the last budget hearing because you are all economists and, you know, maybe can answer this question. Do any of you know of a tax increase that is going to promote economic growth or that will make us more competitive globally? Does it one exist?

Mr. KLEINBARD. Sure. I can—

Mr. BERNSTEIN. Yes.

Mr. KLEINBARD. Well, you go ahead, Jared.

Mr. BERNSTEIN. Well, I was just going to say, not an increase in tax rates necessarily, but an increase in precisely the kinds of base issues and revenue issues we are talking about today. By lowering tax—by repealing or restructuring, lowering tax expenditures that distort economic behavior in the way we have discussed—they distort what people buy, they distort what people invest in, they distort where people set up their companies. Those would be both efficiency enhancing, which I know you like because of where your question is going—

Senator JOHNSON. Just real quick—

Mr. BERNSTEIN. —and revenue.

Senator JOHANNS. It was interesting. I saw Joe Scarborough debating Paul Krugman, and they were basically saying that $1 spent in the private sector is the same as $1 spent in the public sector. Do you actually believe that? Do you really believe that Government is as efficient in allocating capital as the private sector when it comes to investment?

Mr. BERNSTEIN. I do not.

Senator JOHNSON. You do not?

Mr. BERNSTEIN. No.

Senator JOHNSON. Anybody think Government is a good allocator of capital?

Mr. KLEINBARD. I think the Government is a terrific allocator of capital in those places where markets fail.

Mr. BERNSTEIN. Exactly.

Mr. KLEINBARD. And markets fail all the time. It is not the case that markets are perfect. Markets fail in education. Markets fail in infrastructure. And those are the kinds of things that, in fact, we finance through Government. We are the lowest-taxed country in the world of any OECD country. It cannot be the case that we cannot afford a little bit more revenue to pay for the existing level of spending. The problem with spending that the CBO projects is health care. And until the Congress of the United States tackles health care in a much more comprehensive way, we are going to need to raise more taxes.

Senator JOHNSON. Well, that is because Government pays 50 percent of it.

Dr. Roberts, real quick.

Mr. ROBERTS. Yes, I was just going to say we are the lowest of the OECD countries, but, of course, a lot of our taxes are hidden because we have promised to raise taxes tomorrow, which is what borrowing does. And I follow Milton Friedman's rule, which is there are only two kinds of taxes, taxes today and—two ways to finance Government: taxes today and taxes tomorrow. Borrowing is just a way of hiding that fact.

I do not want to be like Norway. I do not want to be like Greece. I do not think we should emulate them. And I think that is the wrong path to go.

Senator JOHNSON. Thank you.

Chairman MURRAY. Thank you.

Senator Baldwin?

Senator BALDWIN. Thank you.

We have had a little bit of discussion about the use of the term "spending" in the Tax Code and "tax expenditures" that I found interesting and the origins of those phrases. My friend and colleague from Wisconsin, Paul Ryan, the Chairman of the House Budget Committee, had this to say about tax expenditures in the Tax Code in his previous budget. He said, and I quote: "These distortions are similar to Government spending. Instead of markets directing economic resources to their most efficient uses, the Government directs resources to politically favored uses, creating a drag on growth."

He went on to say, "Tax expenditures have a huge impact on the Federal budget, resulting in over $1 trillion in forgone revenue each year. To put that number in perspective, $1 trillion is roughly the total amount the Government collects each year in Federal income taxes."

And in this context, I wholeheartedly agree with Chairman Ryan's statement, and I believe that spending in the Tax Code must be a part of our discussions on deficit reduction, and especially noting, as Professor Kleinbard did, that we have two crises facing our country: the need to get our economic engine back on track, job growth, rebuilding a strong and vibrant middle class; at the same time that we responsibly tackle our deficit and debt.

In terms of a focus on a strong and vibrant middle class, Mr. Bernstein, in your testimony, written testimony, you noted that the income going to top 1 percent was about 10 percent in the late 1970s, but it now stands at 19.8 percent. I would like you to just elaborate a little bit about how our Tax Code has played a role in—I know there are multiple factors that do, but how our Tax Code has driven income and wealth inequality in America and, you know, which are the biggest drivers of that in our Tax Code.

Mr. BERNSTEIN. Well, part of our discussion today has emphasized the increase in tax expenditures over time, and I have a figure—I think it is Figure 3 in my testimony—that shows the distribution of tax expenditures and how they disproportionately go to those at the very top of the income scale. I think 66 percent, two-thirds of tax expenditures go to the top 20 percent, 26 percent of them go to the top 1 percent.

So if we are seeing more and more income over time fit the category that Senator Whitehouse and others have talked about that gets treated favorably through the Tax Code, so capital income, dividend income, income from these corporate tax dodges we have been describing, the ability of equity managers to pay a rate that is half that of working persons in the middle class, as long as more income keeps going to those categories, it is just mathematics that that is going to lead to higher income concentration once you apply the Tax Code to the income distribution.

So just to simplify, we have a Tax Code that favors income at the top of the scale. We have more and more of that type of income. Automatically, that helps generate the inequality result you cited.

Senator BALDWIN. From an economic perspective, can you distinguish Government spending from spending in the Tax Code through tax expenditures?

Mr. BERNSTEIN. In many of the examples that I have stressed in my testimony, you really cannot. It is purely a delivery mechanism. And I think this is an essential point. As I stressed, again, if you believe—and many Members of the Senate and the House believe that we have a spending problem. They said it all the time: "We have a spending problem." Then you have to believe we have a tax expenditure problem, because if you look at—I gave you the example of child care, which in many ways is a perfectly venerable thing to subsidize. But we provide child care through direct spending, and we provide child care assistance through tax deductions. The difference is simply delivery. The substantive function is the same.

Senator BALDWIN. It is more of a blunt instrument in terms of getting at a specific desired result.

Mr. BERNSTEIN. Spending through the Tax Code.

Senator BALDWIN. Yes. Thank you.

Chairman MURRAY. Senator Ayotte.

Senator AYOTTE. I thank the witnesses for being here today.

Dr. Kleinbard, I wanted to ask you, Senator Grassley had asked you about the corporate code.

Mr. KLEINBARD. Yes.

Senator AYOTTE. You recommended that we lower it to be looking relative to where we are with respect to other countries around the world. Do you believe that that rate does have an impact on how much investment we have in this country in economic growth?

Mr. KLEINBARD. You know, I do. The marginal tax rates are thought to distort the scale of investment decisions. By bringing down marginal rates, you enable firms to enhance the scale of their investment. You also make the United States a more attractive environment for foreign investors to come in and bring jobs, bring investment into the United States. You know, this is a global economy, and what we forget all the time when we talk about corporate tax and international tax is we forget that the United States is a capital importer as well as capital exporter. So we want to make the United States an attractive environment.

And then if you have, in fact, a tax rate for corporate that it is in the mid-20s and you finance that largely by getting rid of all of these distortive subsidies, well, then, capital will be allocated more efficiently in the United States, which in turn leads to faster growth. Every time we distort investment, what we are doing is we are taking it from where it would be in a market economy and in doing so we are impeding growth over the long term.

So from all those perspectives—and then to the point of view of the small business person, the small business person will incorporate to take advantage of the lower corporate tax rates. So we are offering those lowers rates, in fact, to everybody. Everybody can incorporate.

So it would make, I believe, a much more attractive business environment for the United States.

Senator AYOTTE. And where do you see—in terms of if we do that, given it is a global economy, and we lower rates, would not that system have to be consistent with what most of the world has, which is a territorial type rate?

Mr. KLEINBARD. That actually is a more complicated question. Right now the territorial countries as a group are undergoing massive second thoughts about territorial taxation. You saw in the Financial Times the other day there was a letter from the Finance Ministers of the U.K., Germany, and France, a joint communique published as a letter, saying that they recognized the extent to which there was massive international tax avoidance and evasion, principally enabled by two things: territorial systems outside the United States and by some technical rules in the United States, including something called the “check the box” rules.

So the EU member countries have become terribly concerned about the ease with which territorial systems are abused. The OECD itself has just put out a pamphlet on base erosion and profit shifting, or BEPS, as they call it, saying, you know what, we screwed up. Basically it says, you know, we have enabled, we, the OECD, in how we have urged that the international tax systems have evolved, have made it too easy to avoid tax internationally.

Senator AYOTTE. So are you against a territorial system?

Mr. KLEINBARD. I am in favor of one of two solutions: a territorial system with teeth that is one that has really strong safeguards, which I believe is almost impossible to do as a technical matter—this is a field I know a lot about, having worked in the area for many years—or a worldwide system but with a low rate. If our rate is 25 percent and the rate in China and the U.K. and France and Germany are all comparable rates, how can anybody complain that they are being treated to an uncompetitive tax environment if our worldwide rate is the same as the domestic rate of the countries in which we, in fact, do business?

Senator AYOTTE. As I understand it just from your testimony, I am taking that our rate right now does make us less competitive.

Mr. KLEINBARD. Right now as an economic matter—and I do not want to use too many technical terms. Right now, economists would describe the international tax system of the United States as "all screwed up." And, you know, we have $1.7 trillion of money that U.S. firms keep outside the United States. It is ultimately invested back because they are buying U.S. Treasury bonds with it, so it is not like the dollar is—

Senator AYOTTE. Thankfully, given how we are trying to finance our own debt.

Mr. KLEINBARD. Yes, exactly. We have figured out a way to finance our debt through our crazy tax system. But our system is massively screwed up today. A territorial system with teeth could work. It is just technically much more difficult, frankly, than the members might appreciate. A worldwide system with a low rate—

Senator AYOTTE. And I am sorry to interrupt you, but I have only have a few minutes, and I wanted to get Dr. Roberts' comments on this thought, on our corporate rate, our competitiveness, what we should do in that regard. And also, our rates, in terms of thinking about tax rates, do they impact economic growth?

Mr. ROBERTS. Well, for sure they interrupt economic growth, and most economists I think would argue that the corporate tax rates should probably be zero, which is a political non-starter. Most people argue that—most people like to think that corporations pay their taxes, but, of course, they are really paid for by their workers, by their consumers, their customers, and some by their shareholders. But, of course, a lot of people have their pensions and their shareholders. We like to think of their shareholders as somehow fat cats. They are not. A lot of them are everyday middle-class people. So I think the corporate tax system is a very poor way of satisfying envy. I wish we would pick a different method.

It is expensive, meaning it costs us growth and investment, and that investment, of course, helps everybody. So I would like to see more of that. So reforming the corporate tax system to the extent that Democrats and Republicans could come together to lower that rate and maybe do something else elsewhere would be a good idea, like stop helping Wall Street. How about that for a political deal? That would be good.

Senator AYOTTE. Thank you.

Chairman MURRAY. Thank you.

Senator King?

Senator KING. Well, I guess if we took the corporate rate to zero, it would establish the fact once and for all that corporations are not people.

[Laughter.]

Mr. ROBERTS. There you go.

Senator KING. Because people have to pay taxes.

Mr. ROBERTS. Not all of them.

Senator KING. It seems to me that this has been a fascinating and important discussion, and there is an important issue here that you guys can help us with, and that is, what is the appropriate percentage of GDP for revenues and expenditures in a 21st century First World country? Historically, we know it has been—I think the Ranking Member said 18 percent, 18.5 percent. The question is: What is the effect of the retirement of the baby boomers, the demands they are going to make on the health care system? Which, as somebody pointed out, is where the real growth in their budgets are. So if we could agree on the right number, whether it is 19, 20, or 21, or whatever it is, then all the rest of our deliberations become kind of easy—not easy, but then we are just fighting about how to fill in those numbers.

Go down the row. What is the right number?

Mr. KLEINBARD. Senator King, I think that you have exactly put the horse back where it belongs, in front of the cart. This is the question. And I think that the right number for the next decade is in the neighborhood of 21 percent of GDP, unless and until health care is brought down to world norms.

You know, it is not just health care, just to be clear. The other place where this country is an outlier—only two places where we are an outlier in spending, and the other place, of course, is military, where we spend 43 percent of the entire world's spending on military. Now, I am not saying that is a bad thing. I do not know whether it is a bad thing or a good thing. But I know that if we choose that, we have to pay for it.

So we have two places where we are outliers in spending: health care, long term one would like to think we could get a handle on; but in the meantime, if you just run the numbers, that leads to 21 percent of GDP.

Mr. BERNSTEIN. I also think this is a critical question, and I think it is wrong to simply fall back on 50-year averages and think you are saying anything about needs of today. In no small part, the demographics themselves are different, much more pressure from aging baby boomers, particularly in health care. So you have demographic pressures, you have health cost pressures.

Now, the reason this is hard to answer is because that second part, the health cost pressures are a moving target. We recently found out that if you look at the CBO projections for Medicare spending over the next 10 years, just looking between 2010 projections and 2013 projections, they have come down $500 billion. That is very important and very good. There is a little bit more budget oxygen in the air because we are doing a bit better on controlling health care costs. We are nowhere near out of the woods, but we are doing better.

However, because of the demographic pressures, because of the health care costs, because of things like veterans care that are going to be a greater pressure moving forward, interest on the debt is going to be pressure moving forward, we have things like climate and other pressures that we have to plan for. The 50-year average is a mistake, and I very strongly encourage members to not be susceptible to the tyranny of averages that are not applicable today. My guesstimate is that we are looking north of 22 percent say over the next decade.

Senator KING. Mr. Roberts?

Mr. ROBERTS. Well, respectfully, I do not think it is the right way to think about the question, to pick a particular number.

Senator KING. Gee, the first witness said it was a brilliant question.

Mr. ROBERTS. Well, that is why we are here.

[Laughter.]

Mr. ROBERTS. Different opinions. Maybe we can learn something from our disagreements. But we have a different tyranny, Jared, which is we have a bunch of programs that we put in place in the 1930s that we have not changed much and that were passed at a time when demographics were very different and our economic ability to take care of ourselves was very different.

I do not know why I am going to get a Social Security payment. I am 58 years old. I will be, quote, eligible for Social Security retiring potentially soon. Why? I do not need it. Yes, I paid in my money, but it did not get put aside for me. It went out to pay for my grandmother, and I am glad she got the money. But it is absurd that we have a retirement system that takes money from everybody and gives it to everybody. If we insist on maintaining that system and if we insist on maintaining a system that allows people to buy their health care with other people's money, we are going to face a set of unpleasant choices: either a very high percentage—we can try to get there, we can try to get to 22 or 26 or 27. But my argument is I do not want to live in that world. I do not want my kids to live in that world, because that is going to be in a world where people are treated not as adults but as children, they are not responsible for their own retirement, they are not responsible for their own medical care, they are not responsible for their own health. We do not take advantage of innovations and technology that are coming that will allow those programs to be dramatically cheaper. So I have no particular goal that we should spend 22 or 25 or 18. I would love to spend 12, either by shrinking the military or other things that maybe I hope we will not need in 2043. But I know we do not need to pay for my Social Security. If we insist on doing that for romantic or emotional reasons, we are going to handicap the rest of the economy and handicap people who desperately need the opportunities that come from lower tax rates, more private spending, and more innovation.

So, to me, the crucial question is not how can we raise 22 percent or how can we get to 23 or can we really get to 19 even, or whether there is a tyranny of the past. The question is: What is the appropriate role for Government in these areas? And I just do not see that, again, paying for everybody's retirement is an appropriate goal. Let us pay for people who cannot afford to make their own retirement provisions, people who have bad luck. But why are you paying for me? I have been blessed. I have a good salary. I have been prudent. Why are you paying for me? Why are you taxing other people, poor people, average people, to pay for higher-income people who have this opportunity?

So I just think that is the central question as to whether we can face that level of flexibility and stop doing the things that do not need to be done and give people more freedom to do the things that they can do and create the innovation that will follow.

Senator KING. I once asked my friend George Mitchell, who is the smartest guy I know, that very question, and his answer was very different from yours, and he said, “If we start to means-test Social Security, it immediately becomes a welfare program.”

Mr. ROBERTS. It should be a welfare program. It is a welfare program that is masquerading as a retirement program. I am not going to—I am not counting on it as part—by the way, most people under the age of 40 assume they are going to get zero. I think they are wrong. I think they will get something. But they do not expect to get what you promised them. And I think they are realistic.

Mr. BERNSTEIN. Can I make a comment here? Is it okay?

Senator KING. Sure.

Mr. BERNSTEIN. Listening to Russ, you would think that the typical Social Security beneficiary’s income is like his income. In fact, it is not. The median is about $25,000. So we have a guaranteed pension, a retirement security system that helps economically vulnerable elderly, and that happens to describe a lot more people than I think you would understand from listening to Russ—

Mr. ROBERTS. But not you and me.

Mr. BERNSTEIN. Let me finish, let me finish. Yes, and, therefore, absent these programs, many of our economically insecure elderly persons who have paid into these programs throughout their working career would not only be worse off, but would lack income and health care security in their later years, something that I think would be quite devastating to the social fabric.

Now, that does not mean that every high-income person should get the same benefits they are getting now. We might have an agreement that there could be some flexibility there. But let us be clear about who we are talking about.

Chairman MURRAY. Okay. I am going to—I hate to interrupt this conversation, but I am going to call on our last questioner who I do not think is going to interrupt this conversation. Senator Sanders.

Senator SANDERS. Thank you, Madam Chair.

You know, sometimes in economics, we forget what I think the real issue is, and that is, what is happening to ordinary people. How do we create a vibrant economy which provides decent jobs and decent benefits to people?

I wanted to start off with Dr. Bernstein. Right now in America we have the most unequal distribution of wealth and income of any major country on Earth. In English, what is happening is the middle class is disappearing. Since 1999, median family income has gone down by some $5,000. Real unemployment today is over 14 percent. We have the highest rate of childhood poverty in the industrialized world. Many of the new jobs that are being created are low-wage jobs.

Meanwhile, the people on top are doing phenomenally well. You have an absolutely beyond belief situation where, according to the last study that I have seen, the top 1 percent is earning more than 100 percent of all new income. You have the bottom 99 percent losing ground. All of the new income being generated is going to the top 1 percent. In terms of distribution of wealth, you have the absurdity of the top 1 percent owning 38 percent of the wealth, the bottom 60 percent owning 2.3 percent of the wealth.

So my first question—forget the morality of some people having more wealth than they are going to spend in a million lifetimes while the vast majority of people are struggling in America to keep their heads above water. Forget the morality of all that. Tell me about how you strengthen a strong economy. Can you have a strong economy when so few have so little in order to buy goods and services to create jobs when so few have so much? Dr. Bernstein?

Mr. BERNSTEIN. I have just been writing about this very question, but I will try to be brief. It is very difficult to do so. There is an interesting wealthy entrepreneur named Nick Hanauer who writes about this very point, and he kind of puts it in terms of, you know, I am just not going to buy that many cars. So there is certainly a case to be made that if the benefits of growth were more widely shared—and as you suggest, they are intensely concentrated now—spending, consumption, overall economic demand would also reflect that in ways that would be positive for the broader economy, recoveries would not only or perhaps be stronger but would feel a lot better to most people who have been left out, as you have suggested, for decades now.

Secondly, the thing that I found even more in my recent research—and this is fairly new stuff—is that these high levels of wealth and income concentration interact with money in politics in a way that buys a set of policies that inflates economic inequality—

Senator SANDERS. Well, on that issue I think you do not have to tell the people in this room up here. We know that very well.

Mr. BERNSTEIN. So it has those problems as well.

Senator SANDERS. All right. Professor Kleinbard

Mr. KLEINBARD. You know, when I think about this issue—and, in fact, I am writing about it as well—I look around, and what I see is market failure everywhere. I see opportunities to invest that are not being taken advantage of, and the opportunities that I see are the opportunities to invest in the 310 million Americans who are here.

We have 46 million Americans living today in poverty. They cannot afford to go to college. They cannot afford to invest in themselves. So the reason I disagree so fundamentally with Dr. Roberts about how to think about these issues is that what I see as market failure, I see a critical role for Government in investing in the most unproductive resource in America, which is our fellow Americans.

Senator SANDERS. Good. I apologize, Dr. Roberts. I am going to get to you in a second here. But let me ask this: The great debate that is going on now on the budget is whether, in fact, we bring in more revenue by closing loopholes, by asking the wealthy, who are doing phenomenally well, to pay more, or as many of my Republicans feel, we should cut Social Security, Medicare, Medicaid, education, nutrition? In other words, do you balance the budget on the backs of disabled veterans and the most vulnerable people in this country, or do you ask billionaires and very profitable corporations to pay more?

Let me ask Dr. Roberts and everybody else a simple question. In 2010, Bank of America set up more than 200 subsidiaries in the Cayman Islands to avoid paying U.S. taxes. It worked. Not only did Bank of America pay nothing in Federal income taxes, but they received a rebate from the IRS of $1.9 billion that year. Citigroup, ExxonMobil, Chevron—all of these and many other major profitable corporations invest their profits in the Cayman Islands; they pay very little or nothing in taxes in the United States of America.

Dr. Roberts, does that make any sense to you?

Mr. ROBERTS. I am deeply troubled by the interaction between politics and economics that you referenced a minute ago, especially with respect to the financial sector. And you mentioned inequality. The financial sector is a major source of that inequality. That is the bad kind.

The good kind is Jeff Bezos and Steve Jobs and Sergey Brin, the people who created Apple and Amazon and Google, and I think they should thrive because they thrive by making other people's lives better.

There is another group of people who thrive by taking money from the rest of us. Please stop coddling them. Stop giving them breaks. Stop giving them bailouts. And if you do, do it in a way that punishes them. None of them—very few of them went out of business, and the people who lent them the money that allowed them to make the lousy bets, they got all their money back 100 cents on the dollar. That is a horrible—

Senator SANDERS. So am I hearing you say that you think it is not a great idea that Bank of America is allowed to have hundreds of subsidiaries in the Cayman Islands?

Mr. ROBERTS. I am not an expert on international corporate taxation. I do know that Bank of America gets too many privileges relative to what they produce for the rest of us. And the only other thing I would say is that there is a lot of market failures in our system, Professor Kleinbard. The question is: How good is Government doing in investing in our people, those causes that you care about and that I care about as well? And I would like to see a civil society, a private set of voluntary ways of helping poor children who are being horribly educated by that system that we have thrown billions of dollars at and lost two generations—

Senator SANDERS. Thank you, Dr. Roberts. I apologize.

Dr. Bernstein and Professor Kleinbard, that question.

Mr. BERNSTEIN. The Congressional Budget Office is always very, very careful to be very nonpartisan, which is a very good thing, and to typically avoid making policy recommendations. But in this very area, I stress the issue of the ability of these foreign subsidiaries to defer income. So here is a quote from CBO that is in my written testimony: "...eliminating or curtailing deferral of U.S. taxes on income earned abroad...would dampen incentives to shift investment or reported income on the basis of concerns about tax liability. As a result, those options would generally lead to more economically efficient business investment and increase corporate tax revenues from firms that remained incorporated in the United States."

Okay? So that is a nonpartisan analysis of this question. Not only would ending these practices undermine an injustice that you are describing, but it would improve economic efficiency and revenue. I mean, this is a great deal.

Senator SANDERS. Well, I would point out that we have introduced legislation, Madam Chair, to do just that. It would bring in $590 billion over a 10-year period.

Professor Kleinbard, briefly.

Mr. KLEINBARD. I am, in fact, an expert on corporate international taxation, and as I said to Senator Ayotte, there are only two possibilities. One is that you design a territorial system that cannot be gamed. I do not think that is possible as a technical matter. We do not have time to go through why it is so difficult as a technical matter. That leads to the alternative, which is true worldwide tax consolidation so that the foreign income is treated exactly the same as domestic income and coupling that with a lower corporate tax rate, which in turn makes the United States a much more attractive environment in which to do business.

So I come out thinking that a worldwide tax system is the right place, and then people will not need Ugland House, with its thousands of Cayman Islands shell companies.

Senator SANDERS. Thank you very much.

Thank you, Madam Chair.

Chairman MURRAY. Thank you. We just have a couple minutes left, and Senator Sessions has asked to ask another question.

Senator SESSIONS. Well, thank you, and I really do not believe that there is no waste, fraud, and abuse in the Federal Government, and a sequester or BCA reduction of 2 or 3 percent in the growth is not going to—is poor management by the people who run this Government if children are being starved as a result of that, and I reject that.

But one question, Dr. Kleinbard. You talked about I believe you favor reforming the corporate Tax Code, eliminating loopholes or deductions that are not justified, making it more growth and productive and honest. But if you use—and to do that to reduce the rate, so if you close corporate loopholes under your theory, that would not be money to pay down the debt with, it would be used to create a simpler, more productive corporate tax rate. Is that right?

Mr. KLEINBARD. Yes, sir. I see the business tax environment as needing that kind of reform. There just are not enough dollars to go around to have a lot of dollars left over for deficit reduction. We cannot have the United States with a 35-percent corporate tax rate in the craziest international tax system in the world and call that a reasonable platform when other countries have their corporate rates in the mid-20s. So I think that that is a sensible package.

I think, on the other hand, there are trillions of dollars of poorly targeted spending programs on the individual side where that money can be used for deficit reduction. So I make that distinction between the two silos in my thinking.

Chairman MURRAY. All right. Well, thank you to all of our colleagues for participating today, and I especially want to thank our witnesses for a very productive discussion.

As I said at the outset of this hearing, we have a debate ahead of us, which will include a variety of approaches to our many challenges. Today's hearing really was an opportunity to highlight some wasteful spending in our Tax Code as one approach. And as a reminder to my colleagues, additional statements and/or questions for any of these witnesses from today's hearing are due in by 6:00 p.m. today to our chief clerk. And I again thank all of our witnesses for traveling here today and for participating, and all of our Senators as well.

With that, this hearing is coming to a close.

[Whereupon, at 12:09 p.m., the Committee was adjourned.]

SUPPORTING BROAD–BASED ECONOMIC GROWTH AND FISCAL RESPONSIBILITY THROUGH TAX REFORM

WEDNESDAY, MAY 22, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Committee met, pursuant to notice, at 2:35 p.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, Chairman of the Committee, presiding.

Present: Senators Murray, Wyden, Whitehouse, Kaine, King, Sessions, Grassley, Portman, and Johnson.

Staff Present: Evan T. Schatz, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. This hearing will come to order. I want to thank Senator Sessions and all of our colleagues for joining me today to explore the ways in which tax reform can support broad-based economic growth while helping us tackle our long-term debt and deficit challenges.

And I really want to thank all three of our witnesses who are here today. We will be hearing from Michael Linden, the managing director for economic policy at the Center for American Progress; Adam Looney, senior fellow in economic studies at the Brookings Institution; and Veronique de Rugy, senior research fellow at George Mason University's Mercatus Center. We really appreciate all of you coming and sharing your expertise on these issues.

I am pleased that the possibility of broad reform to our Tax Code has gained some momentum in recent months. With a Tax Code that we all realize is complicated, inefficient, and too often skewed to benefit the well-off and well-connected, there is much to improve.

And reforming our Tax Code also offers opportunities to make progress on major challenges that we face today, like the need to grow our middle class and make sure we can compete in the 21st century global economy and restore our Nation's long-term fiscal health.

So I want to take this opportunity today to discuss a key principle, reflected in our Senate budget that we passed earlier this year, which should guide any tax reform effort.

Tax reform has to be fair to the middle class, and that means we will need more revenue from those who can most afford it, both to reduce the deficit and to make the necessary investments in our future economic strength, because expanding and supporting our middle class in the 21st century global economy is going to be a challenge.

And to make sure we can do it, we have to focus on what the original Simpson-Bowles report called "high-priority investments"—those in education, infrastructure, and research.

Our schools need to prepare our workers—of all ages—to compete for 21st century jobs. Our roads, bridges, airports, and airways should be able to transport people and products quickly and reliably so that companies that want to invest here and hire American workers will. And we need to maintain our edge in research and development so that the innovations that drive future economic growth take root at home rather than overseas.

At the same time, our Nation has made promises to millions of Americans that we absolutely must uphold. Current and future seniors, who have worked hard all their lives, deserve to know that Medicare will be there when they need it. And in the United States, we have always worked to help those struck by hard times get back on their feet.

These commitments, to our future and to those who need and deserve our support, must be met.

If sequestration is not replaced, we will see deep cuts to these kinds of investments—so much so that even the House Republican appropriations chairman called this "an austere budget year." This would hurt us in the short term, at a time when we should be focused on creating jobs and boosting the economy.

Slashing these priorities even further would ultimately make us a very different country—one that has a weaker economy in the long run, and one I think most of us here would agree we do not want to be.

Also, while recent CBO analysis shows that we will run lower deficits in coming years than we expected, I think we also recognize that we have to get our long-term debt and deficits on a sustainable path. And we need to do this in a responsible way that allows us to confront the urgent need to create jobs and boost our country's competitiveness.

As Mr. Linden will discuss, this is why reducing the deficit with a combination of new revenue from tax reform, as well as smart spending cuts, is the fiscally responsible choice.

Democrats are not alone in making this argument. Bipartisan groups have consistently included revenue for deficit reduction in their tax reform plans. Simpson-Bowles and the Senate Gang of Six each proposed more than $2 trillion.

That is significantly more than the $600 billion in new revenue from the wealthiest that we have raised in deficit reduction efforts over the last 2 years. In fact, measured over the same time frame, Simpson-Bowles and the Senate Gang of Six each proposed more new revenue than what we got from the year-end deal and what we proposed in the Senate Budget combined.

Let us remember that reform will require eliminating wasteful and inefficient tax expenditures that are unfairly skewed towards those who need them the least—like special tax breaks for corporate jet owners and hedge fund managers, and loopholes that allow multinational corporations to shift jobs and profits offshore.

These kinds of special tax breaks are just spending by another name, and they often do little to support our economy or our middle class.

So if you really think, like many of my colleagues do, that our fiscal problems are the greatest long-term threat to our Nation's future, why wouldn't you want to take some of the savings from ending inefficient and unfair tax breaks and use it to tackle our debt and deficit? Especially if, in doing so, you could also continue to prioritize the kinds of investments that make our country great and allow more Americans a shot at success.

Unfortunately, some of the plans we have seen from the other side of the aisle take a very different approach. My Republican colleagues have put forward plans that prioritize dramatic reductions in tax rates while bringing in no new revenue for deficit reduction.

The tax reform plan outlined in the House budget is a prime example. Experts have found that to remain revenue neutral, the House budget would cut taxes on those earning $1 million or more by an average of $245,000 while raising taxes on families with income under $200,000 by an average of $3,000.

In other words, the only way the House budget's tax reform plan could avoid raising taxes on the middle class would be to dramatically increase the deficit.

At a time when we need to be thinking about how to secure both our long-term fiscal health and our economic leadership, we really do not need an expensive tax break paid for by shifting tax burdens onto the middle class. That approach would be deeply unfair. And it simply is not an option.

As we will hear today from Mr. Looney, it is very difficult to see how tax reform can dramatically lower rates, help to reduce our deficit, and protect the middle class and most vulnerable from paying more, all at the same time.

I believe we need to focus on what is best for the middle class by ensuring that any tax reform effort helps more Americans share in and contribute to our economic strength and helps reduce our deficit.

Only once we have met these goals does it make sense to look at lowering rates.

Until then, I think it would be very difficult to explain a plan to middle-class Americans that asks them to sacrifice but gives the wealthiest Americans and biggest corporations a pass, and does nothing to invest in our future or our fiscal health.

So as we continue this debate, I encourage my Republican colleagues to be open to working with us on tax reform that puts the middle class first and our economic and fiscal strength first.

Some leading Republicans have acknowledged in the past that there are opportunities for this kind of balanced approach. Speaker Boehner proposed raising $800 billion for deficit reduction by closing what he called special interest loopholes and deductions.

So I really hope there is some room for agreement here, because even though this is not going to be easy, tax reform offers substantial opportunities to make our Tax Code work better for families and our economy.

If we do this the right way—meaning the fair way—tax reform has the potential to make our tax system simpler and more efficient, to ensure that those who invest here in the United States and play by the rules see the benefit, and to encourage the kind of long-term, broad-based economic growth we saw back in the 1990s.

So we should do everything we can to move this forward.

And before I turn it over to Senator Sessions, I do want to note that any significant change to our Tax Code will have very real consequences for families and businesses across the country, and it will be very difficult to enact any changes without the taxpayers' full trust—which is one reason why I, along with many, was appalled at the recent revelations about practices at the IRS, which indicate completely unacceptable and wrong-headed behavior.

The Federal Government, and particularly the IRS, should maintain the highest ethical standards and should be held fully accountable for any failure to do so. I know that my colleagues on both sides of the aisle are working with President Obama to make sure that those involved are held responsible and that such a breach of public trust cannot occur again. And I really want to thank them for doing that crucial work.

I am looking forward to what I think will be a very productive conversation at this hearing today. I do again want to thank all of our witnesses for being here, and with that, we will hear from Senator Sessions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Madam Chairman, and I thank our witnesses. This is a good panel, and we have a very important subject today that impacts policies that we will be setting for the United States in the years to come, and we value your opinions.

We all agree that public policies need to support strong economic growth that benefits all Americans—middle-class Americans, working Americans—whose incomes have not kept up, whose unemployment rates are persistently high, who have dropped out of the workforce in record numbers, whose salaries are not keeping up with inflation for several decades.

There is a growing consensus that one of the barriers to a strong growth is a badly broken tax system. I do reject your characterization of the House tax plan. I do not think they would turn out the way you project. But we all need to be talking about how to improve our tax system.

Our broken Tax Code is but one expression of the burden bad fiscal policy places on the economy. Excessive, non-productive spending and the consequently high and growing national debt hurt the pace of economic activity. We need to adopt sensible fiscal policies to get our budget under control and allow the economy to grow more rapidly. That is why I am so pleased to have Dr. Veronique de Rugy with us testifying today. She is a widely recognized expert on how developed countries have attempted to stabilize their debt and bring their budget, both spending and taxes, under control. Some countries have done this well, others have not, and Dr. de Rugy is here to tell us what works and what does not from the studies she has examined.

There can be no more appropriate time than now to consider the role of tax and spending policies in facilitating higher levels of economic growth. If the fiscal situation is to significantly improve in the near term, then the pace of economic activity must improve very soon. This improvement, however, may be hard to achieve. This economic recovery remains the slowest since the end of World War II. The National Bureau of Economic Research dates the end of the Great Recession in June of 2009. Since then, the economy has grown an average of only 2.1 percent. That is significantly less than the rate of previous recoveries after 15 quarters.

The U.S. economy is 8.3 percent larger today than when the recession ended, which is a little less than half the average increase in the size of the economy after the previous 15 quarters following a recession. So this economic sluggishness comes with great human cost. There are fewer jobs today than when the recession started. Total non-farm employment in April of 2013 was 2.3 million below its level in December of 2007. The overall unemployment rate is 7.5 percent, also higher than it should be this far from the end of the recession. And key unemployment rates for important demographic segments are even higher. The rates for Hispanics stands at 8.4 percent, for blacks at 12.8 percent, and for teenagers at 24.1 percent. These high rates and a surprising workforce dropout rate have reduced personal income and, thus, Federal revenues.

Add to this lost revenue and estimated outlays associated with unemployment being higher than it should be at this point in the recovery, and the total harm to our underachieving economy to the Federal budget is nearly $90 billion this year alone.

Policymakers will note that this amount roughly equals the 2013 fallback sequester reductions. Not all of this lost income, however, is due to unemployment. Some stems from people simply dropping out because the Government benefits are generous and it does not pay them to actually work.

I am increasingly concerned by how well-meaning public policies are creating incentives for otherwise able-bodied workers to stay out of the labor force. The truth is that the generosity of program benefits has grown faster than inflation or wages since 2007.

A paper published by the National Bureau of Economic Research found that between 2007 and 2009, the value of means-tested benefits available to the average non-elderly unemployed worker grew from $10,000 to $15,000. More people but more benefits, higher benefits per each individual at a time when our deficits are soaring.

As more people become eligible for increasingly generous benefits, the penalty for working if unemployment increases. This is especially true for workers who qualify for multiple means-tested programs.

The CBO found that households with incomes just above the poverty line or between $23,000 and $29,000 for a family of four in 2012 can experience a disincentive to work, and that is like a tax rate of up to 60 percent. That is, for every dollar in additional earnings a person might make through hard work or additional work, the households stand to lose a total of 60 cents in both increased taxes and lost Federal benefits. With a high penalty to earning more by working, many low-income people choose either not to work or, as CBO finds, to "put in fewer hours and be less productive."

In my view, the key to stronger economic growth rests with removing burdens we impose on work, savings, and investment. In accomplishing that task, the Tax Code needs to be clearly in our sights.

The economic effect of increased taxes is one of the most widely understood effects in the economic literature. We know what increased taxes do. Increases in marginal tax rates discourage work, discourage savings and investment. Taxes are only effective and efficient if the Government can better spend and allocate the resources than individuals in the market does. Money does not sit under someone's mattress but is instead spent or saved so that taxes again remove money from the economy. Rather than increasing tax rates, we should take a lesson from the tax rate reductions of the 1920s, 1960s, and 1980s. These reductions led to increases in employment, higher returns for stocks, increased investment growth, and have generally promoted economic growth.

There are limits on what reduced taxes can achieve. We are not in a position to sustain large tax reductions now, but I do believe that we have seen historically that good results can come from a lower take of the Federal Government from the economy.

The reduction in taxes on income encourages people to work more because they get to keep more of their pay. A reduction in capital gains taxes increases future consumption because investors receive higher rates of return.

Finally, I do not want us to repeat the mistakes made by some governments of increasing taxes when the real problem is excessive spending. Economists have shown that countries have been able to successfully reduce their debt while improving economic performance when the focus of the policy is on reducing government spending. At the same time, tax increases can damage the chances for success. This is a critical choice we are facing, and we need to honestly review it.

So, Madam Chairman, let us be sure we adjust our leading public policies in a way that reduces the burden and makes our Government leaner and more productive while demanding less from the fragile public sector.

Thank you for this important hearing, and I look forward to participating.

Chairman MURRAY. Thank you very much, Senator Sessions.

We will turn to our witnesses. Again, thank you all for coming and joining us today. Mr. Linden, we will begin with you.

STATEMENT OF MICHAEL LINDEN, MANAGING DIRECTOR FOR ECONOMIC POLICY, CENTER FOR AMERICAN PROGRESS

Mr. LINDEN. Thank you very much. Good afternoon, Chairman Murray, Senator Sessions. Thank you so much for inviting me to be here today. My name is Michael Linden. I am the managing director for economic policy at the Center for American Progress where my work focuses primarily on Federal fiscal policy.

First, allow me to commend the Committee for considering the important issue of tax reform and for doing so explicitly within the context of broad-based economic growth. Coming out of the Great

Recession, we face some daunting economic challenges which we can meet and overcome, but only if public policy is properly calibrated.

Now, the Tax Code is by no means the only tool available to the Federal Government to support broader and faster economic growth, but it is a very important one. And that is why tax reform must be designed to help address the larger economic challenges that we face.

To that end, tax reform should begin with the basic understanding that the middle class is a critical driver of economic growth and that rising income inequality is a drag on that growth.

A strong middle class provides the Nation with its most important source of stable demand for goods and services, it incubates the next generation of entrepreneurs, and it supports the inclusive political institutions that are most likely to reinvest in precisely the kinds of public investments that produce future economic growth and innovation.

We often think about the middle class as an outcome of the economy, but, in fact, we now know that is backwards. The middle class is an input to the economy. The stronger it is, the stronger the economy will be. And, therefore, tax reform must seek to strengthen the middle class, and it can do so in three ways.

First, tax reform must make the code fairer for the middle class.

Second, tax reform must make the code simpler for the middle class.

And, third, and most importantly, tax reform must ensure that the code is generating enough revenue to pay for the investments and protections that are critical to the success of the middle class.

First, making the code fairer to the middle class means doing more to reduce rising income inequality. Three decades ago, a household in the richest 1 percent too home about ten times as much as a household in the middle class. By 2007, that ratio had nearly tripled. And while the Great Recession was certainly not kind to anyone, those at the top have rebounded far faster than everyone else. In fact, the entire gain from the economic recovery so far has flowed exclusively to those at the top.

Now, while the Tax Code cannot by itself fully address this alarming trend, it can do much more to help. Since the beginning of the 1980s, changes in tax policy have generally made the code less effective at reducing post-tax income inequality. In fact, the Tax Code in 2007 was about one-third as effective at reducing income inequality as it had been three decades prior. And while we certainly have taken some steps since 2007 to improve the Tax Code in this regard, the sheer magnitude of the increase in income inequality suggests there is much more to do.

Second, tax reform should seek to make the code simpler for the middle class. Making our tax system simpler means streamlining the code to clear out the dense thicket of tax expenditures that have grown up in the last few decades. Not only do many of these tax expenditures add enormous compliance costs, but they also open up massive opportunities for tax avoidance. And, of course, most of these opportunities are not available to middle-class families. They are only utilized by those who have the resources to hire expensive accountants.

Making the code simpler does not, however, mean reducing the number of tax brackets. The complexity of tax filing has nothing at all to do with how many brackets there are. There could be one or five or ten or a thousand, and it would not make any difference at all to how long it takes or how complicated it is to determine one's tax liability. In fact, Congress should be very wary of proposals that shift the tax bill from the rich onto the middle class in the name of simplicity.

Finally, and most critically, tax reform must strengthen the middle class by ensuring that the code generates adequate revenues to pay for the foundational public investments in middle-class protections. The primary task of any tax system is to generate revenue, sufficient revenue, and right now our system is failing at that. Because our tax system is generating inadequate revenues, we have been forced to cut the very investments—education, transportation infrastructure, scientific investment, economic development—that are most likely to spark future growth and prosperity. As a result, by 2016, and even without sequestration, our total share of national resources that are going to fund those investments will decline to its lowest levels since 1964.

Going forward, we cannot afford to keep making that mistake. Middle-class families and those who aspire to the middle class rely on the public investments that complement those of the private sector. They depend on the protections afforded them by Medicare and Social Security and Medicaid. And they expect the public sector to provide the foundations for a middle-class lifestyle, such as basic transportation networks and educational opportunities for their children. To maintain those middle-class foundations, we will need additional revenue.

Now one common objection to this is that it means generating more revenue than we have on average over the last 40 or 50 years. But this objection is misleading. It is not at all apparent why revenue levels from the 1960s or 1970s should determine what our country needs in the 2020s or 2030s. Our needs change over time. We raised far more revenue in the 1960s and 1970s than we had in the 1910s or 1920s. And given the aging of the population and the dramatically higher costs of health care today, it is not at all surprising that we will need a slightly higher level of revenue than we did in the past.

Indeed, every bipartisan plan put forward to address future budget deficits has incorporated this basic observation into their approach. The budget plans offered by Alan Simpson and Erskine Bowles, by Alice Rivlin and Pete Domenici, all called for revenues above the historical average. In fact, both Simpson-Bowles and Rivlin-Domenici called for revenue levels above those in either the President's budget or in the Senate's budget resolution.

Tax reform is an important and necessary goal. With the economic head winds we are facing, we cannot afford to have a Tax Code that is not precisely designed to meet the needs of the middle class. To meet our economic challenges, we need a code that is fairer to the middle class, that is simpler for the middle class, and, most importantly, generates sufficient revenue to invest in the middle class.

Thank you very much for this opportunity, and I look forward to your questions.

[The prepared statement of Mr. Linden follows:]

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Testimony on "Supporting Broad-Based Economic Growth and Fiscal Responsibility through Tax Reform"

United States Senate Committee on the Budget
624 Dirksen Senate Office Building
Washington, D.C.

May 22, 2013

Tax reform should strengthen the economy by strengthening the middle class

For all the disagreements among policymakers, economists generally agree on the ingredients that make an economy grow: human capital, demand, strong institutions and governance, innovation, and financial capital. While all of these are important, since the late 1970s some tax policymakers have lost sight of the big picture, focusing on financial capital and the activities of the wealthy few. That focus produced supply-side economics and the belief that the government should focus its efforts on wealthy "job creators," and that if those "job creators" were released from the burdens of high taxation and regulation, prosperity for all would trickle down.

But trickle-down economic policies have been a failure. Over the past several decades, the United States has undergone a remarkable transformation, with income growth stalling for the middle class while the incomes of those at the top continued to rise dramatically compared to the rest of the working population. Between 1979 and 2007, the last year before the Great Recession, median family income rose by 35 percent, while incomes for those at the 99th percentile rose by 278 percent.[1] Families in the middle class have also pulled away from those at the bottom, but have achieved these modest income gains only by working longer hours, increasing their labor supply—particularly among wives and mothers—and increasing household debts to maintain consumption as wages failed to keep pace with inflation.

The supply-siders had it backward—a strong middle class is the driver of economic growth, not merely an outcome. When one examines the factors that produce a growing economy, the strength of the middle class is critically important to them:

- A strong middle class promotes the development of human capital and a well-educated population.
- A strong middle class creates a stable source of demand for goods and services.
- A strong middle class incubates the next generation of entrepreneurs.
- A strong middle class supports inclusive political and economic institutions, which underpin economic growth.

Given that the middle class is key to economic growth, and given the mounting stress placed on the middle class over the last 30 years due to stagnant wage growth and rising costs, the question then becomes: What policies will grow and strengthen the middle class?

Tax reform should make the code *fairer* to the middle class

Fairness to the middle class means doing more to reduce America's staggering inequality

Over the past 30 years, our nation's income distribution has grown increasingly unequal. In 1979 the average income for a household in the richest 1 percent was about 10 times higher than the average income for a household in the middle 20 percent. By 2007 that ratio had almost tripled. The average household in the richest 1 percent was now earning nearly 30 times as much as those in the middle. Yet even as income inequality increased dramatically, the effect of the federal tax code on income distribution declined substantially.[2]

Between the early 1990s and the financial collapse, the effective federal tax rate of the richest 1 percent of Americans has plummeted even while their incomes skyrocketed. Households in the top 1 percent more than doubled their incomes from an average of more than $800,000 in 1993 to nearly $1.9 million in 2007. During that same period, their effective federal tax rate dropped from 35 percent to 30 percent.

The Great Recession hit hard the income for those at the top, mostly due to a dramatic drop in capital-gains realizations during the stock-market turmoil of the past few years. Average real income for the top 1 percent dropped 36.3 percent from 2007 to 2009, while the bottom 99 percent saw their income decline by 11.6 percent, shrinking the share of income flowing to the top 1 percent dramatically. It is already clear, however, that this is a temporary effect. Income growth during the recovery has so far favored those at the top. In fact, from 2009 to 2011, the top 1 percent saw their incomes grow by 11.2 percent, while the other 99 percent *lost* 0.4 percent of their income; 99 percent of Americans were worse off two years into the recovery than during the recession, while 121 percent of the economy's growth flowed to the richest 1 percent. As this pattern continues, and capital-gains realizations rebound with the stock market, America's inequality is likely to be worse after the Great Recession than before it.[3]

The American Taxpayer Relief Act of 2012, or ATRA, allowed some Bush-era tax cuts to expire for the very wealthiest Americans—those making more than $400,000 per year. The Tax Policy Center now estimates that the top 1 percent of income earners will face a 35.7 percent effective federal tax rate in 2013.[4] But with top incomes continuing to grow at a tremendous rate, this will do little to affect underlying inequality. As economists Thomas Picketty and Emanuel Saez explain:

> Looking further ahead, based on the US historical record, falls in income concentration due to economic downturns are temporary unless drastic regulation and tax policy changes are implemented and prevent income concentration from bouncing back. Such policy changes took place after the Great Depression during the New Deal and permanently reduced income concentration until the 1970's. In contrast, recent

> downturns, such as the 2001 recession, lead to only very temporary drops in income concentration.
>
> The policy changes that are taking place coming out of the Great Recession (financial regulation and top tax rate increase in 2013) are not negligible but they are modest relative to the policy changes that took place coming out of the Great Depression. Therefore, it seems unlikely that US income concentration will fall much in the coming years.[5]

Over the past several years, America has faced a historic economic challenge not seen since the Great Depression, yet we are stuck in the same tired fiscal and economic policy debates we were having before the financial crisis. Inequality keeps rising over time, and our policy responses have, so far, been inadequate.

America fares very poorly in international comparisons as well. A recent OECD report shows how little the entire system of revenues and investments in the United States does to redress inequality. When the authors look only at the most progressive part of the U.S. tax system, federal income taxes, it appears as if the United States has a reasonably progressive system.[6] But this result is driven by the low levels of revenue the U.S. income tax collects compared to other rich countries, the high underlying inequality in U.S. income, and the American propensity for tax expenditures, which categorize things that other countries call social spending and transfers—subsidies for health care, retirement savings, and homeownership, for example—as "tax cuts." Once the total revenue and transfer system is taken into account, the only OECD country that does less to ameliorate inequality is Korea.[7]

Even looking only at income taxes, America's richest taxpayers pay substantially less than the wealthy pay in other countries. An independent analysis[8] ranked the United States 53rd among nations for the effective income and payroll tax rate paid by a household making $300,000 per year; in the top 2 percent of the U.S. income distribution. According to the study, these households in the United States pay a similar tax rate to similar households in Sri Lanka and Malawi. The effective tax rate for rich households in the United Kingdom and Canada is almost 40 percent higher than in the United States—in some wealthy European countries it's more than 75 percent higher.

Fairness to the middle class means demanding that America's wealthiest pay their fair share

Other rich countries raise *substantially* more revenue from their wealthiest citizens than we do in the United States. This revenue allows them to invest in middle-class benefits and services—like world-class education starting in preschool, universal health care, and robust public pension and safety-net programs. Meanwhile, some of America's wealthiest families pay less in taxes than the middle class.

According to Congressional Research Service data, one in four households making more than $1 million *per year* faces a lower federal tax rate than middle-class families.[9] In fact, according to the Tax Policy Center, in 2011, 7,000 millionaires paid nothing in federal income taxes.[10]

Given that the top marginal income tax rate was 35 percent in 2011 and is now 39.6 percent—still substantially lower than the top rate in the United States in the early 1980s or in other wealthy countries—how is it that so many wealthy people avoid paying their fair share? Because the individual income tax code is riddled with exemptions, deductions, special preferences, and loopholes that disproportionately benefit high-income taxpayers.

Most tax benefits and incentives come in the form of deductions or exclusions. Both are provisions that reduce one's taxable income and include many of the most important—and most costly—tax breaks, such as those for mortgage interest, charitable giving, employer-provided health insurance, and retirement savings. One of the unfortunate and largely unintended effects of structuring tax benefits as deductions or exclusions is that they tend to provide much bigger tax benefits to those in the highest tax brackets.

For a wealthy taxpayer in the highest tax bracket—now 39.6 percent—a $10,000 itemized deduction, such as one for mortgage interest, results in $3,960 in tax savings. For a taxpayer in the 15 percent bracket, however, that same deduction is worth only $1,500.

This "upside-down" effect is not only unfair, but it's also inefficient from a budgetary point of view: It gives the largest tax break to the people who are least likely to need it and also least likely to respond to the incentive. High-income people, for example, are already likely to be homeowners, and they would therefore likely use disposable income to save for retirement even without a tax incentive. We would not tolerate it if a federal spending program distributed benefits in such an inefficient way—and we should be equally cost conscious with programs and subsidies that operate through the tax code.

The Center for American Progress has put forward a proposal to eliminate this inefficient "upside-down" effect by converting many deductions and exemptions into uniform credits that provide an equal value to all taxpayers.[11] The president has proposed partially addressing the problem by limiting tax breaks for the highest-income Americans: People whose high incomes place them in the top tax brackets would be able to claim the same value from deductions that a middle-class taxpayer in the 28 percent bracket gets, but not more. This proposal would make tax breaks fairer and more efficient while raising substantial revenue. The Congressional Budget Office estimates that such a proposal would raise $493 billion over 10 years.[12]

In addition to deductions and exemptions that disproportionately benefit the well off, there are some tax preferences that flow almost *entirely* to the wealthy, and tax loopholes that can only be taken advantage of by particularly sophisticated tax avoiders.

For example, the different treatment of income from investments and income from work is the largest reason that many wealthy households pay lower taxes than the middle class. Under the current code, long-term capital gains and qualified dividends are taxed at a maximum rate of 20 percent, well below the top statutory rate on labor income. The Tax Policy Center has estimated that in 2013, 96 percent of the benefit from low rates on capital gains and dividends went to households in the top quintile, with nearly three-quarters going to the top 1 percent of income earners and nearly half going to the top 0.1 percent.[13]

These preferential rates are even taken advantage of by highly compensated noninvestors: The carried interest loophole allows people who manage investment funds—such as private equity funds and hedge funds—to convert their income into lower-taxed capital gains, driving down their tax bills and costing the federal government $21 billion in revenue over 10 years.[14] A similar loophole exists for derivatives traders, allowing them to convert the margins from their daily trades into "long-term" capital gains for purposes of the preferential rates.

Another loophole allows certain well-off professionals—most famously former Sen. John Edwards (D-NC)[15] and former House Speaker Newt Gingrich[16] during their private-sector careers—to avoid paying Medicare taxes on their income by turning themselves into S corporations and taking their salaries as dividends. The U.S. Treasury's inspector general for tax enforcement has called the loophole a "multibillion dollar employment tax shelter."[17]

Even some "middle-class" deductions have high-income loopholes built in. For example, taxpayers can claim the home mortgage interest deduction not only on their primary residences, but on second homes and even *yachts*; but only if they are big enough to live on.

Any serious effort to strengthen the middle class and address our long-term fiscal challenges must start by asking the country's most privileged people to pay their fair share. The alternative is to raise taxes on the middle class and abandon crucial investments in our future—clearly something we should seek to avoid.

Tax reform should make the code *simpler* for the middle class

A core goal of comprehensive tax reform is to make the tax code simpler. But when we discuss simplification, it is crucial that we are clear about what the real drivers of complexity are. It's not the rate structure: Whether you are looking up your tax liability in a paper table or letting software calculate it for you, it's the same single step whether we have one rate or 20. What drives the ever-increasing complexity of the tax code is the proliferation of special deductions, exclusions, and tax breaks for particular activities.

Simplicity for the middle class means reforming tax expenditures and limiting opportunities and incentives for complicated tax-avoidance schemes

Some tax expenditures are worth the complexity they create, because they support the middle class, further important policy goals, and prevent millions of families from falling into poverty and extreme hardship. But some of the expenditures that most radically increase the need for regulation, tax planning, and litigation, are the very same tax breaks that allow the wealthy to avoid paying their fair share.

Tax expenditures and loopholes add extra calculations and documentation requirements. More importantly, they create incentives for individuals and businesses to engage in complicated schemes to reclassify income and reorient economic activity so as to take advantage of specialized tax breaks. As more taxpayers game the system, ever more regulations are required to curb abuses.

These are the real drivers of increased complexity and compliance costs, and tax simplification should focus on reducing the incentives and opportunities for wealthy, sophisticated taxpayers to push money around in ever more complicated ways to avoid paying taxes.

A perfect example of this dynamic at play is the complexity created by the preferential rates currently in effect for long-term capital gains and dividends. These special rates are a huge giveaway to the very wealthiest Americans, and they are also an enormous driver of complexity: One tax expert has estimated that fully one-third of the Internal Revenue Code and accompanying regulations would be unnecessary if income from labor and capital were taxed at the same rate.[18] This is because the differential creates enormous incentives to classify as much income as possible as tax-preferred capital gains or dividends—this incentive drives an arms race between tax lawyers and Congress/IRS that necessitates ballooning regulations, ever-more-creative accounting and recordkeeping, and extensive litigation.

This effect can be seen across the income tax code, as each special tax break introduced by Congress spawns more creative accounting requiring more detailed regulations. Legislation is then frequently needed to clamp down on the worst inequities and abuses created by special preferences—creating even more complexity. The current alternative minimum tax, legislation to close the carried interest loophole, and enactment of the Buffett Rule, which would assure that millionaires pay an effective tax rate above that of ordinary Americans, would be unnecessary if tax fairness were assured in the regular tax code.

These problems are even more pronounced on the business side, where the stakes are high and armies of lawyers and accountants stand at the ready to take advantage of any special breaks. One prominent example is "deferral": U.S. multinationals that do business overseas are allowed to put off paying taxes on their overseas profits indefinitely, until they "repatriate" these profits to the United States. This creates an incentive to move real economic activity—jobs and assets—overseas, but it also creates an *enormous* incentive to play accounting games that move book profits offshore. By designating profits as "overseas income," corporations can put off paying U.S. taxes indefinitely or until another "one-time only" repatriation holiday. Without the big tax preference for foreign profits created by deferral, there would be no reason for American corporations to set up shell subsidiaries in the Cayman Islands and contort their business and accounting practices to move money through those subsidiaries. Our business tax rules are full of special-interest breaks that increase complexity and compliance costs while allowing America's largest and most profitable corporations to avoid paying taxes.

Simplicity means making tax credit compliance easier for working families and students

Some beneficial tax credits for the poor and middle class are needlessly complicated and difficult to comply with. For example, Congress could make tax filing easier for families with children by simplifying and standardizing definitions used in child-related tax exemptions and credits. Currently, the child tax credit, earned income tax credit, and the head of household filing status have different definitions for a child, with different requirements for both qualified ages and levels of support.[19] By using a single definition, these provisions of the tax code can be administered in a more cost efficient manner. The earned income tax credit has additional complexity, with the Internal Revenue Service noting, "[t]he eligibility requirements and computations are complex, yet EITC recipients are relatively less able to understand complex rules and less likely to speak English as their primary language, creating a recipe for confusion."[20]

Middle-class taxpayers also face a variety of complex tax rules in the higher-education arena. With multiple tax programs to incentivize saving for college, reimburse costs while attending college, and provide support for loan repayment,[21] navigating the tax rules associated with college can become an exhausting task. Furthermore, the American Opportunity Tax Credit continues to be authorized on only a temporary basis and expires after 2017. Congress should make college incentives in the tax code easier to understand by streamlining all of these benefits into one vehicle, a permanent American Opportunity Tax Credit.

Congress should be wary of regressive policy masquerading as simplification

Regressive policies that would shift the tax burden from the rich to those below them on the income scale are of course very unpopular. And so they are often presented as something they are not: measures to simplify tax filing.

The budget outline released by House Budget Committee Chairman Paul Ryan (R-WI) is a case in point. The House budget bemoans the complexity of the tax code at length. But the actual policies proposed have little to do with making the tax code simpler and everything to do with making it less progressive. The talk of simplicity is a distraction from the budget's real-world effects, namely shifting the tax burden from the rich to the middle class.[22] In fact, this approach would keep or expand features of the tax code that add complexity and encourage gaming the system, while dramatically reducing the progressive rate structure in the name of "simplicity."

Simplification is a laudable goal, but Congress should focus on the kind of simplification that matters for middle-class families, while balancing the goal of simplification against distributional goals, revenue needs, and other important policy concerns.

Tax reform should raise revenue for investments in the middle class

We have a revenue problem. Repeated tax cuts played an outsized role in creating the budget deficits of the last decade, and setting the stage for the current drive for austerity that is holding back the recovery and damaging the middle class.

As Oliver Wendell Holmes said, "Taxes are what we pay for civilized society." They pay for the foundational public investments that are critical to a modern prosperous society, such as infrastructure, education, and basic scientific research. They pay for services that only the government can effectively perform, such as national defense and ensuring clean food, safe consumer products, and clean water. Taxes make it possible for us to meet our societal obligation to care for our veterans, our aged, and our impoverished. And taxation allows us to overcome national challenges and achieve extraordinary feats. Apollo 11, the Hoover Dam, and the Internet were all financed with tax revenues.

Current federal revenue levels are at their lowest levels since the 1950s, a time before Medicare and Medicaid, federal aid to education, and a host of other federal programs that are now viewed as core responsibilities of the federal government. Some of this is driven by the recession, but even once incomes begin to rebound, our federal tax code will not raise enough revenue to meet the challenges America will face in the coming decades.

In the long run, the tax code must raise adequate revenue to meet our nation's needs

According to Congressional Budget Office projections, maintaining today's tax code will result in revenues averaging about 18.5 percent of gross domestic product over the next decade.[23] From 1998 to 2001—the last years in which we had balanced budgets—revenues averaged about 20 percent of GDP. And in the intervening years, our population has aged, baby boomers have started to retire, health care costs have risen, and our national security needs have changed dramatically. Clearly, generating additional revenue is a necessary component of any practical plan to address our budget challenges.

In "Reforming Our Tax System, Reducing Our Deficit," the Center for American Progress proposed a plan to overhaul the federal income tax code that will raise increased revenues progressively while making the tax system more efficient, simple, fair, and comprehensible.[24] Under our plan, by the middle to the end of this decade federal revenues will match those revenue levels recommended by the bipartisan "Simpson-Bowles" plan. These revenue levels have been agreed to by Democrats and Republicans, and are sufficient to put the budget on a sustainable path while dealing with sequestration and investing in the recovery. But it is likely that more revenues will be necessary over the long term if America is going to adequately invest in education, infrastructure, science and technology, energy, and the other investments in the middle class that will determine future growth and prosperity.

All of the bipartisan plans, including Simpson-Bowles, have proposed raising revenue levels above that of the historical average. And there are many good reasons to be skeptical that averages from the last 60 years are appropriate benchmarks for the next 60. First and foremost, these averages are highly misleading—they obscure a clear rise in tax revenues, decade by decade, as the federal government took on more responsibility for the health care of senior citizens and as health care costs rose more generally.

More importantly, it's simply wrong to try and budget for the future by looking backwards and trying to shoehorn future needs into whatever the past levels have been. Instead, we should be trying to determine broadly how much public investment will be required as we move deeper into the 21st century, and then how do we pay for those investments in the most efficient way possible. Why should we even consider the average from the past 60 years as an appropriate constraint until 2070? Certainly everyone agrees that times and circumstances have changed, and that the federal government should, presumably, change with them.

The United States raises far less in tax revenue, at all levels of government, than other first world countries. In 2010 only two OECD countries, Mexico and Chile, had lower government revenues as a share of GDP than the United States.[25] Revenue as a share of GDP in the United States was more than 25 percent lower than the OECD average.[26] That difference amounted to nearly $1.3 trillion in revenue in that year alone.[27] The United States has historically been a low-tax country, and can remain a low-tax country even while substantially increasing federal revenues to provide needed services to the middle class.

Because U.S. taxes are so much lower than the OECD average, many services provided to the middle class in other developed countries are not available in the United States. In Denmark, the OECD country with the highest tax revenue as a percentage of GDP,[28] the government pays for higher education, universal health care, and care for the sick and elderly,[29]—costs that many middle-class American families struggle to pay out of their own pockets. Similarly, other countries, including Mexico, are able to invest vastly more in preschool than the United States, increasing student achievement and allowing middle-class families to participate in the workforce without worrying about what to do with their preschoolers while they work.[30] When low taxes on the rich translate to reduced services and increased costs for the middle class, the American economy suffers.

Even the most progressive revenue proposals currently on the table are largely geared toward stabilizing U.S. debt as a share of GDP, replacing the misguided and damaging spending cuts required by "sequestration," and paying for some relatively small investments to help speed the recovery. These are important short-term revenue goals that should not be held up by a longer tax-reform process; ensuring that the government takes in enough revenue to meet current basic funding needs, and raises that revenue in a progressive way, should be seen as a crucial prerequisite to any broader tax reform. But in the context of comprehensive reform, Congress should ensure that the tax code reflects the revenue needs of a growing economy with a vibrant middle class. The coming decades will present challenges and opportunities that we have not yet imagined, and we need a tax code capable of raising the revenue we will need to confront these changing circumstances efficiently and progressively.

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Chairman MURRAY. Thank you very much.

Dr. Looney, we will turn to you.

STATEMENT OF ADAM LOONEY, PH.D., SENIOR FELLOW, ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Mr. LOONEY. Thank you very much. Chairman Murray, Ranking Member Sessions, and members of the Committee, thank you for inviting me here to share my views on the role of tax reform in supporting broad-based economic growth and fiscal responsibility.

The United States faces a daunting outlook for budget deficits, an increasingly challenging global economy for many American workers and businesses, and rising income inequality.

Improvements in tax policy could help address these challenges by making our tax system more fiscally sustainable, more efficient, and more fair. Indeed, any tax reform will ultimately be evaluated based on how it affects each of those three criteria.

But improving on all three dimensions simultaneously is increasingly difficult because of tradeoffs between competing goals of efficiency, revenues, and equity.

Today's long-term budget outlook means that we are likely to need higher tax revenues in the future. And rising inequality means that changes in policy are going to be increasingly scrutinized for how they affect the progressivity of the tax schedule. But a tax reform that devotes revenues to deficit reduction and retains our progressive system would have much more difficulty achieving other goals, such as lowering tax rates.

In my testimony today, I want to describe some of these tradeoffs and some potential paths forward.

Much of the energy surrounding tax reform focuses on the model of the Tax Reform Act of 1986. In that reform, tax rates were lowered substantially, and the lost revenue was restored by cutting tax breaks, tax deductions, and other so-called tax expenditures. In the 27 years since then, however, the economic context has changed, making such a reform much harder to achieve.

First, we face a much more challenging long-run budget outlook. Most believe that putting the budget on a sustainable path is going to require contributions both from spending cuts and from revenue increases. Many hope that tax reform can help produce those revenues.

That makes tax reform just a lot more difficult to achieve because revenues allocated to deficit reduction are revenues that cannot be used to lower rates, and vice versa.

Moreover, raising revenues and cutting rates at the same time is a really tall order. At first glance, the list of tax expenditures is projected to add up to $1.4 trillion in 2015. But that figure dramatically overstates the likely revenues that are available from cutting tax expenditures.

Most of these tax expenditures serve substantive goals. They remain on the books because they were too difficult to eliminate in 1986. And as you know, they are backed by very popular constituencies. Because of these and other considerations, the Congressional Research Service warns that "it may prove difficult to gain more than $100 billion to $150 billion" a year from reducing tax expenditures.

And just to put that number in perspective, in order to be revenue neutral, the tax plan included in House Budget Committee Chairman Ryan's budget would require eliminating roughly $450 billion a year just to balance out on the individual side. And the plans initially developed by Domenici-Rivlin and Simpson-Bowles likely require reductions in tax expenditures of a similar or even larger magnitude.

And so that gap between the reductions in tax expenditures that are required in these plans and those that could be likely agreed upon just illustrates the challenge of formulating a plan that simultaneously achieves both goals of lower rates and higher revenues.

And, of course, a second consideration is the issue of rising income inequality and its relationship to the Tax Code. Income inequality has increased dramatically, particularly at the top, and changes in the tax system have tended to exacerbate these inequalities. The very people who have received the biggest income gains in the past three decades have also seen the largest tax cuts.

Concerns about income inequality were much less salient the last time we did tax reform in 1986. Back then, the phenomenon of rising inequality had yet to be fully understood or discovered. The technical expertise to measure how the tax system affects inequality had yet to really be developed.

Today not only are such concerns about how progressive the tax schedule is, you know, those concerns are much more heightened today, but so is our ability to measure how taxes affect those different income groups, and that raises the level of scrutiny directed to tax reform but also illustrates a substantive tradeoff: Not only must any changes in tax rates and tax expenditures balance out to yield whatever revenues are required, but they have to balance out within income groups in order to retain a progressive tax structure.

In a series of papers, colleagues at the Tax Policy Center and I have analyzed some of these tradeoffs by examining a hypothetical tax reform with the stated goals of maintaining revenues, lowering marginal tax rates, and ensuring a progressive tax system. We estimated revenue losses due to lower rates and then tried to pay for those revenues losses by eliminating tax expenditures. Overall, the available tax breaks were enough to offset revenue losses from lower rates. But the resulting tax schedule was less progressive. Even when we tried to implement the most progressive possible way of reducing the tax breaks, there was simply not enough revenue from the breaks in the top brackets to offset the revenue losses from lowering marginal rates. This was true even when we incorporated revenue feedback, not just according to the standard dynamic effects, but also have incorporating additional feedback effects from potential economic growth.

And so the implication is that such a tax reform must give up on at least one of its stated goals: either higher-income taxpayers would receive a tax cut and middle- and lower-income taxpayers a tax increase; the deficit would have to go up; preferences for savings and investment would have to be reduced; or marginal tax rates would need to be higher.

Of course, these considerations do not rule out tax reform; indeed, many experts have put forward plans that provide more incremental reforms that simultaneously achieve efficiency gains, higher revenues, and a more progressive system. But such plans require substantial compromises.

For instance, certain plans achieve their distributional goals by eliminating preferential rates for capital gains and dividends or curtailing other savings and investment-related tax breaks.

Other incremental reforms propose improving the efficiency by cutting inefficient tax expenditures. A common thread is that all of these proposals enhance economic efficiency, raise revenues, and do so in a progressive way.

That concludes my prepared remarks, and I look forward to your questions. Thank you.

[The prepared statement of Mr. Looney follows:]

Embargoed Until 5/22/2003 at 2:30 p.m. ET

Testimony Prepared for the Hearing:
"Supporting Broad-Based Economic Growth and Fiscal Responsibility through Tax Reform"
Senate Committee on the Budget
May 22, 2013

By Adam Looney
Senior Fellow
The Brookings Institution

Chairman Murray, Ranking Member Sessions, and Members of the Committee: Thank you for inviting me to share my views on the role of tax reform in supporting broad-based economic growth and fiscal responsibility.

The United States faces a daunting outlook for budget deficits, an increasingly challenging global economy for many American workers and businesses, and rising income inequality.

Improvements in tax policy could help address these challenges by making our tax system more fiscally sustainable, more efficient, and more fair. Indeed, any tax reform will be evaluated based on how it affects each of those three criteria.

But improving on all three dimensions simultaneously is increasingly difficult because of tradeoffs between competing goals of efficiency, revenues, and equity.

Today's long-term budget outlook means that we're likely to need higher tax revenues in the future. And rising inequality means that changes in policy will be increasingly scrutinized for how they affect the progressivity of the tax schedule. But a tax reform that devotes revenues to deficit reduction and retains our progressive system would have much more difficulty achieving other goals—such as lowering tax rates.

In my testimony today, I want to describe some of these tradeoffs and some potential paths forward.

Tax Reform and the Budget

Much of the energy surrounding tax reform focuses on the model of the Tax Reform Act of 1986. In that reform, tax rates were lowered substantially and the lost revenue was restored by cutting tax breaks, deductions, exclusions, and other so-called tax expenditures. That reform enhanced economic efficiency without increasing the deficit. In the 27 years since then, however, the economic context has changed, making such a reform harder to achieve.[1]

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[1] For a further discussion see: Greenstone, Michael, Dmitri Koustas, Karen Li, Adam Looney, and Leslie B. Samuels. "A Dozen Economic Facts About Tax Reform," The Hamilton Project (May 2012).

First, we face a dire long-run budget outlook; most believe that putting the budget on a sustainable path will require contributions from both spending cuts and revenue increases. Many hope that tax reform can help produce those revenues.

This makes tax reform more difficult because revenues allocated to deficit reduction are revenues that cannot be used to reduce rates, and vice versa.

Moreover, raising revenues and cutting rates at the same time is a tall order. At first glance, the list of tax expenditures is projected to add up to $1.4 trillion in 2015.[2] But that figure dramatically overstates the revenue gains that are available from cutting expenditures.

Some expenditures, including obscure items like imputed rent, would be difficult to eliminate for practical or administrative reasons; others, like credits and deductions for working families with children are integral to combating poverty and encouraging employment. These categories account for roughly one quarter of all tax expenditures.[3] An additional one-third of the tax expenditures arise from the preferential treatment of savings and investment. And the largest non-savings-related expenditures include those for health insurance, mortgage interest, state and local taxes, and charitable contributions. These, and many others, tend to serve substantive goals, remain on the books because they were too difficult to eliminate in 1986, and, as you well know, are backed by popular constituencies.

In addition to political difficulties, there are basic practical issues to consider. Certain tax expenditures exist for the purposes of simplifying the tax system, to reduce record keeping, or to minimize the filing burden on taxpayers. Eliminating those provisions or scaling back others could make the system more complicated and onerous.

Because of such considerations, the Congressional Research Service warns that "it may prove difficult to gain more than $100 billion to $150 billion" each year from reducing tax expenditures.[4] And those estimates are based on a 35 percent top rate; if marginal tax rates were reduced, eliminating a dollar's worth of deductions would raise proportionately less revenue. In other words, if eliminating a dollar of mortgage interest today raised 39 cents, under a top rate of 25 percent, it would raise only 25 cents—37 percent less.

To put these numbers in perspective, in order to be revenue-neutral, the tax plan included in House Budget Committee Chairman Ryan's budget would require eliminating roughly $450 billion worth of tax expenditures each year just to balance out the individual income tax rate cuts targeted in his plan.[5] The plans initially developed by the Domenici–Rivlin Task Force

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[2] Marron, Donald B. "How Large are Tax Expenditures? A 2012 Update," Tax Notes (April 9, 2012): 235.
[3] For a description of these expenditures, see Nguyen, Hang, James Nunns, Eric Toder, and Roberton Williams. "How Hard Is It to Cut Tax Preferences to Pay for Lower Tax Rates?" Tax Policy Center (July 10, 2012): Table 1.
[4] Gravelle, Jane G. and Thomas L. Hungerford. "The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening," Congressional Research Service (March 22, 2012): 3.
[5] Tax Policy Center Table T13-0110

and the Bowles–Simpson Commission, which reduce rates and contribute to deficit reduction, likely require reductions in tax expenditures of a similar or larger magnitude.

The gap between the reductions in tax expenditures required by such plans and those that could be agreed upon illustrates the challenge of formulating a plan that achieves both lower rates and higher revenues.

Tax Reform in a Progressive System

A second consideration is the issue of rising income inequality and its relationship to the tax code. Earnings have risen dramatically at the top—by more than 250 percent over the past 30 years for households in the top one percent of the income distribution. At the same time, many households at the middle and bottom have experienced stagnating or even declining earnings. Changes in the tax system over the past 30 years have exacerbated these problems; the very people who have received the biggest income gains in the past three decades have also seen the largest tax cuts. A progressive tax code is perhaps the most significant and powerful tool available to counteract income inequality. Indeed, there are increasing calls for policymakers to use the tax code for that purpose.

Such concerns were much less salient the last time we did tax reform. In 1986, the phenomenon of rising inequality had yet to be fully discovered or understood, and the technical expertise to measure how the tax system affected inequality had yet to be developed.

Today not only are concerns about the progressivity of the tax schedule heighted, but so is our ability to measure how tax changes affect different groups. That raises the level of scrutiny directed to reform and also reveals a substantive tradeoff: that any changes in rates and tax expenditures must balance out within income groups in order to retain a progressive tax structure.

In a series of papers, colleagues at the Tax Policy Center and I analyzed these tradeoffs by examining a hypothetical reform with the stated goals of maintaining tax revenues, lowering marginal tax rates, while at the same time ensuring a progressive tax system.[6] We took as an example a plan that lowered the top rate from 35 to 28 percent and continued the low rates that apply to savings and investment. These rate reductions are roughly the same levels specified in earlier plans from Bowles–Simpson and Domenici–Rivlin, but are substantially smaller than those specified in Chairman Ryan's plan. We asked what it would take to achieve other goals of revenue and progressivity.

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[6] Brown, Samuel, William Gale, and Adam Looney. "On the Distributional Effects of Base-Broadening Income Tax Reform," Tax Policy Center (August 1, 2012); Brown, Samuel, William Gale, and Adam Looney. "TPC's Analysis of Governor Romney's Tax Proposals: A Follow-Up Discussion," Tax Policy Center (November 7, 2012); Marron, Donald. "Understanding TPC's Analysis of Governor Romney's Tax Plan," Tax Vox (August 8, 2012); and Nguyen et al. (2012).

In that analysis, we estimated the revenue losses due to lower rates, and then tried to pay for those revenue losses by eliminating tax expenditures. We assumed that certain tax expenditures were off the table because of the administrative difficulty of closing certain breaks; others were off the table because they provided preferential treatment for savings and investment.

Overall, the available tax breaks were enough to offset revenue losses from lower rates. But this resulting tax schedule, we found, was less progressive. Even when we implemented the most progressive way of reducing the remaining tax breaks, there was simply not enough revenue from these breaks in the top brackets to offset the revenue losses from lower marginal tax rates.

This result—that this sort of base-broadening reform led to a less progressive tax system—was true even when we incorporated revenue feedback, not just according to the standard dynamic effects used by Tax Policy Center, Treasury, and the Joint Committee on Taxation, but also additional feedback effects from optimistic estimates of potential economic growth, drawn from theoretical models.

The implication is that such a tax reform must give up on at least one of its stated goals: either higher-income taxpayers would receive a tax cut and middle- and lower-income taxpayers a tax increase; the deficit would go up; preferences for savings and investment would have to be reduced; or marginal tax rates would need to be higher.

Prospects for Reform

Of course, these considerations don't rule out tax reform; indeed, many experts have put forward plans that provide more incremental reforms that simultaneously achieve efficiency gains, higher revenues, and a more progressive tax system. But such plans require substantial compromises.

For instance, certain plans proposed by the Domenici–Rivlin Task Force and the Bowles–Simpson Commission achieve their distributional goals by eliminating preferential rates for capital gains and dividends and curtailing other savings and investment-related tax breaks.

A host of other incremental reforms propose improving the efficiency of the tax system not by reducing rates but by reducing inefficient or wasteful tax expenditures. For example, deductions and exemptions—like for mortgage interest, that currently provide tax savings of up to 39.6 percent—could be replaced with flat credits of, say, 15 percent, providing continued support for homeowners but in a less-costly and more progressive way.[7] An overall limit on the value of tax expenditures at 2 percent of income would provide an across-the-board reduction in costly tax expenditures.[8] The President's Budget includes a provision to limit the amount that certain tax deductions and preferences can reduce tax liability by to 28 percent. And at a meeting

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[7] Batchelder, Lily L., Fred T. Goldberg, Jr., and Peter R. Orszag. "Reforming Tax Incentives into Uniform Refundable Tax Credits," The Brookings Institution Policy Brief 156 (August 2006).

[8] Feldstein, Martin, Daniel Feenberg, and Maya MacGuineas. "Capping Individual Tax Expenditure Benefits," NBER Working Paper 16921 (April 2011)

convened by the Hamilton Project last February, a bipartisan group of tax experts presented proposals to reduce benefits from the mortgage interest deduction, subsidies for fossil fuels, preferences for retirement savings, and the overall value of deductions.[9] A common thread is that all of these proposals enhance economic efficiency, raise revenues, and increase progressivity.

Beyond economic appeal, proponents of this approach hope for political appeal. To paraphrase Harvard Professor Martin Feldstein: if Republicans want to reduce the deficit by cutting spending and Democrats want to increase revenues, by focusing on tax expenditures we should find a middle ground.[10]

[9] See Alan Viard, "Replacing the Home Mortgage Interest Deduction," Joseph E. Aldy, "Eliminating Fossil Fuel Subsidies," Karen Dynan, "Better Ways to Promote Saving through the Tax System," and Diane Lim "Limiting Individual Income Tax Expenditures" in *15 Ways to Rethink the Federal Budget*, The Hamilton Project (February 2013).

[10] Feldstein, Martin. "A Simple Route to Major Deficit Reduction," The Wall Street Journal (February 20, 2013).

Chairman MURRAY. Thank you very much.
Dr. de Rugy?

STATEMENT OF VERONIQUE DE RUGY, PH.D., SENIOR RESEARCH FELLOW, MERCATUS CENTER AT GEORGE MASON UNIVERSITY

Ms. de Rugy. Chairman Murray, Ranking Member Sessions, and members of the Committee, it is an honor to appear before you today to talk about fiscal responsibility and economic growth. My name is Veronique de Rugy. I am a senior research fellow at the Mercatus Center at George Mason University where I study tax and budget issues.

Last week, the Congressional Budget Office released numbers showing that the U.S. short-term fiscal situation has improved over the last few months. While this is a welcome development, it also shows that our long-term budget outlook is still extremely worrisome.

As the CBO noted in its report, not only are high and sustained levels of debt an impediment to economic growth in the long term, but it also makes it very hard for the Federal Government to prevent and respond to future financial crises. And one of the reasons the CBO adds is that it makes the use of monetary and fiscal stimulus extremely difficult. In other words, the long-term improvement in our deficit outlook should not distract Congress from addressing our long-term debt problem.

However, in the pursuit of debt reduction, Congress ought to be very careful. While most of the recent discussions about debt reduction have focused on size, what researchers show is that actually it is more what the debt reduction packages are made of that matters. So debt reduction can be achieved by cutting taxes—by cutting spending, sorry, by increasing taxes, or by doing a mix of both. However, each of these policies has a very, very different outcome on level of debt and economic growth.

So today I will show, based on the research I have done and looking at the way other countries have addressed their debt problems, I want to show that spending cuts are more likely to reduce debt levels than tax increases; and, two, that spending cuts are less likely than tax increases to produce recession and more likely to produce economic growth in the short term and in the long term.

So let us start. When thinking about debt reduction, one of the important questions is to ask: What kind of debt reduction packages is the most effective at cutting the debt? The general consensus among academics working on this issue, including ones from the IMF and the OECD, is that fiscal adjustment packages based mostly on spending cuts are far more likely to lead to lasting debt reduction than those based on tax increases. These findings hold true no matter how fiscal adjustments are measured.

The second question is this: Which is more likely to harm economic growth in the short term—spending cuts or tax increases? And just as there is a lot of debate about the short-term economic impact of spending increases on economic growth, economists do not have a definitive answer on the short-term impact of spending cuts on the economy. However, through this debate a few lessons have emerged.

The first one is that tax increases hurt the economy more than spending cuts. Extensive research by Harvard University economist Alberto Alesina as well as by economists at the IMF has shown that fiscal adjustments achieved through spending cuts are less recessionary than those achieved through tax increases. I think the case of Europe is a powerful example of this.

Contrary to the common perception, European governments have seldom cut spending, and when they have, these cuts have been overwhelmed by large tax increases. As a result, these countries have mostly failed to reduce their debt, and many of them are sliding back into recession.

Second, while expansionary fiscal adjustments based on spending cuts are possible, they are more likely to occur when they are accompanied by growth-oriented policies such as structural labor market reforms and/or monetary easing.

Third, while cutting spending may not always result in a short-term economic boost, there are long-term fiscal reasons for pursuing them since they will help prevent future debt crises.

Finally, I would be remiss if in a hearing about economic growth and tax reform I did not mention that most economists believe that lower taxes are associated with higher economic growth. Keynesian models, for instance, emphasize the short-run benefits of tax cuts, stressing that they put money in the pockets of consumers and in the accounts of businesses, which then boost aggregate demand. On the other end of the spectrum, the real business cycle school of thought focuses on the longer run and emphasizes that lower marginal tax rates tend to increase people's incentive to work and save, increasing aggregate output.

Real-world experience validates the academic case for low taxation. Macroeconomists Christina and David Romer, for instance, examined 60 years of U.S. data, and they found that a tax cut of 1 percent of GDP increases real GDP by about 3 percent over the short term and by about 1.8 percent over the medium run. But while Romer and Romer focused on the short and medium term, there are a lot of other studies that have focused on the long-term impact of low taxes. For instance, Nobel Prize winner Ed Prescott has actually looked at the change in habit, in work habit in different countries, in particular between Europe and the U.S., and one of the things that he has found is that this change in work habit can mostly be attributed to the difference in tax rates in those countries.

So, for instance, one of the things that he found is that when the U.S. had higher marginal tax rates than Europe in the 1970s, Americans worked much less than Europeans back then. And when this has been the reversed, the impact on work habits have changed.

This is even more pronounced in countries where the welfare state is more beneficial. So, I mean, there is a lot of work on the impact and the benefit of a low level of taxes on the economy.

On this I will end, and I am looking forward to your questions. Thank you.

[The prepared statement of Ms. de Rugy follows:]

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TESTIMONY

THE EFFECT OF TAX INCREASES AND SPENDING CUTS ON ECONOMIC GROWTH

BY VERONIQUE DE RUGY
Senior Research Fellow

Testimony before the Senate Budget Committee
May 22, 2013

Good morning, Chairman Murray, Ranking Member Sessions, and members of the committee. Thank you for the chance to discuss the effect of tax increases and spending cuts on economic growth. I appreciate the opportunity to testify today.

Last week the Congressional Budget Office released a revision of its budget outlook for FY 2013.[1] According to CBO, our short-term outlook seems to be improving, at least on a superficial level, with this year's deficit now expected to be $642 billion. That is $200 billion lower than projected in February, which would make it the smallest deficit since 2008.

There are many reasons for continued pessimism, however. At 76 percent, the debt-to-GDP ratio is still much higher than the 2008 level of 36 percent. Unfortunately, even under the new projections the debt-to-GDP ratio will still be around 74 percent at the end of the decade. And that's assuming Congress doesn't overturn sequestration and all of CBO's assumptions hold true. In CBO's alternative scenario, debt will be above 83 percent of GDP by the end of the decade.

The explosion of spending from programs such as Social Security, Medicare, and Medicaid will trigger even higher levels of debt in the years outside the 10-year budget window. Unfortunately, high debt levels are problematic. As CBO explains,

> Such high and rising debt later in the coming decade would have serious negative consequences: When interest rates return to higher (more typical) levels, federal spending on interest payments would increase substantially. Moreover, because federal borrowing reduces national saving, over time the capital stock would be smaller and total wages would be lower than they would be if the debt was reduced. In addition, lawmakers

1. Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," May 2013, http://cbo.gov/sites/default/files/cbofiles/attachments/44172-Baseline2.pdf.

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would have less flexibility than they would have if debt levels were lower to use tax and spending policy to respond to unexpected challenges. Finally, a large debt increases the risk of a fiscal crisis, during which investors would lose so much confidence in the government's ability to manage its budget that the government would be unable to borrow at affordable rates.

In other words, a brief dip in the deficit is no reason to be complacent. The federal government should continue to work on addressing its long-term debt problem. However, in the pursuit of debt reduction, it is important to remember that the *type* of fiscal adjustment that we implement is more important than its size.

In theory, debt reduction can be achieved by cutting spending or by raising taxes, or by adopting a mix of spending cuts and tax increases.

When anti-austerity policymakers or critics talk about austerity without even alluding to this distinction in how deficit reduction is achieved, they do a disservice to the clarity of the issues at hand, since different types of austerity measures produce very different results.[2]

This testimony is based on a paper I wrote with Harvard University economist Alberto Alesina, called "Austerity: The Relative Effects of Tax Increases versus Spending Cuts." As we explain in detail in that paper, the consensus in the academic literature is that the composition of fiscal adjustment is a key factor in achieving successful and lasting reductions in the debt-to-GDP ratio. The general consensus is that fiscal adjustment packages comprising mostly spending cuts are more likely to lead to lasting debt reduction than those composed of tax increases.

There is still significant debate about the short-term economic impact of fiscal adjustments, but some important lessons have emerged. First, fiscal adjustments and economic growth are not incompatible. Second, while fiscal adjustments may not always trigger immediate economic growth, spending-based adjustments are much less costly in terms of output than tax-based ones. In fact, when governments try to reduce their debt by raising taxes, the policy is more likely to result in deep and pronounced recessions, possibly making the fiscal adjustment counterproductive. Finally, there is some evidence that expansionary fiscal adjustments are more likely to occur when they are accompanied by growth-oriented policies, such as policies liberalizing both labor regulations and markets for goods and services, in addition to a monetary policy that keeps interest rates low.

These findings are key to designing proper policies for the United States. They also suggest that the budget plans proposed by both President Obama and Chairman Murray are unlikely to reduce the country's debt and may also slow economic growth if implemented as proposed.

1. HOW TO REDUCE DEBT-TO-GDP RATIOS

The United States is not the first nation to struggle with a worrisomely high debt-to-GDP ratio. The evidence suggests that the types of fiscal adjustment packages that are most likely to reduce debt are those that are heavily weighted toward spending reductions, not tax increases.[3]

2. Alberto Alesina and Silvia Ardagna, "The Design of Fiscal Adjustments" (NBER Working Paper 18423, National Bureau of Economic Research, September 2012), http://www.nber.org/papers/w18423.pdf (subscription only).

3. Matt Mitchell of the Mercatus Center at George Mason University has reviewed the academic literature on this issue, finding that, of the 22 papers published that looked at this question, all of them find that the most promising way to shrink the debt is to not increase taxes and to restrain spending so that it shrinks relative to economic output. See Matt Mitchell, "Does UK Double-Dip Prove That Austerity Doesn't Work?" *Neighborhood Effects* (blog), Mercatus Center at George Mason University, April 26, 2012, http://neighborhoodeffects.mercatus.org/2012/04/26/does-uk-double-dip-prove-that-austerity-doesnt-work/. See also Alesina and Ardagna, "Design of Fiscal Adjustments";

One of the difficulties of studying the impact of large fiscal adjustments on both debt and economic growth involves the definition and identification of successful and expansionary episodes. For a long time, the identification criteria were based on observed outcomes: a large fiscal adjustment was one where the cyclically adjusted primary-deficit-over-GDP ratio fell by a certain amount (normally at least 1.5 percent of GDP). Following the approach pioneered by University of California, Berkeley, economists Christina Romer and David Romer,[4] IMF economists suggested a different way to identify large exogenous fiscal adjustments: a large fiscal adjustment is an explicit attempt by the government to reduce the debt aggressively and it is unrelated to the economic cycle.[5] This new approach was meant to guarantee the "exogeneity" of the fiscal adjustments.

The authors also suggest that a difference in the way fiscal adjustments are measured would change the overall results. However, the difference in the way fiscal adjustments are defined does not change the overall result. A 2012 study by Alberto Alesina and Goldman Sachs's economist Silvia Ardagna shows that spending-based adjustments are more likely to reduce the debt-to-GDP ratio, regardless of whether fiscal adjustments are defined in terms of improvements in the cyclically adjusted primary budget deficit or in terms of premeditated policy changes designed to improve a country's fiscal outlook.[6] Similar results with more advanced technical tools using the IMF episodes are also reached by Alberto Alesina and Bocconi University economists Carlo A. Favero and Francesco Giavazzi.[7]

Other research has found that fiscal adjustments based mostly on the spending side are less likely to be reversed and, consequently, have led to more long-lasting reductions in debt-to-GDP ratios.[8] Beyond showing whether spending-based adjustments or revenue-based ones are more effective at reducing debt, the literature has also looked at which components of expenditures and revenue are more important. The results on these points are not as clear-cut, partly due to the wide differences in countries' tax and spending systems. With that caveat in mind, successful fiscal adjustments are often rooted in reform of social programs and reductions to the size and pay of the government workforce rather than in other types of spending cuts.[9] Results about which type of revenue increases contribute to successful fiscal adjustment are much less clear.[10]

Also, while successfully reducing the debt-to-GDP ratio is possible, a majority of historical fiscal adjustment episodes fail to do so. Data from studies by Alesina and Ardagna and by Andrew Biggs and his

and Alberto F. Alesina, Carlo A. Favero, and Francesco Giavazzi, "The Output Effect of Fiscal Consolidations" (NBER Working Paper 18336, National Bureau of Economic Research, August 2012), http://www.nber.org/papers/w18336 (subscription only).

4. Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," *American Economic Review* 100, no. 3 (2010): 763–801.

5. Peter Devries et al., "A New Action-Based Dataset of Fiscal Consolidation" (Working Paper 11/128, IMF, June 2011), http://www.imf.org/external/pubs/ft/wp/2011/wp11128.pdf.

6. Alesina and Ardagna, "Design of Fiscal Adjustments."

7. Alesina, Favero, and Giavazzi, "Output Effect of Fiscal Consolidations."

8. Alesina and Ardagna, "Design of Fiscal Adjustments."

9. Andrew Biggs, Kevin Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked" (AEI Economic Policy Working Paper, American Enterprise Institute, Washington, DC, 2010). See also Alberto Alesina and Roberto Perotti, "Fiscal Expansions and Fiscal Adjustments in OECD Countries" (NBER Working Paper 5214, National Bureau of Economic Research, August 1995), http://www.nber.org/papers/w5214; Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects" (Working Paper 96/70, IMF, June 1997), http://www.imf.org/external/pubs/cat/longres.cfm?sk=2037.0; Philip R. Lane and Roberto Perotti, "The Importance of Composition of Fiscal Policy" (Working Paper 200111, Trinity College Dublin, October 2001); Stephanie Guichard et al., "What Promotes Fiscal Consolidation: OECD Country Experiences" (Working Paper 553, Organisation for Economic Co-operation and Development, May 2007), http://search.oecd.org/officialdocuments/displaydocumentpdf/?doclanguage=en&cote=eco/wkp(2007)13.

10. Biggs, Hassett, and Jensen, "Guide for Deficit Reduction."

colleagues show that roughly 80 percent of the adjustments studied were failures.[11] One explanation is that even (or especially) in a time of crisis, lawmakers are driven more by politics than by good public policy. Countries in fiscal trouble generally get there through years of catering to pro-spending constituencies, be they senior citizens or members of the military industrial complex, and their fiscal adjustments tend to make too many of the same mistakes. As a result, failed fiscal consolidations are more the rule than the exception.

2. FISCAL ADJUSTMENTS AND ECONOMIC GROWTH

While there is little debate over the fact that sound fiscal balance and restraints in government spending have a positive impact on GDP in the long run, the question of whether, in the short term, budget cuts shrink or expand GDP is far from settled.[12] This is an especially important question for countries where government spending as a share of GDP is close to or above 50 percent. A few uncontroversial points have emerged, however, despite the differences in approaches and in the definitions of successful or expansionary episodes.[13]

First, expansionary fiscal adjustments are not impossible. There is now a long trail of academic papers that have studied and documented the impact of fiscal adjustments on economic growth. The first in the series was by Francesco Giavazzi and Marco Pagano in 1990.[14] It was followed by a large literature, which was reviewed in depth by Alesina and Ardagna in 2010.[15] However, today the question is not whether expansionary fiscal adjustments are possible, but whether in the current circumstances it is possible to design fiscal adjustments with as little cost as possible to the economy, given that monetary conditions will provide little additional help. It is perfectly possible that fiscal adjustment today might be on average more costly than in the past, but this does not mean that the medicine is not necessary.

Second, while not all fiscal adjustments lead to economic expansion, spending-based adjustments are less recessionary than those achieved through tax increases.[16] Moreover, when successful spending-based adjustments were not expansionary, they were associated with mild and short-lived recessions, while tax

11. Alesina and Ardagna find that about 84 percent of fiscal reforms fail to substantially reduce a nation's debt-to-GDP level. Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending" (NBER Working Paper 15438, National Bureau of Economic Research, October 2009), http://www.nber.org/papers/w15438. Biggs and his colleagues find an 80 percent failure rate. Biggs, Hassett, and Jensen, "Guide for Deficit Reduction."

12. On the long-run benefits of modest government spending, see Matt Mitchel, "Why This Isn't a Time to Worry That the Government Is Spending Too Little," *Neighborhood Effects* (blog), June 30, 2010, http://neighborhoodeffects.mercatus.org/2010/06/30/why-this-isnt-a-time-to-worry-that-government-is-spending-too-little/. See also Andreas Bergh and Magnus Henrekson, "Government Size and Growth: A Survey and Interpretation of the Evidence" (IFN Working Paper 858, Institutet för Näringslivsforskning, April 2011).

13. Alesina and Ardagna's 2012 paper gives a detailed look at recent controversies by performing a host of sensitivity tests, changing definitions, and exploring alternative approaches. They try to clarify the differences between the methodologies and empirical results. Their paper brings other variables that sometimes accompany fiscal adjustments into the discussion, expanding the analysis to include the effects of a vast set of policies that constitute the "package" accompanying the fiscal cuts. By considering many alternative definitions of fiscal adjustments, they are able to do robustness checks on their previous results. Alesina and Ardagna, "Design of Fiscal Adjustments."

14. Francesco Giavazzi and Marco Pagano, "Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries," *NBER Macroeconomics Annual* (MIT Press, 1990): 95–122, http://www.nber.org/papers/w3372.

15. Alesina and Ardagna, "Large Changes in Fiscal Policy."

16. For another good summary of the IMF findings on this issue, see Garett Jones, "Which Hurts More in the Long Run, Tax Hikes or Spending Cuts?," *Econlog* (blog), November 14, 2012, http://econlog.econlib.org/archives/2012/11/which_hurts_mor.html.

increases were unsuccessful at reducing the debt and associated with large recessions.[17] These findings hold even when using the IMF definitions of fiscal adjustments.[18]

In fact, these findings are consistent with IMF studies themselves.[19] For instance, IMF economists Jaime Guajardo, Daniel Leigh, and Andrea Pescatori study 173 fiscal consolidations in rich countries and find that "nations that mostly raised taxes suffered about twice as much as nations that mostly cut spending."[20]

Third, successful and expansionary fiscal adjustments were those based mostly on spending cuts rather than tax increases.[21] Also, these adjustments lasted slightly longer and were associated with higher growth during the adjustment. Using data from 21 Organisation for Economic Co-operation and Development countries from 1970 to 2010, Alesina and Ardagna find that successful fiscal adjustments on average reduced the debt-to-GDP ratio by 0.19 percentage points of GDP in a given year. GDP grew by 3.47 percentage points in total, which is 0.58 percentage points higher than the average growth of G7 countries. Successful adjustments lasted for three years on average.[22]

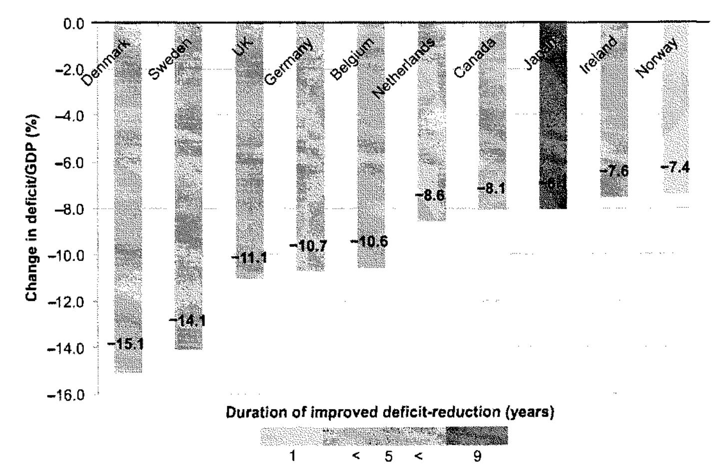
Table 1. The 10 Largest Episodes of Successful Fiscal Adjustments

COUNTRY	PERCENT CHANGE IN DEFICIT/GDP RATIO	PERIOD	DURATION (YEARS)
Denmark	−15.1	1983–1986	4
Sweden	−14.1	1993–1998	6
UK	−11.1	1994–2000	7
Germany	−10.7	1984–1990	7
Belgium	−10.6	1996–2000	5
Netherlands	−8.6	1993–1997	5
Canada	−8.1	1993–1997	5
Japan	−8.1	1979–1987	9
Ireland	−7.6	1986–1989	4
Norway	−7.4	1999–2000	1

Source: Authors' calculations based on Alberto Alesina and Silvia Ardagna, "The Design of Fiscal Adjustments" (NBER Working Paper No. 18423, National Bureau of Economic Research, Washington, DC, September 2012), http://www.nber.org/papers/w18423.pdf (subscription only).

17. Alesina, Favero, and Giavazzi, "Output Effect of Fiscal Consolidations."
18. Alesina and Ardagna, "Design of Fiscal Adjustments"; Alesina, Favero, and Giavazzi, "Output Effect of Fiscal Consolidations."
19. Pete Devries et al., "An Action-Based Analysis of Fiscal Consolidation in OECD Countries" (Working Paper 11/128, IMF, June 2011), http://www.imf.org/external/pubs/cat/longres.aspx?sk=24892.0.
20. Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, "Expansionary Austerity New International Evidence" (Working Paper No. 11/158, IMF, Washington, DC, July 2011).
21. Alesina, Favero, and Giavazzi, "Output Effect of Fiscal Consolidations"; Alesina and Ardagna, "Design of Fiscal Adjustments."
22. Alesina and Ardagna's data indicate that successful fiscal adjustment episodes comprised 72 percent in spending cuts and 28 percent in tax increases, resulting in an average spending reduction of 4.18 percentage points of GDP and a 1.64 percentage point tax increase. However, even using the IMF definition, the authors find that successful fiscal adjustment comprised 67 percent in spending cuts and 33 percent in tax increases, resulting in an average spending reduction of 3.89 percentage points of GDP and a 1.6 percentage point tax increase. Alesina and Ardagna, "Design of Fiscal Adjustments."

Figure 1. The 10 Largest Episodes of Fiscal Adjustments



Source: Alesina and Ardagna, "Design of Fiscal Adjustments."

How can we explain the fact that spending-based adjustments can result in lower output costs for the economy than tax-based ones, or in no output costs at all? IMF economists Prakash Kannan, Alasdair Scott, and Marco Terrones argue that this difference in outcomes is not a result of the composition of the fiscal adjustment packages, but rather a result of the business cycle having picked up because of other forms of government interventions, such as expansionary monetary policy.[23] However, Alesina, Favero, and Giavazzi's work shows that taking the business cycle and monetary policy into account does not change the main finding.[24]

If the difference between tax-based and spending-based fiscal adjustments is not the result of the business cycle or of monetary policy, what explains it? The standard explanation is that lower spending reduces the expectation of higher taxes in the future, with positive effects on consumers and investors. In particular, there might be a boost in the confidence of the latter—as Alesina, Favero, and Giavazzi have shown. But there is more. As is often the case, the devil is in the details. Studies by Alesina and Ardagna and by Roberto Perotti have noted that fiscal adjustments are multiyear rich policy packages.[25] Austerity measures are often undertaken at the same time that other growth-enhancing policy changes are made, and, as such, there is much to learn by looking into the details of each successful episode.

23. Prakash Kannan, Alasdair Scott, and Marco E. Terrones, "From Recession to Recovery: How Soon and How Strong" (IMF, 2012), http://www.imf.org/external/np/seminars/eng/2012/fincrises/pdf/ch8.pdf.

24. See Alesina, Favero, and Giavazzi, "Output Effect of Fiscal Consolidations." See also Alesina and Ardagna, "Design of Fiscal Adjustments"; and Alberto Alesina and Francesco Giavazzi, eds., *Fiscal Policy after the Financial Crisis*, National Bureau of Economic Research conference report (Chicago: University of Chicago Press, 2013).

25. Alberto Alesina and Silvia Ardagna, "Tales of Fiscal Adjustments," *Economic Policy* 27 (October 1998): 487–546; Roberto Perotti, "The 'Austerity Myth': Gain Without Pain?" (NBER Working Paper 17571, National Bureau of Economic Research, Washington, DC, November 2011), http://papers.nber.org/tmp/29877-w17571.pdf.

One important lesson is that several accompanying policies can moderate the contractionary effects of fiscal adjustments on the economy and enhance their chances of success.[26] For instance, spending-based fiscal adjustment accompanied by supply-side reforms, such as liberalization of markets for labor, goods, and services; readjustments of public sector size and pay; public pension reform; and other structural changes tend to be less recessionary or even to have positive economic growth.[27]

Such reforms signal a credible commitment to more market-friendly policies: less taxation, fewer impediments to trade, fewer barriers to entry, less labor market and business regulation. And, of course, with enhanced economic freedom, unit labor costs fall and productivity improves, making an expansionary fiscal adjustment more likely than a contractionary one.

Germany's fiscal adjustment of 2004–2007 provides a good example.[28] First, the country implemented a stimulus by reducing income tax rates. This reduction was part of a series of supply-side-oriented reforms implemented between 1999 and 2005, including a wide-ranging overhaul of the income tax system that was meant to boost potential growth but that did not have much effect until 2004. In addition, significant structural reforms to tackle rigidity in the labor market were put in place, as well as changes to the pension system to relieve demographic pressures. These reforms included "an increase in the statutory retirement age, the elimination of early retirement clauses, and tighter rules for calculating imputed pension contributions."[29] Finally, Germany adopted large expenditure cuts to the fringe benefits in public administration (such as ending Christmas-related extra payments) and also serious reductions in subsidies for specific industries, including residential construction, coal mining, and agriculture.[30]

Sweden provides another example of successful adjustment. The data show that after the recession Sweden's finance minister, Anders Borg, not only successfully implemented reduction in welfare spending but also pursued economic stimulus through a permanent reduction in the country's taxes, including a 20-point reduction to the top marginal income tax rate. At the same time, Sweden benefited from a very aggressive monetary policy followed by strong export revenues and firm domestic demand. The country's economy is now the fastest-growing in Europe, with real GDP growth of 5.6 percent, which has helped the country to rapidly shrink its debt as a percentage of GDP over the past decade.[31]

26. Perotti, "Austerity Myth."

27. See Alesina and Ardagna, "Design of Fiscal Adjustments"; the case studies by Alesina and Ardagna, "Tales of Fiscal Adjustments"; and Perotti, "Austerity Myth." For specific statistics on average changes to goods regulation, barriers to entry, public ownership, employment protection, union density, etc., see tables 17, 18, and 7b in Alesina and Ardagna, "Design of Fiscal Adjustments."

28. Christina Breuer, Jan Gottschalk, and Anna Ivanova, "Germany: Fiscal Adjustment Attempts with and without Reforms," in *Chipping Away at Public Debt: Sources of Failure and Keys to Success in Fiscal Adjustment*, ed. Paolo Mauro (Hoboken, NJ: John Wiley & Sons, 2011), 85–115.

29. Ibid., 107.

30. The German consolidation also responded quickly to unanticipated challenges arising from the reforms. For instance, the government responded to the higher-than-expected cost of labor-market reforms by raising the Value Added Tax (VAT) rate, with part of the VAT collection going toward financing a reduction in the overall tax burden through a cut in unemployment contribution rates.

31. IMF's Fiscal Monitor, "Lessons from Sweden," *Taking Stock: A Progress Report on Fiscal Adjustment* (Washington, DC: IMF, October 2012), http://www.imf.org/external/pubs/ft/fm/2012/02/pdf/fm1202.pdf. The data mentioned come from the Organisation for Economic Co-operation and Development Stat Extracts, October 2012, http://stats.oecd.org/. See also Veronique de Rugy, "GDP Growth Rates: The Swedish Approach," Mercatus Center at George Mason University, May 16, 2012, http://mercatus.org/publication/gdp-growth-rates-swedish-approach.

The Swedish example raises the question of the appropriate role of monetary policy in successful fiscal adjustments. For instance, there is some evidence that at times exchange rate devaluation (induced by an accommodating monetary policy) can help to boost a country's exports as the country becomes more competitive and, as a result, can compensate for a previous slowdown in domestic demand.[32]

Economist Scott Sumner has made the case that the best way to get austerity and growth simultaneously is to increase "[nominal] GDP and budget surpluses—the Swedish way."[33] To be sure, monetary policy in Europe—or in the United States, for that matter—could increase the effectiveness of spending cuts and structural reforms (a little like the water you drink to help the medicine to go down). But it is a mistake to oversell it, and it certainly will not achieve our long-term goals without serious reductions in government spending. In particular, the devaluation of a country's currency is neither a necessary nor sufficient condition for success, as shown by Alesina and Ardagna.[34]

There is growing evidence, however, that private investment tends to react more positively to spending-based adjustments. The data from Alesina and Ardagna, and Alesina, Favero, and Giavazzi, for instance, show that private-sector capital accumulation increases after governments cut spending, which compensates for the reduction in aggregate demand due to the fiscal adjustments.[35]

The good news is that it is possible to design a fiscal adjustment that could both reduce the deficit and have a minimal or even, in some cases, positive impact on the economy. It requires austerity based mostly on spending cuts. This can be accomplished without hurting the least advantaged in society. As Alesina wrote in November 2012,

> But if we cut spending, do we necessarily hurt the poor? Not in such countries as Greece, Portugal, Spain, and Italy, whose public sectors are so inefficient and wasteful that they can certainly spend less without affecting basic services. Even in countries with better-functioning public sectors—such as France, where public spending is nearly 60 percent of GDP—there's a lot of room to economize without hurting the poorest and most vulnerable. And even in America, public spending is about 43 percent of GDP, a level common in Europe not long ago, and up from 34 percent in 2000.[36]

In other words, Western governments can save money and avoid inflicting injury on lower-income earners or the poor by improving the way welfare programs are targeted; scaling back programs such as Medicare that use taxes raised in part from the middle class to give public services right back to the middle class; and gradually raising the retirement age to 70. The same holds true for Social Security. What is more, lots of savings could be achieved by cutting subsidies going to businesses—which are often large, well-established, and politically connected firms, such as gas and oil companies, farms, automobile manufacturers, and banks.[37]

32. Alesina and Ardagna, "Design of Fiscal Adjustments." Also, the current devaluation debate surrounding the G20 "currency war" has been a prime example. See Jan Strupczewski, "G20 Currency Promises Unlikely to End Devaluation Debate," *Financial Post*, February 18, 2013, http://business.financialpost.com/2013/02/18/g20-currency-war-promises-unlikely-to-end-devaluation-debate/.

33. Scott Sumner, "Austerity and Stimulus in Northern Europe," *The Money Illusion*, May 17, 2012, http://www.themoneyillusion.com/?p=14381.

34. Alesina and Ardagna, "Design of Fiscal Adjustments."

35. Ibid.

36. Alberto Alesina, "The Kindest Cuts," *City Journal*, Autumn 2012, http://www.city-journal.org/2012/22_4_spending-cuts.html.

37. Matthew Mitchell, "The Pathology of Privilege: The Economic Consequences of Government Favoritism," (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 8, 2012), http://mercatus.org/publication/pathology-privilege-economic-consequences-government-favoritism.

CONCLUSION

Economists disagree a lot when it comes to fiscal policy. For instance, there is no consensus about the size of the spending multiplier or where on the Laffer curve most countries are situated. However, a consensus seems to have emerged recently that spending-based fiscal adjustments are not only more likely to reduce the debt-to-GDP ratio than tax-based ones but also less likely to trigger a recession. In fact, if accompanied by the right type of policies (especially changes to public employees' pay and public pension reforms), spending-based adjustments can actually be associated with economic growth.

Fortunately, successful fiscal adjustments are possible when based mostly on spending cuts and accompanied by policies that increase competiveness, as we have seen in the case of Germany, Finland, and other more recent examples, such as Estonia and Sweden. However, it is important to refrain from oversimplifying these results since fiscal adjustment packages are often complex and multiyear affairs. Also, many of the successful (i.e., expansionary and debt-to-GDP-reducing) fiscal adjustments in this literature are ones where the growth is export-led during times when the rest of the global economy is healthy or even booming. While there has been some recovery in the midst of the recession, we should recognize that it may be much harder today to achieve export-led growth when many countries are struggling.

The cost of well-designed adjustments plans will not be zero, but will be relatively low. Besides, it is not clear that the alternative to reducing spending is more economic growth. In fact, the alternative for certain countries could be a very messy debt crisis.

ABOUT THE AUTHOR

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Chairman MURRAY. Thank you very much.

Chairmen Camp and Ryan in the House have made rate reduction their number one priority in tax reform. They have set a goal of reducing the top individual and corporate tax rates by about one-third to 25 percent. Along with that rate reduction goal, they also are saying they are going to repeal the alternative minimum tax and the Affordable Care Act. All together, those policies would reduce tax revenues by more than $5.7 trillion.

Now, experts have told us that in order to keep this tax reform plan from increasing deficits, the tax base would have to be broadened to such an extent that the plan on net would actually cut taxes on millionaires and raise taxes on filers making less than $200,000. In other words, the wealthiest Americans would receive the lion's share of the benefits of lower tax rates while experiencing a proportionally smaller reduction in the current tax breaks, and the opposite would be true for our middle-class families.

Clearly, there is a tension between lowering tax rates, maintaining revenues, and pursuing the current levels of progressivity in the tax system. That is, of course, why the Senate budget was very clear that before we set out to lower tax rates, we would first make sure that tax reform generates the revenue that we need to reduce the deficit and invest in our economic future and maintains or increases the progressivity of the Tax Code.

So, Dr. Looney, let me start with you. You talked a little bit about this, but could you talk about the tension between lower tax rates, revenues, and progressivity?

Mr. LOONEY. Sure. Thank you very much. Thank you for that great question. It is a central question to evaluate and understand in these tax reform plans. And just to give you some context, we took a look at a tax reform plan that proposed cutting the top rate from 35 percent to 28 percent, retaining preferences for capital gains and dividends and other savings-related tax incentives. And we asked whether it is possible to achieve all the goals of tax reform, keeping a progressive tax system, maintaining tax revenues at a then historical level, and also cutting rates.

And what we found is that if we wanted to achieve the goals of revenues and lower rates and protecting preferences for savings and investment, then we would have to give up on another goal, for instance, having to enact a net tax cut on high-income taxpayers financed by tax increases on lower- and middle-income taxpayers.

Chairman MURRAY. Okay. Last week, the CBO released projections, and it showed that, absent any changes in law, revenues will average about 18.9 percent of GDP over the next 10 years. Our Republican colleagues have pointed to those estimates which show revenues rising above their 40- year average of about 18 percent of GDP to support the contention that additional revenue is now off the table. But this argument really ignores several key factors.

First of all, spending has not been below 18 percent of GDP since 1966, and, in fact, over the course of the last three Republican administrations, spending has averaged more than 21 percent of GDP. So if we are going to be realistic with ourselves, I think it is very clear that revenue levels must rise considerably above their historical average if we are ever going to balance the budget. And, also, the last five times we have had a balanced budget, revenues have ranged between 19.5 percent and 20.6 percent of GDP. That is significantly higher than CBO's recent projections. And I think, Mr. Linden, you mentioned the challenges we face today that are drastically different than 20, 30, 40 years ago with the baby-boom generation, and that is going to have a significant impact on our budgets here as well.

So, Mr. Linden, let me start with you. Do you agree with the Senate budget—and, actually, I think every bipartisan group that has examined the budget situation— that we cannot spend responsibly, address our long-term fiscal challenges with spending cuts alone?

Mr. LINDEN. Yes. Simply put, yes, I agree very much. One of the things that citing the historical average for revenues often misses is that for most of those years we ran deficits. So if we want to run smaller deficits or we want to even balance the budget, we cannot look at the historical average because we ran deficits during most of those years. And, in fact, if you look closely at those numbers, you will find that in the years when there were lower deficits or balanced budgets, as you pointed out, Chairman, we had higher-than-average revenues. So if we want fiscal sustainability to be a goal, the very data, the very historical data that opponents often point to, to say we cannot have more revenues, actually supports the contention that we will need higher revenues to have fiscal sustainability, because that is what we needed in the past. And as you pointed out, that was before the retirement of the baby-boom generation, and that was before health care costs have risen as much as they have.

Chairman MURRAY. Okay. Thank you very much, and I have run out of time. I want to make sure all of our Committee members have an opportunity to ask questions, so, Senator Sessions, I will turn to you.

Senator SESSIONS. Thank you. It is hard to figure all of that, but as revenues and the economy grows and people are making more money, they pay in at higher rates and in higher brackets than the percentage of GDP would tend to grow, it seems to me. It is hard to figure all these numbers.

Mr. Linden, I think you and others seem to believe that the income gap that is out there that is troubling is to be closed by just taking more money from those who are already paying higher taxes and just redistribute that to people who are not doing as well. And I believe the right approach is to figure out why it is that we are not having enough growth in the economy, create more growth, and allow the middle-class workers and others to find jobs at higher pay which be my fundamental analysis of how to get this economy going in the right direction.

Ms. de Rugy, critics have suggested that austerity in Europe has not worked. We hear that a lot. Their argument is that economies have cut spending and they have had slow growth. But it does seem to me, based on your testimony, we have a little bit of a different situation. You are saying that their spending cuts have been exaggerated in the media in the minds of most of us in public life in the United States and their tax increases have been underestimated and underappreciated. Would you tell us a little more about that?

Ms. de Rugy. Sure. Thank you, Senator, for this question. It has been one of the many frustrating things about the debate over austerity in Europe, is this misconception. Very often when people talk about austerity that took place in Europe, it is assumed that what took place is savage spending cuts. In fact, I mean, I use these words because these words have been used. But when you actually look at what many of the countries we talk about, even England, which has been talked about a lot, France, Italy, Spain, what you realize is that many of these—most of these countries have not certainly savagely cut spending. Some of them have not even cut spending. What has been often overlooked is the dramatic increase in taxes that all of these countries have implemented.

I have a list here for you, if you are interested—and I am happy to send it over—of many of these countries' tax increases. I guess one of the common denominators, Europe has seen a really large increase in the value-added tax, sometimes by 2 or 3 points. This is probably the main culprit of the problems in Europe. But there has been also a lot of increase in income tax in the form of higher marginal rates, taxes on capital, and this is often overlooked.

And what is happening in Europe actually is extremely consistent with what we have seen, what the academic research shows, and that is that first 80 percent of the studied attempt by countries to reduce their debt-to-GDP ratio are made mostly of tax increases, and these packages tend to fail not only at reducing the debt-to-GDP ratio but also at boosting growth.

Senator SESSIONS. So you say that 80 percent of their attempts at reducing deficit amounts to the tax increases and only 20 percent to spending cuts?

Ms. de Rugy. Yes, and so the successful—this is where the data comes from, looking at what are the countries who have successfully reduced their debt-to-GDP ratio have done. And when you look at the kind of things they have done, you realize that they have adopted packages that are mostly made of spending cuts. And the ones that have failed have actually mostly adopted debt reduction packages that are made of tax increases.

Senator SESSIONS. Can you give us an example of—

Ms. de Rugy. Well, I guess we do not have to look very far or very—back in time. We can actually look at Canada. In the 1990s, the Canadian Government was facing a debt-to-GDP ratio that was very close to ours. It was 69 percent. And in the course of the last 10 years, it adopted a large amount of spending cuts, not cuts to the growth of spending but actual reduction in spending, meaning that their government was spending less tomorrow than they spent the year before, and adopted the type of fundamental tax reform that we are talking here, closing loopholes and—and what has happened is a dramatic reduction in debt-to-GDP ratio from 69 percent to 29 percent, and without slowing down of their rate of growth and without increasing unemployment. That is one of the models that I can think about. We can look at Germany in the 2000s and Sweden—

Senator SESSIONS. Please explain.

Ms. de Rugy. Germany implemented large reform of their structural transfers and large reform of their labor market. They cut spending. And I think economists mostly agree that these reforms that were implemented in 2004 and 2005—and, by the way, they also reduced marginal tax rates—were responsible for the way actually that Germany sustained itself economically and with much lower unemployment rates than other European countries during the financial crisis.

Senator SESSIONS. Well, thank you. Thank you very much, and obviously you suggest the choice of reducing deficit between cutting spending and raising taxes, the better choice is to reduce spending.

Chairman MURRAY. Thank you.

Senator Kaine?

Senator KAINE. Thank you, Madam Chair. Good to be together with you. I will try to be quick. I would like each of your opinion on whether widening income inequality hurts economic growth. Can I just go in order?

Mr. LINDEN. I guess that puts me first. I think it does. I think not in every case and not in every situation, but that the levels that we have seen in the United States over the last 30 years, there are reasons to be concerned. More and more of the academic research has been showing that income inequality can be a drag on growth for a number of reasons, including it reduces trust in public institutions; it hurts human capital development. And, of course, as I mentioned in my testimony, the middle class is the very important source of stable demand for goods and services.

Senator KAINE. Dr. Looney?

Mr. LOONEY. Thank you. So I think that you are right to be concerned about that issue. Another perspective on that is just that if you look at the forces behind widening income inequality, they arise from things like globalization, technological change, you know, the fact that the United States participates in a very vigorous form of capitalism. And I think the Tax Code is a way that protects our citizens from the downsides of that, ensures that in some sense we are all in it together, and allows for those who are not as fortunate in the turmoil of the economy to still participate and to get ahead.

Senator KAINE. Dr. de Rugy?

Ms. de Rugy. Senator, this is not my area of expertise, but one of the things that I think we should focus on is more income mobility. I think income mobility is what makes this country great. This is living the American Dream.

The good news is actually research by one of your colleagues, Scott Winship at the Brookings Institution, has shown that income mobility is doing better than we think. But there is some work to be done for lower-income men in America, and this is something we should focus on.

Senator KAINE. I completely agree on the income mobility, but do you not have an opinion about whether widening—

Ms. de Rugy. You know, this is really not my area of expertise.

Senator KAINE. —income inequality inhibits growth?

Ms. de Rugy. I could not—

Senator KAINE. Next question. Dr. de Rugy's testimony I think lays it out pretty plainly. Debt reduction can be achieved by cutting spending or by raising taxes or by adopting a mix of spending cuts and tax increases. To each of the three, cut spending, raise taxes, or a mixture? And I would love it if you could just answer in a sentence.

Mr. LINDEN. I will answer in a word. Mixture is the right way.

Senator KAINE. Dr. Looney?

Mr. LOONEY. I would say a mixture as well.

Senator KAINE. Dr. de Rugy?

Ms. de Rugy. Well, I think the mixture usually does not work because one of the forces that are at play is—

Senator KAINE. So, I mean, but you—so you think no mixture, just cut taxes?

Ms. de Rugy. No, I think that what the data shows is roughly 85 percent—and obviously it is not an exact game, but what they show is that successful fiscal adjustment ended up being roughly 85 percent of spending cuts and the rest in tax revenue, not necessarily—the tax revenue could have been the product of increasing growth. For instance, take Canada—

Senator KAINE. But can I just—

Ms. de Rugy. Canada implemented a package—

Senator KAINE. Do you have an opinion, just on the three answers—cut spending, raise taxes, a mixture? If you could just answer one of those three, what is your preferred approach to reducing the deficit?

Ms. de Rugy. Cutting spending.

Senator KAINE. Okay. You have an example—you mentioned Germany and Sweden. Do you know what their top marginal tax rates are?

Ms. de Rugy. They are much higher than ours.

Senator KAINE. 47 percent in Germany and 56 percent in Sweden, and those are the examples that you used.

The last thing I will ask is this: With respect to tax policy—

Ms. de Rugy. Europeans are very regressive taxes overall compared to the U.S. in spite of their high marginal tax rates.

Senator KAINE. Indeed, and they are held as an example. And the last one, on the effective tax policy, does it make a difference if you are trying to get additional revenue whether you raise rates or reduce tax expenditures?

Ms. de Rugy. Yes, it does make a difference.

Senator KAINE. And what is the preferred way to do it?

Ms. de Rugy. The better way is to close loopholes.

Senator KAINE. Great. Thank you, Madam Chair.

Chairman MURRAY. Senator Grassley?

Senator GRASSLEY. Dr. de Rugy, during the budget hearings in March on tax expenditures, I asked the Democrat witness, Professor Edward Kleinbard, about tax reform. I asked if corporate rates should be reduced if we eliminate corporate tax expenditures. He replied that revenue from closing business tax expenditures and loopholes should be used to pay down the corporate rate.

Do you agree with Professor Kleinbard that increased revenue from corporate tax rates should be used to lower corporate tax rates? And, second, what do you think the economic impact would be of eliminating tax expenditures to support more Government spending?

Ms. de Rugy. So the corporate income tax in the U.S. is extremely punishing. The U.S. is one of the highest corporate income tax rates in the OECD countries, but also has a worldwide tax system, which means that companies competing with foreign companies abroad, they are subjected to a much more punishing system. So any reform that would lower the rates of the corporate income tax would be a welcome move for the U.S.

I would welcome making the Tax Code fairer and simpler and having a more unified base, but certainly not if the revenues is meant to go to pay for more spending. If we are talking about reducing the debt, that would be something, except that history tells us that this is rarely the way additional revenues are used.

Senator GRASSLEY. Again to you, under current law CBO projects that tax revenue will exceed the 40-year average of 17.9 percent of GDP in 2014 and remain near 19 percent of GDP through 2023. At the same time, spending is expected to grow, reaching 22.6 percent of GDP in 2023, well above the historical average of 21 percent.

This may seem like a simple question, but don't these CBO projections indicate that spending is the problem and will become an even bigger problem at the end of the 10-year window? Further, if we increase taxes by $975 billion, as the Senate budget would do through tax reform to support this level of spending, how will that affect economic and job growth?

Ms. de Rugy. Well, I think you are totally right that we have a spending problem, and we have an even bigger spending problem going forward if you look at CBO projection, and the driver of spending and, hence, of our future debt are program like Social Security, Medicare, and Medicaid.

As to the question of whether we could be raising much more revenue, it is hard to tell because we have not actually done in a sustained way raised much more significant—we have not raised 21 percent of taxes, tax revenue as a share of GDP in a sustained way. We have not done it under the current tax regime.

I would argue that it is probably because when marginal rates are increased, people find ways around it, but also in important ways because Congress has a tendency when it raises taxes to also carve the tax base. I mean, I think we have seen it in the fiscal tax deal where Congress proceeded to increase marginal tax rates but also to give a lot of—to extend a lot of the tax extenders to corporate businesses. So I think that is a problem.

And as I have said, I think the academic literature is very clear. There is a strong support for evidence that shows that lower level of taxes are associated with higher level of growth, and the reverse is true.

Senator GRASSLEY. Okay. Now, let us go back to Europe. You spoke about that. I want to zero in on a couple countries. You have done a lot of work studying the impact of taxes there and economic growth there. Many of my colleagues use the economic turmoil in Greece and Spain as a reason to support increased spending and tax hikes to address our own sluggish economic growth and our growing debt. The austerity measures enacted by Greece and Spain differ greatly from the measures enacted by Germany and Estonia and have had much different results.

So, to you, what can we learn from comparing the fiscal plans of Estonia and Germany with those of Greece, Spain, and Italy?

Ms. de Rugy. Well, I think these two sets of countries are very representative of what the overall literature shows. In the case of Greece and Spain, both of which have implemented some small level of government spending reductions, they have also implemented really large and often overlooked—I mean, one of the things that really surprises me, Keynesian economists in this country should be screaming loud and be very displeased with what these countries are doing by raising taxes because it actually goes against Keynesian policy. They have increased taxes tremendously, and, hence, we should not be surprised that their economy are not growing.

On the other hand, Estonia, and Germany before it, Estonians have actually cut spending. They have also implemented some fundamental tax reforms. They have refrained, and so has Sweden, in using spending as a form— as a tool to stimulate the economy. And so I think they should be our model rather than Spain and—

Senator GRASSLEY. Thank you. Thank you.

Chairman MURRAY. Senator King?

Senator KING. Dr. de Rugy, this is your lucky day because Senator Sanders is not here.

[Laughter.]

Senator KING. So I may channel him a bit. You mentioned that Germany lowered their taxes. From what to what?

Ms. de Rugy. I cannot remember now, but I would be happy to send you the data.

Senator KING. But it was somewhere in the 50s to the high 40s?

Ms. de Rugy. Yes.

Senator KING. Okay. And our top rate is now at least 10 points below that. Is that correct?

Ms. de Rugy. Yes.

Senator KING. Okay. You also mentioned that Canada had an overall budget package. What did that consist of, roughly, in terms of cuts versus—

Ms. de Rugy. $8 in spending cuts for $1 in revenue increases.

Senator KING. Okay. So that was the overall package that they—

Ms. de Rugy. Over time.

Senator KING. You mentioned that we have a spending problem, and it was interesting, in the next phrase you mentioned Social Security, Medicare, and Medicaid. I would argue we do not have a spending problem; we have a health care problem. We have a health care cost problem, because all of the growth in the Federal budget over the next 20 years that is based on all the projections I have seen is based on growth in health care costs. And the Federal Government is a big consumer of health care and, therefore, it affects the budget.

I am afraid that this whole discussion is—we are talking about growth in Federal spending, and we are hitting the wrong target, because the growth in Federal spending is not Pell grants or National Park guides or even food stamps. It is health care costs. And if we cut all those other areas and do not do something about the overall health care expenditure, we are never going to solve this problem.

Would you agree in general with that proposition?

Ms. de Rugy. Yes, you have no debate with me. I think it is important to put this country on a sustainable fiscal path that we address the explosion in spending, in particular in Medicare spending.

Senator KING. Would it surprise you to know that non-defense discretionary spending is now at the lowest percentage of GDP in 50 years?

Ms. de Rugy. No, and it probably as a share of the budget is going to go down because of our increased interest payment and the increased spending on mandatory programs is going to lead to a smaller share of these programs.

Senator KING. It seems to me that a way to discuss this is to try to identify what is the sweet spot in terms of percentage of GDP for both revenues and expenditures. Is it 17.5 percent, 18, 19? In terms of the economic effect, is there any data that shows that, for example, 19 percent is better than 18 percent? Because here is the problem: We are facing a demographic explosion, aging, it is just going to happen, plus the cost of health care. Those two things, it seems to me, make it very hard to say we should maintain ourselves at 17 or 18 percent if, in fact, everything else is flat, those two things are going up, and we have no choice but to either cope with them or cut everything else essentially almost to zero.

Ms. de Rugy. I mean, I think what you are saying is correct. I think we should not be starting with a certain percentage that we are trying to achieve. One of the things that we need to do is to address the cause of the explosion of spending, which will drive our future debt. But, I mean, it is very hard to pinpoint first the moment where the country has gone too far and there is very little we can do. And in the same way, it is very hard for me, or I suspect any other economist, to tell you what is the exact level of equilibrium that you should be reaching. For instance, there may be instances where actually deficits are fine at a certain level. But I am not the—I cannot tell you this. There are so many factors that I cannot be the one telling you which level is exactly the appropriate one.

Senator KING. Well, I would agree with you that the real thing—we should be focusing on what is causing the deficit problem, which is health care. Demographics we cannot do much about. Health care we can do something about. My concern is that by using this explosion of Federal expenditures based on health care to cut things like defense and nondefense discretionary spending is like attacking Brazil after Pearl Harbor. We are going at the wrong target.

Ms. de Rugy. Well, one of the things that is interesting, actually, looking at the successful fiscal adjustment packages and looking at what they have actually cut, one of the things that you find is that these countries have engaged in more structural reforms. They have reformed their transfer payments. That is, in the American context, entitlement. And this is the thing I agree with you we should be focusing on. And one of the reasons is because if we do not, for those of you who care about the lowest-income people in America, they are the one who are going to be the most penalized when the crisis hit.

Senator KING. I realize I am almost out of time, but my only disagreement with that would be if we only focus on the entitlement Medicare, then all we are going to do is shift the growing health care cost to somebody else, either seniors or States or somebody else. We really have to be talking about health care generally so it goes down for everyone—corporations, individuals, Medicare or Medicaid. Because if we only focus on, you know, we are going to send Medicaid back to the States, block grant it, all you are really doing there is saying, okay, the excessive cost of health care growth is going to be picked up by the States.

It has to be a broad conversation about the whole subject, it seems to me.

Ms. de Rugy. You are right that we should be addressing not only Medicare but Medicaid and Social Security, and everything ought to be on the table, including defense spending.

Senator KING. No, no, no. You are missing my point. We should be talking about health care spending generally for everybody, not just those programs you mentioned.

Ms. de Rugy. I think what the Government can only concern itself with is the part of its budget that it spends on health—that itself spends.

Senator KING. Well, that is another discussion.

Thank you, Madam Chairman.

Chairman MURRAY. Senator Portman?

Senator PORTMAN. Thank you, Madam Chair.

I would say to my colleague from Maine that, at the risk of getting him in trouble, it sounded like he was channeling Tom Coburn more than Bernie Sanders.

Senator KING. I will accept that.

[Laughter.]

Senator PORTMAN. Focusing on health care. I think you made a really good point that if we do not get our health care costs under control, it is unlikely that our fiscal condition can be saved. And it is because of the Federal connection, of course, with Medicare and Medicaid, but those reflect, if you look at the data, broadly speaking, the increasing costs in health care being the biggest payer.

This is a hearing on tax reform, and I appreciate the testimony from all of you about the fact that we need tax reform. I think that should be stipulated. Each of you said that, and I think all of you think we should broaden the base. Some of you think we should lower the rate more. Some of you think we should not. But since we are talking about percent of GDP and, you know, what ought to be the right level of revenue and what ought to be the right level of spending, and it was just talked about in terms of is it 18 or 19 percent, let me ask a question, if I could, of you, Dr. Looney, to give Dr. de Rugy a little break, and that is with regard to really the question that Senator King raised, you know, what is the right level.

Here is where we are now. We have a projection from the Congressional Budget Office, as you know, showing that our revenue as a percent of GDP is up above the historic levels. Within a couple years, they say by 2015, we will be at about 19 percent. The historic average, closer to 18 percent; 18.3 I think since World War

II is the average. So revenue as a percent of the economy is going up, relatively low now, relatively high in a couple years. And if the economy picks up more quickly, it will go up higher.

It is the spending that is obviously unsustainable, and I say that because they say that over the next three decades our spending goes from the 22-, 23-percent level up to 25, 30, 35, and in the third decade it gets to 39 percent. And that is where they sort of stop and say, you know, this is not sustainable, so we are just going to stop there.

So let us say 39 percent. So when you talk about a balanced approach with more revenue and more spending, what are you talking about? Are you talking about in a few decades from now a spending level based on current projections—which, by the way, has certain projections on health care I think that are even conservative compared to what we have seen over the last decade. But let us say 39 percent. You have revenue at 19 percent. Do you split the difference? Is that what balance means? Is it 29 percent? Or if you assume that there will be savings on interest on the debt because you have this higher revenue, maybe it is not 29 percent, maybe it is 27 percent, and if so, where do you find the revenue for that? Certainly our current income Tax Code could not provide it. We would have to look back historically, and there is no record of ever having raised these kind of taxes. We have to double your income tax rates, at least, probably triple them to get there, according to CBO.

So what does balance mean? And when people like me say we have to deal with the spending side and specifically the health care side, that is what we are looking at. So what is the right balance?

Mr. LOONEY. Well, thank you, Senator, a very interesting set of issues. When I was a grad student, I used to live large on $15,000 a year. Now that I have a wife and two kids and a mortgage, that just does not pay the bills and, you know, things change. And I think that in our budget, the thing that has changed is that we have an aging population and we have rising health care costs. And I think that that makes that historical comparison, which includes periods when we did not even have the Medicare program, where we had not enacted the Disability Insurance program. It is just not a perfect comparison to what we are facing in the future.

How much does that mean we should target for revenues versus spending? I think that is a broader and more challenging question, and I think there are tradeoffs involved there. I think it is probably true that we could support a higher level of revenues. At the same time, it is clear that the level of spending and the costs of health care are going to rise well beyond what we could sustain in the Tax Code or through the deficit. And so that has obviously got to be reined in as well.

Senator PORTMAN. Dr. Linden or Mr. Linden, any response?

Mr. LINDEN. I broadly agree with Dr. Looney. You know, I think the discussion has turned a little bit toward health care, which I think is appropriate, but there is some really good news on that front. Over the last two CBO projections, the costs of health care—the amount of money the Federal Government is projected to spend on Medicare and Medicaid has been reduced in the last two CBO outlooks by a combined $550 billion. To put that into perspective, that is more than twice as much as what you would get by raising the Medicare retirement age. And if that continues, a lot of the problems that we are talking about here will be much easier to solve. And I think that is an important trend that we should keep a close eye on. Obviously we do not know exactly how much of the recent slowdown in health care costs is because of the economy and how much is structural, although there have been some recent studies that suggest at least a substantial portion of it, if not all of it, is structural. So that is really good news. And I think that if we are talking about reducing spending, which we should be, as well as raising revenues, that is where we should be focusing on. What are we doing right in health care that is bringing down the growth in health care costs? And how can we improve on that? I think that is the place where we should be focusing in addition to raising a little bit more revenue.

Senator PORTMAN. My time has expired, but you are right, we have seen some reduction in the projections. We are still above inflation, of course, and we still are, based on all the projections, at an unsustainable level. And I appreciate both your responding to it honestly saying that we need to reduce that spending level. But you believe we can sustain higher taxes, and I would just suggest that the statement that spending is the problem is an objective statement if you look at it as a percent of GDP. If you assume that we need to spend more because you think health care costs cannot be contained, then I guess you have a different answer.

Thank you, Madam Chair.

Chairman MURRAY. Thank you.

Senator Whitehouse?

Senator WHITEHOUSE. Thank you, Chairman, and I am delighted that this discussion has turned to the health care issue, and the one thing I would add to that before I turn to my questions is that there is plenty of objective evidence that there really are enormous savings that can come out of our health care system if we treat our health care cost problem as a health care system problem and not just look at the Medicare or Medicaid portions and starve those. All that means is that businesses and seniors have to pick up the slack. We have not solved the problem. We have just squeezed the balloon and forced the problem elsewhere. And when we are spending 18 percent of GDP on health care and the least efficient other industrialized country in the world is only spending 12 percent and getting better health care results for it, that is a pretty strong signal that this is an area where we should be able to work together in a bipartisan fashion to make health care better and less expensive across the board, for businesses, for seniors, for people on Medicaid, for everyone. So I am delighted that we have turned this way.

But let me ask a different question because we are here on tax reform, and I think most of us are on board with the general notion, that our individual and corporate Tax Codes are riddled with nonsense; that people who have clout in Washington have been able to manipulate the Tax Codes to their advantage against the ordinary people; and that there is room to bring down the nominal top corporate rate of 35 percent, which virtually nobody pays because of all the loopholes—it is a Swiss cheese system.

But here is my question: Let us say that we want to bring the corporate tax rate down from 35 percent to 25 or 28 percent. And let us also say that there are wonderful companies like CVS in Rhode Island, headquartered in Woonsocket, Rhode Island, great national company, pays near the full 35 percent, like most big retail companies do. Then you have companies like Carnival Cruise Lines, which pays 0.8 percent tax rate, last time I checked. We just had a hearing on Apple, hiding immense revenues offshore, paying 0 percent on those revenues. GE famously on all of its earning has as a profit center its tax department and paid negative tax rates during very profitable years.

So should we also be looking at trying to get rid of these folks who are gaming the system and paying no tax whatsoever, or virtually no tax whatsoever, and try to, as we are bringing the top rate down, also try to improve—there is a nominal corporate AMT that raises virtually nothing. How do you bring the corporate tax rate up at the bottom so the true tax cheats, scofflaws, whatever you want to call them, who are paying nothing—not because they had a bad year but because they were playing games with the Tax Code. What is the best way to try to make sure that there is, I do not know, a 2-percent, 3-percent, 5-percent, 8-percent, some minimum that people are actually paying when they are truly profitable?

Mr. LOONEY. I will try to take a stab at that, Senator. Thank you.

Senator WHITEHOUSE. Do you, first of all, agree that that is a problem that is worth addressing, that if there are gimmicks in the Tax Code that are keeping entities from paying taxes, we should try to solve that and not just bring down the top rate?

Mr. LOONEY. I agree. I think that is one of the biggest sources of inefficiency in the corporate code, the fact that there are some companies—you mentioned CVS, but it is clear that there is a distribution of tax rates that apply to different companies, domestic retailers that cannot benefit from things like international provisions offshore and cannot benefit from things like accelerated depreciation because they are not a capital-intensive business, cannot benefit from other things. They get a raw deal, in effect, in comparison with industries that can take advantage of them. And that is not just unfair in some sense. That is bad economic policy because it distorts the way the economy grows, and it suggests that—

Senator WHITEHOUSE. There is no economic rationale to having CVS, a prominent drug store chain, pay a 50 times higher tax rate than Carnival Cruise lines, correct?

Mr. LOONEY. Yes. And more than that, it basically says to businesses that we should have more Carnival Cruise Lines and fewer CVSes, and it is not really clear that the Government should be in the business of—

Senator WHITEHOUSE. And it also says to the businesses, you should put more of your money not into productive activity but into more accountants and more lawyers to play games with the system and to restructure yourself through corporate mechanisms rather than engage in productive work, because there is a huge reward for that. Correct?

Mr. LOONEY. There is a huge reward right now for engaging in a lot of these avoidance schemes.

Senator WHITEHOUSE. Thank you.

Chairman MURRAY. Senator Johnson?

Senator JOHNSON. Thank you, Madam Chair.

I will answer both your questions. The way we start controlling health care costs is we reconnect the consumer of the product with the payment of the product. If you take a look at history, what really happened in terms of rising health care costs—

Senator WHITEHOUSE. Good luck with the unconscious consumer.

Senator JOHNSON. Well, what really happened in terms of rising health care costs is the third-party payer system, whether it is through rising insurance, first-dollar coverage as opposed to high-deductible plans, and then, of course, the Government involvement in it.

So you are right, Mr. Linden, that the—I believe what is restraining health care costs is the structural changes, and that was occurring prior to the passage of the health care law as the evolving of growth of HSAs did reconnect the consumer of the product with the payment of the product. And as a result, companies like CVS, Walgreens, and Walmart responded to the marketplace, and they opened up walk-in clinics where you could get, for example, a child's ear infection checked out by a nurse practitioner for $35 rather than an emergency room for a couple hundred bucks. So the marketplace is a marvel that actually works.

In terms of, you know, how do we capture corporate income, I would suggest—I am glad that Senator Wyden is here—the way to do that is treat all corporate income as pass-through income. In other words, tax corporate income at the shareholder level. It works great for LLCs, Subchapter S's. We would not have to—I was part of that Apple hearing. You have real problems in terms of allocating a profit between different tax jurisdictions, so the way to do it just tax the income at the shareholder level like pass-through income, and I would love to work with Senator Wyden on that tax idea.

Mr. Linden, you mentioned 2007, an interesting year, because that was really the record in terms of the top 1 percent paying 40.4 percent of the income tax. That same year, the bottom 95 percent of taxpayers paid 39.6 percent. So a unique year, a record year. The top 1 percent's income was around 20 percent of total income. They paid double that in terms of the share of the income tax.

At what point do you actually start considering the top 1 percent as paying their fair share?

Mr. LINDEN. 2007 was a banner year for income inequality, which is why you saw such a huge share of the taxes being paid by the top 1 percent. They were making a huge share of the income. So when you allocate taxes based on income—we do not do a per head tax; we do it based on income, broadly speaking, with the income tax—you end up with those who have the most income paying the most in income taxes.

It is worth also pointing out—

Senator JOHNSON. So, again, you think it is fair for the top 1 percent—by the way, the top 1 percent is always going to have the larger share, no matter what it is, and there is some mobility. Do you think it is not fair that if they are making 20 percent of the income and they are paying 40 percent of the income tax, that is not fair enough yet for you?

Mr. LINDEN. I think it is interesting that you are ignoring payroll taxes and State and local taxes—

Senator JOHNSON. Well, we can take a look at that, too, but that also—

Mr. LINDEN. But if you put that all together, if the put the entire tax system together, the top 1 percent is actually—was not paying, is currently not paying much more a share of the taxes than the share of their income. It is actually pretty much in line. And, in fact, if you look at the very, very high, the very, very top, the system—you know, our overall system is actually progressive, you are right. It does take more from people—

Senator JOHNSON. Let me ask the question I generally ask people in this situation. What do you think is the top—what should be the top marginal tax rate?

Mr. LINDEN. Current top marginal rate is 39.6—

Senator JOHNSON. No. What do you think it should be?

Mr. LINDEN. —and I think that is a reasonable place for it to be. It certainly does not need to be any lower. I do not think it needs to go very much higher. I think the place where we should be looking for more revenue is in reducing these tax expenditures that do generally primarily benefit those at the top.

Senator JOHNSON. You know, Mr. Looney or Professor Looney, are you aware of the fact that in 63 years, regardless of the top marginal tax rate, regardless of how much we are trying to punish success, we have only raised revenue that exceeded 19 percent of GDP 13 times? Are you aware of that statistic?

Mr. LOONEY. I am.

Senator JOHNSON. What gives anybody any confidence that no matter what we try and do, try and extract more than, let us say, 19 percent out of the economy that we would have any success doing it?

Mr. LOONEY. I think we have had experiences where we have raised that much. I think if you look at the combination of Federal, State, and local, we have raised much more than—closer to 30 percent of GDP, and then, of course, an international comparison, we are actually very low. So I am not saying that those are comparisons that we necessarily want to make, but I do not think that there is— I think that those historical levels reflect political decisions and the democratic process rather than some real hard economic law.

Senator JOHNSON. Mr. Linden, you made an interesting comment when you were talking about why economic—or income disparity is so harmful to economic growth. You said one of the reasons is because it reduces trust in public institutions. I just have to ask you, why would increased trust in public institutions increase economic growth?

Mr. LINDEN. Well, public institutions I think have an important role to play, certainly not the only ones. I mean, the private sector obviously needs to be the ones who are driving economic growth. But certainly investment in public goods, things that most economists would tell you the public sector has the role to play—transportation, education, basic scientific research. These are things that before a few years ago were pretty commonly understood to be the role of the public sector. Now, we can debate the level that that should be played, but no matter what, we do expect the public sector to play some role in the economy, and we would like to trust the Government is doing so in a way that is not unfairly benefitting those at the very top.

Senator JOHNSON. Okay. Thank you.

Thank you, Madam Chair.

Chairman MURRAY. All right. Thank you.

The last questions go to Senator Wyden.

Senator WYDEN. Thank you, Madam Chair. I want to commend Senator Whitehouse on this point with respect to efficiency in the health care system. This is clearly an area where I think Democrats and Republicans can work together. You look, for example, at chronic care, which is responsible for 70 percent of the Medicare bill in this country, and it is so fragmented and so poorly coordinated. This ought to be an area where we can work together, and I want to work with the Senator. And I think the Senator from Wisconsin knows I am also interested in this idea of involving the consumer. Let us just make sure we do not put at risk the vulnerable and the low-income, and we will talk about that.

I want to ask about this issue of revenue, and Senator Murray is absolutely right on this point, that with $1 trillion of tax expenditures—and that is really the only way to describe them—they are spending. This is a place where clearly we ought to make some changes, and that will be beneficial to our country and to, I think, a more rationale set of priorities.

I want to ask about something else in the Tax Code, though, with respect to generating revenue, and you at Brookings and at CAP have helped me a lot on tax reform essentially all of the last decade. I think if you go back through your history, Rahm Emanuel and I introduced a bill where we could not even get a Republican on the bill. You all stayed with us, and others, and finally the former Ranking Member, Senator Gregg, worked with us for several years, and we were able to get that bill in.

One of the key features we picked up along the way is that central to reform and generating more revenue in a consumer-driven economy is the role of the middle class and the middle-class person, because that middle-class person, who right now is hard-pressed in terms of getting by, is the person who goes into the economy, makes a decision, for example, about remodeling their place, buys goods and services—it is the old Henry Ford argument. He wanted to do well, but for him to do well, his people had to be able to buy his cars, and those kinds of purchases helped our economy and helped us create a middle-class way of life in our country and helped Government and generated revenue and allowed us to fund our priorities.

In that regard, we have been able to get bipartisan support—bipartisan support—for the idea of tripling the standard deduction, which means in effect if you are making $60,000 in the economy today, we are putting off limits $30,000. Essentially we are putting $3,000, somewhere in that vicinity, of permanent tax relief into the pockets of the middle-class person.

Both of your organizations—and, ma'am, I have not had a chance to work with you in the past. I do not want you to feel that I am ignoring you just for any other reason. We have worked with these two organizations in the past. Talk a little bit about how expanding opportunities for middle-class people in an economy where the consumer is driving about 50 percent plus of economic activity can help us create jobs and generate the additional revenue, which our Chair, Senator Murray, has correctly identified as something we ought to focus on doing.

So either of you gentlemen, in particular, and I would be happy to have you add a thought as well, but your organizations, since you assisted us in the past, we will try to get your thoughts this afternoon.

Mr. LINDEN. Thank you, Senator. That is an excellent question, and I think it hits it right on the head, that if we want to see broader economic growth, we want to see faster economic growth, which will then generate more revenue, we have to focus on the middle class. That really is where the drivers for economic growth come from. And I mentioned in my testimony all the different ways the middle class is really integral to economic growth.

So when we consider tax reform, we should really think about ways in which we can make the code more efficient for the middle class and also for those who aspire to get into the middle class, people who are working to get into the middle class. How do we build those ladders up into the middle class and improve on economic mobility? Because I agree very much with my colleague that economic mobility is a very important factor here.

So the Center for American Progress, for example, put out a tax reform plan in December—

Senator WYDEN. A very good one.

Mr. LINDEN. Well, thank you very much. We had some impressive co-authors, including Bob Rubin and Larry Summers and John Podesta and Neera Tanden. And so that proposal included something similar. We proposed a very large standard credit—

Senator WYDEN. Right.

Mr. LINDEN. —to do something similar, which is remove a whole portion of income from people—from taxation. We prefer the credit system rather than the deduction system because deductions are by their nature upside down. They benefit those at the top more than people in the middle.

So things like that that move the system to consider middle-class needs I think is where we should go.

Senator WYDEN. Well said.

Mr. Looney?

Mr. LOONEY. Thank you, Senator. So you started your question with a discussion of tax expenditures, and I think that is a great place to start as well. That is an issue where, to paraphrase Martin Feldstein, if Republicans want to cut spending and Democrats want to include a mix of revenues and spending cuts, then tax expenditures are a great place to start. They are spending that occur through the Tax Code. There is a lot of them. There is opportunity to rein them in. And there are probably opportunities to do it in a way that simplifies the Tax Code, gets people off the—from filing complicated returns, just as raising the standard deduction would.

And so I think it is a very promising approach, and I hope we would pursue it.

Senator WYDEN. Very good.

Thank you, Madam Chair.

Chairman MURRAY. Thank you, and I want to thank all of our colleagues who participated today. I especially want to thank all of our witnesses for your excellent testimony today. And as I said at the outset of this hearing, there is much to improve in our very complicated and inefficient Tax Code, and I believe that our Senate budget does lay out a vision for tax reform that can reduce our deficits and strengthen the middle class and grow our economy in a broad-based and sustainable way.

I think today's hearing was a great step forward in furthering that discussion, so I really thank everybody for participating.

As a reminder to all of our colleagues, additional statements and questions for our witnesses from today's hearing are due in by noon tomorrow.

And with that I will call this hearing to a close. Thank you.

[Whereupon, at 4:05 p.m., the Committee was adjourned.]

Michael Linden's Responses to Questions for the Record

Question #1: We discussed to some length the experience of European countries that have recently implemented fiscal adjustments. Could you elaborate on the composition of those adjustments? To what extent did the governments rely on spending cuts and tax increases? How has the economy responded?

The deep recessions and high unemployment many European countries have experienced over the past few years should have led policymakers to combine smart reforms with temporary stimulus. Instead, European policymakers chose damaging austerity, implementing fiscal-consolidation packages that paired draconian spending cuts with smaller increases in regressive taxes. These policies have not solved Europe's fiscal problems, but they *have* magnified Europe's economic troubles, harmed vulnerable populations, and slashed investments in future economic growth.

Now that European austerity has been proven a failure, some advocates are claiming that Europe *hasn't really* cut spending; rather, tax increases are the true source of Europe's woes, and real spending cuts would be good medicine. This is absolutely false.

The Organisation for Economic Co-operation and Development has found that the average fiscal consolidation of its member countries from 2009 to 2015 has consisted of approximately two-thirds spending cuts to one-third tax increases.[1] Three of the largest fiscal adjustments that took place in Europe since the recent recession involved Portugal, Ireland, and Greece.[2] Each of these countries, as well as the United Kingdom, has slashed government spending. What has followed is continued or worsening unemployment and stagnant economic growth.

In Greece, where the dire economic conditions have been the most pronounced, the initial fiscal-adjustment package was comprised of a nearly 2-1 spending-cut-to-tax-increase ratio.[3] The spending reductions focused on cuts to government wages, pensions, and investments in infrastructure, education, and public health.[4] Cuts to government programs were so deep that by 2012, real government spending per person in Greece had fallen by more than 22 percent since 2009.

Even given these draconian cuts, government spending measured as a share of gross domestic product was actually higher in Greece in 2012 than it was in 2009. How could that be? How does a country cut real spending per capita by about 22 percent in four years and still end up with higher spending as a share of the total economy? It can happen if all those spending cuts send the economy into a tailspin. And that is precisely the trap that Greece finds itself in today. From 2009 to 2012 Greek GDP declined by more than 17 percent in real terms. Since the passage of the austerity package in 2010, the unemployment rate in Greece has nearly doubled, from 12.6 percent in 2010 to 24.3 percent in 2012.[5]

Ireland followed a similar path, with an austerity package composed of spending cuts and tax increases in a roughly 2-1 ratio: Ireland's original €15 billion fiscal adjustment called for €10 billion in reduced spending and €5 billion in tax increases.[6] €3 billion of the spending reduction called for came from decreased investments in infrastructure, with the other reductions coming from reduced pensions and welfare spending.[7] Ireland's economy continues to suffer, with unemployment rising from 13.9 percent to 14.7 percent from 2010 to 2012.[8] The story is the same in Portugal, where policymakers enacted large deficit-reduction packages consisting of more than €2 in spending cuts for every €1 of increased revenue from 2011 to 2013.[9] Unemployment in Portugal has risen from 12 percent in 2010 to 15.9 percent in 2012.[10]

The United Kingdom's damaging austerity package was even more tilted toward spending reductions, with 77 percent of the planned consolidation from 2010 to 2016 delivered through spending cuts.[11] Since the enactment of their austerity measures, the United Kingdom has been plunged back into recession, and seen its unemployment rate rise.[12]

It is worth noting that, while Europe's spending cuts have been *particularly* harmful, the specific tax increases enacted by European governments during this round of austerity were also misguided. Deficit reduction in general is a bad idea during an economic crisis, and European authorities compounded their mistake by focusing on large, damaging spending cuts while targeting what tax increases they passed at those citizens least able to pay. Greece increased its value-added tax, along with excise taxes on alcohol, tobacco, and gaming.[13] The United Kingdom and Ireland also used increases in the value-added tax to raise revenue in their fiscal consolidations.[14] These are taxes that fall heavily on the middle class and the poor, and directly constrain the spending power of those consumers whose demand for goods and services is the crucial driver of economic recovery.

We would not defend the revenue portion of European austerity packages; there should have been no austerity packages, let alone massive spending cuts coupled with regressive tax hikes. But any claim that Europe's problems are tax driven, or that the European experience somehow counsels against *long-term, progressive* tax reform in the United States, is disingenuous at best.

<u>Question #2:</u> Dr. de Rugy cited academic studies supporting deep spending cuts as a means to address the budget challenges we face. How does the fact that so many of the advanced economies are cutting back more or less at the same time impact the benefits anticipated by these academic studies? Can you further comment on the strengths and weaknesses of these studies? There was a suggestion that a consensus among academics exist. Do you agree?

The United States is still recovering from a deep recession. Cutting government spending when demand from the private sector cannot pick up the slack will result in lower growth and higher unemployment than would otherwise be the case. Both the claim that fiscal adjustments in a depressed economy will result in economic growth, and the claim that spending cuts are more economically advantageous than tax increases, have been completely disproved in the economic literature and in the real-world experience of the past five years. Dr. de Rugy's alleged "academic consensus" is nothing of the sort; it is an ideological conclusion drawn from a small set of deeply flawed and thoroughly debunked studies that are no longer taken seriously by most economists.

It has long been clear that an economic slump is not the time to balance budgets, and that contractionary fiscal policy results in lower economic growth following a recession.[15] At the beginning of the current crisis, Alberto Alesina and his co-authors began releasing studies that seemed to indicate otherwise. This man-bites-dog angle on fiscal austerity made a splash, and sadly became the basis—along with now-discredited work by Reinhart and Rogoff on the link between debt and growth—for Europe's misguided and deeply damaging austerity policies.

Alesina et al.'s work on "expansionary contraction" was quickly debunked. Independent analysts have torn apart the methodology and conclusions of these papers, demonstrating that Alesina's own data counsels *against* fiscal contraction during an economic slump.[16]

International Monetary Fund economists found that Alesina et al.'s work did not identify periods of fiscal contraction correctly, and correcting for those mistakes found that austerity led to lower growth and higher unemployment.[17] They found that "[a] fiscal consolidation equal to 1 percent of GDP typically reduces GDP by about 0.5 percent within two years and raises the unemployment rate by about 0.3 percentage point. Domestic demand—consumption and investment—falls by about 1 percent."[18] The IMF study further cautioned that the current environment is worse than usual for fiscal consolidation. Two factors that generally mitigate austerity's impact on economic growth, currency depreciation and lower policy-interest rates, are currently unavailable to the United States, where we are facing a global slump and near-zero interest rates.[19]

Furthermore, experts from the Roosevelt Institute found that the vast majority of the fiscal contractions that Alesina et al. point to as "successful" were undertaken during economic booms. In the 26 episodes of fiscal consolidation analyzed by Alesina et al., the countries attempting deficit reduction had an average growth rate of 4.1 percent of GDP in the year before their deficit-reduction packages were implemented.[20] Of the small handful of countries that substantially reduced their deficits as a share of GDP while their economies were struggling, most saw growth decline following their budget cutting. Again, the study that purported to show that austerity can help a struggling economy shows exactly the opposite: The boom and not the slump is the time for balancing budgets, and austerity during a downturn is associated with slower growth.

Once their initial claims had been disproved, austerity advocates changed their argument to specify that keeping taxes low while slashing spending is the key to economic growth; that it's not just any kind of austerity, it's spending-cut-driven austerity that matters. These claims too have been disproved in both the academic literature and the real world. In fact, economists have found that the negative cumulative fiscal multipliers are much *larger* for spending cuts than for tax increases, especially in the United States.[21] Austerity during a slump reduces growth, and spending cuts are substantially worse than tax increases.

Unfortunately, the fiscal consolidations undertaken by various European countries have provided a real-world experiment for U.S. policymakers to observe. The fiscal consolidation in Europe was primarily spending based, and has resulted in crippling unemployment. Greece, Ireland, Portugal, and the United Kingdom have all cut spending over the past few years, but unemployment has increased in each country. While the United States' fiscal policy has not expanded enough to spur rapid job growth, we have avoided the worst contractionary policy mistakes of Europe, and unemployment has slowly decreased from its recession peak.

The academic argument is settled—fiscal contraction, especially in the form of spending cuts, is incredibly damaging to weak economies—yet these misguided and misleading calls for austerity continue to surface. Each time, the claims are slightly different, or accompanied by more qualifiers, or based on a new set of questionable methodologies and data. Each time, they fall apart under closer scrutiny.

There are those who believe that the solution to every problem, at every time, is tax cuts for the wealthy and spending cuts for everyone else. That philosophy has failed time and again, in country after country. In reality, economic growth does not trickle down from the wealthy few—it comes from the middle out. In the near term, policymakers should focus on ending the current economic crisis. In the longer term, comprehensive tax reform can increase growth and shared prosperity if it makes the tax code fairer for the middle class, simpler for the middle class, and more able to raise the revenue needed to invest in the middle class.

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[20] Jayadev and Konczal, "The Boom Not The Slump: The Right Time For Austerity."

[21] Baum, Poplawski-Ribeiro, and Weber, "Fiscal Multipliers and the State of the Economy."

BROOKINGS

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Economic Studies

Chairman Patty Murray
United States Senate

Re: Question for the record, "Supporting Broad-Based Economic Growth and Fiscal Responsibility through Tax Reform

Dear Chairman Murray,

Thank you for your very important questions regarding the budget challenges we face and whether there is a consensus among academics how best to address them.

If there is an area of consensus among economists about how best to address our long-run deficit problem it is about *when* to reduce the deficit: enact credible deficit reduction now but implement those budget cuts in the future when the economy has returned to full employment and interest rates have returned to more normal levels. According to the Congressional Budget Office (CBO), the deficit reduction policies taking effect this year will slow the pace of economic growth by roughly 1-1/2 percentage points this year—slowing the economic recovery and swelling the ranks of the unemployed. Deferring these deficit reduction policies a year or two into the future would provide for a more rapid improvement in the job market while still achieving roughly the same budget goals.

An additional area of consensus is that, despite the deficit reduction enacted in the near term, much more needs to be done to address the nation's longer-term fiscal imbalances. According to the CBO, in a few years the federal deficit will begin rising sharply again, largely as a result of the aging of the population and rising healthcare costs. Addressing these longer-term pressures will require not just reductions in the growth of healthcare spending, but also additional revenues if services for current retirees and Americans nearing retirement are to be maintained.

Finally, regarding how best to achieve lasting deficit reduction, there is not a consensus that deep spending cuts are the appropriate means to address our budget challenges. In particular, the American record suggests that most lasting deficit-reducing deals included a balanced approach, including reductions in spending and increases in revenues. Salient examples include the 1983 Social Security Amendments, which both improved protections for the most disadvantaged retirees and their families and improved the program's long-term solvency, or OBRA 1990 and 1993, which helped set the country on a path to budget surplus by the end of the 1990s. Each of these changes involved a mix of spending cuts and revenue increases and produced long-lasting deficit reduction.

Thank you for your interest. I would be pleased to discuss these matters further.

Sincerely,

Adam Looney

THE FISCAL AND ECONOMIC EFFECTS OF AUSTERITY

TUESDAY, JUNE 4, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:32 a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, chairman of the committee, presiding.

Present: Senators Murray, Wyden, Nelson, Whitehouse, Baldwin, King, Sessions, Grassley, and Johnson.

Staff Present: Evan T. Schatz, Majority Staff Director; and Marcus Peacock, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. This hearing will come to order.

But before we begin, I just want to take a moment to remember Senator Frank Lautenberg. He was a very passionate public servant who was not afraid to fight and vote for what he believed in, and I think it is important to note this morning that he was Ranking Member of this committee from 1997 to 2000 and helped negotiate the Balanced Budget Act of 1997, which produced the first balanced budget in decades. Frank made tax relief and support for middle-class families a priority constantly, and he promoted a responsible approach to our deficit and budget challenges.

Frank was somebody who gave everything he had to public service, and those who served with him know that that is what gave him satisfaction constantly. He will be missed by all of us, all of us on this committee in particular, and I think I join with all of my colleagues in letting his family know he is in our thoughts and prayers.

Senator SESSIONS. Madam Chairman, thank you for making reference to our friend, Frank Lautenberg. He was a great Senator, a good friend. I really liked him. He understood, of course, as a highly accomplished businessman, he understood the economy and how the system worked in an extraordinary way.

And a lot of people might not know that he landed on D- Day. I used to say that he would correct it every time because he landed about three weeks after the Normandy invasion and he did not want to claim that he was there at the beginning, but he was there, and the last, I guess, surviving World War II veteran that we had.

So a real patriot, a man of great accomplishment, and thank you for making reference to his fine service.

Chairman MURRAY. Thank you very much.

With that, let me thank my ranking member, Senator Sessions, all of our colleagues who are joining us here today, and all the members of the public who are here and watching online.

I want to begin by thanking our witnesses, Larry Summers, former Treasury Secretary under President Clinton and NEC Director under President Obama, and now Charles W. Eliot Professor at Harvard University.

We also have Simon Johnson, Ronald A. Kurtz Professor of Entrepreneurship at MIT Sloan School of Management and a Senior Fellow at the Peterson Institute for International Economics.

And we have Salim Furth, who is a Senior Policy Analyst for Macroeconomics at the Heritage Foundation.

I really appreciate all of you coming today and sharing your expertise.

The topic of today's hearing is "The Fiscal and Economic Effects of Austerity." This is a subject that has received a lot of attention recently, and it is important for those of us here on the Budget Committee to understand it as we work with our colleagues across the Senate to negotiate a budget deal between the House and Senate, replace sequestration, write and pass spending bills for the next year, and make sure we are making the investments we need in jobs and long-term economic growth.

I have long believed that the case for austerity during times of economic weakness has been fundamentally flawed. When demand falls off in the private sector and millions of workers are losing their jobs, I think the last thing government should do is make things worse by slashing spending and causing aggregate demand to drop even further. When the economy is struggling, government should act to make things better for the middle class and most families by investing in jobs and economic growth that not only boost demand in the short term, but also lays down a strong foundation for long-term and broad-based growth for years to come.

That was the theory behind the Senate budget we passed that put jobs and the economy first. It is one shared by the vast majority of economists across the political spectrum. and it is one of the many reasons I believe the House budget is wrong for our country and our economy.

In recent weeks, however, it has been made clearer than ever that the case for short-term austerity is not just the wrong way to go, it is flat out wrong. A very specific claim in an academic paper cited frequently by many of my Republican colleagues on this committee to make the case for short-term austerity was found to be flawed, and recent changes in deficit projections have made it clear that despite the claims of some of my colleagues, there is no short-term debt or deficit crisis.

We have serious long-term deficit and debt challenges that we need to tackle. We certainly do not want to leave our children and grandchildren with an unmanageable pile of our bills. But we have made significant progress recently when it comes to our short- and medium-term deficits. And now the focus should be on creating jobs, preserving our fragile recovery, long-term deficit reduction, and setting the conditions for economic growth built from the middle out.

Since the Simpson-Bowles Commission's report in 2010, we have worked to reduce the deficit by $2.4 trillion, disproportionately through spending cuts, and to be clear, that $2.4 trillion is the amount of deficit reduction before counting the $1.2 trillion in savings that will come from either sequestration or, as proposed and passed by this committee and the Senate in March, an alternative approach that replaces the damaging automatic cuts with a responsible and balanced mix of spending cuts and new revenue.

A few weeks ago, the Congressional Budget Office released its latest baseline, which gave us an updated view on our debt and deficits. These revisions show we have made more progress on reducing our short- and medium-term deficits than we had thought. CBO now estimates that the deficit for 2013 will be over $200 billion less than its February projection. This means that in the two years from 2011 to 2013, CBO expects the deficit will have been cut in half.

That is welcome news. And again, it makes clearer than ever that now we need to focus, above all else, on our fragile economic recovery and that the case for austerity in a time of economic weakness is simply wrong.

History has shown us that austerity is not the right way to boost economic growth in the short term, especially during times when the economy is still recovering, as it is right now. Our experience as a country following the Great Depression in the 1930s showed us how turning to austerity too quickly can have serious consequences for economic recovery after a time of crisis, and Europe's recent adoption of austerity policies has yielded similarly negative results. Countries across Europe have experienced economic downturns that have exacerbated or been prolonged by austerity policies.

Right now, we are seeing how the indiscriminate and irresponsible cuts from sequestration are hurting our economy. When I was back home in my home State of Washington last week, I heard story after story after story about the impact they are having on families and communities.

I met with a man named Elliot Gregg in Kitsap County in my State who runs the Kitsap Credit Union. Elliot's credit union has been part of that community for decades, and it has grown with the thousands of Navy families who call Kitsap home. Even though sequestration has been just in effect for a few months, he is seeing dramatic impacts. Families hoping to buy their first home or purchase a car are telling him, with furloughs and layoffs looming, they cannot take out loans they might not be able to pay back. They do not understand why Congress would continue along the path of deep and indiscriminate cuts, and frankly, I do not, either.

During this time when our economic recovery is real but remains fragile, experts agree we should be instead investing in job creation and economic growth and continuing on the path to austerity right now would weaken our economy and do serious damage to job creation and growth.

Not only is austerity bad for short-term economic growth, but it also hurts our ability to lay down a foundation for long-term broad-based growth and prosperity. As a country, we have to continue to invest in the programs we need to compete globally in the 21st century economy, the kinds of investments that make our country stronger.

In fact, the bipartisan Simpson-Bowles Commission highlighted the importance of, and I quote, “investing in education, infrastructure, and high-value research and development to help our economy grow, keep us globally competitive, and make it easier for businesses to create jobs.” Investing in infrastructure, like roads and bridges, creates jobs today, but it also makes our families safer and lays down a strong foundation for long-term economic growth.

I, in fact, saw this firsthand at home in my home State, where on Friday a week ago, I saw the devastation that was caused by an entire section of Interstate 5 which collapsed into the Skagit River. This is the kind of disaster that we can expect when our roads and bridges have outdated designs or fall into disrepair and it should certainly be a wake-up call that we need to invest in repairing our crumbling roads, bridges, and highways. And, by the way, that is not just having an effect on the highways. It is having an effect on every business surrounding there, where they have seen a tremendous loss of business because of the collapse of this bridge.

Thankfully, by the way, no one was seriously injured. We are beginning work on a temporary and a long-term repair, but our families have been seriously disrupted by this and it is really a wake-up call to all of us about what we need to be focusing on.

By strengthening our transportation systems, we are helping to connect people across town and across the country, and this will create a more productive environment for American businesses to grow over the long term.

Now, the same is true for our investments in people and schools. Investment in education through programs like Pell Grants and worker training are some of the smartest the Federal Government can make to boost our economy in the long term. If our businesses are going to be creating 21st century jobs, we need our students and workers to have 21st century skills. And in order to maintain our edge in innovation, we need to keep investing in research and development. These types of investments have led to private sector growth and they have led to new industries and new drugs and new inventions and new jobs.

If we fail to maintain these important investments, we could lose our position as a global leader in research and technology. But taking the path of austerity would cut these national investments in infrastructure and education and research that help make sure we leave our children a stronger country than the one we received. And it would weaken our economy in the short and long term.

Now, this debate can sometimes seem academic, but it has very real implications on policy decisions that we make here in Congress. I am extremely frustrated that some Republicans here in the Senate are blocking us from moving to a bipartisan budget conference where we could work together to move away from the constant lurching from crisis to crisis and get back to regular order my Republican colleagues have claimed they wanted. But even though we do not yet have a budget agreement, over the next few weeks, our Appropriations Committees are now beginning to make some key decisions about our discretionary spending for fiscal year 2014 and they are going to face this choice between a path of austerity or an approach that maintains critical investments in our families and communities.

Senate Democrats believe the path of austerity that long-term cuts from sequestration lead toward is not the right direction for our country. That is why we are going to continue to work to replace sequestration with a balanced mix of responsible spending cuts and revenue from those who can afford it the most, and that is why the Senate Appropriations Committee, led by Chairwoman Mikulski, will maintain a $1.058 trillion cap during this process, the amount of discretionary spending that we agreed upon in the bipartisan Budget Control Act.

House Republicans, on the other hand, will be writing their spending bills at the overall level that assumes sequestration will continue, $967 billion. And to be clear, House Republicans are not keeping to the bipartisan Budget Control Act. They are violating it by shifting funds from non-defense programs in order to keep defense spending at pre-sequestration levels.

We all know sequestration was never intended to be implemented, so we should be focused on replacing it, not trying to make an unworkable policy just a bit less bad. The difference between $1.058 trillion and $967 billion may seem abstract, but we are going to continue to see the very real impact that spending cuts and sequestration are having on our veterans, our students, our seniors, and our families, not just today, not just tomorrow, but for years and years to come.

Already, House Republicans are recognizing the impact this approach has on our ability to maintain important national investments. Their own budget places severe restrictions on spending levels for critical programs like our national defense, education, and health care spending, and so they are taking funding from some parts of the budget to pay for others. Robbing Peter to pay Paul is not the right way to set our priorities as a nation. It is a gimmick, and as we will see over the next few weeks, the House Appropriations Committee is going to be highlighting the fact that even they know their budget levels, which are worse than sequestration, are not practical and not sustainable. My colleague, the Republican Chair of the House Appropriations Committee, said, and I quote, "This is clearly an austere budget year," and he did not mean that in a good way.

As we continue in this appropriations process, I hope we can all keep in mind a clear vision for what will create economic success and broad-based prosperity in the short term and over the long term. So I am very glad that we are having this very timely discussion today. We owe it to the American people to come together around a responsible vision for building a foundation for growth and restoring the promise of American opportunity, and I look forward to hearing from all of our witnesses today about this important subject in just a few minutes.

With that, I would like to turn it over to my Ranking Member, Senator Sessions, for his opening statement.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Madam Chairman.

This is a good panel and it is dealing with a critically important issue, and that is how to get our economy growing and how to get out of the debt situation that we are in that every expert has told us is unsustainable. We cannot continue on this path. We can have some short-term, and hopefully will have some short- term improvements in our deficits, but with the entitlement programs the way they are today and the way they are projected to be, we are going to be in a situation of unsustainable debt again in the years to come.

So, I believe it is important beyond words that we deal with this rhetoric about Europe and the recession and the difficulties there and that they made this classical colossal mistake of austerity, and that they cut spending and that this has made Europe so poor and broke and just the wrong thing to do.

But we are going to hear from Dr. Salim Furth. He is going to talk to us about what happened in Europe, and what basically happened is the austerity we talk about is raising taxes. That is what they did right off the bat. The U.K. had a big tax increase right at the time of the recession and it did not help circumstances. And the data and studies show that the way to get a country who is out of control with its debt under control is better done with reducing spending than increasing taxes. It just is.

And we are not, you should all know, going to come away from the Budget Control Act spending limitations that we passed, Congress passed, the President signed, and went into law. That is not going to be eliminated. You can just forget that. It is $2 trillion in reduction of the growth of spending over ten years. We raised the debt ceiling $2.1 trillion. We reduce the growth of spending by $2.1 trillion over ten years. We have already hit the debt limit again. We have spent and added almost $2.1 trillion to the debt now. And so are we going to walk away from those modest spending reductions?

For example, how much was that? If we kept spending at the current rate when we passed the Budget Control Act, we would have spent $37 trillion over ten years. But on the CBO baseline, we were projected to increase spending to $47 trillion over ten years, and the BCA would make that $45 trillion over ten years, a substantial increase.

And the House budget does not cut spending. The House budget increases spending three percent a year and still balances the budget within ten years. We do not have to cut spending to balance the budget. We can allow spending to increase.

And what do we have from the President and what do we have from the Democratic Senate budget? Raise taxes a trillion dollars. Raise spending a trillion dollars. The taxes are not used to pay down the debt. The taxes are used to fund new spending above the current baseline. That is not the way to get our country in the right circumstances, in my opinion.

This is a good panel. Dr. Summers, we are delighted to have you. We respect you. You have wrestled with these issues for a long time. It is an honor to have you here.

Dr. Johnson, it is good to have you again and I appreciate some of your willingness to ask some tough questions about financial maneuverings in our country.

And, Dr. Furth, thank you for being here. I know you have done original research. You have looked hard at the European situation. You can give us some information, I think, that will help us form our judgment.

And what is the big dispute that we are in today? What is it that we want? My Democratic colleagues want to tax more and spend more. They are not using the tax increases to reduce the deficit. They are using tax increases to fund new spending, and we need to ask if that is the right thing to do, and can we not reduce spending more? We can in certain areas, that is for sure.

The reduction in spending in the Budget Control Act was a good number, a reasonable number. It is not a dramatic reduction in spending overall, but it did impact fairly dramatically the military, and I think they can, as one- sixth of the budget, they take half of the cuts.

So I believe that it is right for us, Madam Chairman, to ask, can we spread out some of those cuts to areas that had zero reductions in spending? Huge chunks of our government got zero reductions in spending. Can we not spread that out and maintain the commitment that we made to the American people? We told them, we are going to reduce the growth of spending by $2.1 trillion over ten years and we would raise the debt ceiling by $2.1 trillion. We need to honor that commitment.

I would just note that this issue continues to be hot and a matter of big discussion. At the ministerial meeting on May 29 of this year, the Organization for European Cooperation and Development adopted a surprisingly upbeat tone for Europe. The Secretary General of OECD, Angel Gurria, concluded, quote, "The fiscal adjustment of the last few years is beginning to pay off. Several countries are close to stabilizing their government debt-to-GDP ratios and ensuring a gradual decline in indebtedness over the long run." "Stay the course," the Secretary General said. "You are almost there."

Earlier in the week, Bundestag Bank President Jens Weidmann argued for a continued commitment to fiscal consolidation, spending constraint, and a rejection of the demands by some, including our own Secretary of Treasury, Jack Lew, who presided over the largest deficits in the history of the United States and claimed his budget would end deficit spending when it certainly did not, he claimed that they should stop these programs. So those are the kind of things that are going on.

We are in a big debate about how to handle this financial situation. It is clear to me—and Dr. Summers, you have discussed it—I believe that one thing we should be able to agree on is that with the unsustainable growth of our entitlement programs, that proper constraint in that growth path could do something we could agree on on a bipartisan basis. It would reduce spending more as the years go by than immediately today and put our country on a long-term financial path, and I look forward to discussing these issues with you today.

Chairman MURRAY. With that, we will turn to our panelists, and Dr. Summers, we will begin with you. And again, thank you to all three of you for being here.

STATEMENT OF LAWRENCE H. SUMMERS, PRESIDENT EMERITUS AND CHARLES W. ELIOT UNIVERSITY PROFESSOR, HARVARD UNIVERSITY

Mr. SUMMERS. Chairman Murray, Ranking Member Sessions, members of the committee, it is an honor to have the opportunity to testify before you.

I, like you, Senator Murray, had the great privilege of working with Frank Lautenberg. He was an extraordinary public servant, extraordinary in his dedication to using budgets to make lives better for people. He saw them not as financial abstractions, but as vehicles of positive change, and I hope that spirit can infuse all of us, whatever our particular views as debates on budgets go forward.

I would like to do three things in my testimony this morning: First, indicate why I have become relatively optimistic about the U.S. economic outlook; second, speak about your central subject today, the economic impacts of austere budget policies and distinguish sharply between their impacts in good times and in difficult times like the present; and third, offer some observations on what I regard as most productive paths going forward.

I am as optimistic, probably more optimistic about the future of the U.S. economy than I have been at any time in the last 15 years. Fifteen years ago, we faced rising bubbles in the Internet and stocks. Those bubbles collapsed, leading to recession, leading to deflationary threats. Before long, bubbles arose. Those bubbles were a matter of concern. And then, of course, in 2007, the current financial crisis and economic downturn began.

Recovery, inevitably, perhaps, has been relatively slow, if real and sustained. And there is now, I believe, a basis for hope that recovery will accelerate. That comes from the substantial turn in housing. It comes from the substantial investments that appear to lie ahead in the energy sector. It comes from improvement in consumer balance sheets. And it comes, very importantly, from the fact that unless further steps are taken, the adverse impact of austerity measures on economic growth will have largely played out by the end of 2013, reducing a headwind and, therefore, leading to the possibility of acceleration in economic growth going forward.

There are, of course, risks to the forecast from the global economy, other risks, as well. And, certainly, the productive potential of the economy has been diminished by what has happened. But I think there is a real prospect of accelerating growth as we move to the end of this year and into 2014 and 2015.

What about the underlying economic principles for budget policy? As Treasury Secretary in 1999 and 2000, I was proud to have the opportunity to preside over the Federal Government's intervening in the debt market to recover, redeem, and repay outstanding Federal debt as a consequence of the surpluses that we were able to run at that time. Those surpluses reflected strong economic growth and they reflected a bipartisan commitment in a balanced way to reduced budget deficits through both measures to contain spending and to enhance revenue collections. They were, in my judgment, very salutary at that time. Indeed, we were able to set off a kind of virtuous circle in which reduced budget deficits led to increased confidence, which led to more growth, which led to reduced budget deficits, and the cycle moved on.

Ultimately, our goal has to be to restore such economic performance. In the short run, however, circumstances in the United States today are very different than they were at that time. Very substantial numbers of people remain unemployed. Interest rates are at zero and cannot be further reduced. And the global economy is weak.

In such circumstances, measures that maintain and increase demand are essential. Measures which operate to cut demand back further are counterproductive with respect to economic growth and may even be counterproductive in terms of reducing debt burdens because slower economic growth leads both to larger budget deficits and to a lower level of GDP and, therefore, a higher debt-to-GDP ratio.

This is not the time for austerity or further cutbacks. It is the time to make plans for the medium and longer term. For the medium and longer term, we do absolutely need to recognize and take long-run steps, many of which would be desirable even in the absence of budget problems, such as containing the growth of health care costs, reforming the tax code where tax subsidies distort economic activity and reduce the economic efficiency of our economy, as well as costing the government revenue.

It is also an appropriate moment for us to look at crucial expenditures which the country will have to undertake at some point and undertake them now at a moment when the cost of borrowing will be uniquely low, at a moment when their productivity and employing people will be uniquely high because of high unemployment. Particularly important in that regard is the need to maintain and upgrade our country's infrastructure, an investment need we will face at some point, and we will reduce burdens on our children by meeting that obligation today rather than bequeathing it to them.

A balanced approach that focuses appropriately on supporting demand in the short run while containing long-run budgetary pressures in a balanced way for the medium and long term will best promote growth, best increase confidence, and best offer us the prospect that again, as in the 1990s, we can be in a position to start paying down the Federal debt.

[The prepared statement of Mr. Summers follows:]

Opening Remarks to Senate Budget Committee
Hearing on "The Fiscal and Economic Effects of Austerity"
June 4th, 2013

Lawrence H. Summers
Charles W. Eliot University Professor
Harvard University

Thank you for the opportunity to speak before this committee. You have chosen to address issues relating to austerity at an opportune time as both our economic and our budget situations are in considerable flux and as a broad rethinking of reflexively austere policies is underway worldwide. In my testimony today I want to do three things:

First, I will characterize the economic and fiscal outlook. Second, I will reflect on the economics of austerity, arguing that too little of the policy debate in recent years has focused on the imperative of increasing economic growth which, in the short and medium term, goes back to issues relating to demand. Third, I will comment on some of what I see as policy priorities for the years ahead.

The Economic and Fiscal Outlook

I am increasingly optimistic about our economic recovery. Indeed, I believe our economic prospects now look as sound as at any time in the last 15 years. The late 1990s saw the emergence of a major stock market bubble which was followed by recession in 2001 and slow recovery giving rise to fears of deflation. Soon enough bubbles recurred, this time credit and housing markets, leading me to observe in 2006 and 2007 that again, "The main thing we have to fear is lack of fear itself." In August of 2007, the financial crisis began with profound distress overtaking the economy in late 2008. Recovery since that time has been real if inadequately paced.

I think it is now reasonable to expect the pace of recovery to accelerate if sound policies are pursued. I base this judgment on a number of considerations.

- It appears that housing has decisively turned with home prices up at double digit rates nationwide over the last year and construction rising sharply. Given that the shortfall in housing construction during the post 2007 bust substantially exceeded the excess inventory created during the bubble period, robust housing demand should be with us for years to come. Strength in housing should also propel recovery through improvements in consumer balance sheets and increased demand for durable goods.

- The United States has the potential to benefit from a substantial renaissance in domestic energy production associated with shale oil, so called "tight oil" more generally and natural gas. It is very plausible that North America will be a net energy exporter by the end of the decade. Increased domestic energy production will involve investment on a substantial scale approaching $100 billion, and significant job creation, including in hard hit sectors, like construction, and in struggling areas of the country, like Western Pennsylvania. Lower oil and natural gas prices will likely lead to increased consumer spending and to some re-shoring of manufacturing.

- There has been substantial improvement in household, corporate and financial institution balance sheets setting the stage for increased spending. Indeed it has been several decades since household wealth rose as rapidly as it has recently, with both the stock and housing markets providing support.

- While fiscal contraction at an excessive pace has been an important economic headwind since the Recovery Act began phasing out in 2011, most of this blow will have been absorbed by the end of this year, setting the stage for some acceleration in growth unless further policies that immediately reduce demand are enacted. By 2014, it is likely that government will not be a retardant on economic activity for the first time in 4 years.

These favorable aspects of the current situation are real. But optimism needs to be tempered by two unfortunate features of the current situation:

First, the economy has suffered long term damage from the financial crisis and recession of the last several years. Long term, unemployed workers have withdrawn, quite likely permanently, from the workforce. Young workers coming out of school have had much greater difficulty than usual getting on career ladders. Capital investment in new capacity has been held back, as has corporate investment in research and development and the establishment of new brands and product categories. Infrastructure investments on some measures have not kept up with deterioration and obsolescence. It is sobering to contemplate that the CBO estimate of the economy's potential capacity after full cyclical recovery in 2017 is now fully 7.2 percent or $1.2 trillion below the CBO's 2007 estimate.

Second, there remain real risks to the recovery. The rest of the world, especially Europe, faces major growth challenges. Increasing inequality acts to hold back spending. There are some signs of froth reappearing in credit markets. Measures of confidence, while improved, remain somewhat depressed and the possibility of geopolitical shocks can hardly be discounted. Everything we know about the aftermath of financial crises from the United States' 1930s depression to Japan's experience since 1989, suggests that achieving a return to sustained real growth is very difficult and that premature declarations of victory can be very costly.

Fortunately, relatively good economic news in recent months has been matched by even better budget news. A combination of factors has led to substantial downward revisions in projected budget deficits, to the point where the debt-GDP ratio is now expected to decline through 2020. These factors include a stronger economy, a striking slowdown in the growth rate of health care costs and enhanced revenue collections beyond what might immediately be expected given economic performance. While there are no certainties, experience suggests that favorable revisions in the budget outlook tend to be followed by further favorable revisions and vice-versa. It is therefore reasonable to judge that while the nation continues to face a serious long run fiscal challenge, the budget outlook is today far less grim than it appeared several years ago.

This experience should be a useful caution to all of us involved in policy debates. While it is important to address long run issues, our visibility is limited. For example, the CBO publishes reports that analyze their five-year real GDP growth forecasts versus actual realized growth. Historically, the forecast error is 1.2% per year. To put that number in perspective, it implies that there is about a 1 in 4 chance of that our current estimates of real GDP in 2018 are off by more than a trillion dollars (7.4% of GDP). The error in 10-year projections would be significantly greater.

The Economics of Austerity

Both in the United States and abroad there have, in recent years, been fierce debates about budget policies and ideas around austerity and deficit reduction. These debates which are often framed in universal terms have often shed more heat than light. A prudent government must over time seek to balance spending and revenue collection in a way that assures the sustainability of debts. To do otherwise, leads to instability and needlessly slow growth, and courts default and economic catastrophe. Equally however, responsible fiscal policy requires recognizing that when economies are weak and movements in interest rates are constrained, as has been the case in much of the industrial world in recent years, changes in fiscal policy will have large impacts on economic activity that in turn will affect revenue collections and social support expenditures. In such circumstances, aggressive efforts to rapidly reduce budget deficits may actually backfire as a contracting economy offsets their direct benefits.

It is a truism that deficit finance of government activity is not an alternative to tax finance or to supporting one form of spending by cutting back on another. It is only a means of deferring payment for government spending and, of course, because of interest expenses increasing the burden on taxpayers. Just as a household or business cannot indefinitely increase its debt relative to its income without becoming insolvent, a government cannot either. There is no viable permanent option of spending without raising commensurate revenue. The meaningful choices involve the size of public activity and the timing of government spending and taxation.

It follows that in normal times there is no advantage to deficit policies. Public borrowing does not reduce ultimate tax burdens. It tends to crowd out private borrowing to finance growth and job creating investment and tends to foster international borrowing, which means an excess of imports over exports. Or the expectation of future tax increases may discourage private spending. While government spending, or tax cutting financed by borrowing, creates increased demand in the economy, the Federal Reserve can in normal times achieve this objective by adjusting base interest rates.

It was essentially this logic that drove the measures taken in the late 1980s and in the 1990s, usually on a bipartisan basis, to balance the budget. As a consequence of policy steps taken in 1990, 1993 and 1997, it was possible by the year 2000 for the Treasury to use surplus revenues to retire Federal debt. There is no question in my view that deficit reduction, and the associated reduction in capital costs and increase in investment, was an important contributor to the nation's very strong economic performance during the 1990s when productivity growth soared and unemployment fell below 4 percent. Essentially, we enjoyed a virtuous circle in which reduced deficits led to lower capital costs and increased confidence, which led to more rapid growth, which further reduced deficits reinforcing the cycle.

As a Treasury official in the 1990s, I was proud to support and help implement these measures. The time will come again when deficit reduction should be the immediate first priority of budget policy.

But, in recent years, circumstances have been anything but normal in the United States and most of the industrial world. High levels of unemployment, low levels of job vacancies and deflationary pressures all indicate that the level of output is not constrained by what the economy is capable of producing, but by the level of demand. Moreover, with base interest rates at or close to zero, the efficacy of monetary policy is circumscribed. In the United States, GDP has been as much as a trillion dollars a year or more than $10,000 per family below its potential.

Under these circumstances, there is every reason to expect that changes in deficit policies will have a direct impact on levels of employment and output in a way that is not normally the case. Borrowing to support spending, either by the government or the private sector, raises demand and therefore increases output and employment above the level they otherwise would have reached. Unlike in normal times, these gains will not be offset by reduced private spending because there is substantial excess capacity in the economy, and cannot easily be achieved via monetary policies because base interest rates have already been reduced to zero. Multiplier effects operate far more strongly during financial crisis economic downturns than in other times.

Two further considerations magnify these effects. As I noted earlier, sustained poor economic performance, in addition to reducing output and employment, adversely affects future economic performance. So, measures that support demand raise future, as well as present, output. Also, support for demand helps to stimulate the economy by offsetting contractionary, deflationary pressures.

In a study published last year in the Brookings Papers on Economic Activity, that I ask be included in the hearing record, Brad Delong and I made estimates suggesting that the effect of expansionary fiscal policies might well be to reduce, rather than increase, future debt burdens because of their positive economic impacts. These estimates remain the subject of substantial debate among economists and I would never want to suggest that policy should be driven by the results of a single study. Yet, I do think it is a fair conclusion that once account is taken of the direct impact of budget policies on economic performance, their impact on debt burdens is greatly attenuated.

To illustrate: Consider the effect of the sequester in 2013. The sequester will impact the last 10 months of calendar year 2013. The CBO estimates that the sequester will, over this 10 month interval, reduce spending by $64 billion. With no other change, this would result in a reduction of $64 billion in the Federal debt, which is equivalent to reducing the debt/GDP ratio by 0.39 percent.

However, we must also consider the sequester's effect on GDP growth. The CBO estimates that the sequester will reduce the GDP growth rate in 2013 by 0.6 percentage points. This stifling of growth actually increases the debt/GDP ratio through two effects: First, by reducing the GDP growth rate, the sequester reduces the denominator of the debt/GDP ratio. Second, lower GDP during 2013 means lower tax revenue, which increases the deficit.

We cannot ignore these spillover effects of the sequester onto the economy and onto tax revenue. When we account for these spillover effects, the CBO estimates imply that, the sequester will have a negligible effect on our debt/GDP ratio, at the end of the day.

These observations have strong implications for recent debates over austerity—debates that have reached a crescendo with recent controversies over the work of my Harvard colleagues Carmen Reinhart and Ken Rogoff. I have attached a commentary reflecting my views on their work.

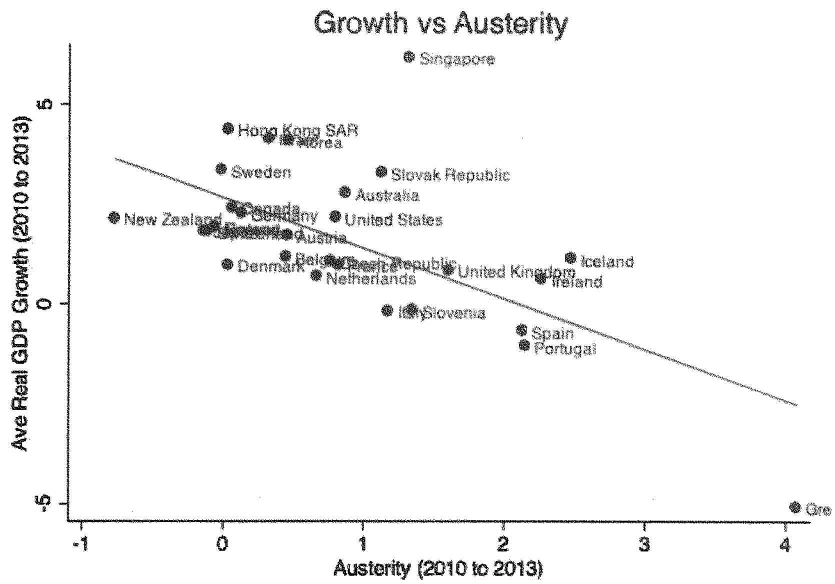
More important than arguments over their data and statistical procedures is the simple observation that the impact of debts and deficits will vary with economic circumstances and the further point that while high levels of debt can retard economic growth, increases in borrowing can enhance economic growth by mitigating downturns. This has the additional impact as I have already noted of raising future potential output.

International comparisons tend to confirm the view that excessively rapid fiscal consolidation has adverse impacts on economic performance.

In Figure 1, we see that countries that pursued harsher austerity policies in recent years also had lower real GDP growth. In Figure 2, we see the difference in unemployment in the US and Eurozone. In 2009, the US and Eurozone had almost the same unemployment rates. In the interim, the Eurozone pursued far harsher austerity policies. Today, the gap in the unemployment rates between the US and Eurozone is 4.6 percentage points.

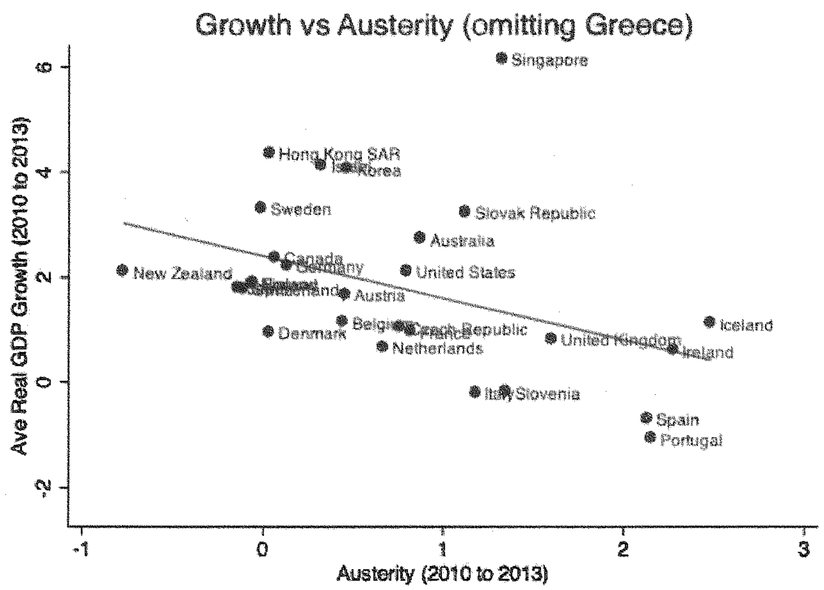
Naturally, I would be remiss if I did not caution that correlation is not the same as causation. And there are many different ways of processing these data. However, in the face of these data it is difficult to credit claims that more rapid fiscal consolidation is likely to accelerate economic growth.

Figure 1: Growth vs Austerity



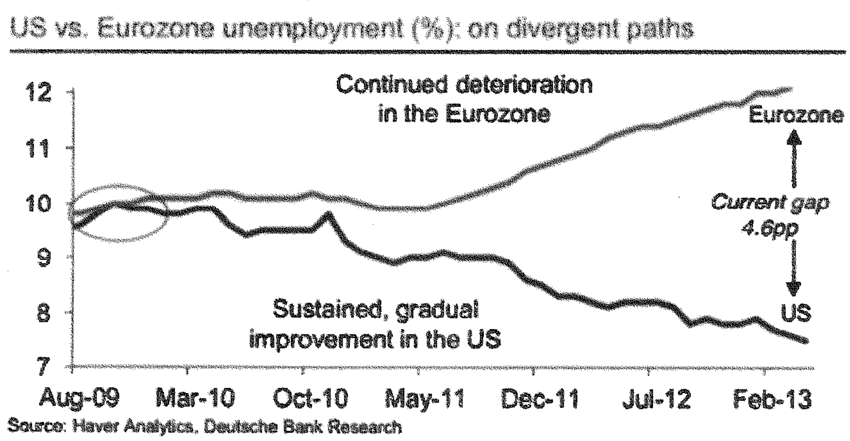
Caption: Austerity = Average Change in (Cyc Adj Primary Balance)/(Potential GDP)

Figure 1 (alternate version): Growth vs Austerity



Caption: Austerity = Average Change in (Cyc Adj Primary Balance)/(Potential GDP)

Figure 2: US vs Eurozone unemployment



Policy Going Forward

The foregoing analysis suggests several important principles regarding US fiscal policy in the years ahead.

First, it would not be desirable to undertake further measures to rapidly reduce deficits in the short run. Excessively rapid fiscal consolidation in an economy that is still constrained by lack of demand, and where space for monetary policy action is limited, risks slowing economic expansion at best and halting recovery at worst. Indeed, there is no compelling macroeconomic case for the deficit reduction now being achieved through sequestration, as the adverse impacts of spending cuts on GDP more or less offset their direct impacts in reducing debt. An ultimate judgment on sequestration should therefore depend on a view about the merits of the expenditures being cut back in providing public benefit. I think it is unlikely that aside from the macroeconomic argument, which is dubious, that policymakers would adopt the sequestration cuts simply on grounds of efficient public expenditure though this is not at root an economic judgment.

Second, while uncertainties are great and progress has been made, the United States does face an unsound long run imbalance between forecast expenditures and revenue collections. Spurring growth is the best way to reduce this imbalance. Indeed a 1 percent increase in the growth rate of GDP maintained for 10 years would reduce cumulative deficits by more than $3 trillion. Accelerating growth should be a central aspect of budget debates going forward.

Third, the highest priority in terms of structural reforms to reduce future deficits should be attached to measures that would be desirable even in the absence of prospective deficits. Candidates here include steps to control the growth of health care costs and tax reform. Careful international studies suggest that the excess of US health care costs over foreign costs are more related to a given procedure costing more in the US than to more procedures being performed in the US. This suggests an emphasis on improving approaches to purchasing care rather than on curbing consumer demand for medical assistance. There are a number of features of the tax code that both cost the government revenue and make the economy less efficient. These include corporate tax provisions that support the shifting of economic activity and accounting income to tax havens, subsides that favor particular industries over others, and measures that create an economic bias towards risky financial transactions. Sound loophole-closing tax reform offers the prospect of increased revenues, increased incentives for productive economic activity through lower rates, and increased government revenues.

Fourth, attention should be devoted to measures that reduce future deficits by pulling expenditures forward to the present when they have the additional benefit of increasing demand. It is important to recognize that just as increasing debt burdens future generations, so also does a failure to repair decaying infrastructure, or to invest adequately in funding pensions, or in educating the next generation burdens future generations. Wherever it is possible to reduce future public obligations by spending money today, we should take advantage of this opportunity especially given the very low level of interest rates. In particular, a major effort to upgrade the nation's infrastructure has the potential to spur economic growth, raise future productive capacity and reduce future deficits. It should be a high priority.

Thank you very much for the opportunity to speak with you today. I look forward to your questions.

Financial Times Column

The buck does not stop with Reinhart and Rogoff

May 6, 2013

The economics commentariat – and no small part of the political debate – has been consumed in the past few weeks with controversy surrounding a piece of research by my Harvard colleagues (and friends) Carmen Reinhart and Kenneth Rogoff. The article, published in 2010, had been widely interpreted as showing that economic growth is likely to stagnate in a given country once the ratio of its government debt to gross domestic product exceeded a threshold of 90 per cent. But scholars at the University of Massachusetts have demonstrated – and the duo have acknowledged – that the two professors accidentally omitted some relevant data in forming their results, thanks to a coding error. Questions have also raised with respect to how they weighted observations and which data they used.

Many have asserted that the debate undermines the claims of austerity advocates around the world that deficits should be reduced quickly. Some have gone so far as to blame Profs Reinhart and Rogoff for the unemployment of millions, asserting that they were crucial intellectual ammunition for austerity policies. Others believe that, even after review, the data support the view that deficit and debt burden reduction is important in most of the industrialised world. Still others say the controversy has called into question the usefulness of statistical research on economic policy questions.

Where should these debates settle? First, the whole experience should change the way we approach economic and statistical research. Profs Rogoff and Reinhart are rightly regarded as careful, honest scholars. Anyone close to the process of economic research or financial markets will recognise that data errors such as the ones they made are distressingly common.

Indeed, an internal investigation by JPMorgan into the $6bn loss it made last year on the "London whale" trade found mistakes not unlike those made by Profs Reinhart and Rogoff. Simple errors in a model meant that the bank dramatically underestimated the risks that it was running. In future, authors, academic journals and commentators need to devote more effort to replicating significant research results before broadcasting them widely.

More generally, no important policy conclusion should ever be based solely on a single statistical result. Policy judgments should be based on the accumulation of evidence from multiple studies done with differing approaches. Even then, there should be a reluctance to accept conclusions from "models" without an intuitive understanding of what is driving them. It is right and understandable that scholars want their findings to inform the policy debate. But they have an obligation to discourage and, on occasion, contradict those who would oversimplify and exaggerate their conclusions.

Second, all participants in policy debates should retain a healthy scepticism about retrospective statistical analysis. Trillions of dollars have been lost and millions have been unemployed because the lesson was learnt from 60 years of experience between 1945 and 2005 that "American house prices in aggregate always go up". This was not a data problem or misanalysis. It was a data regularity – right up until it wasn't.

The extrapolation from past experience to future outlook is always deeply problematic and needs to be done with great care. In retrospect, it was folly to believe that with data on about 30 countries it was possible to estimate a threshold beyond which debt became dangerous.

Even if such a threshold existed, why should it be the same in countries with and without their own currency, with very different financial systems, cultures, degrees of openness and growth experiences? And there is the old chestnut that correlation does not establish causation. Any tendency for high debt and low growth to go together might reflect the way that debts can rapidly accumulate as a consequence of slow growth.

Third, while Reinhart and Rogoff's work, even before the recent replication efforts, did not support the claims made by prominent figures on the right in the US and UK regarding the urgency of deficit reduction efforts, the joy taken by some on the left from their embarrassment is inappropriate.

It is absurd to blame Reinhart and Rogoff for austerity policies. The political leaders advancing austerity measures made their choice of policy first, and then cast about for intellectual buttresses. While there may be no threshold beyond which debt becomes catastrophic, and while the British and US experiences both suggest that fiscal contraction in a slack economy where interest rates are near zero is inimical to growth, it is a grave mistake to suppose that debt can or should be accumulated with abandon.

On all but the most optimistic forecasts, further actions will be necessary almost everywhere in the industrial world to assure that debt levels are sustainable after economies recover.

This is not the time for austerity, but we forget at our peril that debt- financed spending is not an alternative to cutting other spending or raising taxes. It is only a way of deferring those painful acts.

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Fiscal Policy in a Depressed Economy

ABSTRACT In a depressed economy, with short-term nominal interest rates at their zero lower bound, ample cyclical unemployment, and excess capacity, increased government purchases would be neither offset by the monetary authority raising interest rates nor neutralized by supply-side bottlenecks. Then even a small amount of hysteresis—even a small shadow cast on future potential output by the cyclical downturn—means, by simple arithmetic, that expansionary fiscal policy is likely to be self-financing. Even if it is not, it is highly likely to pass the sensible benefit-cost test of raising the present value of future potential output. Thus, at the zero bound, where the central bank cannot or will not but in any event does not perform its full role in stabilization policy, fiscal policy has the stabilization policy mission that others have convincingly argued it lacks in normal times. Whereas many economists have assumed that the path of potential output is invariant to even a deep and prolonged downturn, the available evidence raises a strong fear that hysteresis is indeed a factor. Although nothing in our analysis calls into question the importance of sustainable fiscal policies, it strongly suggests the need for caution regarding the pace of fiscal consolidation.

This paper examines fiscal policy in the context of an economy suffering, like the United States today, from protracted high unemployment and output short of potential. We argue that although the conventional wisdom articulated by John Taylor (2000) rejecting discretionary fiscal policy is appropriate in normal times, such policy has a major role to play in a severe downturn in the aftermath of a financial crisis that carries interest rates down to the zero nominal lower bound.

Our analysis reaches five conclusions about fiscal policy as a stabilization tool in a depressed as opposed to a normal economy:

—The absence of supply constraints in the short term, together with a binding zero lower bound on interest rates, means that the Keynesian multiplier is likely to be substantially greater than the relatively small value it is thought to have in normal times. This multiplier may well be further magnified by an additional zero-bound effect: the impact of economic expansion on expected inflation and hence on real interest rates.

—At current and expected future real interest rates on government borrowing, even a very modest amount of "hysteresis," through which cyclical output shortfalls affect the economy's future potential, has a substantial effect on estimates of the impact of expansionary fiscal policy on the future debt burden. Although the data are far from conclusive, a number of fragments of evidence suggest that additional government spending that mitigates protracted output losses raises potential future output, even if the spending policies are not directly productive in themselves.[1]

—Policies of austerity may well be counterproductive even by the yardstick of reducing the burden of financing the national debt in the future. Austerity in a depressed economy can erode the long-run fiscal balance. Stimulus can improve it.[2]

—Arguments that expansionary fiscal policy at the zero bound is not self-financing and does not pass a benefit-cost test by raising the present value of future potential output hinge on establishing one of three conditions: that monetary policy offsets the demand effects of fiscal policy even at the zero bound sufficiently that the multiplier is near zero, or that future potential output is invariant to the size and length of the downturn, or that interest rates are at or above the range seen historically, at least in the United States.

—Only when a government must pay a substantial premium over the social rate of time discount in order to borrow is the economy unlikely to benefit from expansionary fiscal policy at the zero bound.

The paper is organized as follows. Section I presents a highly stylized example making our basic point regarding self-financing fiscal policy. It then lays out an analytical framework for assessing the likelihood that expansionary fiscal policy will actually be expansionary, and it identifies the parameters that are most important in evaluating the impact of fiscal policy changes.

1. Of course, this case is strengthened and the long-term benefits of debt-financed government purchases at the zero bound are amplified if the government purchases themselves are directly productive and so boost the economy's stock of public capital or private human capital.

2. This point was made a generation ago by Blanchard and Summers (1987). As Erceg and Linde (2010) recently put it, there could then be a "fiscal free lunch."

Two further sections examine evidence on the central parameters in our framework: the fiscal multiplier and the extent of hysteresis. Both must be greater than zero for our central point to hold, yet both are subject to considerable uncertainty. Other key parameters are subject to less uncertainty: estimates of the expected future growth rate of potential output are tightly clustered; the financial market's estimate of real Treasury borrowing rates far into the future is public information.

Section II argues that the multiplier is context-dependent, depending in particular on the reaction function of monetary policy. It concludes that at moments like the present—when interest rates are constrained by the zero bound, the output gap is large, and cyclical unemployment is high—fiscal policy is likely to be more potent than standard estimates suggest. This conclusion boosts the benefits of expansionary fiscal policy in a depressed economy substantially, but, importantly, it does not depend on the policy-relevant multiplier being higher than standard estimates of the fiscal policy multiplier.

Section III examines the available evidence on the extent of hysteresis. Financial crises and demand-induced recessions appear to have an impact on potential output even after normal conditions are restored. This makes it plausible that measures that mitigate their effects would have long-run benefits. We find corroboration both in the behavior of economic forecasters and in a number of fragments of evidence on the effects of recessions.

Finally, section IV takes up issues relating to interest rates and monetary policy. It argues that available evidence on central bank behavior suggests that it is unlikely that, in a severely depressed economy, expansionary fiscal policy will lead to an offsetting monetary policy response. The section concludes with a discussion of policy implications of the analysis for the United States and the world. An appendix uses the framework laid out in section I to consider the conditions under which expansionary policy is not self-financing but nonetheless passes the benefit-cost test of raising the present value of output—what we call the "extra-output benefit-cost test."

I. Self-Financing Fiscal Policy

Assume an economy in which output is well below its potential, cyclical unemployment is elevated, supply constraints on short-run demand are absent, conventional monetary policy is constrained by the zero lower bound, and the central bank is either unable or unwilling to, but in any case does not, provide additional stimulus through quantitative easing or other means (an assumption we discuss further in section IV).[3] A simple calculation then conveys the main message of this paper: under these circumstances, a combination of real government borrowing rates in the historical range, modestly positive fiscal multiplier effects, and small hysteresis effects are together sufficient to render fiscal expansion self-financing.

Imagine, for example, that in this demand-constrained economy the fiscal multiplier is 1.5, the real annual interest rate on long-term government debt is 1 percent, a $1 increase in GDP increases the net tax-and-transfer fiscal balance by $0.33, and a $1 shortfall of GDP below potential this year permanently reduces future potential GDP by $0.01—that is, a hysteresis "shadow" on future potential output of only 1 percent. Assume further that the government has the power to undertake a transitory increase in spending and then reverse it without any impact on the risk premium that it pays on its borrowing.

Under these assumptions, the effect of an incremental $1 of government spending is to increase current GDP by $1.50 and to raise the debt by $0.50. The annual real debt service on this additional debt is $0.005. The $1.50 increase in this year's GDP increases future potential output by $0.015, which in turn augments future-period tax revenue by $0.005, on the assumption that actual output averages to potential output over the relevant future periods. Hence the fiscal expansion is self-financing. In such a scenario, worries about the adverse impact of fiscal stimulus on the government's long-run budget are unwarranted, for there is no adverse impact.

This central point is made substantially stronger if one allows for:

—underlying growth in the economy, so that the relevant fiscal balance requirement is one of a stable debt-to-GDP ratio rather than a stable real debt;

—increases in the future price level, as a result of the fiscal expansion, that further reduce the real interest rate on accumulated and newly issued debt; and

3. Most estimates of Federal Reserve reaction functions suggest that, if it were possible to have negative short-term safe nominal interest rates, such rates would have been chosen in recent years. This fact indicates the relevance of our analysis. See Rudebusch (2009) and Taylor (2010).

—the possibility that the additional government spending raises future productivity, and thus future output, by increasing the productive stocks of public infrastructure capital and private human capital.[4]

This central point is a matter of arithmetic. It depends only on the existence of a fiscal multiplier μ that is not near zero, the existence of a plausible hysteresis shadow on future potential output, low and unchanged government borrowing costs, and the assumption that a temporary boost to government purchases is possible. If these four assumptions are granted, the conclusion follows.

This section presents a reduced-form framework for assessing under what conditions fiscal expansion is self-financing; the appendix discusses the conditions under which, if fiscal expansion is not self-financing, it nonetheless passes an extra-output benefit-cost test. Our conclusions will apply to any underlying model that generates such a reduced form.

A temporary boost to government purchases ΔG boosts aggregate demand through the short-term fiscal multiplier. More formally, an increase in government spending for the present period only of ΔG percentage-point-of-potential-GDP-years is amplified by the economy's short-term policy-relevant multiplier coefficient μ, reducing the output gap in the present period Y_n ("n" for "now") by an amount ΔY_n, also measured in percentage-point-years:

$$\Delta Y_n = \mu \Delta G. \tag{1}$$

We discuss in section II the value of μ in normal times and make the crucial point that there is a strong likelihood that μ is now above that value.

Financing this expansion of government purchases requires increasing the national debt by an amount ΔD, also measured in percentage-point-of-potential-GDP-years. Given μ as before and assuming a baseline marginal tax-and-transfer rate τ, the required increase in the national debt is then

$$\Delta D = (1 - \mu\tau)\Delta G, \tag{2}$$

4. It is worth stressing that with current real Treasury interest rates near zero (some estimates are provided later in this section), even if additional spending had no impact on current GDP, every government investment project that promises a positive real rate of return of any magnitude would boost the present value of future real GDP.

which is less than in the absence of the multiplier because higher current output brings with it higher tax collections and thus an immediate partial recapture of some of the costs of the fiscal expansion.

If the economy's long-run growth rate is g and the real government borrowing rate is r,[5] this additional debt ΔD imposes on the government an annual financing burden in percentage points of a year's potential GDP of

$$(r - g)\Delta D = (r - g)(1 - \mu\tau)\Delta G, \tag{3}$$

if it is to maintain a stable long-run debt-to-GDP ratio. In order to maintain a stable debt-to-GDP ratio, the government must increase its primary surplus by the difference between the growth rates of the debt and of GDP times the increment to the debt. That is the left-hand side of equation 3. And the increment to the debt is simply $(1 - \mu\tau)\Delta G$.

A depressed economy is one in which many workers are without employment for an extended period. As a consequence, many see their skills, the networks they use to match themselves with vacancies in the labor market, and their morale all decay. A depressed economy is also one in which investment is low, the capital stock is growing slowly if at all, and entrepreneurial exploration is low, and it is certainly possible that this deficit is not made up quickly. These factors may well have an impact on future potential output.

Assume that in future periods production is determined by supply and that there is no gap between real aggregate demand and potential output. Then, in a typical future period, potential and actual output Y_f (where "f" stands for "future") will be reduced by a hysteresis parameter η times the depth by which the economy is depressed in the present:

$$\Delta Y_f = \eta \Delta Y_n = \eta\mu\Delta G. \tag{4}$$

The units of η are inverse years: η is the percent reduction in the flow of future potential output per percentage-point-year of the present-period output gap. We discuss the mechanisms determining η in section III.

A fiscal expansion undertaken to prevent hysteresis thus creates a fiscal dividend: it raises future tax collections by an amount

$$\tau\Delta Y_f = \tau\eta\mu\Delta G. \tag{5}$$

5. In the main text of this paper, r refers to both the social rate of time discount and the government's borrowing rate. The appendix considers the case when these two need to be distinguished.

Equations 3 and 5 together imply that if

$$(6) \qquad (r - g)(1 - \mu\tau) - \eta\mu\tau \leq 0,$$

then at the margin, transitory expansionary fiscal policy is self-financing. The boost to future potential output, and thus to future net tax revenue, provided by shortening and lessening the current downturn creates more public financial resources in the future than are consumed by amortizing the additional debt incurred to finance the transitory expansion. There is no cost to count against this benefit from future fiscal expansion. This is the most important conclusion of this paper.

Rearranging equation 6, we can show that this net future fiscal dividend from the present-period fiscal expansion ΔG arises as long as r satisfies

$$(7) \qquad r \leq g + \frac{\eta\mu\tau}{(1 - \mu\tau)}.$$

As long as there is a short-term fiscal multiplier μ, a hysteresis shadow η, a tax-and-transfer share τ, a real government borrowing rate r, and a debt amortization equation incorporating a trend growth rate g such that expression 7 holds, fiscal expansion now improves the government's budget balance later.[6] In this case, arguments that a depressed economy cannot afford fiscal expansion now because the government dare not raise its debt have little purchase.[7] And arguments that governments in such circumstances need to demonstrate the credibility of their long-run fiscal strategy by curbing spending today lack coherence, because cutting spending does not improve but rather worsens the long-run fiscal picture.

For what values in the parameter space does expression 7 hold, if we take the marginal tax rate τ and the expected rate of long-run GDP growth g to be their consensus values? For the marginal net tax-and-transfer share τ, we assume the baseline value to be 0.333. For g, the long-term growth rate of real potential GDP, we take the Congressional Budget Office's current estimate of 2.5 percent per year. This leaves μ and η—the fiscal multiplier and the hysteresis coefficient that captures the shadow cast by the downturn on the long run—as variable parameters. We take the plausible range for μ

6. For a somewhat different argument that austerity worsens the government's budget balance, see Denes, Eggertsson, and Gilbukh (2012).

7. This point is by no means new: see Lerner (1943). Wray (2002) argues that Milton Friedman's post-World War II proposal for stabilization policy achieved through a money supply provided by countercyclical deficit financing and 100 percent reserve banking is in its essence the same idea.

Table 1. Parameter Values for the Base Case

Parameter	*Interpretation*	*Assumed value*
μ	Present-period government spending multiplier	0–2.5
r	Real government borrowing rate and social rate of time discount, per year	0.025–?
g	Trend growth rate of potential GDP, per year	0.025
τ	Marginal tax-and-transfer rate	0.333
ξ	Disincentive effect: reduction in potential output from raising additional tax revenue	0.25–0.5
η	Hysteresis effect: proportional reduction in potential output from a temporary downturn	0–0.2

in a severely depressed economy at the zero lower bound to be between zero and 2.5, and the plausible range for η to be between zero and 0.2. Table 1 summarizes the framework parameters and their base-case values.

When calibrating η, it is probably best to consider it as a "permanent equivalent" concept. Short-term Keynesian effects die out in less than 5 years; permanent effects are forever. In a growing economy, permanent effects are thus capitalized at a multiple of $1/(r - g)$, which for plausible borrowing rates and social rates of time discount r, and plausible growth rates g, can be a very large factor. However, many plausible channels through which a deep and prolonged downturn casts a shadow on future potential output produce not permanent but rather persistent effects: they last for one generation, but not for three.

We therefore consider η to be the size of the persistent effects of a downturn on potential output in a permanent-equivalent metric: that is, we correct for the fact that these effects are long-run but not truly permanent, and hence should be capitalized not at a factor $1/(r - g)$ but rather at $[1 - (1 - r + g)^T]/(r - g)$, where T captures the length of the persistent but not truly permanent effects.

Table 2 reports critical Treasury borrowing rates below which expansionary fiscal policy is self-financing (expression 7 holds) for various values of η and μ. For example, for a multiplier μ of 1.5 and a hysteresis parameter η of 0.10, the second term on the right-hand side of expression 7 is 10 percent per year. This means that if the spread between the real Treasury borrowing rate r and the real growth rate of GDP g is less than 10 percentage points per year, fiscal expansion today improves rather than degrades the long-term budget balance of the government. Given our assumption that $g = 2.5$ percent, that implies a real Treasury borrowing rate of 17.5 percent per year or less.

Table 2. Critical Values of the Real Treasury Rate for Fiscal Expansion to Be Self-Financing

	Critical real Treasury interest rate for indicated value of multiplier μ *(percent per year)*[a]				
Hysteresis η	$\mu = 0$	$\mu = 0.5$	$\mu = 1.0$	$\mu = 1.5$	$\mu = 2.5$
0	2.50	2.50	2.50	2.50	2.50
0.025	2.50	2.99	3.73	4.95	14.29
0.050	2.50	3.49	4.96	7.40	26.07
0.100	2.50	4.48	7.43	12.30	49.64
0.200	2.50	6.45	12.35	22.10	96.97

Source: Authors' calculations.

a. The critical rate is the highest rate that satisfies expression 7 in the text. Other parameters take the values assumed in table 1.

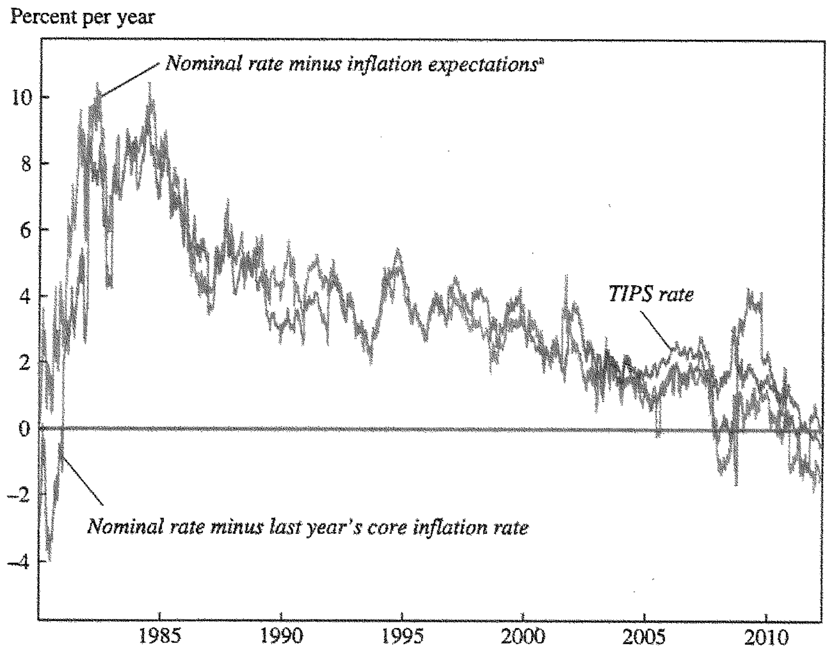
For μ of 1.0 and η of 0.1, the second term on the right-hand side of expression 7 is about 5 percent per year. In this case, if the spread between r and g is less than about 5 percentage points, fiscal expansion today improves rather than degrades the long-term budget balance of the government. That implies a real Treasury borrowing rate of about 7.5 percent per year or less.

For μ of 0.5 and η of 0.05, the second term on the right in expression 7 is about 1 percent per year. In this case, if the spread between r and g is less than about 1 percentage point, fiscal expansion today improves rather than degrades the long-term budget balance of the government. That implies a real Treasury borrowing rate of about 3.5 percent per year or less.

How credible is the claim that the Treasury's borrowing rates will stay below the relevant value in table 2, and thus that expansionary fiscal policy would be self-financing? Since January 1997 the interest rates on Treasury inflation-protected securities (TIPS) provide a direct, market-based measure of the real rate at which the Treasury can borrow. For earlier periods, subtracting a measure of the inflation rate from nominal interest rates provides a proxy. Figure 1 plots, in addition to the yield on 10-year TIPS, two such proxies: the yield on 10-year nominal Treasuries minus expected inflation from the University of Michigan Survey, and the same 10-year nominal yield minus the previous year's core inflation rate. These two measures do not markedly or persistently diverge from the TIPS rate over the period for which the latter is available. The expectations-based measure shows a somewhat higher mean value and more variability, but since the Volcker disinflation of the early 1980s it has tracked or undershot the current value of inflation.

The multiplier μ has to be low and the hysteresis parameter η almost negligible for the critical interest rate r to lie above the range of real interest

Figure 1. Proxies for Real Ten-Year Treasury Interest Rates, 1980–2012



Sources: FRED database, Federal Reserve Bank of St. Louis; University of Michigan; Bureau of Labor Statistics.

a. Inflation expectations are measured as the median expected percent change in prices over the next 12 months from the Thomson Reuters/University of Michigan Surveys of Consumers.

rates on Treasury debt seen in the historical record. At a real interest rate of 5 percent per year, expansionary fiscal policy is self-financing for $\mu = 2.5$ as long as $\eta > 0.005$; it is self-financing for $\mu = 1.5$ as long as $\eta > 0.025$; it is self-financing for $\mu = 1.0$ as long as $\eta > 0.050$; and it is self-financing for $\mu = 0.5$ as long as $\eta > 0.125$. The case for expansionary U.S. fiscal policy imposing any significant budgetary cost thus appears to rest on a claim that μ is significantly less than 1.0, or that η is significantly less than 0.05.

Moreover, current and expected future interest rates today are much lower than in the historical post-World War II experience, and today's long-term Treasury rates indicate that r is expected to stay extraordinarily low for a generation. As of June 1, 2012, the 10- and 30-year nominal Treasury rates were 1.47 and 2.53 percent per year, respectively; the 10- and 30-year TIPS rates were –0.59 and +0.36 percent per year, respectively—and many market observers see TIPS rates as elevated today because of perceived lack of liquidity. If there is no expected term premium—if the expectations theory of the term structure holds—then financial markets currently anticipate that the short-term nominal Treasury rate will average less than 1.47 percent per year over the next 10 years, and less than 2.53 percent per year over the next 30 years. These are extraordinarily low rates. At an expected annual inflation rate of 2.0 percent and an expected real annual GDP growth rate of 2.5 percent, 1 percent of GDP worth of debt borrowed now and funded for 30 years with no nominal amortization raises the debt-to-GDP ratio a generation hence by only 0.55 percentage point. Assuming log utility and a zero rate of pure time preference, public spending that has a current-dollar benefit-cost ratio of only 0.55 is worth undertaking today as long as it can be funded with 30-year Treasuries.

Moreover, it is extremely unlikely that the expectations theory of the term structure holds without any term premium driving a wedge between expected future short-term rates and the current 30-year Treasury bond rate. If the past generation's detailed investigations into financial markets have taught us anything, it is that a great many risks that do not have a clear correlation with the marginal utility of aggregate consumption are nevertheless priced, indeed priced substantially. The risk that the value of one's long-term bonds will be eroded by inflation has been priced in the past through a considerable term premium relative to the expectations hypothesis of the term structure. It is hard to see any reason for this historical correlation to fail to hold in the future. This means that the arithmetic of government spending now is even more favorable, for markets do not anticipate a return of interest rates to their postwar norm for at least a generation.

At this point a very natural question arises: if interest rates on Treasury debt are usually (except in the early 1980s) sufficiently low to allow the government to borrow, spend, and end up with no net increase in its debt burden, why not do so always? The principal reason is that it cannot do so in normal times. A multiplier μ of even 1 is, as we discuss in section II, likely to be unusual. It is likely to prevail only when the zero lower bound on short-term interest rates is binding and cyclical unemployment is substantial. At other, normal times, μ is likely to be much smaller than 1. When interest rates are away from their zero bound, when the output gap is small, or when high unemployment is not cyclical but structural, then either bottlenecks or monetary policy offset make it unlikely that fiscal expansion will impart any significant boost to real GDP. When that is so, there is no stabilization policy case for expansionary fiscal policy.

Note that the arithmetic of table 2 does not hinge on the economy being close to the edge of or in the range of dynamic inefficiency. The key interest rate in table 2 is r, and here it matters that r is the real interest rate on government borrowing and not the private marginal product of capital, the real social rate of time discount, or the rate of return on public capital.[8]

The conclusion that fiscal expansion may be self-financing is at least partially a point about the attractiveness of Treasury debt to investors (see Krishnamurthy and Vissing-Jorgensen 2012). If government debt is sufficiently attractive as a safe savings vehicle, and if there are at least minor counterhysteresis benefits from expansionary fiscal policy, then there need be no net financing burden of extra government purchases on taxpayers. Thus, the government can borrow, spend to boost the economy, use the extra taxes from a more prosperous economy to amortize part of its debt, refinance the debt and so push out the time horizon at which it is to be retired, and, as that horizon is extended, watch the debt-to-GDP ratio fall indefinitely. This would not be possible if Treasury debt were unattractive, because this would drive a wedge between the rate at which the Treasury can borrow and the rate of time discount.

The idea that, for some range of plausible parameter values, expansionary fiscal policy is self-financing means that for a *wider* range of parameter values, expansionary fiscal policy passes sensible benefit-cost tests. The benefits from such policy are, as before, the current-period boost to production and income from higher demand, and future-period boosts to potential output from the smaller shadow cast on future growth by a shorter and shallower downturn. The costs are the drag on future output produced by the higher taxes needed to amortize the debt incurred to finance the fiscal expansion. If fiscal expansion is self-financing, there are no costs, only benefits. And if fiscal expansion is nearly self-financing, then the increase in taxes needed to amortize the debt will be small, and so will the costs. The appendix details the arithmetic of such an extra-output benefit-cost calculation.

II. The Value of the Multiplier

Valerie Ramey (2011) surveys estimates of the fiscal multiplier and classifies them into four groups: estimates from structural models, estimates

8. How is it that a government can borrow at less than the social rate of time discount? Perhaps because government debt has unique collateralization properties that make it in some sense "money-like" (see Krishnamurthy and Vissing-Jorgensen 2012). In this case the wedge between the government borrowing rate and the social rate of time discount captures a real service flow provided to the economy by the provision of extra government debt. To the extent that the government can borrow unusually cheaply because investors are making mistakes, the welfare economics becomes complex.

from exogenous aggregate shocks (relying largely on increases in military spending associated with wars), estimates from structural vector autoregression models (VARs), and "local multiplier" estimates.[9] She concludes (pp. 680–81) that

> the range of plausible estimates for the multiplier in the case of a temporary increase in government spending that is deficit financed is probably 0.8 to 1.5. . . . If the increase is undertaken during a severe recession, the estimates are likely to be at the upper bound of this range. It should be understood, however, that there is significant uncertainty involved in these estimates. Reasonable people could argue that the multiplier is 0.5 or 2.0. . . .

Christina Romer (2011) also surveys multiplier estimates. She summarizes the evidence as suggesting a somewhat higher central tendency for estimates of the government purchases multiplier slightly above 1.5. She stresses a strong presumption that econometric estimates are likely to be lower than the constant-monetary-and-financial-conditions multiplier, which as we argue below is itself a lower bound to the current policy-relevant multiplier. As Romer (p. 11) states, concurring with Emi Nakamura and Jón Steinsson (2011): "In the situation like the one we are facing now, where monetary policy is constrained by the fact that interest rates are already close to zero, the aggregate impact of an increase in government spending may be quite a bit larger than the cross-sectional effect."

The International Monetary Fund (IMF 2009) finds a government purchases multiplier in a broad range of post-World War II experiences similar to Romer's central estimate. Alan Auerbach and Yurii Gorodnichenko (forthcoming) attempt to distinguish the multiplier in normal times from that which prevails when the economy suffers from slack aggregate demand. They estimate a multiplier of around 0.5 for normal times and around 2.5 when the economy is depressed.[10] IMF (2010) concludes that the multiplier at the zero lower bound is more than twice what it is in normal times.

9. See, among many, many others, Ramey and Shapiro (1998), Blanchard and Perotti (2002), Gordon and Krenn (2010), Suárez Serrato and Wingender (2010), Clemens and Miran (2010), Barro and Redlick (2011), Nakamura and Steinsson (2011), Chodorow-Reich and others (2011), Romer (2011), Mendel (2012), and Ramey (2012). Moretti (2010) estimates a local multiplier that is explicitly a supply-side economic-geography concept rather than a demand-side macroeconomic concept. The relationship between economic-geography local multipliers and macroeconomic local multipliers is not clear to us.

10. See Parker (2011) on the importance of nonlinearities and on the difficulty of picking out the depressed-economy multiplier of interest here. Hall (forthcoming), however, cautions that Auerbach and Gorodnichenko's finding "has little to do with the current thought that the multiplier is much higher when the interest rate is at its lower bound of zero . . . [for their] . . . sample surely includes only a few years when any country apart from Japan was near the lower bound."

To summarize: the range of current multiplier estimates extends from Ramey's lowest for which "reasonable people could argue," 0.5, up to Auerbach and Gorodnichenko's estimate of 2.5, which applies when GDP is below potential such that increases in nominal spending are highly likely to show up primarily as increases in real GDP. However, it is far from clear that these estimates or the methodologies that generate them shed sufficient light on the fiscal multiplier concept relevant for our framework in section I. At present in the United States, not only is GDP below potential, but the zero lower bound constrains interest rates, and substantial frictions interfere with the functioning of credit markets. These features were seldom present during the periods and in the countries for which these multipliers were estimated.

We can use Ramey's categorization to rehearse some of the potential problems with applying these multiplier estimates from the literature to a depressed economy. First, structural model estimates are only as good as the identification of the structural model. Second, estimates based on changes in military spending will underestimate the impact of fiscal policy in a context like the present, to the extent that spending increases are associated with tax increases and Ricardian equivalence does not hold in full, or to the extent that supply constraints associated either with the rapid shift of production, heedless of efficiency, from civilian to military uses found in an emergency military mobilization, or with a high rate of resource utilization, slow output growth. Third, the identification of exogenous fiscal shocks using time-series techniques seems to us problematic: it is often difficult to identify historical events in the narrative or contemporary notes that expectations have shifted in those quarters in which time-series techniques identify "shocks" orthogonal to an information set consisting of a few lagged values.

Most promising are the estimates of "local multipliers" made by Nakamura and Steinsson (2011) and an increasing number of others. They examine differences in government spending across regions and identify a multiplier holding monetary and financial conditions constant. This literature appears to be coalescing around an estimate for such a multiplier of 1.5, although with substantial imprecision.[11]

11. There remains some uneasiness about the interpretation of local multiplier estimates. The presence of demand spillovers across regions tends to bias such estimates down, as does the possibility that higher expected inflation rates, in the manner of Christiano, Eichenbaum, and Rebelo (2011) and Eggertsson and Krugman (2011), are a channel of transmission. Moreover, consider a permanent increase in government purchases in one region financed by taxes on all regions. Under a full Ricardian regime, such a permanent increase in spending would have no effect at all on demand and output. Yet a local multiplier study would show a considerable multiplier in both the short and the long run—an economic-geography

The principal issue in linking these estimated multipliers to the reduced-form fiscal multiplier relevant for the framework of section I is whether and to what extent the monetary policy reaction function in normal times differs from that in a depressed economy. Indeed, our suspicion is that much of the substantial variation over the past 80 years in the judgments of American economists, at least, about discretionary fiscal policy reflects changes in the nature of this function, and thus in the monetary-and-financial-conditions curve that underlies their analyses. As views of the likely slope of this function (depicted as the MP curve in figures 2 through 4 below) have changed, views of the efficacy of fiscal expansion in a depression have changed as well.

From the time of Keynes' *General Theory* to the 1960s, the default assumption was that interest rates would remain constant as fiscal policy changed, because the central bank and the fiscal authority would cooperate to support aggregate demand: fiscal expansion would be accompanied by monetary policy accommodation that produced not crowding out but crowding in. With the changes in macroeconomic thinking and the inflationary experience of the 1970s, the natural assumption in the United States came to be that the Federal Reserve was managing aggregate demand. Thus, changes in fiscal policy, just like changes in private investment demand, would be offset as the Federal Reserve pursued the appropriate balance between inflation and investment. Today, however, at least until the economy exits from the zero lower bound or cyclical unemployment drops substantially, the economy is once again in a regime in which real interest rate movements amplify rather than offset the effects of fiscal stimulus.

Consider a central bank that includes both inflation and output in its objective function, in an economy that is well modeled by the neo-Hicksian framework of Romer (2000). In such an economy, output Y and the real interest rate charged to firms r^f are jointly determined by an IS saving-investment condition and an MP monetary policy reaction function. Assume that real aggregate demand is a function of the fiscal policy impetus ΔG, the constant-monetary-and-financial-conditions multiplier μ, and r^f. An increase in government purchases in the current period from

parameter: the inverse of 1 minus the share of regional demand spent on locally produced commodities. As Mendel (2012) points out, local multiplier studies not only hold monetary and financial conditions constant; they also hold constant future fiscal conditions in the form of expectations of future broad-based taxes. To the extent that the argument against the effectiveness of expansionary fiscal policy relies on present-day reductions in spending stemming from anticipated future tax burdens, local multiplier studies will overstate the policy-relevant concept.

baseline, ΔG, would then, all else equal, raise current-period output relative to baseline according to the IS condition:

$$\Delta Y = -\alpha\left(\Delta r^f\right) + \mu\Delta G. \tag{8}$$

However, if the monetary authority responds to this expansionary fiscal policy by raising r^f or allowing it to rise, according to the following MP function,

$$\Delta r^f = \left(1/\gamma\right)\Delta Y, \tag{9}$$

then the reduced-form relationship between the fiscal expansion and the resulting difference in output from baseline is

$$\Delta Y = \frac{\gamma}{\left(\gamma + \alpha\right)}\mu\Delta G. \tag{10}$$

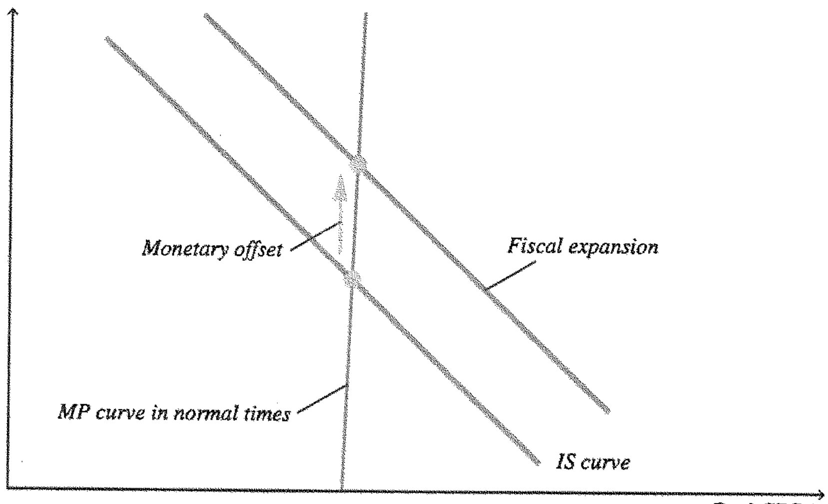
Thus, an estimate of the multiplier over a period during which the monetary policy reaction function is characterized by a particular γ will give not the constant-monetary-and-financial-conditions multiplier μ, but rather

$$\mu' = \frac{\gamma}{\left(\gamma + \alpha\right)}\mu. \tag{11}$$

What value of γ will an optimizing central bank pick for its reaction function if, like the Federal Reserve from the end of the 1970s to the mid-2000s, it is focused on its price stability mission? The central bank will have a view about what level of Y is best suited to advance that mission over the long term. That level of Y will not be much altered by the stance of fiscal policy. The implication then is that the central bank will pick a value of γ very close to zero, and the MP curve will be nearly vertical. Whatever shocks shift the IS curve, whether fiscal policy or other factors, will then affect interest rates but will affect the level of output little if at all. Thus, in normal times the policy-relevant reduced-form multiplier μ' is likely to be small. Figure 2 illustrates this monetary offset of the fiscal expansion in normal times.

The situation is different when the economy is at the zero bound, precisely because the fiscal expansion ΔG then extends the set of economic outcomes Π attainable through monetary policy in a manner that provides access to superior outcomes previously unreachable. At the zero bound, the central bank is setting the short-term safe nominal interest rate i that it

Figure 2. IS-MP Analysis of a Fiscal Expansion in Normal Times[a]



Source: Authors' model described in the text.

a. In normal times, when the economy is at or near full employment and short-term interest rates are away from their zero nominal lower bound, any attempt to increase real GDP through fiscal expansion is virtually fully offset by a rise in real interest rates.

controls at zero. It would not respond to fiscal policy that boosts output by raising the short-term nominal interest rate to offset its effects, for that level of output is a previously unreachable superior outcome.

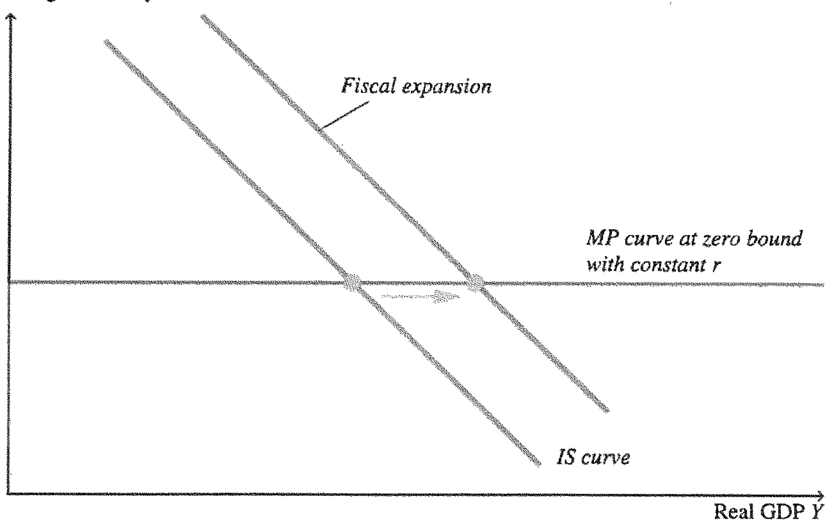
If the long-term rate to firms r^f were at a constant premium to the short-term safe nominal interest rate i, then at the zero bound the monetary policy reaction function would set a constant real rate. The MP curve would be flat, and the parameter α in equation 8 would be zero. And as in figure 3, the policy-relevant reduced-form multiplier would equal the constant-monetary-and-financial-conditions multiplier: $\mu' = \mu$.

In reality, however, there is slippage between i and r^f. The relationship between them is

$$r^f = i - \pi + \sigma. \tag{12}$$

In words, the relevant real interest rate is equal to the short-term safe rate, minus inflation, plus a spread σ—which itself has duration, risk, and default components. The inflation rate will be increasing in output: more

Figure 3. Fiscal Expansion at the Zero Lower Bound with a Constant Real Interest Rate[a]



Source: Authors' model described in the text.

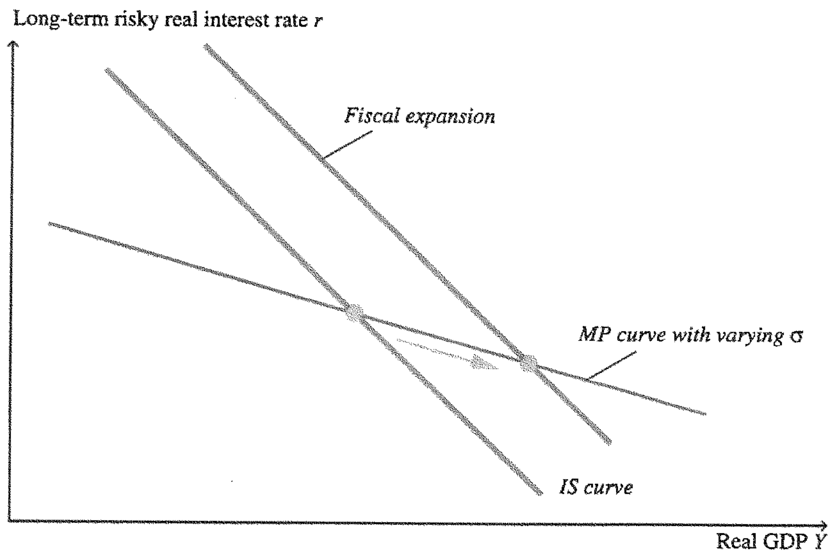
a. In a depressed economy where short-term interest rates are at the zero bound, a constant spread between short-term safe and long-term risky rates means the MP curve is flat. Thus, real long-term interest rates do not rise to attenuate the impact of fiscal expansion on real GDP, but neither do they fall to amplify it.

demand both raises the chances that producers will increase prices and increases how much they will raise them.[12] The interest rate spread σ, in contrast, may well be a decreasing function of output: a more prosperous economy is one with fewer defaults, and the price of bearing risk is lower because there is less risk in the economy.[13]

12. Christiano and others (2011), Eggertsson and Krugman (2012), and others point out that the impact of upward price pressure expected from expanded aggregate demand on real interest rates at the zero bound could have substantial quantitative significance. Earlier the same point had been phrased in reverse, as a fear of the potentially catastrophic consequences of deflation. See Fisher (1933).

13. The effects on duration premiums are less clear. One potential channel is that, in a depressed economy, with short-term safe nominal interest rates at their zero lower bound, if monetary authorities are willing to commit to keeping them there for a considerable period, the framework-relevant reduced-form multiplier is likely to be even larger to the extent that inflation is inertial: higher inflation in the short run due to fiscal expansion will raise expected inflation and thus lower the real interest rates expected for future periods as well. With a product-market equilibrium condition IS slope α of -0.6 as in Hall (2012), an expected duration of the zero lower bound of 3 years could double the policy-relevant reduced-form multiplier relative to the constant-monetary-and-financial-conditions multiplier.

Figure 4. Fiscal Expansion at the Zero Lower Bound with a Declining Real Interest Rate[a]



Source: Authors' model described in the text.

a. If the spread σ between short-term safe and long-term risky rates is not constant but narrows as output rises, because an economy closer to full employment presents less risk to investors, then given short-term rates at the zero bound, the MP curve is not flat but downward sloping, and the increase in real GDP from a fiscal expansion is amplified.

Thus, instead of an MP curve in which increases in GDP are associated with increases in r^f, and instead of a flat MP curve, a depressed economy at the zero bound is likely to see the following relationship between interest rates and the state of the economy:

$$\Delta r^f = -\delta \Delta Y. \tag{13}$$

The multiplier estimated in that case, and the one relevant for the reduced-form framework of sections I and II, will be neither the (relatively small) normal-times reduced-form multiplier μ' nor the constant-monetary-and-financial-conditions multiplier μ, but rather

$$\mu^* = \frac{\mu}{(1 - \alpha\delta)}, \tag{14}$$

and the ratio of this policy-relevant multiplier at the zero bound to the normal-times multiplier will be $\mu^*/\mu' = [1 + (\alpha/\gamma)]/(1 - \alpha\delta)$.

Figure 4 illustrates this difference between the (small) multiplier likely to be seen in normal times and the multiplier relevant at the zero bound.

Whereas the MP curve in normal times is steeply sloped upward, causing virtually all of any increase in output through fiscal expansion to be offset by a rise in r^f, the MP curve relevant for a depressed economy at the zero bound slopes downward: the stronger the economy, the lower is the real cost of capital to firms seeking to borrow.

A situation in which fiscal expansion is accompanied not by higher but rather by lower real interest rates for firms fits a scenario often mentioned by observers but rarely modeled: that of "pump priming," a term popularized by Jacob Viner and Lauchlin Currie during the New Deal of the 1930s (Jones 1978). The claim is that private spending will flood into the marketplace and boost demand, once initial government purchases have restored the normal channels of enterprise.

Note that the presence of an exceptionally accommodative monetary reaction function at the zero bound raises the possibility that an increase in government purchases might under some circumstances be self-financing even without any hysteresis at all. At a marginal tax-and-transfer share τ of 1/3, a depressed-economy policy-relevant Keynesian multiplier μ^* of 1.5 would mean that the rise in the national debt ΔD is only half as large as the spending from an expansionary fiscal boost ΔG. A μ^* of 3 would mean that fiscal policy becomes self-financing through demand channels without resort to supply-side hysteresis. Back in 1977, Walter Heller, who had served as chairman of the Council of Economic Advisers during the Kennedy and Johnson administrations, testified before the Joint Economic Committee of Congress that reduced real interest rates brought about by monetary accommodation had raised the policy-relevant multiplier applicable to the 1964 Kennedy-Johnson tax cut enough to put it on the edge of self-financing. As Bruce Bartlett (2003, p. 5) quotes Heller:

> What happened to the tax cut in 1965 is difficult to pin down, but insofar as we are able to isolate it, it did seem to have a tremendously stimulative effect, a multiplied effect on the economy. It was the major factor that led to our running a \$3 billion surplus by the middle of 1965, before escalation in Vietnam struck us. It was a \$12 billion tax cut, which would be about \$33 or \$34 billion in today's terms. And within 1 year the revenues into the Federal Treasury were already above what they had been before the tax cut. . . . Did it pay for itself in increased revenues? I think the evidence is very strong that it did. . . .

From early in the Kennedy administration through the end of 1964, the proxy for the real annual rate on 10-year Treasuries calculated by subtracting the subsequent year's inflation from the nominal rate was around 3 percent;

thereafter it dropped rapidly to around 1.5 percent. The Congressional Budget Office (CBO) was more cautious than Heller, concluding that between "25% and 75%" (Bartlett 2005, p. 5) of the static 2-year debt increase from the tax cut had been offset by the boost to output and thus to tax revenue that it had delivered.

The argument that normal-times policy-relevant fiscal multipliers should be presumed to be very small can be made more general. Optimizing central banks will be expected to offset shifts in discretionary fiscal policy—and thus lead to multiplier estimates near zero—under relatively unrestrictive conditions. Consider a government choosing monetary policy so as to achieve the best economic outcome from the set of outcomes attainable by policy Π. A change in fiscal policy from baseline would change the relationship between monetary policy and the economic outcome. But unless the change in fiscal policy opens up access to an outcome not in the set Π that is superior, or eliminates access to the best economic outcome in Π, the government will shift its monetary policy so that it still picks the same economic outcome. It will thus engage in full monetary offset.

Note that for this point to hold, the choice of monetary policy m and the choice of fiscal policy g cannot themselves be part of the outcome the government values. A central bank that values a smooth path for interest rates (as did the pre-1979 Federal Reserve) or has preferences about the size of its balance sheet (as did the Federal Reserve under Paul Volcker) will not engage in full monetary offset. Monetary and fiscal policy must enter into the central bank's objective only through their effects on economic outcomes for full monetary offset to hold.

For these reasons it is difficult, for us at least, to consider the empirical evidence on multipliers without reaching the conclusion that the base-case multiplier of 1.0 of section I is likely to be an underestimate, and perhaps a substantial underestimate, of the policy-relevant multiplier in excess-capacity economies at the zero bound like the United States today.

III. Hysteresis

As Edmund Phelps (1972) was the first to point out, there are reasons for believing that recessions impose costs even after they end, and that a "high-pressure economy" (Arthur Okun's term for one continuously operating at potential) has continuing benefits. It is not easy to quantify these "hysteresis effects," in part because the factors that cause a downturn may continue to have an impact once the downturn has ended, which is difficult to disentangle from the hysteresis effect. In this section we survey some of the evidence in an effort to come to a plausible view about our reduced-form framework parameter η, the impact of a 1-percentage-point shortfall of GDP below potential for 1 year on the subsequent path of potential output.

It would indeed be surprising if downturns did not cast a shadow over future economic activity. A host of mechanisms have been suggested, including reduced labor force attachment on the part of the long-term unemployed, scarring effects on young workers who have trouble beginning their careers, reductions in government physical and human capital investments as social insurance expenditures make prior claims on limited public financial resources, reduced investment in both in research and development and in physical capital, reduced experimentation with business models and informational spillovers, and changes in managerial attitudes.

Bottom-up evidence on hysteresis is provided by Kim Clark and Summers (1982), who documented substantial persistence in individuals' labor supply decisions and found that past work experience was a key determinant of current employment status. They concluded that this persistence of labor supply decisions meant that the hypothesis of a "natural" or non-accelerating-inflation rate of unemployment (NAIRU), as a medium-run proposition, was false. Steven Davis and Till von Wachter (2011) find that workers who lose their jobs when unemployment is high lose an extra amount, relative to when unemployment is low, equal to the present value of an extra 1.5 years of earnings in their subsequent careers—a 7.5 percent reduction in permanent earnings. At a typical average unemployment duration of 17 weeks, the aggregate demand shock associated with such a loss of employment amounts to a third of a year's earnings. This suggests a contribution to the η parameter of 0.225 ($0.075 \div 0.333$) from the labor side alone, and that only if the average duration of unemployment rapidly returns to normal levels.[14]

In addition to these effects on the labor side, the past several years have seen substantial shortfalls in both public and private investment.

14. Such calibration efforts are hazardous. The potential for selection effects to confound estimates is large. There is little warrant for believing that the difference between income losses following layoffs in low- and those in high-unemployment periods in the past corresponds to the effects of a shock outside the previous range like the one the U.S. economy is now experiencing.

Government nondefense capital formation in the United States is already 0.4 percentage point below its early-2008 peak as a share of potential GDP, and cuts continue. Private gross investment is still 3.5 percentage points of potential GDP below its precrisis level and has been depressed for 4 years.

The natural way to calibrate these effects on the investment side to the current downturn is to say that a 20-percentage-point-year cumulative shortfall from potential GDP has carried with it a relative decline in the capital stock equal to 14 percentage points (3.5 percentage points × 4 years) of annual potential GDP. At a marginal product of capital of 10 percent per year, that implies a 1.3 percent reduction in potential output and an investment-side contribution to η of 0.13; at a marginal product of capital of 5 percent per year, it implies a 0.65 percent reduction in potential output and an investment-side contribution to η of 0.065.

In the standard Solow growth model, the shortfall in private investment generated by the financial crisis and the recession will eventually be made up as the economy reconverges to its steady-state capital-to-output ratio. Long-term-unemployed workers who become discouraged and drop out of the labor force will reach retirement age within several decades. The long-run effects of a long, deep downturn on potential output are thus much more plausibly viewed as persistent than as truly permanent. The $1/e$ time of convergence to the steady-state capital-to-output ratio is on the order of 33 years. The average time to retirement of labor force dropouts is likely to be somewhat less. Thus, permanent-equivalent measures of the persistent effects of downturns on future potential output will be somewhat smaller. Even so, the bottom-up evidence of persistent effects of downturns on potential output indicates a value for η that is at or above the top of the range considered in section I.

Top-down evidence for hysteresis in Europe was provided by Olivier Blanchard and Summers (1986). Reacting to increases in the unemployment rate in Western Europe from the 1970s to the mid-1980s, they argued that hysteresis links between the short-run cycle and the long-run trend were key: that increases in unemployment from recessions "have a direct impact on the 'natural' rate of unemployment" around which an economy would oscillate. Others had argued that Western Europe's persistently high unemployment was primarily due to rigidities in labor markets (high minimum wages, high firing costs, and the like). Laurence Ball (1997), however, suggested that the link between labor market rigidities and the transformation of cyclical into structural unemployment in Western Europe in the 1980s had been overdrawn. In his estimation, "countries with larger decreases in inflation and longer disinflationary periods have larger rises in the NAIRU. [Measured] imperfections in the labor market [had] little direct relation to change in the NAIRU,"[15] with the possible exception of an interaction between the generosity of the unemployment insurance system and the depth of the downturn.

Ball's (1997) attribution of cross-national variation in changes in the NAIRU in the 1980s and 1990s to inadequate stabilization policy in some countries that allowed cyclical unemployment to turn structural has striking implications. He finds that in countries that pursue long, slow rather than short, sharp disinflations—with an active pursuit of disinflation on the order of 4 years—effectively all of the cyclical decline in employment becomes a permanent decline. Four percentage-point-years of a negative shock thus produces a 1 percent fall in potential output, for an η of 0.25.

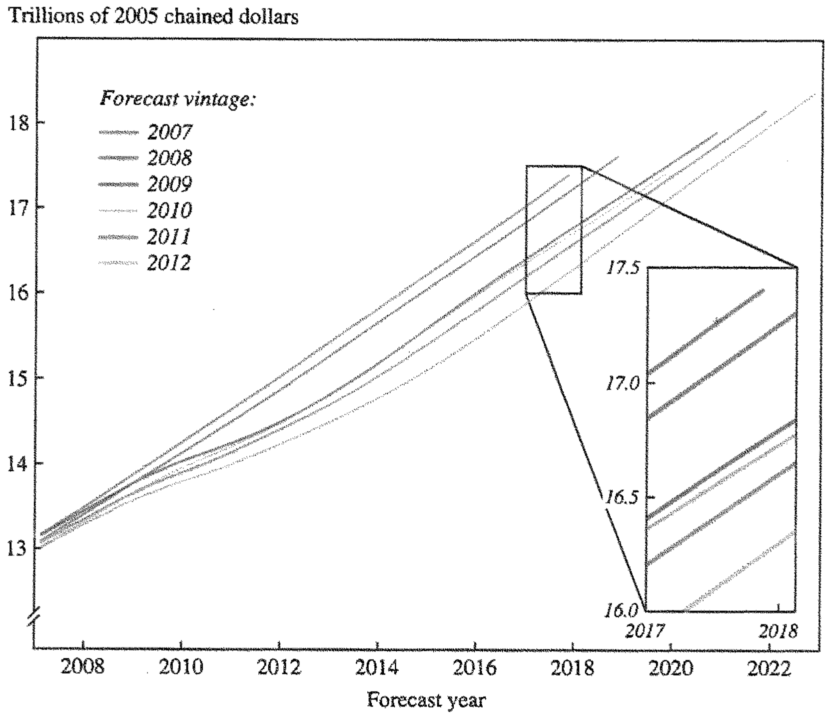
Findings similar to those of Ball (1997) are reported in IMF (2009), which examines the effects of demand shocks produced by financial crises at a 7-year horizon. In that study of the aftermath of 88 financial crises in the past two generations, each output decline of 1 percent of GDP in the short-run response to a financial crisis is associated on average with a 1 percent shortfall of GDP from its precrisis trend. If the "short run" during which output is depressed because of inadequate demand is 3 years, this result is consistent with an η of 0.33.[16]

A second form of top-down evidence is provided by professional economic forecasters. As a group, they do not appear to hold to the position that the current economic downturn will have no or small effects on the growth path of U.S. potential output. Instead, their recent revisions of their projections for the next decade implicitly incorporate very substantial hysteresis effects. To take one prominent example: between January 2007 and January 2009, as the economy slid into its deep, financial crisis-driven recession, the CBO marked down its estimate of potential GDP for the end of 2017 by 4.2 percent (figure 5). The CBO took some heart from the end of the recession in late 2009, and in its January 2010 forecast revision

15. Ball (1997, p. 168). See, in addition, Stockhammer and Sturn (2012), who also conclude that the degree of labor-side hysteresis is likely to have only weak connections with labor market institutions but a rather strong association with the persistence of high unemployment and the failure of activist stabilization policies to quickly fill the output gaps created by downturns. In their results, hysteresis has "strong [associations with] monetary policy, and . . . [perhaps] the change in the terms of trade, but weak (if any) effects of labour market institutions during recession periods. Those countries which more aggressively reduced their real interest rates in the vulnerable period of a recession experienced a much smaller increase in the NAIRU. . . ."

16. Also consistent is Romer (1989), who argues that the output effects of demand shocks are very long lasting.

Figure 5. Recent CBO Forecasts of Potential GDP



Source: Congressional Budget Office.

it raised its estimate of end-of-2017 potential GDP by 0.4 percent. Then, over the next 2 years to January 2012, the CBO—in near lockstep with private forecasters—lowered its forecast of end-of-2017 potential GDP by an additional 3 percent. Thus, as of the beginning of 2012, the CBO had marked down its estimate of potential GDP 5 years hence by a cumulative 6.8 percentage points. Were that markdown to be interpreted as the result simply of the 20-percentage-point-year output gap to the present, it would correspond to an η of 0.34. Even if that markdown were based on a belief that the economy has so far experienced only half of the cumulative gap relative to potential output that will ultimately result from this episode, that would correspond to an η of 0.17.

It is possible that these revisions reflect not a belief in hysteresis but merely the recognition that previous forecasts of potential output were too high. However, an elementary signal extraction point rebuts this interpretation. When observing a noisy series that has a permanent component, an observation lower than the current estimate of the permanent component leads a rational forecaster to reduce his or her estimate of that permanent component. However, one should not reduce one's estimate of potential output if lower-than-previously-expected levels of production are associated with lower-than-previously-expected levels of inflation. Estimates of potential output are conceptually based not on quantities alone, but on quantities and prices. Typically, the bad news that leads to a marking down of potential output is not news that output is lower than, but rather news that output and inflation together are above, their anticipated co-movement line. Such news is not in evidence.

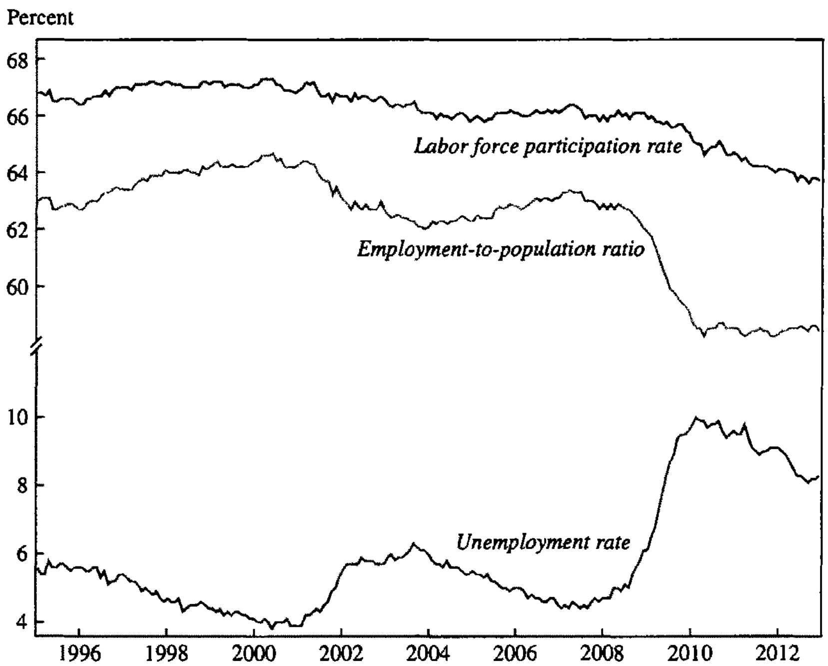
Blanchard and Summers's (1986) line of thought was that significant hysteresis was a uniquely European phenomenon. Their model carried the implication that the United States was likely to be largely immune from permanent labor-side effects of what was originally transitory cyclical unemployment.[17] They stressed the "insider-outsider" wage-bargaining theory of hysteresis: workers who lose their jobs no longer vote in union elections, and so union leaders no longer take their interests into account in negotiations, focusing instead on higher wages and better working conditions for those still employed. Since union strength and legal obligations on employers to bargain were much weaker in the United States than in Europe, insider-outsider dynamics generated by formal labor market institutions seemed to give the United States little to fear.

However, the labor market dynamics of the past two and a half years raise the possibility that the United States is not so immune after all from the considerations raised by Blanchard and Summers (1986). Rather, a transformation of cyclical into structural unemployment may be under way in the United States today, as the pace of real GDP growth during the current recovery is no greater than the precrisis trend growth rate of potential output, so that the output gap remains large.

Here it is worth noting the divergence between the behavior of the measured U.S. unemployment rate and the behavior of the measured U.S. adult employment-to-population ratio over the past two and a half years. From the late-2009 peak in the unemployment rate until April 2012, the civilian employment-to-population ratio fell by only 0.1 percentage point, the civilian adult labor force participation rate by a more substantial 1.4 percentage points, and the unemployment rate by an even larger 1.9 percentage points, from 10.0 percent to 8.1 percent (figure 6).

17. An alternative also put forward by Blanchard and Summers (1986) focuses on how the long-term unemployed become detached from the labor market. See Granovetter (1973) and especially Layard, Nickell, and Jackman (2005).

Figure 6. Labor Force Participation Rate, Employment-to-Population Ratio, and Unemployment Rate, 1995–2012

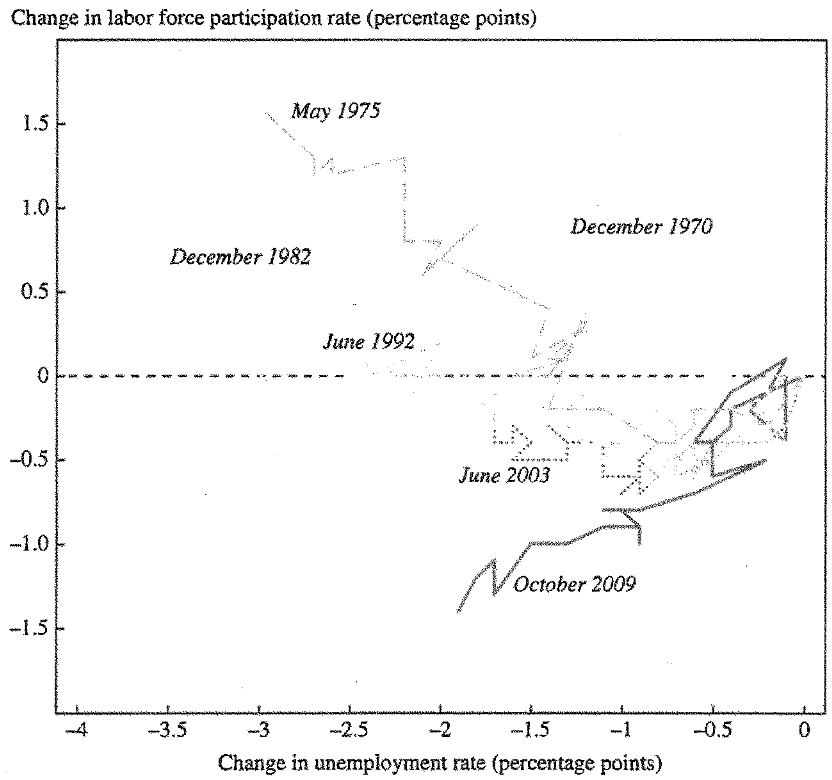


Source: Current Population Survey.

Such a divergence between the unemployment rate and the employment-to-population ratio is unprecedented in the United States. The years immediately following the 1970, 1975, and 1982 unemployment rate peaks saw strong recovery in the labor force participation rate, and the 1992 and 2003 unemployment rate peaks were followed by effectively flat labor force participation rates and very slow eventual recoveries. Only after the 2009 unemployment rate peak has the civilian labor force participation rate continued to decline, and indeed to decline by enough to offset the effects of the falling unemployment rate, leaving the employment-to-population ratio virtually unchanged from the low point reached at the end of the recession (figure 7).

Since the late 1990s, the retirement of many members of the baby-boom generation has led to lower employment-to-population ratios for a given unemployment rate. But this is a slow-moving generational trend, amounting to a fall in labor force participation on the order of 0.05 percentage

Figure 7. Changes in Unemployment and Labor Force Participation Rates after Cyclical Peaks[a]



Source: Authors' calculations from Current Population Survey data.
a. Each line plots the month-to-month changes in the two measures for a single recession, beginning with the month (labeled) in which the unemployment rate peaked.

point per year. The total reduction in labor force participation since the end of the recession is thus an order of magnitude too large to be attributed to this phenomenon alone.[18] Moreover, there are counteracting pressures stemming from the financial crisis that should tend to raise labor force participation: one would expect many middle-aged Americans whose wealth (housing or financial, or both) has been reduced by the crisis to delay retirement. Indeed, there are signs of such a wealth effect at work in the increasing employment of those past retirement age since 2007.

18. See Daly, Hobijn, and Valetta (2011). There is a potential argument for an interaction effect, however: perhaps the older labor force of today is more likely to be induced into early retirement by the experience of unemployment.

Consider a counterfactual in which the unemployment rate had followed its actual trend but the labor force participation rate had remained at its same level between October 2009 and April 2012, rather than falling by 1.4 percentage points in those 30 months as it did. The supply of workers in America today is 2.2 percent lower than in that counterfactual baseline. Under the assumption that potential output scales one for one with the labor force, such a reduction in labor supply implies a 2.2 percent reduction in potential output. Assuming instead a potential-output production function with a labor share of 0.65, the reduction in potential output would be 1.4 percent.

From the start of 2008 through the end of 2011, the cumulative shortfall of real GDP from the Congressional Budget Office's potential GDP series amounted to 20.5-percentage-point-years. Under the assumption that potential output scales one for one with the labor force, dividing 2.2 percent by 20.5-percentage-point-years yields an η of 0.107; assuming instead that potential output scales with a labor share of 0.65 gives an η of 0.07. Moreover, this calculation assumes that the NAIRU has remained unchanged over the past 5 years. Christina Romer (2012) documents, however, that the NAIRU estimates of the CBO, the Federal Open Market Committee, and the Survey of Professional Forecasters have been raised since 2007 by 0.8, 0,7, and 1.2 percentage points, respectively.[19] A counterfactual in which the NAIRU had remained at its 2007 rate would produce a potential labor force at full employment 3.0 percent larger than the current situation, which would imply correspondingly higher values of η.

The U.S. economy in the aftermath of the 2008–09 crisis thus appears not to be repeating the exceptional rapid rebound that used to distinguish it from the sclerotic Western Europe analyzed by Blanchard and Summers (1986). Instead it seems to be following much more closely the typical post–financial crisis pattern found by IMF (2009). In their sample, 7 years after the crisis, real GDP on average was some 10 percent below its precrisis trend.[20] Both the capital stock and employment were substantially depressed below their precrisis trends, with shortfalls relative to previous trends in total factor productivity as well. In particular, IMF (2009, pp. 4–5) found:

—There was, on average, no recovery to trend from the level relative to trend of the short-run output decline: "the path of output tends to

19. The CBO's estimates are found in its *Budget and Economic Outlook*, various issues; those of the Federal Open Market Committee in its Summary of Economic Projections, various issues; and those of the Survey of Professional Forecasters in Federal Reserve Bank of Philadelphia (2011).

20. The IMF is relatively strident on this point. It writes of "sobering implications" of the analysis and praises "forceful macroeconomic policy response[s] . . . in the form of substantial fiscal and monetary stimulus."

be depressed substantially and persistently . . . with no rebound on average to the precrisis trend."

—Crises that did not generate large output declines in the short run tended not to generate large shortfalls relative to trend at the 7-year horizon: "what happens to short-run output is also a good predictor of the medium-term outcome."

—The economies that did approach their precrisis trend growth path in recovery tended to be those that had applied substantial macroeconomic stimulus immediately after the crisis: "although post-crisis output dynamics are hard to predict, the evidence suggests that economies that apply counter-cyclical fiscal and monetary stimulus in the short run after the crisis tend to have smaller output losses" relative to trend at the 7-year horizon.

The historical evidence on the existence of hysteresis is thinner than one would wish, as is inevitable when one is attempting to generalize from a few previous episodes. Thus, any conclusions must be weak and tentative. The question of how large a shadow is cast on future potential output by a deep cyclical downturn rests on a few historical cases: the experience of the United States and Western Europe in the Great Depression, the long Western European downturn of the late 1970s and the 1980s (comparing both Europe with the United States and the European countries with each other), and Japan's "lost decades" starting in the 1990s. In the United States, moreover, the Great Depression was followed by the great boom of total mobilization for World War II, so that if the Great Depression did cast a shadow, it was erased by the war.

Perhaps the recent departure of the unemployment rate and the labor force participation rate from their earlier historical pattern of co-movement will turn out to be a transitory cyclical anomaly. Perhaps in the next few years the economy will quickly rebound to its pre-2008 path of potential output growth. But our reading of the remaining cases—the experience of Western Europe since the late 1970s and Japan during the 1990s and after—provide strong reason to presume that hysteresis effects on the order of those in table 2 are more likely than not to be a reality. In that case the standard call for further research in this area becomes urgent.

IV. Conclusion

Real interest rates on Treasury securities have fluctuated within a relatively narrow range throughout their history, except for the few years of the Volcker disinflation of the early 1980s. Rates in this historical range, in a depressed economy at the zero lower bound, with even a modest short-run government purchases multiplier μ and a small hysteresis parameter η, generate as a matter of arithmetic the conclusion that expansionary fiscal policy does not impose a future fiscal burden. Moreover, as the appendix shows, even when expansionary fiscal policy fails to be self-financing in these circumstances, it is still likely to pass a sensible extra-output benefit-cost test, at least as long as there is no substantial wedge between the government's real borrowing cost and the real social rate of time discount.

Sections II and III made the case that the short-run reduced-form policy-relevant fiscal multiplier μ is likely to be substantial enough *in a depressed economy,* and that hysteresis effects η are likely to be present. And there is today no sign of a large wedge between the government's real borrowing cost and the real social rate of time discount.

It is important to stress that our argument does not justify unsustainable fiscal policies, nor does it justify delaying the passage of legislation to make unsustainable fiscal policies sustainable. If committed spending and committed revenue plans are inconsistent, adjustments will be necessary. Nothing in our analysis calls into question the widely held proposition that it is desirable for those adjustments to be committed to sooner rather than later. Indeed, the sooner that is done, the less likely is the emergence of the wedge between government borrowing costs and the social discount rate that would make expansionary fiscal policy unwise even in a depressed economy. Expansionary fiscal policy is more likely to be self-financing when there is confidence in long-run fiscal balance than otherwise.

Three crucial questions confront any attempt to draw policy implications:

—Doesn't the argument prove too much? Can it be the case that most governments at most times can take on increased debt, relying on the benefits of induced growth to pay it back?

—Is the kind of temporary fiscal stimulus envisioned in our model feasible in the world, or does it inevitably, in reality or perception, become at least quasi-permanent, thus amplifying debt-servicing costs without amplifying the output benefits?

—Third, whatever the merits of fiscal stimulus, should not monetary policy be relied on as an alternative and superior instrument?

We briefly consider each of these questions in turn.

On the first question, it surely cannot be the case that more expansion is desirable most of the time. We have stressed our belief that, outside of extraordinary downturns where the zero lower bound constrains interest rates, the right assumption is that the fiscal multiplier is likely to be small.

Increases in demand run up against supply constraints,[21] even when they are not offset by monetary policy. And in the normal-times case of a small policy-relevant multiplier, judgments about fiscal policies should be made on allocative rather than stabilization policy grounds. As a corollary, even in depressed economies, expansionary fiscal policy surely should not be pursued without limit.

With regard to the second question, the premise of our analysis is that expansionary fiscal policy can be both timely and temporary. Thus, it makes a case only for as much fiscal stimulus as can be delivered in a timely and temporary way. If, because of political frictions, stimulus will not in fact be temporary, or if there are substantial lags in its implementation, the calculus of costs and benefits is altered. Is temporary stimulus inconsistent with belief in long-run consolidation? It is possible that short-run fiscal expansion undercuts the credibility of long-run fiscal consolidation. It is also possible that, in a world with limited political energy and substantial procedural blockages, any effort toward one objective compromises the other.

Our reading of the recent U.S. experience is encouraging as to the feasibility of significant timely and temporary stimulus—contrary to Taylor (2011), Juan Carlos Suárez Serrato and Philippe Wingender (2010), and others who suggest that a substantial fraction of the fiscal stimulus enacted in the 2009 recovery act translated rapidly into increased spending and was not offset by triggered changes in state and local fiscal policy. There is also experience with phased-in long-run deficit reductions (for example, the 1983 bipartisan agreement on the Social Security recommendations of the Greenspan Commission). The recent U.S. experience also suggests that fiscal stimulus can be reversed: certainly whatever stimulus was provided by the 2009 act already has been.

But even if it is granted that stimulus can be timely and temporary, the question of how large it can be while preserving these attributes remains for future research.[22] And as Carlo Cottarelli (2012) warns, countries that

21. Note that Gordon and Krenn (2010) find a multiplier of 1.88 for the pre–Pearl Harbor mobilization for World War II at the zero nominal bound when they end their sample in the still demand-constrained first half of 1941, but of only 0.88 when they end their sample at the end of 1941, when supply constraints begin to bite. This feature does not make it into modern models. As Hall (forthcoming) comments, "The simple idea that output and employment are constrained at full employment is not reflected in any modern model that I know of. The cutting edge of general-equilibrium modeling—seen primarily in the DSGE models popular at central banks around the world—incorporates price and wage stickiness that makes supply quite elastic both above and below full employment."

22. See Erceg and Linde (2010) on the nonlinearity of responses to fiscal expansion at the zero bound.

commit to short-term deficit reduction as a down payment on a move to long-term sustainability may find that

> growth slows more than expected . . . [they are] inclined to preserve their short-term plans through additional tightening, even if it hurts growth more . . . my bottom line: unless you have to, you shouldn't . . . interest rates could actually rise [even] as the deficit falls . . . [if] growth falls enough as a result of a fiscal tightening.

On the third question, our analysis has taken it as given that at the zero bound, monetary policy does not change when fiscal policy is altered. Central banks, however, do have room for maneuver, both in their ability to operate directly on a wider range of financial instruments than they use in normal times, and in their ability to precommit policy. As a matter of logic, it is possible that increased fiscal actions will call forth a contractionary monetary policy response by causing central banks to use these tools less expansively. Perhaps, then, as Gregory Mankiw and Matthew Weinzierl (2011) assert, arguments for fiscal expansion in a depressed economy are even better arguments for monetary expansion.

On the other hand, in the United States the Federal Reserve has sought to encourage short-run fiscal expansion. There appear to be limits to the efficacy of nonstandard monetary measures and to the willingness of central banks to expand their balance sheets in order to engage in them. And expansionary fiscal policies may well both support and call forth a more expansionary monetary policy response by, for example, raising the credibility of commitments to monetary expansion after the economy has recovered, or increasing the extent of debt monetization.

It seems to us that, especially if fiscal policy is self-financing, it will be appropriate to include it in the instrument mix, for several reasons. First, given model and parameter uncertainty, diversification among policy instruments is appropriate, as William Brainard (1967) suggested long ago. Second, nonstandard monetary policies at the zero bound are perceived by central banks as carrying substantial costs or risks if engaged in on a large scale—hence central banks' hesitancy at undertaking them. Third, expansionary monetary policies carry costs not represented in standard models, including distortions in the composition of investment, impacts on the health of the financial sector, and impacts on the distribution of income. And fourth, history suggests a tendency for low-interest-rate environments to give rise to asset market bubbles, which economists and policymakers today fear more than they did even half a decade ago. Together these considerations indicate that monetary policy cannot bear all the burden. There is thus a strong case for expansionary fiscal policy in a depressed economy.

APPENDIX

An Extra-Output Benefit-Cost Test

If expression 7 in the text does not hold and the government borrowing rate exceeds or will exceed the critical value, then determining the desirability of expansionary fiscal policy calls for a benefit-cost calculation. It is appropriate to weigh present benefits from expansionary fiscal policy against future costs. A natural quantity to examine for such a benefit-cost calculation is the present value of the change in future output: the summed, discounted effects on present and future GDP of contemporary transitory fiscal expansion.[23]

Call these effects ΔV. Then, in terms of the framework of section I, where ΔY_n is the impact of the transitory fiscal expansion ΔG on present-period output and ΔY_f is the impact on potential output in a representative future period,

$$\Delta V = \Delta Y_n + \frac{\Delta Y_f}{r - g},^{24} \tag{A.1}$$

where r is in this case the real social rate of time discount, which we identify here with the real government borrowing rate.

Assume that the appropriate long-run measure of r is or will rapidly normalize to a value larger than the growth rate of the tax base g. The economy is thus dynamically efficient. If the economy is not dynamically efficient, then there is no benefit-cost calculation to perform: expansionary fiscal policy is worthwhile.

Fiscal expansion has benefits in terms of higher GDP in the short run through the multiplier. It has benefits in terms of higher future potential output in the long run through the avoidance of hysteresis. These benefits are counterbalanced by the supply-side drag on future potential output from higher tax rates needed to raise the revenue to amortize the higher debt burden.

Equation A.1 assumes that the long-term effects of fiscal expansion, both through avoiding hysteresis and through debt amortization, are truly

23. The change in the present value of output can, of course, be questioned as a welfare measure. In contexts like the present, however, we suspect that the social value of the leisure of the currently unemployed is low, and that society attaches a high value to the extra output gained in the future by, for example, avoiding cutbacks to innovation spending or by avoiding labor force withdrawal by those who after a long spell of unemployment retire or apply for disability. See Krueger and Mueller (2011), Gordon (1973), Granovetter (1973), and Gordon (2011).

24. In this equation and throughout the appendix we suppress a "length-of-short-run" parameter in order to make the notation less cumbersome.

permanent and scale with economic growth. Thus, ΔV is calculated by discounting ΔY_f at the rate $r - g$. If the effects are long-lasting but not truly permanent, the appropriate discount factor in the analogue of equation A.1 would be higher, but the basic logic of the argument would remain the same: there are short-term benefits and both short- and long-term costs, with the long-term costs attenuated to the extent that the wedge between the borrowing costs and the growth rate of the tax base is relatively low.

The impact ΔY_n of the transitory contemporary fiscal expansion ΔG on current-period output is as given by equation 1 in the text. The full impact ΔY_f on potential output in a representative future period is more complex. It has two components. The first is the positive impact $\eta \Delta Y_p = \eta\mu\Delta G$ from the lessened shadow cast by the downturn on future potential output. The second is the burden imposed on future GDP by the cost of amortizing the debt incurred to finance the fiscal expansion. This second supply-side cost component depends on two factors: (i) the additional debt ΔD that must be amortized, multiplied by (ii) the disincentive effect on potential output from the higher future taxes needed to fund each dollar of amortization; we model this second factor with the parameter ξ, which represents the reduction in future potential output from raising an additional dollar of revenue. However, these costs are themselves partially offset by another supply-side effect: by avoiding or reducing hysteresis, higher current-period GDP allows the burden of amortizing the preexisting costs of government to be spread over a larger tax base, and so allows for lower tax rates and thus further raises future potential output.

If raising an additional dollar of net tax revenue in the representative future period has disincentive effects that reduce future-period GDP by ξ, then the effect on future-period real GDP is

$$\text{(A.2)} \qquad \Delta Y_f = \{\eta\mu - \xi[(r-g)(1-\mu\tau) - \tau\eta\mu]\}\Delta G.$$

We assume the normal-case value of ξ to be 0.25 and the extreme-case value to be 0.5.

Discounting equation A.2 back to the present and adding it to equation 1 then produces the net effect of contemporary transitory expansionary fiscal policy on the present value of real GDP:

$$\text{(A.3)} \qquad \Delta V = \left\{\mu + \frac{\eta\mu}{r-g} + \frac{\xi}{r-g}[\eta\mu\tau - (r-g)(1-\mu\tau)]\right\}\Delta G.$$

The first term within the braces on the right-hand side of equation A.3, μ, is the multiplier term. The second, $\eta\mu/(r-g)$, is the hysteresis term: the smaller long-term shadow cast by a smaller downturn. The third term is the impact on future potential output of the net burden of additional debt. It is equal to the net impact on government cash flow, from the left-hand side of equation 6, multiplied by ξ, which captures the supply-side benefits to output from lower tax rates, expressed as a present value through division by $r - g$. This third term is composed of two subterms: $\xi\tau\eta\mu/(r - g)$ and $-\xi(1 - \mu\tau)$. The first subterm is the Blanchard and Summers (1987) term: the effect on potential output from lower tax rates made possible by the counterhysteresis effects of the fiscal expansion ΔG on potential output. The second subterm is the burden of amortizing the extra debt needed to finance the fiscal expansion ΔG. Even if this third term is negative and fiscal policy is not self-financing, expansion still passes the extra-output benefit-cost test if the first two terms are large enough to more than counterbalance it.

We draw five significant lessons from equation A.3:

—A fiscal expansion's effects are as much long-run as short-run.

—In a nondepressed economy, fiscal policy is highly likely to fail its benefit-cost test (equation A.3) because the multiplier μ is likely to be near zero.

—Even in the absence of hysteresis, fiscal policy may pass its benefit-cost test.

—Failure of the benefit-cost test in a depressed economy seems to require a high disincentive coefficient ξ.

—If interest rates substantially exceed the social rate of time discount, fiscal policy will fail its benefit-cost test.

The first lesson follows from observing that in equation A.3 only the initial term μ is a short-run term. Even outside of the consequences for cash flows, long-run benefits are a factor $\eta/(r - g)$ greater than short-term benefits. For the central case of table 2, with $\eta = 0.05$ and $\mu = 1.0$, this ratio of short- to long-term benefits is 1.7 at the critical real interest rate of $r = 5.77$ percent per year. Expansionary fiscal policy thus should not be analyzed as if pursuing it removes political-economic focus from the long run.

As with all present-value calculations at interest rates not too much larger than growth rates, a large proportion of the value comes from the distant future. If we impose the condition that our forecasting horizon ends 25 years into the future, on the grounds that the world more than a generation hence is likely to be different from the world of today in an "unknown unknowns" fashion, the ratio of long-run to short-run benefits falls to 1.14. But it is not just the long-run benefits of current expansionary policy from the counter-hysteresis effect that are subject to exhaustion when a truly new deal is dealt; a truly new deal might well alter government financing burdens as well.

Our second lesson is that in a nondepressed economy, the policy-relevant reduced-form multiplier is likely to be small, and thus fiscal policy is highly likely to fail the benefit-cost test. The positive terms in equation A.3 are all linear in μ and thus shrink with μ. But the negative term $\xi(1 - \mu\tau)$ is not linear in μ and does not become small. The multiplier μ relevant for equation A.3 is a reduced-form multiplier inclusive of monetary offset. It is not the multiplier holding real or nominal interest rates constant. It is not even the multiplier holding the monetary base or the money stock constant. It is the multiplier taking into account whatever the typical monetary policy reaction function to macroeconomic news is.

In normal times that inclusive-of-monetary-offset multiplier is small. The central bank will almost invariably have strong views about what course of real aggregate demand is appropriate given its long-run price stability objectives. The central bank will be uninterested in having real demand pushed off what it regards as the appropriate path by the actions of any other agencies of government. It will thus attempt to offset whatever effects expansionary fiscal policy has on aggregate demand. And because central banks can work inside the discretionary fiscal policy decision loop of legislatures and executives, they will do so.

In a depressed economy, things are different. With interest rates at the zero bound, the central bank may lack the power to manage aggregate demand by itself without pushing nonstandard monetary policy beyond the limits it regards as plausible. And even if the central bank believes that it has the power, it may lack the will—and may well lack the formal legal authority—to undertake nonstandard policy measures that might be better classified as quasi-fiscal policies.

If, in a depressed economy, a central bank possesses both the power and the will to target real aggregate demand and offset any effects of fiscal expansion, then the policy-relevant multiplier μ in equation A.3 will be sufficiently small that expansionary fiscal policy fails to pass its benefit-cost test. But if the central bank lacks either the power or the will to do so, our argument applies. The fact that expansionary discretionary fiscal policy fails the benefit-cost test of equation A.3 in normal times carries no implications for the test in a depressed economy.

Our third lesson is that even in the absence of hysteresis effects, discretionary expansionary fiscal policy may well pass its benefit-cost test. In the absence of hysteresis effects, when $\eta = 0$, equation A.3 becomes

$$\Delta V = \left[\mu - \xi(1 - \mu\tau)\right]\Delta G. \tag{A.4}$$

This expression is positive when

$$\mu > \frac{\xi}{1 + \xi\tau}. \tag{A.5}$$

For a tax-and-transfer share τ of 1/3, a multiplier μ of 0.5 produces a positive extra-output benefit-cost test for any ξ less than 0.6:

—A μ of 1.5 produces a positive benefit-cost test for any ξ less than 3: a ξ of 3 would mean that the economy is so far to the right on the Laffer curve that the marginal dollar raised from taxes reduces potential output by \$3.

—A μ of 1 produces a positive benefit-cost test for any ξ less than 1.5.

—Even a μ of 0.5 would require a ξ of 0.6, which seems unlikely: other North Atlantic countries have significantly higher values of τ with no clearly visible signs of such severe effects of taxes on potential output.

Our fourth lesson is that adding in hysteresis effects through a positive value of η makes the arithmetic of the benefit-cost test of equation A.3 even more compelling. The analogue of expression A.5 then becomes:

$$\mu > \frac{\xi}{[1 + \xi\tau + \eta(1 + \xi\tau)/(r - g)]}. \tag{A.6}$$

For temporary expansionary fiscal policy to fail its benefit-cost test with even very moderate multiplier and hysteresis effects, the requirements are stringent. For τ of 1/3, g of 2.5 percent per year, μ of 0.5, η of 0.05, and r of 6 percent per year, temporary fiscal expansion fails its benefit-cost test only if ξ is greater than 10.

This leads to the fifth and last lesson: Only a small value of μ is typically needed in expression A.6 for expansionary fiscal policy to pass the benefit-cost test, because the critical value of μ is reduced by the hysteresis term in the denominator, and because the presence of $r - g$ can make this term large. Any set of parameter values in which $\eta/(r - g)$ is nonnegligible makes the critical value of μ small. Thus, the benefit-cost test is likely to be passed unless $r - g$ is relatively large—and in this case r is not the real social rate of time discount but instead the real Treasury borrowing rate. It follows that discretionary fiscal policy in a depressed economy is most likely to fail its benefit-cost test if there is a wedge between the real Treasury borrowing rate (which determines the burden of the debt) and the social rate of time discount (which determines the multiple at which future benefits and costs are capitalized). For a wedge ρ between the real social rate of time discount r and the government's real borrowing cost $r + \rho$, the benefit-cost calculation in equation A.3 becomes

$$\text{(A.7)} \qquad \Delta V = \left[\mu + \frac{\eta\mu}{r-g} + \frac{\xi\eta\mu\tau}{r-g} - \frac{(r+\rho-g)(1-\mu\tau)}{r-g}\right]\Delta G.$$

The costs in the final term on the right-hand side are then amplified by the factor $(r + \rho - g)/(r - g)$, while the benefits in the first three terms stay the same as they were in equation A.3. A government that must borrow at the terms of a present-day Greece or Spain—or that fears that even marginal additional borrowing will produce a market reaction that will force it to borrow on such terms—will find the arithmetic of expansionary fiscal policy unpleasant indeed. But there is no such wedge for the United States today. Nor are there any visible signs in asset values that the future emergence of such a wedge is priced into today's markets, at any detectable probability.

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Chairman MURRAY. Thank you very much.
Dr. JOHNSON.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, AND SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. JOHNSON. Thank you very much, Senator, for the opportunity to be here today, and members of the committee.

I share Professor Summers' optimism on the U.S. economy, and I hope that he is right on these points. I would, though, like to emphasize the risks that we still face from the global economy. I would then like to speak briefly about the effects of the uncertainty generated by our current fiscal policy and come back to some of the longer-term budget issues that Senator Sessions has already touched on.

The European economy remains very unsettled. There is a serious problem within the Eurozone currency area. There are associated sovereign debt problems, and their financial sector is, frankly, in very bad shape. All of these pose risks to our outlook and we need to be careful. It does give us this ironic advantage in the sense that we are seen as a stronger safe haven relative to other investments because the Europeans have made so many mistakes in recent years. But we must be aware that the international environment can turn against us quite suddenly and we should plan accordingly.

Now, the interesting contrast between European fiscal policy, in fact, fiscal policy in most other industrialized countries and what we do in the United States, is that we have relatively weak so-called automatic stabilizers and relatively more importance for discretion in fiscal policy. So instead of it being the case that when you hit a major financial crisis in a large recession, in most other countries, most of the fiscal countercyclical effect is done by automatic falls in tax revenue, automatic increases, for example, in unemployment benefits. You on Capitol Hill, in our situation, have to make a lot of decisions.

And I testified to this committee for the first time in November 2008, and I testified again at the beginning of 2009—I think Senator Sessions was in those hearings—and I was really struck and impressed by the bipartisan spirit of those hearings, and there was the agreement, not perhaps on all the priorities, but the agreement that this was a major crisis. It was unprecedented in our lifetimes and it required a fiscal response of some kind, with different opinion between how much you want to put on tax breaks versus spending increases. I also went back and looked at the testimony from the Heritage Foundation in those months and years and it was running very much along these lines.

Now, of course, we have reached the difficult phase, which is exactly as you laid it out, Senator Murray. Where do we make the choices going forward regarding spending and taxes? And I am rather on your side in terms of the Senate Democratic budget, in terms of where you put that weighting. And, obviously, we are going to disagree about that today, but, I think, more than anything, I would stress the unfortunate effects of uncertainty.

And I would recommend to you again—I think I have spoken to this committee before, also—about the work of Nick Bloom at Stanford University and his colleagues, who have studied the effects of all the different kinds of uncertainty that we have had at the macro level in recent years. And the one thing that stands out in their work as having made people more uncertain and then, presumably, less willing to invest—and I am talking about the private sector—it was that debt ceiling fight in the summer of 2011. And it was also, just to some degree, what began to happen at the beginning of this year, but fortunately, there was a backing away from another confrontation over the debt ceiling.

So I would really echo and reinforce your point, Senator Murray, that we should move away from the sequester. Putting in place that kind of automatic cut is not a good way to deal with the fiscal issues. You emphasized education and infrastructure. I would second that and I would add public health. The Head Start program, for example, which is a combination of public health and education, is being cut, and the last data I have seen suggests that 70,000 children will not participate in Head Start this year because of the sequester. Those children are gone. They are only in that critical, vulnerable age group once and then they are lost. Then we have lost the human capital. We have lost the productive ability. And we know that these early childhood education and health interventions are very effective.

So the sequester is not a good way to proceed. The debt ceiling confrontations, other confrontations, when they generate more uncertainty unfortunately, have a big negative effect on the private sector. And as a Professor of Entrepreneurship, I spend a lot of time with private sector people who believe in the United States, who actually look around the world at opportunities and say the United States is a good place to invest, exactly as Professor Summers was saying. But when there are big fights about fiscal policy, that is a disincentive.

My third and final point is about the long-term budget issues. I think we agree completely, Senator Sessions, that looking out 20, 30, 50 years, there are important issues that need to be confronted and I think there has to be a conversation about Social Security. That is part of, I think, what you were flagging for us, and I agree with that wholeheartedly. And I wrote a book, White House Burning, that deals, in part, with this topic.

But I would also stress the importance and centrality of health care spending in that discussion. But it is not just about Medicare and other government-funded parts of the health care system. It is also about health care spending and our, to date, limited ability—perhaps the latest information is a bit more encouraging—but over the last couple of decades, we have demonstrated a very limited ability to control health care spending.

If you take that health care spending from the public sector and say, all right, government is out of this business. It is now all a private responsibility through insurance, self-insurance, or insurance you are going to buy, according to the Congressional Budget Office, that will push up our health care costs as a percent of GDP.

You have less buying power as individuals and as small groups than the government has when the government buys health care for roughly 100 million Americans, as it does today.

So I think we should have exactly that conversation, Senator Sessions, talk about the aging of the population, talk about the social insurance programs that we want and that we do not want in that context.

I testified to the Joint Economic Committee of Congress recently alongside Senator Judd Gregg and I was very struck by his thoughtful statements along these lines and his inclination, actually, to allow taxes, tax revenue at the Federal Government level, to rise over the medium term, reflecting the costs of social insurance and, I think, presumably, reflecting the reforms that he would want in how those programs are operated. But he was talking about taxes relative to GDP rising above 20 percent—perhaps 21 percent, perhaps 22 percent—we should let him speak for himself on that—but I thought that that reflected exactly the kind of compromise and seeking of the middle ground that we need if we are going to put the longer-term budget issues on a sustainable footing at the same time as maintaining our essential investments, particularly in more vulnerable lower-income Americans today.

Thank you very much.

[The prepared statement of Mr. Johnson follows:]

Testimony submitted to Senate Budget Committee, hearing on "The Fiscal and Economic Effects of Austerity", Tuesday, June 4, 2013 at 10:30am. (Embargoed until hearing starts.)

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; co-founder of http://BaselineScenario.com; member of the CBO's Panel of Economic Advisers; member of the FDIC's Systemic Resolution Advisory Committee; and member of the Systemic Risk Council.[1]

A. Main Points

1) The U.S. and global economy continues the process of slow and difficult recovery from the financial crisis of 2008. Financial markets can easily become unsettled. A serious sovereign debt crisis remains unresolved in Europe's euro area. There are potential risks on the horizon for countries such as Japan, China, and Brazil.

2) In this context, continuing uncertainty around the U.S. federal budget in general and the debt ceiling in particular is not helpful – and may prove destabilizing both at home and around the world. Another round of confrontation over the debt ceiling, for example in the early fall of 2013, would not be helpful to growth or employment.

3) At the same time, a sudden move towards further tightening fiscal policy in the U.S. would undermine our economic recovery and has the potential to destabilize financial markets. We are currently moving in a precipitate manner towards an excessive and inappropriate degree of immediate austerity.

4) There is no meaningful evidence that we "need" to cut federal deficits dramatically this year or next year or even over the next five years. There is no threshold for our federal debt, either gross or net, that would necessarily trigger slower growth or higher bond yields or any other economic problem.

5) It is far more important to get the economy back onto a sustainable growth path – and this includes not disrupting the private sector with damaging or disruptive public spending cuts. As the economy recovers, this will strengthen tax revenues and help put the budget back on to a more sustainable footing – and there are early indications in 2013 that this is exactly what is happening.

6) The ongoing sequester is a perfect example of how not to manage fiscal policy, particularly as this tends to undermine all forms of investment in and by the public sector. Combined with repeated confrontations over the debt ceiling and the possibility of a government shutdown, arbitrary and across the board spending cuts are hardly likely to help boost growth either in the short-term or the longer-term. Nor do they help boost confidence in the private sector.

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[1] This testimony draws on *White House Burning: The Founding Fathers, Our National Debt, and Why It Matters to You* (Pantheon, 2012), co-authored with James Kwak. Underlined text indicates links to supplementary material; if necessary, please access an electronic version of this document, e.g., at http://BaselineScenario.com. The Systemic Risk Council is a private group founded and chaired by Sheila Bair. All views expressed here are personal; additional disclosures are available at http://baselinescenario.com/about/.

7) Now is a good time to discuss longer-term issues that will drive budget outcomes in future decades, particularly the paramount importance of the likely rising cost of healthcare (meaning all healthcare costs, not just those paid by the government). But this potentially sensible debate about healthcare has become very confused and shows no signs of improvement.

8) Significantly cutting federal discretionary domestic spending below current projected levels will weaken our education system, undermine our future human capital, and further fray our physical infrastructure – i.e., actually reduce attainable growth rates in the United States. This is not a good time to squeeze the provision of essential public goods.

9) More broadly, the rhetoric around supposedly "excessive" government spending has itself become excessive. The long-standing project to shrink the federal government – sometimes known as a strategy of "starve the beast" – has reached a new and very dangerous phase.[2]

10) There is a danger that we will inflict upon ourselves an unnecessary and damaging degree of austerity. We should instead be building an economy within which federal revenue can be robust and public spending growth can be contained over the next decade.

11) A separate, but very important, issue is how to limit total healthcare spending – not just the government component of healthcare spending – as a percent of GDP over the next 20-50 years.

B. Do We Face a "Fiscal Crisis"?

Standard solvency analysis – including, for example, the tools used by the International Monetary Fund – confirms there is no prospect of an immediate fiscal crisis in the United States. We currently have "fiscal space", in the sense here is strong global demand for Treasury obligations in the foreseeable future.[3]

Long-term interest rates are low and remarkably stable. Partly this is due to actions by the Fed through various forms of "quantitative easing", but U.S. government securities are also seen as a safe haven for international investors. However, this safe haven status will be jeopardized if markets perceive a significant probability that we will not pay our debts as contracted – or if we create the perception that our economy will be thrown into repeated turmoil through regular showdowns over the debt ceiling or through dramatic cuts in government spending.

Over the CBO's 10-year forecast window, with the partial expiration of the Bush-era tax cuts, there is no insurmountable budget problem.[4] There is no fiscal emergency over this time horizon.

Our most important budget problems come *after* the ten-year horizon, because Medicare spending accelerates due to an aging population and increasing health care costs. The real issue

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[2] For more historical background and relevant details on the development of this strategy since the 1970s, see Chapter 3 in *White House Burning*.

[3] Comparative cross-country estimates are provided in Jonathan D. Ostry, Atish R. Ghosh, Jun I. Kim, Mahvash S. Quereshi, "Fiscal Space," IMF Staff Position Note, September 1, 2010, SPN/10/11.

[4] See James Kwak, "The Weirdness of 10-Year Deficit Reduction," http://baselinescenario.com/2011/07/21/the-weirdness-of-10-year-deficit-reduction/.

here is containing healthcare costs – i.e., schemes that cut Medicare in such a way as to shift healthcare costs onto families do not offer an appealing solution, particularly as this would likely raise healthcare spending as a percent of GDP.[5]

We should aim to find a way to limit healthcare costs as soon as possible – every year of high healthcare cost inflation makes the problem worse. Our competitors are controlling healthcare costs much more effectively than we are; with the set of advanced countries, the US stands out as having the worst (highest) projections for rising healthcare costs through 2030 or 2050.[6]

The United States is in the midst of a significant demographic transition, in the sense that our population is ageing. We need to invest in education and ensure access to affordable healthcare to everyone if we are to increase productivity as the proportion of older Americans increases. Ultimately, higher productivity is necessary – although not sufficient – to ensure that older, retired workers can receive a sustainable level of reasonable benefits (including pensions and healthcare).

In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. An important part of that should include additional tax revenues.[7] The Bush-era tax cuts reduced revenue to an excessive degree, given the ageing of society. We are still struggling to recover from that flawed way of thinking about our public finances.

It is striking the extent to which income inequality has increased dramatically since the last tax reform in 1986, primarily due to the impact of information technology and globalization on incomes – helping top earners and squeezing people in the middle of the income and skill distribution.[8] According to the latest available data, from 1993 to 2011, average real income for the bottom 99 percent of the population (by income) rose by 5.8 percent, while the top 1% experienced real income growth of 57.5%. The top 1 percent captured 62 percent of all income growth over this period.[9]

The returns to higher education have greatly increased in recent decades and, on average, there are not good income prospects for anyone with only a high school education (or less). If anything, the tax system should lean towards becoming more progressive – and investing the proceeds in public goods that are not sufficiently provided by the private sector, like early childhood education and the kind of preventive healthcare that helps prevent disruption to education (e.g., due to childhood asthma).

At the same time, we must not lose sight of the very large fiscal risks posed by the nature and structure of our financial system. Our worsening budget picture since 2000 is due to a combination of factors – including large tax cuts, two foreign wars, and the introduction of

[5] For more detail, see the CBO assessment of the budget proposal put forward by Congressman Paul Ryan: http://cbo.gov/sites/default/files/cbofiles/ftpdocs/121xx/doc12128/04-05-ryan_letter.pdf.
[6] See the IMF's Fiscal Monitor (October 2012), Statistical Table 12a, columns 3 and 4.
[7] For more details on the viable options, see *White House Burning*, particularly Chapter 7. Reducing tax expenditures is part of the sensible route to follow. These reductions can be phased in gradually.
[8] For more details and discussion of what accounts for the increase in inequality, see David Autor and Daron Acemoglu, "Skills, Tasks and Technologies: Implications for Employment and Earnings," http://econ-www.mit.edu/files/5571.
[9] This is from data on Emmanuel Saez's website, http://elsa.berkeley.edu/~saez/, downloaded on March 12, 2013. See the first item under "Income and Wealth Inequality"; the link to his spreadsheet is called "(Tables and Figures **Updated to 2011** in Excel format, January 2013)".

Medicare Part D. The recent increase in government spending as a percent of GDP is due almost entirely to the way the financial sector imploded and damaged the rest of the private sector in 2007-08.[10]

To see the fiscal impact of the last finance-induced recession, look at changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO projected that over the next eight years debt will rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion.

Most of this fiscal impact is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.[11]

We should be attempting to strengthen the safeguards in the Dodd-Frank financial reform legislation. Repealing or rolling back that legislation poses a major fiscal risk.[12] The fact that this is not currently scored by the Congressional Budget Office does not reduce this risk or make it any smaller.

In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States.[13] This can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what senior officials at the Bank of England refer to as a "doom loop".

The remainder of this testimony reviews in more detail: why spending cuts – either from a government shutdown or from some other form of immediate austerity – will be contractionary in the current US context; and how to think about our debt levels in a cross-country perspective.

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[10] Over the past decade, foreign wars also contributed to increased government spending. But the negative fiscal effect of the financial crisis was much larger than the cost of the Iraq and Afghanistan wars combined.

[11] See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10th of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

[12] See Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown*, Pantheon, 2010.

[13] See Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive," Stanford University, March 2011 (revised), https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf. For a comprehensive assessment of banking and why capital requirements should be significantly higher, see Anat Admati and Martin Hellwig, *The Banker's New Clothes: What's Wrong with Banking and What to Do about it*, Princeton University Press, 2013.

C. Spending Cuts Would Be Contractionary

Immediate spending cuts would, by themselves, likely slow the economy. The IMF's comprehensive recent review of cross-country evidence concludes: "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point."[14]

The contractionary effects of spending cuts can sometimes be offset by other changes in economic policy or conditions, but these are unlikely to apply in the United States today

If there is high perceived sovereign default risk, fiscal contraction can potentially lower long-term interest rates. But the US is currently perceived as one of the lowest risk countries in the world – hence the widespread use of the US dollar as a reserve asset. To the extent there is pressure on long-term interest rates in the US today due to fiscal concerns, these are mostly about the longer-term issues involving healthcare spending; if this spending were to be credibly constrained (e.g., in plausible projections for 2030 or 2050), long rates should fall. In contrast, cutting discretionary spending would have little impact on the market assessment of our longer-term fiscal stability.

It is also highly unlikely that short-term spending cuts would directly boost confidence among households or firms in the current US situation, particularly with employment still around 2 percent below its pre-crisis level. The US still has a significant "output gap" between actual and potential GDP, so unemployment is significantly above the achievable rate. Fiscal contractions rarely inspire confidence in such a situation.

If monetary policy becomes more expansionary while fiscal policy contracts, this can offset to some degree the negative short-run effects of spending cuts on the economy. But in the US today, short-term interest rates are as low as they can be and the Federal Reserve has already engaged in a substantial amount of "quantitative easing" to bring down interest rates on longer-term debt. It is unclear that much more monetary policy expansion would be advisable or possible in the view of the Fed, even if unemployment increases again – for example because fiscal contraction involves laying off government workers.

Tighter fiscal policy and easier monetary policy can, in small open economies with flexible exchange rates, push down (depreciate) the relative value of the currency – thus increasing exports and making it easier for domestic producers to compete against imports. But this is unlikely to happen in the United States, in part because other industrialized countries are also undertaking fiscal policy consolidation. Also, the preeminent reserve currency status of the dollar means that it rises and falls in response to world events outside our control – and at present political and economic instabilities elsewhere seem likely to keep the dollar relatively strong.

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[14] *World Economic Outlook*, October 2010, Chapter 3, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," p.113. This study has important methodological advantages, in particular because it focuses on policy intentions and attempts to implement spending cuts and revenue increases. For more on the IMF's thinking on fiscal policy – and how it has been unable to provide sufficient support to the economic recovery – see the recent work of Prakash Lougani, including http://www.prakashloungani.com/2013/05/tackling-unemployment-return-of-two.html and the links provided in that blog post.

The available evidence, including international experience, suggests it is very unlikely that the United States could experience an "expansionary fiscal contraction" as a result of short-term cuts in discretionary federal government spending. Recent experience with austerity in the United Kingdom should also not inspire us to head rapidly in the same direction.

D. Fiscal Crises in Comparative Perspective

The advisable debt limit, relative to GDP, for the United States is subject to considerable debate and is not knowable with a high degree of precision. For a country like the United States – issuing debt in its own currency and with its assets widely regarded as a safe haven -- there is no precise debt-to-GDP level at which a crisis is necessarily triggered. Higher debt levels, however, do constitute a source of vulnerability, particularly when foreign investors are holding a substantial proportion of the debt outstanding.[15]

If any shock throws the economy into recession, fiscal policy in most industrialized countries will to some degree automatically counteract the effect – as spending increases (on unemployment benefits and other forms of social support) and taxation declines (as GDP falls). Such automatic stabilizers are generally helpful as they prevent the recession from becoming more serious – or even some form of prolonged collapse, which was the pre-1945 experience of many countries.

It is important not to oversimply fiscal concerns into precise cut-offs for "dangerous" debt levels. Recent European experience provides ample illustration that countries can run into trouble refinancing their debts at a wide range of debt-to-GDP values.

Greece ran into trouble in 2010 with gross debt relative to GDP of 147.9 percent; its debt levels in 2006 and 2007 were around 107 percent.[16] This is a classic case of too much debt by any measure – although the full extent of the debt and underlying deficits were not completely clear until market perceptions shifted against Greece. In addition, an important part of the problems in Greece is structural – both in terms of how the eurozone functions as a monetary area, and in terms of the longer-run failure of productivity to converge towards levels in northern, higher income European countries.

Portugal faced a fiscal crisis with gross debt at 108.0 percent of GDP in 2011, but its gross debt was only 68.3 percent of GDP in 2007. The issue for Portugal is low achieved and expected growth relative to fiscal deficits – the markets have become unwilling to support debt that continues to increase as a percent of GDP.

Ireland, another eurozone country that currently has an IMF program, is a different kind of fiscal disaster. In this case, the on-balance sheet government debt was low (25.0 percent of GDP in 2007 for general government gross debt) but there was a big build up in off-balance sheet

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[15] Statistical Table 12a in the IMF's Fiscal Monitor, April 2013, reports "nonresident holding of marketable central government debt" for the third quarter of 2012. For the United States this is 55.1 percent.

[16] These data are from the latest available Fiscal Monitor, published by the IMF in April 2013 (http://www.imf.org/external/pubs/ft/fm/2013/01/pdf/fm1301.pdf); see Statistical Table 4. International comparisons of fiscal accounts are difficult; we recommend using the gross general government debt numbers from the IMF's Fiscal Monitor.

obligations – in the form of implicit support available to a banking system that was taking on large risks. Bailing out the banks in fall 2008 and losing tax revenue due to severe recession pushed up gross debt to 106.5 percent of GDP in 2011 and debt levels will reach over 120 percent of GDP (in the official IMF estimates) before stabilizing.

In the UK, gross debt was 43.0 percent of GDP in 2006, which was low relative to other industrialized countries at that time. Gross general government debt reached 79.4 percent of GDP in 2010, when the new Conservative government decided to adopt relatively austere budget policies. However, growth since that time has been lackluster and debt continues on an upward path, reaching 90.3 percent of GDP in 2012 and expected to reach 93.6 percent in 2013. In the latest IMF projections, it will peak at 100.7 percent of GDP in 2016. Given that Britain does not belong to the eurozone and still has its own central bank, the wisdom of its current fiscal policy stance has increasingly been called into question.

Compared with other industrialized countries, Japan stands out as an extreme. Government debt-relative to GDP is expected to reach 245.4 percent in 2013 (on a gross basis) and stay above 240 percent of GDP for the foreseeable future. On a net basis – taking out government debt held by other parts of the public sector – debt is expected to be 146.7 percent of GDP in 2013 and to remain above 150 percent of GDP through at least 2018. But over 90 percent of Japanese government debt is held by residents – and, at least for the time being, Japanese household and business savings remain high.[17]

Countries with greater reliance on foreign savers, such as the US (where nonresidents held 32.1 percent of general government debt and 55.1 percent of marketable central government debt in 2012) and the UK (nonresidents held 31.9 percent of general government debt in 2012) need to be much more careful. Within the eurozone, as a result of greater financial integration combined with the mispricing of risk, foreigners typically hold 40-90 percent of all outstanding government debt (mostly held by other eurozone financial institutions).

The increase in debt relative to GDP in industrialized countries was from 77.2 percent in 2006 to 110.7 percent in 2012 (this is general government gross debt as a percent of GDP, calculated by the IMF as an unweighted average across countries).[18] Most of this increase was due to automatic stabilizers, i.e., the increase in spending and fall in taxation that occurs whenever a country goes into recession.

Seen in that context, the increase in the US general government gross debt – from 66.1 percent of GDP in 2006 to 98.2 percent at the end of 2010 and 106.5 percent at the end of 2012 – was very much in line with experience in other countries.[19]

In terms of net general government debt held by the private sector, at the end of 2012, the US was around 89.0 percent of GDP – up from 48.4 in 2007. This number will rise to 87.6 percent in 2016 and 86.6 percent in 2018, according to the IMF. This is unlikely to cause any kind of serious fiscal crisis.

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[17] In Table 12a of the IMF's Fiscal Monitor, April 2013, nonresident holding of general government debt in 2012 is 8.9 percent of all such debt.

[18] This series is from the IMF's Fiscal Monitor, October 2012; it is not available in the April 2013 version of this publication.

[19] These gross and net debt numbers are taken from the IMF's Fiscal Monitor, April 2013, Statistical Table 4.

In the Congressional Budget Office's longer-term projections, the future costs of healthcare cause a rise in debt to Japanese levels or beyond by 2030 or 2050. But the issue there is rising healthcare costs as a percent of GDP – not just the government component of those costs.

The role of the US dollar as the world's preeminent reserve currency means there is a strong demand for our government securities in the foreseeable future. In 1948 and in 1968, world holdings of US dollar assets in the form of reserves were worth about 2 percent of GDP. Now world reserve holdings of dollar assets are worth at least 15 percent of GDP – and some would put this as high as 30 percent of GDP.[20]

But it is not clear how far this will carry us – particularly as alternative reserve assets typically develop in a diverse world economy with competing national interests. It would be wise to undertake medium-term fiscal consolidation, i.e., over the next two decades. Rising healthcare costs, a weak tax base, and deteriorating public goods could well undermine our long-term potential growth – as well as our ability to ensure that all Americans can participate in economic prosperity.

In addition, the United States continues to face very large potential fiscal liabilities in the form of implicit support available to the financial sector, both directly – if "too big to fail" global banks get into trouble – and indirectly, in the form of automatic stabilizers that will always kick in when the economy declines sharply due to a banking crisis (e.g., through the decline in tax revenue when economic activity contracts).

If a financial crisis due to the mispricing of risk causes a fiscal crisis, including immediate spending cuts and tax increases, this has major distributional consequences. The financial sector executives and traders who do well during a financial boom are highly paid; typically this is on a return-on-equity basis without appropriate adjustment for risk, so they take on too much debt. When the downside risks materialize, the costs of the crisis are borne by those who lose jobs and suffer other collateral damage.

If sharp spending cuts follow that reduce essential public services (e.g., Head Start or other government-supported education programs), this effectively transfers the costs of dangerous compensation schemes for the financial elite onto the middle class and relatively poor people.[21]

There is nothing pro-market or pro-private sector about an inefficient redistribution scheme that allows a few people to become richer due to implicit government subsidies for "too big to fail" global financial institutions. Such firms are likely to damage themselves with some regularity – their executives have little incentive to be sufficiently cautious. If the consequent crises undermine public goods, such as access to effective education and quality healthcare, this is likely to permanently lower growth rates through undermining the human capital of the US workforce. Unfortunately, this is the trajectory on which we currently find ourselves.

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[20] For more details on the rise of the dollar as a reserve currency amidst the evolution of the international monetary system, see Chapter 2 in *White House Burning*.

[21] For some examples, see Simon Johnson, "Austerity's Children", Project Syndicate, March 25, 2013, http://www.project-syndicate.org/commentary/the-unfair-burden-of-fiscal-adjustment-by-simon-johnson.

Chairman MURRAY. Thank you very much.
Dr. FURTH.

STATEMENT OF SALIM FURTH, SENIOR POLICY ANALYST IN MACROECONOMICS, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

Mr. FURTH. Thank you. My name is Salim Furth. I am a Senior Policy Analyst in Macroeconomics in the Center for Data Analysis at the Heritage Foundation. I thank Chairman Murray, Ranking Member Sessions, and the rest of the committee for the opportunity to testify on the impact of austerity. The views expressed in my testimony are my own and should not be construed as representing any official position of the Heritage Foundation.

I heartily agree with the panelists that real sustained economic growth is the main point. But we need to put aside this term "austerity," which is really too broad to be helpful. Distinguishing among the elements of austerity, we need to distinguish between tax increases, spending cuts, and structural reforms, all of which have been called austerity at different times in the past.

So, today, I am going to talk about unbundling austerity in that way. I am going to revisit policies that have been pursued in the last five years, discuss the sequester for a moment, and then look forward to potential policies the U.S. can pursue.

The most proven and fiscally sound and long-lasting policies under the austerity umbrella to help achieve growth are structural reforms. Structural reforms emphasize making markets more competitive. On the fiscal side, structural reform can be identified, as compared to merely cutting spending, by, I think, two criteria. In the first case, it should be a systematic and ongoing spending cut. And in the second, incentives for economic activity should be improved by the reform.

So a simple example of structural reform might be to raise the Social Security early retirement age from 62 to 65. Another might be to cut subsidies for industrial farms or, with apologies to my fellow panelists, to cut subsidies to big ticket private universities.

Lower government spending can bring debt under control and it can promote investment and subsequent growth. Empirical research by Giavazzi and Pagano; Alesina and Perotti; Von Hagen, Halite, and Starch; Lambertini and Tavares; Ardagna; and researchers at the OECD and the IMF, among others, has unanimously found that reducing deficits through spending cuts is more successful than doing so through tax increases. Higher tax rates slow the economy immediately and depress future growth.

In addition, economic harm done by the tax increase automatically increases government spending on unemployment insurance and poverty programs. I expect this is why most tax-based attempts at deficit reduction have failed to shrink debt and have substantially increased the odds of a recession.

The 2013 budget sequestration was poorly designed policy. However, its artlessness does not outweigh the fact that it is a step in the right direction on spending. Pier Carlo Padoan, Chief Economist of the OECD, emphasized in his speech last week that the U.S. should make the spending cuts of the sequester less harmful by incorporating them into a credible, permanent fiscal consolidation.

Since taking effect in March, sequestration has had no discernible impact on overall growth or employment numbers nor on financial markets. Where sequestration policies are particularly perverse, straightforward legislation can improve the content of policies while remaining revenue neutral. There are many places in the Federal budget where small savings can be found at little economic costs. In fixing sequestration, policy makers should restore government investment at the expense of the government wage bill and transfer payment growth.

Going back to the experience of recent years, since 2007, few governments have pursued anything like a comprehensive austerity agenda. Most have spent more and some have taxed more. Spending cuts, on the other hand, have been rare outside Europe's crisis countries. Only three of 28 OECD countries have policies that would lead to a budget surplus in a strong economy, let alone in the current stagnation. And 18 countries have instead expanded their deficits.

Transfer payments, such as Social Security, Food Stamps, and unemployment insurance, have risen 16 percent in the typical OECD country and 14 percent in the U.S. That occurred despite a research consensus that transfers must be contained or cut in order to have successful deficit reduction. Now, I am not saying that we ought to be slashing transfers right now or that countries should have done so over the last five years. But the fact that they have been instead growing indicates that this narrative that there has been vicious austerity in Europe simply is at odds with the facts.

In an economic downturn, one expects that the ratio of tax revenues to GDP, the revenue rate, will fall. That is what we expect. Instead, 13 OECD countries have raised their revenue rate since 2007. In ten of those countries, higher taxes funded higher government spending. Only Greece, Italy, and Hungary have pursued both tax increases and spending cuts.

So there has been a very wide variety—I go through this a little bit more in my written testimony—of specific fiscal policies that different countries have pursued. We can certainly talk about that variety. But throwing it all into a basket and calling that basket austerity is not helpful.

My fellow panelist, Dr. Summers, coauthored a recent paper—he discussed it slightly here and more in his written testimony—which presents a novel and valuable idea. It is interesting and worthy of further study, how the effects of a recession can echo through into the long term. I agree wholeheartedly with DeLong and Summers that more consideration should be given to the long-term effects of short-term policies.

However, I think that policy makers should put greater weight on concerns which are founded in more substantial and longer-run research agendas. We have more research showing that structural reform that contains entitlements and increases competition is a proven method of raising labor force participation and is more proven than borrowing and spending and other potential policies that have been mooted.

Coming back, there is no substitute for private sector economic growth. Although government can easily boost its own portion of GDP, it can only indirectly have a positive impact on private consumption and private investment, which are the cornerstones of material well-being, present and future.

Concluding, Angel Gurria, Secretary-General of the OECD, last week laid out a mandate for structural change, saying, ″moving to best practice across a number of policy areas would raise per capita incomes by some 20 percent in the median OECD country. This is huge. So our call continues to be, go structural.″

Thank you very much.

[The prepared statement of Mr. Furth follows:]

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CONGRESSIONAL TESTIMONY

Statement of

Salim Furth, Ph.D.
Senior Policy Analyst in Macroeconomics
Center for Data Analysis
The Heritage Foundation

Before the Committee on the Budget of the United States Senate

Delivered June 4, 2013

"The Fiscal and Economic Effects of Austerity"

Introduction

My name is Salim Furth. I am Senior Policy Analyst in Macroeconomics in the Center for Data Analysis at The Heritage Foundation. I thank Chairman Patty Murray, Ranking Member Jeff Sessions, and the rest of the committee for the opportunity to testify today on the fiscal and economic effects of austerity. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

My testimony focuses on the following points:

- Tax increases are harmful to the economy and the debt;
- Spending cuts can improve both the budget and the economy;
- Structural reforms can permanently improve economic performance; and
- To date, "austerity" in Europe has consisted mainly of tax increases.

Three Distinct Approaches

Austerity is an overly broad term of economic opprobrium; its effects depend on its contents. The U.S. should pursue targeted spending cuts and structural reform, but eschew further tax increases.

Lower government spending has little immediate effect on the private economy, but can bring debt under control and promote investment and subsequent growth. Reductions in spending lower the odds of future tax increases and future inflation. Historically, successful fiscal consolidations are associated with spending cuts.

Higher tax rates slow the economy immediately and depress future growth.[1] Revenue gains are mediocre, as lower investment, attenuated work effort, and inefficient tax-avoidance depress receipts. In addition, economic harm done by the tax increase automatically increases government expenditures on unemployment insurance and poverty programs.

Structural reform of social transfer programs and regulatory regimes can substantially increase long-run growth. Among developed economies, which share the same technology and similar cultures and political systems, the extent of the government's intrusion into private lives is a primary candidate for explaining output differences.[2,3] In the U.S. for the next few decades, structural reform means balancing obligations to retiring baby boomers against competing claims on scarce productive workers. Without reforms that ease and reward productive activity, labor force participation will remain low and the fiscal burden will be staggering.

The U.S. should enact wise and permanent structural reforms, including effective marginal tax rate cuts to the poor, sustainable reform to Social Security and Medicare, and curtailment of destructive government agencies.

Has Austerity Occurred?

"Austerity" is often a term of obfuscation. Estonia, for instance, is often considered a poster child for austerity despite its 14 percent rise in government consumption and 22 percent rise in transfer payments (items like Social Security and unemployment insurance) since 2007.[4] Germany likewise grew government 11 percent over the crisis years. At the same time, both countries have raised taxes enough to keep their budgets close to balance. Meanwhile, Ireland allowed its tax revenue to fall and shifted government expenditure from government consumption (-7.5 percent) to transfer payments (+20 percent). Spain has a lower revenue rate, higher government consumption, and higher transfers than it

[1] Karel Mertens and Morton Ravn, "The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States," *American Economic Review*, June 2013 (forthcoming).

[2] Giuseppe Fiori, Giuseppe Nicoletti, Stefano Scarpetta and Fabio Schiantarelli, "Employment Effects of Product and Labour Market Reforms: Are There Synergies?" *The Economic Journal* 122, February 2012.

[3] Edward C. Prescott, "Why Do Americans Work So Much More Than Europeans?" *Federal Reserve Bank of Minneapolis Quarterly Review* 28(1), July 2004.

[4] Author's calculations based on OECD Statistics and OECD Economic Outlook #93.

did in 2007. Yet all these countries are routinely lumped as "austere," with the emphasis usually placed on the rare spending cuts.

Much less austerity has occurred globally than is commonly reported, and U.S. policies have expanded, not contracted, deficits in the past several years. We are a long way from austerity.

Fiscal Consolidations and the Historical Record

Fiscal consolidation denotes a policy change designed to shrink deficits – and it may include both spending cuts and tax increases. Twenty years of research have found that consolidation plans in which spending cuts preponderate are more effective and more conducive to growth than tax increases. In the Appendix, I present an extensive record of empirical academic research showing that spending cuts have great potential for good and tax increases great potential for harm.

Investigating the optimal mix of spending cuts and tax increases, Biggs, Hassett, and Jensen find "strong evidence" that expenditure-based consolidations are more successful than tax-based expenditures.[5] They conclude that when fiscal consolidation is needed, it should be at least 85 percent spending cuts. They also find that composition matters: successful consolidations feature large cuts to transfer programs. This confirms the basic economic result that disincentives to work will reduce economic activity.

Biggs, Hassett, and Jensen also emphasize the particular situation of the U.S.: with the coming retirement surge, the U.S. has a longer-term need for fiscal consolidation than most of the historical examples. Both historical experience and the exigencies of the present urge us to adopt structural reforms that diminish dependency on transfer payments.

A famous series of papers during the 1990s identified the counterintuitive "expansionary fiscal consolidations."[6] Seven such episodes occurred during the 1980s, in Belgium, Canada, Denmark, Ireland, Italy, Portugal, and Sweden: the cyclically adjusted deficit fell substantially, but private consumption and investment continued to grow.[7] Since then, several more episodes of "expansionary consolidation" have burnished the record of spending-based deficit reduction.

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[5] Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," American Enterprise Institute *Economic Policy Working Poper* 2010-04, December 2010.

[6] Francesco Giavazzi and Marco Pagano, "Can Severe Fiscal Adjustments Be Expansionary?" in *NBER Macroeconomics Annual 1990*, Olivier Blanchard and Stanley Fischer, eds., 1990.

Alberto Alesina and Roberto Perotti, "Reducing Budget Deficits," *Swedish Economic Policy Review*, III, 1996.

[7] Roberto Perotti, "Fiscal Policy in Good Times and Bad," *The Quarterly Journal of Economics* 114, 1999.

Alesina and Perotti send "a rather clear message to the policy maker: any fiscal adjustment hoping to be successful, cannot avoid dealing with cuts in the welfare state and in government wages and employment."[8]

Although expansionary fiscal consolidations are the exception, they are not unthinkable. Success stories most often occurred in environments where debt had risen far and fast and future growth had become uncertain. While spending cuts and structural reform are no guarantee of expansion for the present U.S., such "austerity" would improve our chances of strong, sustained growth.

The Developed World Since 2007

With a plethora of evidence, all of it militating against tax increases as a means of fiscal consolidation, one might imagine that today's policymakers have avoided such means. But in fact the opposite has occurred: harmful, tax-based "austerity" has been adopted by at least half of Europe.[9] Spending cuts have been rare outside Europe's crisis countries, and transfer payments have risen in every country I examined.

As early as 2007, the OECD could state plainly that "[f]iscal consolidation is required in most OECD countries."[10] While it is undoubtedly true that the boom years of the 2000s were a better time to initiate fiscal consolidation, those who did not take the opportunity had less flexibility to respond to the 2008 financial crisis and ensuing depression.[11] Those who protest that we should wait until the economy is strong to reform entitlements should recall that such opportunities came – and went – often in the last two decades.

What Austerity?

At present, only three OECD countries are running a cyclically adjusted budget surplus. That is, most current policies would lead to deficits during "normal times."

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[8] Alberto Alesina and Roberto Perotti, "Fiscal expansions and fiscal adjustments in OECD countries," NBER *Discussion Paper* Series No. 754, 1995.

[9] Revenue/GDP has risen in 13 of 23 European countries in my sample. Throughout the following discussion, I have a sample of 27 or 28 OECD countries, depending on data availability. I excluded Luxembourg as a special case, and Chile, Mexico, and Turkey as emerging markets. Canada, Korea, New Zealand, Norway, and the Slovak Republic lack data for certain metrics. All data are from OECD Statistics and OECD Economic Outlook, 2013 (1).

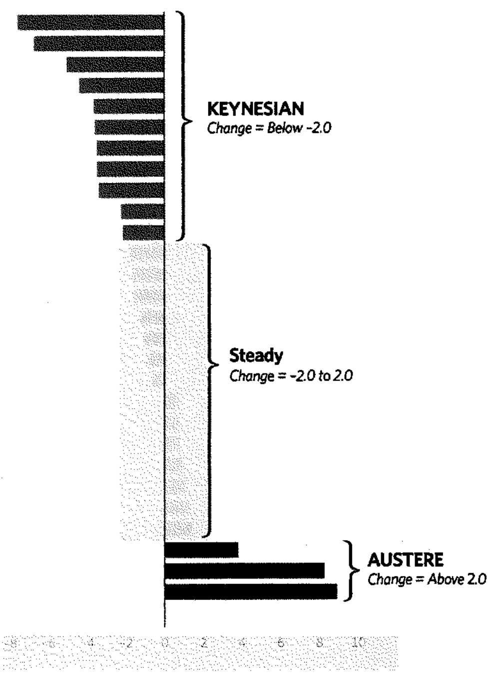
[10] Stéphanie Guichard, Mike Kennedy, Eckhard Wurzel, and Christophe André, "What Promotes Fiscal Consolidation: OECD Country Experiences," OECD Economics Department *Working Papers*, 2007.

[11] Alesina and Ardagna record that the Netherlands, Sweden, and Switzerland initiated successful consolidations around 2004, while Germany, Norway, and Portugal initiated unsuccessful consolidations. Alberto Alesina and Silvia Ardagna, "The design of fiscal adjustments," NBER Working Paper No. 18423, 2012.

CHART 1

Few Governments Have Enacted Real Austerity

	Cyclically adjusted surplus or deficit as % GDP: 2006 and 2007	Cyclically adjusted surplus or deficit as % GDP: 2012 and 2013	Change
Japan	-2.30	-9.90	-7.60
New Zealand	4.20	-2.55	-6.75
Spain	0.55	-4.50	-5.05
Finland	3.05	-1.35	-4.40
Canada	0.80	-2.85	-3.65
Australia	1.45	-2.15	-3.60
Iceland	3.30	-0.20	-3.50
Israel	-2.30	-5.80	-3.50
Denmark	2.60	-0.80	-3.40
Ireland	-1.70	-3.95	-2.25
United States	**-3.65**	**-5.80**	**-2.15**
Netherlands	-0.20	-2.00	-1.80
Belgium	-0.95	-2.60	-1.65
United Kingdom	-4.10	-5.70	-1.60
Korea	3.85	2.60	-1.25
Sweden	1.00	-0.10	-1.10
Slovenia	-2.80	-3.75	-0.95
Poland	-2.90	-3.60	-0.70
Germany	-1.05	-0.30	0.75
Switzerland	0.35	1.10	0.75
Austria	-2.35	-1.55	0.80
Czech Republic	-3.40	-2.40	1.00
France	-3.95	-2.80	1.15
Portugal	-4.20	-2.85	1.35
Estonia	-0.85	0.65	1.50
Italy	-3.95	-0.15	3.80
Hungary	-9.40	-1.15	8.25
Greece	-9.60	-0.70	8.90



Source: OECD.

Just ten OECD countries have tightened their cyclically adjusted deficits since 2006–2007. Chart 1 illustrates the paucity of fiscal tightening. Despite major crises, even Ireland, Iceland, and Spain have increased their cyclically adjusted deficits. Where recent tightening has been reported, such as in the U.K., it is largely due to winding down even larger deficits created during the recession years.

The U.S. is no exception. In 2006–2007, the U.S. was running a large cyclically adjusted deficit, almost 4 percent of GDP. It has since broadened to almost 6 percent of GDP, not including the lower tax receipts and higher spending associated with the weak economy. Without policy action, deficits will remain unsustainably large indefinitely.

Government consumption, reported in Table 1, rose in 20 OECD countries. Likewise, government consumption's share of GDP rose in 20 countries. The U.S., France, and Germany each increased spending by at least 7 percent. The U.K. was the only country to cut government (by 1.3 percent) without being forced by a major crisis. But the U.K. counteracted the cut with a much larger increase in transfer payments. The rest of the countries on the left side of Chart 2 have decreased government consumption only because they are considered a default risk.

TABLE 1

Changes in GDP, Government Spending, and Revenue, 2007-2012

		GROWTH IN GOVERNMENT SPENDING			
	GDP Growth	Government Consumption Growth	Transfers Growth	Change in Revenue Rate (share of GDP)	Actual 2012 Surplus or Deficit (% of GDP)
Eurozone					
Austria	3.0%	8.8%	11%	1.76%	-2.51%
Belgium	2.1%	14.5%	19%	3.33%	-4.08%
Czech Republic	1.4%	0.1%	10%	-2.41%	-4.15%
Estonia	-5.0%	13.9%	22%	4.48%	-0.28%
Finland	-2.8%	11.9%	19%	1.31%	-2.32%
France	0.5%	7.2%	12%	2.06%	-4.97%
Germany	3.5%	10.9%	6%	0.83%	0.16%
Greece	-22.4%	-20.6%	0%	4.55%	-10.05%
Ireland	-6.2%	-7.5%	20%	-4.05%	-7.38%
Italy	-7.1%	-3.4%	7%	2.18%	-3.06%
Netherlands	-0.3%	9.6%	14%	-0.11%	-3.99%
Portugal	-5.8%	-14.4%	12%	-0.36%	-6.60%
Slovak Republic	10.0%	9.8%	22%	-0.06%	-4.32%
Slovenia	-5.4%	7.7%	11%	0.60%	-3.72%
Spain	-4.3%	1.8%	19%	-6.31%	-10.94%
European Union, Non-Eurozone					
Denmark	-4.4%	11.1%	16%	3.25%	-4.51%
Hungary	-4.9%	-4.7%	0%	4.26%	-2.13%
Iceland	-5.3%	-1.2%	21%	-4.82%	-3.21%
Poland	16.7%	17.0%	18%	-1.54%	-4.00%
Sweden	5.1%	8.2%	7%	-4.48%	-0.72%
United Kingdom	-2.0%	-1.3%	12%	-0.72%	-5.90%
Others					
Australia*	13.0%	13.7%	17%	-2.11%	-4.16%
Israel*	17.6%	9.0%	14%	-5.47%	-4.12%
Japan*	-0.8%	5.4%	16%	-1.90%	-8.53%
Norway	3.2%	18.1%	17%	2.52%	15.60%
Switzerland*	6.1%	13.7%	17%	3.02%	0.56%
United States*	2.8%	7.2%	22%	-3.02%	-9.96%
Median	0.0%	8.2%	16%	-0.06%	-4.08%

* Incomplete OECD data for 2012 at the time of writing, so 2011 data was used where necessary.
Note: GDP, Government Consumption, and Transfers Growth are calculated as log differences.

Source: OECD.

Sacred Cows and Third Rails

Transfer payments – government benefits like Social Security, Medicare, unemployment insurance, or food stamps – have not diminished anywhere. The median OECD country grew transfer payments by 16 percent and devoted 2.9 percent more of GDP to transfers in 2012 than in 2007. Some of that growth is obviously the automatic stabilizers of recession, and some is due to aging. What is remarkable in the data is the absence of austerity.

Even countries undergoing severe crises or "austerity" programs failed to control the growth of transfer programs. In Spain transfers are up 19 percent, in Ireland 20 percent, in the U.K. 12 percent, and in Estonia 22 percent. Table 1 shows that only five countries reported less than 10 percent transfer growth.

The U.S. has grown transfer payments 22 percent, and transfers consume 2.9 percent more of GDP now than in 2007. This growth includes disincentives to work for those with low income, including food stamps and Social Security Disability Insurance expanded far beyond their original intent. Removing these economic disincentives would result in economic growth, higher tax receipts, lower government spending.

Recall that the empirical evidence emphasizes the importance of cutting transfer payments to achieving expansionary fiscal consolidation. Instead, OECD countries are spending more on transfers and will require steeper, more painful fiscal adjustments in the future.

Taxes Go Up

Despite a Keynesian approach to spending, many governments have raised taxes to cut the deficits they built up with all the new spending. It's a textbook error.[12]

Writing in 2010, Broadbent and Daly noted disapprovingly that "none of the existing sets of fiscal plans in the major economies... qualifies as 'expenditure-based' and 'significant'... Where there are significant corrections planned [in the U.S. and the U.K.] these are driven not by cuts in current spending but (predominantly) by lower investment or higher taxes."[13]

In measuring tax increases, I use a very tight definition: has a country increased its tax receipts as a share of GDP? This "revenue rate" will normally fall in recessions and rise in booms, so one expects to see revenue rates down somewhat across the board in the absence of policy changes.

Instead, thirteen OECD countries have increased their revenue rates. Of these, only Greece, Italy, and Hungary faced crises severe enough that they raised taxes and cut government consumption – classic

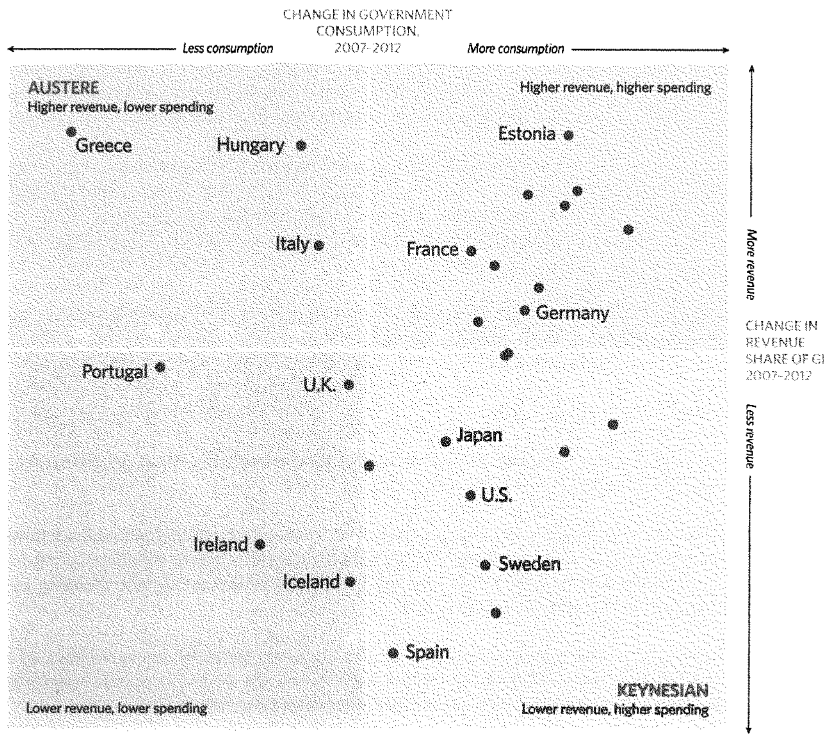
[12] Recall Alesina and Perotti, "Fiscal expansions and fiscal adjustments in OECD countries."

[13] Ben Broadbent and Kevin Daly, "Limiting the Fall-Out from Fiscal Adjustment," *Goldman Sachs Global Economics Paper* No. 195, April 2010, p.5.

austerity, in the upper left corner of Chart 2.[14] The other ten have raised taxes along with government consumption and transfers. Instead of funding deficit reduction, the new taxes fund larger government.

CHART 2

Most Governments Have Increased Spending Since 2007



Source: OECD.

Outside of Europe, Keynesian policies are more common. The U.S., Japan, Israel, and Australia[15] have lowered revenue rates while increasing government spending. The U.S. and Japan are running unsustainably large deficits and have very high debt-to-GDP ratios.

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[14] Not coincidentally, these three also experienced some of the lowest increases in transfer payments, clearly reflecting reforms to the transfer systems.

[15] The only four non-European countries in the relevant sample.

How Will the Economy Go Forward?

Meanwhile, there is pressure in the U.S. to raise taxes while preserving the temporary spending surge associated with the recession and stimulus. As decades of evidence indicate, raising taxes without cutting spending has a poor record of containing debt and a worse record of returning the economy to growth.

A better path is to accept that short-term stimulus has been tried – on a spectacular scale – and failed, and move on to preparing the country for stability and growth through the retirement boom of the 2020s by cutting spending and controlling the growth of transfers.

Sequestered?

The 2013 budget sequestration was poorly designed policy. However, its artlessness does not outweigh the fact that it is a step in the right direction. Pier Carlo Padoan, Chief Economist of the OECD, emphasized in a speech last week that the U.S. should make the spending cuts of the sequester less harmful by incorporating them into a credible, permanent fiscal consolidation.[16]

Since taking effect in March, sequestration has had no discernible impact on growth or employment numbers, nor on financial markets. Where sequestration policies are particularly perverse, straightforward legislation can improve the content of policies while remaining revenue neutral. There are many places in the federal budget where small savings can be found at little cost.[17] In fixing sequestration, policymakers should restore government investment at the expense of the wage bill and transfer payment growth.

Stimulated?

Temporary deficit spending – optimistically called stimulus – is designed to move economic activity from the future to the present. It can effectively do so when there is slack labor and capital, but the question remains whether there is a large welfare benefit to shifting forward tomorrow's GDP. By running large deficits each of the last five years, the U.S. has engaged in an enormous stimulus program.

Some have argued that the $640 billion of stimulus from the federal deficit in 2013 is not enough, and the amount should be increased. DeLong and Summers show that when the negative effects of a recession have permanent drag on the economy (i.e., unit root hysteresis), deficit spending can be self-financing under certain conditions and assumptions.[18] Their paper is valuable in that it reminds the

[16] Pier Carlo Padoan, "Presentation of the May 2013 OECD Economic Outlook," May 29, 2013, http://www.oecd.org/about/secretary-general/presentation-of-the-may-2013-oecd-economic-outlook.htm (accessed May 30, 2013).

[17] See, for example, Patrick Louis Knudsen, "$150 Billion in Spending Cuts to Offset Defense Sequestration," Heritage Foundation *Backgrounder* No. 2744, November 15, 2012, http://www.heritage.org/research/reports/2012/11/150-billion-in-spending-cuts-to-offset-defense-sequestration.

[18] For example, see J. Bradford DeLong and Lawrence H. Summers, "Fiscal Policy in a Depressed Economy," *Brookings Papers on Economic Activity*, Spring 2012.

economics profession of how little is known about the existence or size of hysteresis, and how much long-run gains or losses can outweigh short-run considerations.

But DeLong and Summers' model could easily be rewritten to instead feature coefficients from the literature on debt drag, which would show that under certain conditions, spending cuts are self-financing.[19] Better yet, DeLong and Summers' model could incorporate the permanent productivity gains from structural reforms, such as the labor market reforms championed by the OECD.[20] There is substantially more empirical evidence that debt drag is a problem and structural reform is a solution than there is about hysteresis, although more research may ultimately shed light on the latter.

A more likely scenario is that money spent today will not pay for itself, and will have to be cut from government spending tomorrow. Deficit spending for hopeful stimulus today could easily mean cuts to Social Security and Medicare in the 2020s, or a lack of public and private investment as interest payments crowd out valuable government functions and raise hurdle rates over the next few decades.

Structural Reform

There is no substitute for private sector economic growth. Although government can easily boost its own portion of GDP, it can only indirectly and imprecisely have a positive impact on private consumption and private investment, which are the cornerstones of material well-being present and future. The most proven, fiscally sound, and long-lasting policy changes to help achieve growth are structural reforms.[21]

Angel Gurría, Secretary-General of the OECD, laid out a mandate for structural change:[22]

> We have done the number crunching: we have simulated the effects of structural reforms on potential output across the OECD area through 2060. Our analysis shows that moving to best practice across a number of policy areas – product and labour market regulations, and education, just to name a few – would raise per capita incomes by some 20% in the median

[19] For a summary of the debt drag literature, see Salim Furth, "High Debt Is a Real Drag," Heritage Foundation *Issue Brief* No. 3859, February 22, 2013, http://www.heritage.org/research/reports/2013/02/how-a-high-national-debt-impacts-the-economy.

[20] Pier Carlo Padoan, "Presentation of the May 2013 OECD Economic Outlook."

[21] See, among many, Alan Krueger and Jorn-Steffan Pischke, "Observations and Conjectures on the U.S. Employment Miracle," NBER *Working Paper* No. 6146, 1997; Clifford Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," *Journal of Economic Literature* 31(3), 1993; Edward P. Lazear, "Job Security Provisions and Employment," *Quarterly Journal of Economics* 105(3), 1990; Andrea Bassanini and Romain Duval, "The determinants of unemployment across OECD countries: Reassessing the role of policies and institutions," *OECD Economic Studies* 42(1), 2006; John Williamson, "What Washington Means by Policy Reform," in *Latin American Adjustment: How Much Has Happened?* John Williamson, ed., 1990;

[22] Angel Gurría, "Presentation of the May 2013 OECD Economic Outlook", prepared remarks, May 29, 2013, http://www.oecd.org/about/secretary-general/presentation-of-the-may-2013-oecd-economic-outlook.htm (accessed May 30, 2013).

> OECD country. This is huge! And those gains would be even higher for those countries that are now furthest from best practice. So our call continues to be: "go structural". It is good for growth and prosperity, and it is good for the public finances.

The U.S. is better situated in terms of product and labor market regulations than the crisis countries of Southern Europe, but improvements could raise U.S. labor participation substantially.

Fiscal structural reforms can be distinguished from merely cutting spending by two criteria:

(1) A systematic or ongoing form of spending is cut, and
(2) Incentives for economic activity are improved by the reform.

Structural reform in the U.S. could lower the effective marginal tax rates[23] facing low-income workers by cutting some of the benefits which eviscerate the reward to work. Structural reform could shut down subsidies to farmers, favored energy companies, and big-ticket colleges. Structural reform could undo Social Security Disability Insurance's growth into a catch-all welfare program.[24] Structural reform could shrink government agencies primarily involved in economically destructive activities, such as the Commerce Department and the EPA. Structural reform could include an end to favorable tax treatment for mortgage interest and employer perks from health insurance to parking.

Structural reform shifts the government's role in society away from replacing private economic activity and toward protecting individual liberty.

This testimony makes no pretense of evaluating or recommending a specific set of structural reforms. But in the context of the difficult choices of "austerity" or debt drag, cutting deficits and promoting growth through structural reform offers the best way forward.

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[23] Elaine Maag, C. Eugene Steuerle, Ritadhi Chakravarti, and Caleb Quakenbush, "How Marginal Tax Rates Affect Families at Various Levels of Poverty," *National Tax Journal* 65(4), December 2012.

[24] David H. Autor and Mark G. Duggan. "The Growth In The Social Security Disability Rolls: A Fiscal Crisis Unfolding," *Journal of Economic Perspectives* 20, 2006.

Stefan Staubli, "The impact of stricter criteria for disability insurance on labor force participation," *Journal of Public Economics* 95(9–10), October 2011.

APPENDIX: Empirical Evidence that Spending Cuts Are Better than Tax Increases.

The discovery of expansionary fiscal consolidations led researchers to study the variety of fiscal consolidations and their average effects. Alesina's extensive research program has anchored this literature for twenty years, but he is by no means alone in his investigations.

Alesina and Perotti showed that when deficits expand, it is usually due to spending increases, and when deficits shrink, it is usually due to tax increases. Spending cuts are the exception, but they are the only way that countries have closed budget deficits without harm to the economy. They argue that "fiscal adjustment cannot have long-lasting effects unless it tackles two expenditures – government employment and social programs – often regarded as untouchable by policymakers and their advisors."[25]

OECD economists found that spending-based deficit reduction was more effective at lowering the debt-to-GDP ratio. The spending cuts were most effective when they were based on rules, enforced over time, and maintained transparency.[26] An OECD model of fiscal adjustment found that cutting spending at the margin can yield "surprisingly large income gains compared with the alternative of raising taxes."[27]

Ardagna looked simultaneously at the growth and debt consequences of fiscal consolidation,[28] and found that the composition of the adjustment determines whether economic growth follows. Fiscal adjustments featuring cuts to the government wage bill led to higher subsequent growth.[29]

Alesina, Perotti, and Tavares document 23 years with successful consolidations in which deficit reduction came 66 percent from spending cuts. On the other side, there were 49 years of unsuccessful deficit reduction, with just 27 percent from spending cuts. The spending cuts in unsuccessful consolidations occurred mostly to government investment and left government wages and transfer payments untouched.[30]

IMF economists noted that "consolidation is more painful when it relies primarily on tax [increases]", is more painful for Euro members, and is more painful if the central bank does not or cannot

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[25] Alesina and Perotti, "Fiscal expansions and fiscal adjustments in OECD countries."

[26] Guichard, Kennedy, Wurzel, and André, "What Promotes Fiscal Consolidation: OECD Country Experiences" 553, 2007.

[27] Boris Cournède and Frédéric Gonand, "Restoring Fiscal Sustainability in the Euro Area: Raise Taxes or Curb Spending?" OECD Economics Department *Working Papers* 520, 2006.

[28] This is an important distinction. Papers that track the evolution of (debt/GDP) may conflate differing effects.

[29] Silvia Ardagna, "Fiscal Stabilizations: When Do They Work and Why," *European Economic Review* 48(5), 2004.

[30] Alberto Alesina, Roberto Perotti, José Tavares, "The Political Economy of Fiscal Adjustments," in *Brookings Papers on Economic Activity*, Vol. 1998(1), Maurice Obstfeld and Barry Eichengreen eds., 1998.

accommodate the budget cut.[31] Lambertini and Tavares found that spending cuts contributed more to the effectiveness of fiscal consolidations than tax increases.[32]

Von Hagen, Halite, and Starch looked at the factors that determine the length and success of fiscal consolidations. They found that consistency in approach is valuable, and that consolidations based on cuts to "politically sensitive items... such as transfers, subsidies, and government wages" are more likely to persist long enough to be effective.[33] There is a payoff to political courage.

Alesina and Ardagna advanced and extended the previous literature with recent data. They confirmed the previous findings: tax-based fiscal consolidations usually fail, and lead – on average – to a recession. Using two datasets, their model estimates that a 1 percentage point drop in government spending has mild positive effects on growth or no effect on growth, and that a 1 point increase in taxes has either mild or severe negative effects on growth.[34]

McDermott and Wescott of the IMF confirmed Alesina and Perotti's key findings: cutting transfers and government wages is the key to successful and expansionary fiscal consolidation. They detail one case of expansionary austerity: New Zealand slashed government spending in the teeth of a 1991 recession and emerged with high growth, low unemployment, and a slim debt-to-GDP ratio.[35] Recent data yielded more examples of "expansionary fiscal consolidation," including Canada, Finland, Sweden, and the U.K. in the 1990s and Denmark, the Netherlands, and Switzerland in the 2000s.[36]

Alesina, Favero, and Giavazzi[37] have responded to the political debate of the last few years by formalizing their definitions and working with new data made available by Devries, Guajardo, Leigh, and Pescatori.[38] Focusing on multi-year plans and treating planned and surprise fiscal changes differently, Alesina et al. again confirmed that tax-based consolidations are more costly in terms of output losses.

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[31] Daniel Leigh, Pete Devries, Charles Freedman, Jaime Guajardo, Douglas Laxton, and Andrea Pescatori, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," International Monetary Fund *World Economic Outlook: Recovery, Risk and Rebalancing*, 2010.

[32] Luisa Lambertini and José A. Tavares, "Exchange Rates and Fiscal Adjustments: Evidence from the OECD and Implications for the EMU," *Contributions to Macroeconomics* 5(1), 2005.

[33] Juergen von Hagen, Hughes Halite, and Rolf Starch, "Budgetary Consolidation in Europe: Quality, Economic Conditions, and Persistence," *Journal of Japanese and International Economics* 16, 2002, p. 35.

[34] Alberto Alesina and Silvia Ardagna, "The design of fiscal adjustments," NBER *Working Paper* No. 18423, 2012.

[35] C. John McDermott and Robert F. Wescott, "An Empirical Analysis of Fiscal Adjustments," IMF *Working Paper* 96/59, 1996.

[36] Alesina and Ardagna, "The design of fiscal adjustments," Tables 2a and 2c.

[37] Alberto Alesina, Carlo Favero and Francesco Giavazzi, "The Output Effect of Fiscal Consolidations," Harvard University working paper, May 2013.

[38] Pete Devries, Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, "A New Action-based Dataset of Fiscal Consolidation," IMF *Working Paper* 11/128, June 2011.

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Chairman MURRAY. Thank you very much to all three of you. We really appreciate it.

And I wanted to start with the issue of sequestration. These across-the-board cuts were actually never supposed to go into effect. They were really imposed in order to push Democrats and Republicans to come together to compromise, and I think we all agree they are not the right way to achieve deficit reduction, particularly because they fall disproportionately on the discretionary accounts. So that means our investments that are so important to us that I talked about and some of you did are really being impacted by this.

CBO has now estimated that sequestration will lower employment by 750,000 jobs this year alone, and that is not just a big number, it is a threat to the well-being and opportunity for families across our country and really is unacceptable when so many people are fighting so hard today to get back on their feet.

As I mentioned, I was back home in Washington State last week, as all of our colleagues were in their home States, and I heard about this issue constantly and consistently, no matter where I was, from people who were experiencing the real and very devastating effects of sequestration. Many of the furloughs have just been announced. They are just taking effect. So families are trying to figure out how they are going to deal with as much as a ten percent pay cut over the next four months, let alone the sequestration that occurs for the next eight to nine years.

Kids in Head Start that you talked about, Dr. Johnson, teachers are right now telling parents they are not taking any more kids in Head Start. We will start seeing the impacts of that, short and long term. Workers, again, facing furloughs and deep effects.

So my first question to all of you, really, then, is on the broader fiscal and economic impacts of the sequestration. Lowering spending may reduce the deficit in the short term, but I want to ask how it affects prospects for future economic growth and fiscal sustainability and could it actually make it harder to solve our budget challenges in the longer term, and I would like to start with you, Dr. Summers.

Mr. SUMMERS. I believe sequestration at current magnitudes is counterproductive at three levels. First, it reduces demand and growth in the economy, which impacts adversely the level of income in the short run and casts a shadow forward onto the economy's future potential. Indeed, as I calculate in my testimony, the CBO estimates imply that the debt-to-GDP ratio at the end of this year will be no lower than it would have been if sequestration had not been adopted, that the fact that we will have a slower growing economy and, hence, a lower GDP at the end of the year just about offsets the direct benefits of sequestration.

Second, sequestration reduces investments that are crucial for the economy's future potential. We have stressed the example of Head Start, but there are others, as well—investments in basic research and development and the like—that have an adverse impact on our economy going forward.

Third, in many cases, expenditures reduced by sequestration are only postponed and magnified. We will be paying more for prison because of the cutbacks in Head Start as a country. It is much cheaper—it would have been much cheaper to have fixed that bridge in your State than it is to build a new one. And so the microeconomic consequence of sequestration cuts is often likely to be an increase rather than a reduction in future deficits.

There certainly is a role for spending reduction in any comprehensive approach to our long-run budget issues, but the current sequestration program is not the right way to implement that role.

Chairman MURRAY. Thank you very much.

Dr. JOHNSON.

Mr. JOHNSON. I agree. I think that the one very bad and costly way to do fiscal adjustment is to not invest, to not repair bridges. And when you have a large, complex, relatively advanced country like the United States, there are many such cuts that you can make, and then your bridges will fall down, which is an absolute disaster. And, of course, as the political pressure is expressed, you get more pressure to keep the FAA running in terms of its current operations and to keep meat inspectors on the job and to do other things that are of relatively high profile, something else has to give. What is that? It is all of the investments.

So you are really and completely undermining— obviously, not intentionally, it is not what you want to do, but the outcome is you undermine the country's future. It is a real shame. And when you talk to people from around the world, they absolutely cannot believe that this is where U.S. public policy stands today.

Chairman MURRAY. Dr. Furth.

Mr. FURTH. I agree with the panelists that the cuts in government investment are probably the worst way that the policy could have been implemented. I think that the fiscal impact, the amount of spending cuts, is really necessary.

To go to your original question, you asked whether these spending cuts would only help the deficit in the short run or if they would help in the long run more, and I do think they will help a little in the short run, but they will help more in the long run. The confidence that Dr. Summers talked about will return. Private sector economic growth over time tends to replace government spending that goes away as resources are moved to more efficient uses over time.

So I think there are longer-term benefits to these spending cuts. I absolutely agree that the cuts should be moved away from the investments and towards the government wage bill and transfer payments, which are what the previous research has shown are the most efficient and growth inducing places to make cuts.

Chairman MURRAY. Well, thank you. My time is up, but I just want to mention that at some of my meetings in my State last week, it was police chiefs and sheriffs who were arguing most compelling to us to not cut Head Start because the vast majority of people in their jails—and I am talking local sheriffs and police—70 to 80 percent of the people in their jails were high school dropouts and they directly link that to our investments in early childhood education that we were losing out on.

Senator SESSIONS.

Senator SESSIONS. Thank you. Well, the sequester was part of the Budget Control Act. That is what we did. And the amount of reduction in spending over ten years, a rather modest reduction in that growth, was agreed upon. It is in law and it has been signed by the President and it is not going to be changed.

What is open and what definitely needs to be done and what the House has done is to look for ways to find other wasteful spending that does not add to our productivity and spread these cuts around in areas that were not touched, in my opinion.

With regard to roads and bridges, I have to push back a bit on that. In the stimulus, the $850 billion stimulus bill, only about four percent of it went to roads and bridges although we were constantly told it was going to rebuild our infrastructure. And we spend now about one percent, one-and-a-half percent, of our total Federal revenues on roads and bridges. So the excuse for tax increases is not to use that money for our infrastructure. If I saw a proposal that would do that, I would be more interested in it.

And, you know, Dr. Johnson, Judd Gregg is very thoughtful. We do have to confront our long-term entitlement spending programs and I think you could see some revenue increases occur as a part of a fix of that. But at this point in history, I think there is not support to raise spending—raise taxes for increasing general spending, and that is what the President's budget does and that is what the Senate budget does. It raises taxes for more spending, not to reach our debt or stabilize our entitlements.

Briefly, just, Dr. Summers, try to get on the same page here. Would you agree that tax increases are a form of austerity as well as spending cuts?

Mr. SUMMERS. Certainly, they can be. It would depend on the precise form they took. If they took a form that was likely to depress spending substantially, then they certainly would be a form of austerity. If they took the form of broadening the tax base in ways that represented the kind of structural reform that Mr. Gurria from the OECD advocated and that increased economic efficiency, then I would be less likely to label those as austerity policies.

But, yes, absolutely, the basic principle of you want to be increasing demand rather than reducing demand in a time of recession applies both on the spending policy side and on the tax policy side.

I might say, also, if I could, that I think you pointed towards what would be a very productive way forward in one of the comments that you made. It seems to me that it would be desirable for the country to embark on a ten-year program of renewing the infrastructure, fixing the roads and bridges and the like, with the understanding that revenues to pay for it would kick in at such point as that was macroeconomically appropriate, when the overall national unemployment rate had fallen below some threshold, as long as if the inflation level became excessively severe, some set of macroeconomic triggers.

But it seems to me we would be much better off approaching infrastructure in a long-run way and then using thresholds to determine how the timing of payments was managed to help support sustained economic growth. That, I think, was implicit in your suggestion and I think it is a very wise one.

Senator SESSIONS. I think that bipartisan support for a serious plan to enhance our infrastructure, but the American people need to know how little of our actual revenue is going to that.

Dr. Furth, you studied the European situation. It seems to me that the U.K., for example, immediately raised taxes and has had not that much spending reductions. We were in Estonia and the cabinet people took 40 percent pay cuts. The doctors in the health care system took big pay cuts. One of the cabinet members said his wife was really unhappy. But it seems to me Estonia added almost nothing to their debt during that time and now has one of the highest growth rates in Europe. Would you share a little bit more about this fundamental question of austerity and how to get our debt and growth back on track.

Mr. FURTH. Sure. Yes, I absolutely agree about the U.K. They raised their Value Added Tax from 17 or 17.5 percent to 20 percent. That is a tax on everything that is produced. And so what the U.K. has had is despite having more people enter the labor force, their economy is shrinking. They have been hard hit by some local factors, such as the decline in finance in London. That is a very big industry there. But they are having a very hard time even when they are successful in getting people back to work. They are taking so much out of the economy in taxation, and that form of austerity, that way of trying to close the budget deficit, is preventing a fulsome economic recovery in the U.K.

Senator SESSIONS. Thank you.

Chairman MURRAY. Senator King.

Senator KING. I was reading the Budget Control Act. It is interesting to me how the discussion of the Budget Control Act and the sequester has evolved, because as I recall, and I went back and I was just reading the statute and read it back this winter, the sequester was designed to be stupid. It was designed to be unacceptable as an alternative, therefore forcing the Super Committee and the Congress to come to a more reasonable alternative.

What I was just looking at was a provision of the Budget Control Act at the end that clearly contemplates that revenues could be part of the solution. The idea was to find another $1.5 trillion of savings, somewhere. And the statute clearly contemplated that revenues could be part of it. That did not happen, unfortunately. It is with a great sense of regret that I read those provisions, because that Super Committee had amazing powers and it is something that- -it was a missed opportunity. But, in any case, here we are. But to say that the sequester is now the baseline, it seems to me, is a misreading of the history of the Budget Control Act.

I guess the question for you, Mr. Johnson, and you have talked about this, as I look at the overall fiscal situation of the Federal Government, the real drive is health care and everything else is flat. I mean, as you probably know, discretionary spending, non-defense discretionary spending right now is at the lowest percentage of GDP in about 45 years. Defense is relatively flat relative to GDP.

So when we talk about controlling growth in spending, what we are really talking about, if we do not do anything about health care, is allowing health care to squeeze everything out, everything else out. My question to you is, what can the Federal Government do as a major consumer of health care to affect the overall growth of health care in the economy? I have some ideas no that, but I would like to hear yours.

Mr. JOHNSON. Well, Senator, you are absolutely right, that if you look out 20, 30, 40 years, health care does not just eat the Federal Government budget, it eats the economy. Now, presumably, that is not going to happen. I do not think we will let that happen, but the question is, what are the policies that will turn it around?

And if you look at the IMF's tables on the back of the publication called the Fiscal Monitor—they put it out every six months—they have comparisons of projections of health care spending across countries. So this is very much looking at the data, looking at who has a better grip on these costs on a projected basis, and it is a hard thing to do, but all those economies that have better projections than ours have some form of single-payer system with something like universal coverage. Now, I am not saying that is what we are going to get in the United States. I am just saying, from a fiscal control point of view, from a budget deficit management over the medium term point of view, that is what strikes, I think, anyone who looks at the cross-country comparative available data.

Senator KING. But would you agree that what we have to have is a conversation about health care costs generally, not just those as applied to the Federal Government? If Medicare says, we are going to have limits, all that does is shift the payments to the seniors or to the States, the same with Medicaid. Professor Summers.

Mr. SUMMERS. I would agree very much with the thrust of your last remark, Senator. I have spent some time in the last month or two learning more about this subject than I did before, and what struck me as I read the literature and spoke with experts was that if you ask the question, U.S. health care costs are much higher than in most other countries. How much of that is because Americans are getting more colonoscopies, more treatments in the months before they die, more stuff, and how much of that is because a given procedure or a given type of hospitalization costs more in the United States? It is much more the latter than the former, which suggests that measures directed at reimbursement reform and purchase more efficiently should be put at a premium, and measures directed at getting people to seek less care should be given lower priority.

Now, as your question suggests, I believe such measures need to be applied universally. It would be a tragedy if we turned Medicare into a program in which a large fraction of doctors withdrew, which would be the risk if we sought only to reduce payments for the public sector programs and engaged in no cooperation with the private sector around cost control.

But I believe coalition of payer initiatives, such as have been raised in a number cities in the United States, that orient towards payment for results and involve cooperation among all those who pay our providers offer the best prospect for containing the growth of health care costs, and I think that very much will require taking a focus, as you suggest, on overall health care costs, not simply the costs coming from the public sector programs.

Senator KING. Well, Mr. Johnson, I remember when I was Governor, health care was 12 percent of GDP and we said, oh, it cannot go much higher than that, and it is now approaching 20. So just saying it cannot happen does not mean it will not unless we do something affirmative.

My closing comment is that as I assess Federal spending, cutting spending generally without dealing with the health care cost is like invading Brazil after Pearl Harbor. It is a vigorous response, but it is the wrong target. Thank you.

Chairman MURRAY. Senator Johnson.

Senator JOHNSON. Thank you, Madam Chair.

In terms of BCA, I remember the primary goal there is to reduce the deficit by about $2.1 trillion. We did, by the way, get a more than $600 billion tax increase, the fiscal cliff, so there is—I think we have got that balance that people talk about, not a balance I particularly agree with.

We utilize the word "investment" a lot, I think pretty loosely. Coming from the private sector, I utilize the word "investment" as hard infrastructure spending, you know, things that are going to last a long period of time. Certainly, in the government, we have got bridges and roads. That is hard infrastructure. We have got other investment, I suppose you can make the argument, that will have long- term implications, things like education. And then you have just basic consumption.

The question I have, and I do not want a real philosophical argument but just the basic percentage or number, does anybody know, out of a $3.6 trillion a year budget, what would you call investment out of there? Dr. Summers.

Mr. SUMMERS. I would have to study it. It is certainly less than half.

Senator JOHNSON. It is way less. I mean, do we not have basically two-thirds of our budget is mandatory spending and entitlement spending, which is basically consumption? So you have maybe got a trillion dollars of discretionary spending. How much of the trillion dollars would be investment?

Mr. SUMMERS. That was really what—I was really addressing the—I misunderstood your question and I was addressing the discretionary spending. But I think it is—

Senator JOHNSON. So to clarify, you agree two-thirds is already consumption. So pretty much all—

Mr. SUMMERS. I do not know how to think about—I think of national defense as an investment in keeping the country secure.

Senator JOHNSON. There again, that is the discretionary side.

Mr. SUMMERS. But I could see how somebody could regard that as not investment in the same sense that a private business would. But I think it is—you are certainly right that most of the entitlement program spending, I do not think, would be prudently viewed as investment. Yes, I agree with that.

Senator JOHNSON. Dr. Johnson, you have been thinking about this. Do you have a number in terms of—out of $3.6 trillion, how much is really investment? Let us start with the infrastructure. Do you have any idea about infrastructure, I mean, hard roads and bridges, what most Americans would really view as investment?

Mr. JOHNSON. I think that is a great question, Senator. We are obviously spending some hundreds of billions on investment, including education, which is a critical part of it. But it is a small part of total Federal spending, without question.

I would stress, though, that what you are running and you are calling consumption is part of social insurance programs. That is not insurance that is readily—or was not readily available through the private sector. Private—

Senator JOHNSON. By the way, would that not be an automatic stabilizer? You said we do not have very good automatic stabilizers in our economy, but yet two-thirds of the budget that is off-budget and on automatic pilot, would that not be an auto-stabilizer?

Mr. JOHNSON. Yes, to some degree, it is, but the point is, our Federal Government is—and our government—

Senator JOHNSON. And that is $2.6 trillion worth.

Mr. JOHNSON. It is smaller than other countries, Senator. That was the point I was making.

Senator JOHNSON. Two-point-six trillion dollars?

Mr. JOHNSON. So we have automatic stabilizers, but it is smaller relative to our economy than it is in other industrialized countries.

Senator JOHNSON. We—

Mr. FURTH. Senator—

Senator JOHNSON. No, we just had a release of the Department of Energy in terms of their loan program, their green energy jobs programs, $26 billion of loan guarantees, about 2,300 jobs created, long-term jobs, at a cost of about $11.5 million per job. As economists, do you recognize any difference between the effectiveness of public spending, public investment, versus private sector investment? Dr. Summers.

Mr. SUMMERS. Oh, I do not think there is any question that the private sector is a better venture capitalist than the government. That does not mean that there are not appropriate instances where government can be catalytic, and where the private sector will not step up, government should not take a role. But, in general, one would expect in spheres like venture capital that private investment would be much more effective.

But if I could just come back on one thing, because I do think it is important to be fair here, investment, in my dictionary, refers to expenditure today for future benefit. A relative of mine is soon going to undergo heart surgery that offers the prospect of substantial life extension—

Senator JOHNSON. Right—

Mr. SUMMERS. —that Medicare is going to pay for. I do not think it would be—I understand why that is quite different from investment as a private sector business would use the term, but I also think it is quite different from consumption as that term is used, and it very much is an expenditure today for future benefit. So I think we have to be a bit careful as we use these categories of consumption and investment, and some of what government does does not fit naturally into the private sector concepts of either consumption or investment.

Senator JOHNSON. But based on your earlier comment in terms of private sector investment being more effective and efficient than the public sector, you would basically agree with Dr. Furth, then, that we should really be looking at how do you incentivize the private sector and get more of the dollars flowing to the private sector for economic growth, which everyone agrees is the number one component of the solution here, correct? We need to juice the private sector, the productive sector—

Mr. SUMMERS. Private sector growth is enormously important, and where we can, at limited cost to the government, juice substantial private sector investment, we absolutely should. That is why, for example, I worked hard during my time at the NEC to include the provisions that provided for expensing of small business investment in the Economic Recovery Act. It included a number of provisions—

Senator JOHNSON. But, of course—

Mr. SUMMERS. —directed at spurring private investment, and even—and I recognize how controversial they are, and there certainly are legitimate questions that can be raised at them, but even the energy subsidies that you raise, Senator, if you look at those programs, the government money is catalytic and the amount of total money invested is very substantial—is a significant multiple of the amount of public money invested. So it is exactly juicing the private sector in the sense you suggest—

Senator JOHNSON. But, of course—

Mr. SUMMERS. You know, whether those programs are ideally designed, you can certainly—that is certainly a totally legitimate area for debate.

Senator JOHNSON. But, of course, the $26 billion came from somewhere. It was taxed out of the private, the more productive sector, or borrowing, which creates all that level of uncertainty because of very bad fiscal policies. So it comes at a huge cost and a very ineffective use of money. Thank you.

Chairman MURRAY. Senator Baldwin.

Senator BALDWIN. Thank you, Chairman Murray and Ranking Member Sessions, for convening us today.

You know, in my view, our country faces twin challenges, stabilizing our debt and deficit without shortchanging our future and continuing to move our economic recovery forward, and I think that is something that all of us here can agree on, but there is real disagreement on how we tackle these twin challenges. In my view, I do not believe this can be an either/or proposition. We cannot have all stimulus or all austerity. We need to have a balanced approach.

However, right now, we are seeing the effects of sequestration and I think that is anything but balanced. This year alone, the Congressional Budget Office estimates that sequestration will cost our economy about three- quarters of a million jobs and we fear that the consequences of sequestration will continue to compound over time. We are cutting away at things like education and scientific research and innovation, which have previously provided a strong foundation for our economic growth and global competitiveness.

Indeed, over the past half-century, more than half the growth in our nation's GDP has been rooted in scientific discoveries. This is the kind of fundamental mission-driven research that is done at places like the Great Lakes Bioenergy Research Center, which I had the chance to visit last Friday. This center is a Department of Energy funded consortium of over 400 researchers and innovators researching advanced biofuel technologies that will help to support an economy that is built to last.

In addition, I had the chance to sit down with and talk to researchers from across the University of Wisconsin- Madison campus who rely on Federal investments, especially research grants from the National Institutes of Health and the National Science Foundation. This entire group talked about their worries, their worries that there will be an entire missing generation of scientists. They explained that diminishing grant opportunities and intense competition are putting the brakes on innovation at a time when we need to be stepping on the accelerator.

The potential for future employment and economic growth opportunities in science, technology, engineering, and mathematics related fields is huge. In my travels around the State of Wisconsin, the question is, will we be able to educate enough young Americans to fill these positions? And, indeed, there is a consensus between business and educators on the need to increase STEM programs in our K through 12 education to meet this demand. At the same time, the Federal Government is pressing the pause button on research and innovation at the highest levels.

Dr. Summers, in your testimony, you talk about the difficulty that recent college graduates have in getting onto career ladders. The researchers I met with at the University of Wisconsin-Madison shared a very similar perspective. From a competitive standpoint, can you speak a little bit about what happens when we begin narrowing the pipeline of young scientists and engineers who are working on basic and applied research.

Mr. SUMMERS. If we—it is like prospecting. Some of the holes come up dry, but when you hit a good one, it is enormously valuable. If we less scientific research, we are doing less prospecting. It is less likely that the next semiconductor will be invented here. It is less likely that we will be the center of the action in biomedical research.

There was a time when Oxford and Cambridge in England were the centers of global scientific research. Over time, as England struggled, there was less support, and while great universities, they lost some of what was special in terms of their capacity to support scientific research. That benefitted the United States very importantly during the 20th century. And the question that history will judge us on, I believe, is whether we allow a transition like that to happen with respect to U.S. scientific leadership or whether we do not.

The 20th century was, in many ways, a century of physics, with the Manhattan Project, the semiconductor, the personal computer, ultimately, the Internet. And our leadership in it was central to our leadership in the world.

I believe the 21st century is going to be a century of the life sciences, with revolutionary understandings that contribute to a cure with tremendous things happening in bioengineering. And it is going to be very important for the position of the United States in the world to what extent we are leaders of that. We are set up to be leaders because of the institutions that we have, but others know how important that is, as well, and the decisions we make about supporting scientific research will guide the choices of our most talented young people and that will have a profound effect on the future of the country.

Senator BALDWIN. If the Chair will indulge a brief response, your painting the picture of the last century is very meaningful to me.

I was raised by my grandparents and my grandfather was U.S.-born but got his Ph.D. in biochemistry at Cambridge University, and at the onset of World War II returned to the U.S. and spent a year at Harvard, seven years at Columbia, and then the rest of his career at the University of Wisconsin-Madison. And I remember when he used to be on grant panels listening to how many were putting in, and even as much as a decade ago, there would be 100 new post docs applying for grants and 25 percent of them might have a chance of getting them.

My research scientists that I talked with last Friday on campus said there were probably half the number putting in for grants and maybe five percent getting awards and that this is having—there will be a lost generation of U.S. scientists.

Mr. SUMMERS. Just a very quick response, if you will indulge me. When Jim Watson did the work that identified the structure of DNA that set the basis for modern biology, he was 27. Today, on average, when you get your first NIH grant if you work in those fields, you are in your early 40s, and there have just got to be a lot of people who would be in that field if they thought they could get independent support at the ages when they were most likely to be brilliant and creative, and it is increasingly becoming more and more difficult for young investigators. And it is not because they do not have the talent. It is not because there are not important problems. And it is not because the problems are not solvable.

Chairman MURRAY. Senator Nelson.

Senator NELSON. A fascinating discussion about the life sciences. I want to return to the budget. In the opinion of this Senator, there is good news and bad news. The good news is that existing circumstances, the deficit will be reduced over a ten-year period to somewhere between $3.6 and $3.8 trillion, not too far off from the $4 trillion goal that we had back in the crisis of 2011.

The bad news is, in the opinion of this Senator, that we are going to have a crisis again come this fall, just like we had in 2011, over the raising of the debt ceiling so that the government can pay its bills, and all the pressures that come in as a result thereof—passing a budget, passing appropriations, the tax revenue and spending questions, tax reform, entitlement reform. Everything is going to come crashing in, in my opinion, this fall, whenever we reach that limit of the debt ceiling. I would like to have the experts reflect upon that.

Mr. SUMMERS. Let me first say, Senator, that I think a default, even for ten minutes, would be catastrophic and would have consequences that go forward for a long time. My son is here sitting behind me. We discuss from time to time his expenditures in college. If I am uncomfortable with his expenditures, one option is that he pays. Another option is that I pay. We do not as a family regard stiffing Visa as being a viable option for working out our difference of opinion.

And in the same way, it seems to me that repudiating our debt should be off the table. And it seems to me that for a great nation to be debating the order in which it is going to pay its creditors or the order in which it is going to pay creditors and those counting on Social Security benefits or those counting on NIH grants is to be having a tragically misguided debate.

So it is absolutely right that there be a requirement of Congressional authorization and appropriation before debt is incurred, and that takes place with respect to every dollar that is obligated for spending by the Federal Government. But I do not believe that using the debt limit and the possibility of default as leverage for action, whether the particular action in question is an action I favor or an action I oppose, is an appropriate tool. It seems to me that if history teaches anything, it is that those who carry the view that their end justifies extreme means are usually on the wrong side of history, and that applies very much with respect to the threat of default.

Senator NELSON. I agree with you, but I am afraid that is where we are headed.

Dr. JOHNSON.

Mr. JOHNSON. Senator, I also agree that may be where we are headed and it concerns me greatly. It does not actually matter so much what the economists and the experts think will happen. We should look at what the private sector thinks about these debt ceiling confrontations. And I mentioned before the research of Nick Bloom and his colleagues that shows clearly that of all the very difficult circumstances we have encountered in the past five or ten years in the United States, the one that really jumps out as having scared the private sector and discouraged investment by the private sector was the fight over the debt ceiling in the summer of 2011. And the idea that we would repeat that or some version of that, I think, is really unappealing and makes no sense. It is purely defeating everything that all of you want to achieve, which is a stronger recovery based on a more vibrant, more confident private sector.

Mr. FURTH. It is very clear that the U.S. needs to not default, and obviously, we do not want to get close to that. It is very good news that the budget situation is better than thought and that Congress has a few more months to work this out before we get close enough that markets start to really get worried.

What we need, obviously, is a long-run plan that comes in gradually, that makes the kinds of entitlement cuts that do not slam into the economy in one year, that grow over time, that change things in 2050 much more than they change things in 2015. And, yes, we need that compromise. The research on other countries shows that plans that work in stabilizing economic growth and stabilizing debt are those that cut entitlements, do so gradually, transparently, with rules such that there is a very clear path that the plan is going to follow. What we do not want is to lurch from one unexpected sequester to another. It will really benefit the economy if the politics can be brought together in such a way that we have a clear plan to take us through the retirement of the Baby Boomers. Thank you.

Chairman MURRAY. Senator Nelson, there is a solution to this, to not get to your crisis, and that would be for our Republican counterparts to allow us to appoint conferees, for the House to appoint conferees, and to put us in a room and have us make a decision before we reach that crisis point.

Senator NELSON. You are absolutely correct.

Senator WHITEHOUSE. But that would mean following the regular order and—

Chairman MURRAY. It would, actually.

Senator SESSIONS. Well, the regular order calls for the bringing up of the House budget on the floor and 50 hours of debate.

Chairman MURRAY. Which has never occurred before.

Senator WHITEHOUSE. Which has—exactly.

Senator SESSIONS. Well, it may not have occurred before, but that is the regular order.

Senator WHITEHOUSE. Yes. We are fighting regular order.

Senator SESSIONS. You are correct fundamentally, Madam Chair. Thank you.

Senator NELSON. As I said, I think we are going to have a problem this fall.

[Laughter.]

Chairman MURRAY. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Madam Chair.

What brings us to this hearing is some history. The history is that the Republican party fought through the fiscal meltdown for an austerity solution. Spending cuts, spending cuts, spending cuts. Europe actually tried the austerity solution. The results are in and the results in Europe are calamitously bad when you look at measures like unemployment and GDP growth compared to where we are. We may not love where we are, but I had some Rhode Island colleagues who are of Portuguese extraction in town last night and we had dinner with the Portuguese ambassador. Portugal has an 18 percent unemployment rate, and they look good by comparison to Greece and Spain, which have 27 percent unemployment rates. Across the EU, economies are not growing slowly like ours. They are actually shrinking. Greece, down 6.4 percent. Portugal, down 3.2 percent. It is a really bad tale, which creates a problem, which creates a problem.

What is the solution? The solution is that the recent Republican witnesses have come in and suggested that the problem with European austerity is that they did not really do spending cuts. It was really about tax increases. And so the lesson that you are supposed to draw from the European disaster of following the austerity recommendation is avoid tax increases. And you look at some of the data and, frankly, it does not add up.

Dr. Furth, I am very concerned about your testimony and I would like you to take some time when you have some time and write back to us and explain yourself, because when I look at the graph, for instance, on page eight, which you sourced to the OECD, if you actually look at what the OECD says about spending cuts versus tax increases, they have actually written what the numbers are, and here is what the numbers actually are according to the OECD. I will start at the top.

Slovenia, 100 percent spending cuts, zero tax increases. That is hardly a solution that counted on tax increases. Iceland, 72 percent spending cuts, 28 percent tax increases. United Kingdom, 69 percent spending cuts, 31 percent tax increases. Spain, 67 percent spending cuts, 33 percent tax increases. Ireland, 66 percent spending cuts, 34 percent tax increases, and on and on until you actually get to the country that the Ranking Member mentioned, Estonia.

Estonia had the lowest spending cuts. It was 26 percent spending cuts, 74 percent tax increases, compared to the U.K., which was your comparison, which was 69 percent spending cuts, 31 percent tax increases. And these are OECD numbers. That is their percentage number.

Dr. Furth, I am concerned that your testimony to this committee has been meretricious and I want an explanation. I want you to sit down and do it in writing so that we have plenty of time, that there is no question about any shortcut that you might have taken or there was not time for this discussion. And I want you to explain how this OECD data that shows that the majority, by OECD's own terms, over and over again of their austerity plan was spending cuts turns out into the data on this graph.

And, I mean, I want to know how you got to that data. I want the explanation. I do not want a lot more talk about economic theory. I am contesting whether you have given us fair and accurate information and I want you to have the opportunity to explain why you say, "Source: OECD" on the bottom of that graph. And I am going to run out of time, so let us not have this discussion now—

Senator SESSIONS. Well, I think—

Senator WHITEHOUSE. Write it down carefully, because I think this is—

Senator SESSIONS. Give him a chance.

Senator WHITEHOUSE. He can answer—

Senator SESSIONS. I think he—

Senator WHITEHOUSE. I will give him a chance to respond. But I do not want him to be in a situation where he did not feel he had enough time to respond. I want—I think it is very important that we in these committees get honest testimony here, and I can turn this every which way but up, but when you look at the actual balance between spending cuts and tax increases that the OECD uses itself to describe what took place in Europe, I cannot connect that to where you come out.

The closest that I can get is the pretense in your testimony that there has been an increase in transfer payments. The best I can tell from what we have actually seen is that you say, in Spain, transfers are up 19 percent, in Ireland, 20 percent, in U.K., 12 percent, and in Estonia, 22 percent. As best I can tell, those programs were not increased at all. What happened is that the transfer payments went up because people lost their jobs. People went broke. They had to go onto relief. You are not improving the economy when you lose your job and go onto relief. So if that is the way you have maneuvered these numbers, I just do not think that is legitimate. I do not think that is honorable. I do not think that is fair.

So, please respond, but I know that this is a contentious subject. But now twice in a row, we have had Republican witnesses say that austerity was really all about tax increases and if you just lay off on the tax increases, we will not go that way. And the OECD information is exactly the contrary. They have actually done the math. It is their own information. So when you cite to their information, I have a real problem with that and I think the committee is entitled to an explanation.

Mr. FURTH. I would be happy to provide one. Very briefly, I can address one of your concerns here very simply. As I stated in my oral testimony, we do expect transfer payments to go up in a recession. I did not claim that that was a change in policy. I said that the fact that they have all gone up indicates that there has not been brutal cutting. There have been some cuts in some places. The ones, for instance, in Greece, it has gone up not at all. And I mentioned in a footnote in my written testimony that that does include programmatic cuts.

Senator WHITEHOUSE. So if a government scientist gets laid off because of a spending cut and has to go onto a transfer payment, as far as you are concerned, that is not a harmful situation.

Mr. FURTH. That is not what I said.

Senator WHITEHOUSE. I have gone beyond my time.

Senator SESSIONS. Well, if the witness would like more time, I think he should be given it. He simply said that the spending went up. It was not reduced. The spending went up by the government. But maybe—you have been very harsh and I think he deserves an opportunity to have a little time to respond to your long discussion.

Senator WHITEHOUSE. I am happy to have him have that time, but I do want to get this in writing and get this sorted out because I just—

Senator SESSIONS. Well, it is—

Senator WHITEHOUSE. —think it is very important that we be given proper, honest data, and I cannot for the life of me correlate the presentation that this witness has made with the data that the OECD itself has put out in very clear terms—69 percent, 67 percent, 53 percent, 44 percent—

Senator SESSIONS. Well, the time is up—

Chairman MURRAY. Dr. Furth—

Senator SESSIONS. —but I would just say this. You are raising—you have raised this point. It is a fundamental point, I acknowledge it. What do we do to create growth and get our debt under control? Is it just raise taxes or is it reduce spending? So this is a fundamental issue and it is important.

Chairman MURRAY. Dr. Furth, I assume that you will respond to this committee in writing.

Mr. FURTH. I would be happy to do so.

Chairman MURRAY. Okay.

Senator SESSIONS. Well, I would just—he had less than a minute against about eight minutes, so if he had any more to—

Mr. FURTH. I do not think that the tenor here is conducive to having further productive discussion.

Chairman MURRAY. Okay, Dr. Furth. Then we will look forward to your response in writing. Thank you.

With that, we have one final questioner, Senator Wyden. I do have to get to the floor. I am going to turn over the gavel to Senator Wyden for his final comment. At the close of his comment, this hearing will close, and I just want to remind all of our colleagues that additional statements from today's hearing are due in by 6:00 p.m. today. And I do truly want to thank all of our witnesses for coming, for your testimony. I think this has been a very productive session. Thank you very much, and Senator Wyden.

Senator WYDEN. [Presiding.] Thank you, Senator Murray.

Dr. Summers, as you know, the flip side of austerity is growth, and you have had a lot of important papers and comments over the years with respect to consumer demand and particularly consumer demand in our economy. And as you know and have written, consumers are responsible for about 70 percent of the economic activity now in our country.

You look at the numbers that we saw last month, which were, by and large, pretty encouraging, you know, housing starts, the employment numbers. But one that was a little troubling was that question of the consumer being, again, a little bit tentative in terms of their spending.

One area where we made some bipartisan progress on has been in the tax reform area as part of the legislation that I have had over the years with Senator Gregg and Senator Coats, in particular. We have had bipartisan support for approaches that could really help us grow the economy by stimulating demand, particularly by tripling the standard deduction for middle class people, so that, in effect, if you had $60,000 in annual income, we would put $30,000 off limits from the taxation side and so middle class people would get some serious tax relief, and we have been able to offer that in a bipartisan way.

Could you spend a minute or two outlining some of the other areas where you think it might be possible as we kind of compare austerity and the growth that you have talked about, which is a view I happen to share strongly, what are other possibilities that we ought to be looking at in order to particularly bring that middle class person back into the economy, buying the goods and services that, as we know in America, lift a lot of boats?

Mr. SUMMERS. Senator Wyden, I think there is a legitimate question that does have to be faced, which is given the increased pressures that will come on the Federal budget, increased pressures that will come because of an aging society, increased pressures that will come because whatever the merits of any past debate, we have accumulated more debt, increased pressures that will come because the relative price of many of the things that government buys—I think, for example, of health care and higher education—has increased very substantially compared to the price of other things in the economy—I think of a television set or a personal computer—and so for all those reasons, we are going to face a substantial pressure on the scale of the Federal budget. And I am not sure that we can afford as a country large-scale tax cutting, whether it is oriented to the middle class or whether it is oriented to some other group.

And so I very much believe that tax reform has substantial potential, but I believe that the best tax reform would be either revenue neutral or, ideally, would provide for some revenue increases.

Senator WYDEN. The striking part about it, Dr. Summers, because we have had it scored, the initial bill has been scored as revenue neutral. What you do, though, is when you eliminate some of those special interest breaks and come back to target to the middle class people, the fact that we get them back into the economy, buying the goods and services—

Mr. SUMMERS. I think if—

Senator WYDEN. —remodel jobs and the like, that is what—

Mr. SUMMERS. I think, if we are successful in identifying a range of special interest provisions and subsidies that should be scaled back, then there is a question as to what to do, and I think that an attractive part of the strategy could be yours of supporting the middle class families through reductions in the standard deduction. Alternative approaches, which I think also have merit, would involve reducing marginal tax rates, which might also have incentive effects.

But I very much share your view that part of propelling consumer demand here is going to be making sure that anything we do is fair and equitable in the sense of having its benefits concentrated on the middle class where the propensity to spend is likely to be greatest.

Senator WYDEN. No, your point is very well taken, and obviously, in this kind of fiscal climate, you cannot just promise and promise some more and not have a revenue source, and that has been the point of what a number of conservative Republicans have worked on with me over the last five years.

And I think what I would like to do, because you are writing and your recent work has been so helpful on this point, is why do we not hold the record open and I would like to get a sense, because I thought that tax reform was a possibility, well-targeted transportation initiatives—as you know, we had the Build America bonds program that came out of the Finance Committee, all worked with us on that for many, many months—I would just like to hold the record open—

Mr. SUMMERS. I will submit something in writing with a longer list of growth-promoting programs.

Senator WYDEN. Very good.

As per Senator Murray, we are now adjourned, and—

Senator SESSIONS. Could—

Senator WYDEN. I think, Senator Sessions, I was not here for the previous discussions. Senator Murray indicated that we are adjourned. I am going to stick around and visit with you privately. Thank you.

Senator SESSIONS. Very good. All right. Thank you.

[Whereupon, at 12:11 p.m., the committee was adjourned.]

Budget Committee Hearing

Opening Statement by Ranking Member Jeff Sessions

The Fiscal and Economic Effects of Austerity

June 4, 2013

I want to thank the Chairman for scheduling this hearing. There are few policy debates more worth having than this one. Either we find a path to a viable fiscal future that supports strong economic growth and addresses the fiscal threats ahead, or we don't. If we fail to find this path as Congresses have failed in the past, then ours will be a predictable legacy that none of us at this table are eager to own.

I think we've made some good strides toward taming our spending. While the recently enacted spending reductions should have been implemented more intelligently, they represent a clear signal to taxpayers and investors that we understand we have a spending problem and are committed to doing something about it. Indeed, there's mounting evidence that a part of our current uptick in economic activity is due to this signal being clearly delivered to the business community.

Unfortunately, some want us to retreat from deficit reduction commitments we've already made. Slower than expected growth in the U.S. and economic troubles in Europe, particularly increasing unemployment in several European countries, leads some to conclude that further efforts at deficit reduction need to be placed on hold until economic times improve. In fact, this view is shared by some Members of this Committee.

However, this is certainly not the time to change course. The academic research clearly shows that lowering deficits with spending reductions more often leads to strong economic growth than cutting deficits with tax increases and only modest spending cuts. Indeed, employment gains have been particularly strong in successful deficit reduction plans that relied primarily on lower spending. (See chart on employment gains)

Angel Gurria, the Secretary-General of the OECD, agrees that we should keep commitment to lower spending and debt reduction. Mr. Gurria, speaking at the opening session of last week's OECD Ministerial Meeting, said, "the fiscal adjustment of the last few years is beginning to pay off. Several countries are close to stabilizing their government debt-to-GDP ratios and ensuring a gradual decline in indebtedness over the longer term... Stay the course," the Secretary-General urged. "You're almost there."

Earlier in the week, Bundesbank president Jens Wiedmann [Yens VY-dman] argued for a continued commitment to fiscal consolidation and a rejection of the demands by some (including current Treasury Secretary Jack Lew) to end "austerity" and start a new round of economic stimulus.

Indeed, you have to wonder what critics of deficit reduction are pointing to when they argue that austerity has failed in Europe. OECD data released last week show that only 10 of the 28 OECD countries have a smaller deficit today than in 2006/2007 time frame, once the effects of the business cycle are adjusted out. In fact, only three (Italy, Hungary, and Greece) have reduced their deficits by more than 5 percent. The United Kingdom actually increased its cyclically adjusted deficit from 4.1 percent of GDP to 5.7 percent over this period.

We should pay particular attention to the United Kingdom's recent fiscal challenges. Prime Minister David Cameron and his political partners chose a deficit reduction plan that was "balanced" in the same way the President and the Senate majority like to describe: tax increases alongside spending reductions. Unfortunately, the UK's tax increases preceded their spending cuts, and the tax hikes compounded the economic slowdown and caused a much slower escape from their recession.

Even so, Britain limped out of recession earlier this year, cut its deficit in half (although it is still whopping 7 percent of GDP), but was left with a soaring ratio debt to GDP. Had the British government not increased taxes at exactly the wrong time in the process of fiscal consolidation, the United

Kingdom's economic and fiscal results would likely have been much stronger.

It is crucial that we allow our policy making to be informed by this body of real data. The stakes for getting this right are enormous.

As long as the United States and other major economies of the OECD fail to lighten the weight of government on the private sector, the costs of economic sluggishness will be borne by low- and medium-income households, while the benefits of high spending and cheap money will continue to flow to investors and large business owners.

That is why there can be no more appropriate time than now to embrace deficit reduction policies that facilitate higher levels of economic growth. If the federal budget is to significantly improve in the near term, then the pace of economic activity must improve very soon. U.S. economic recovery remains the slowest since the end of World War II.

This sluggishness comes with a huge human cost. There are still fewer jobs today than when the recession started: total non-farm employment in April 2013 was 2.3 million below the level in December 2007. The overall unemployment rate is 7.5 percent, also higher than it should be this far from the end of the recession; and key unemployment rates for some demographic segments are even higher: the rate for Hispanics stands at 8.4 percent, for Blacks at 12.8 percent, and for teenagers at 24.1 percent.

These high unemployment rates and the sluggish economy comes after we've had trillions in stimulus spending, ongoing infusions of new credit from the Federal Reserve, and relatively steady level of high federal spending.

Conclusion

Congress can choose the path of reduced spending without further tax increases or higher taxes and no additional spending controls. Evidence clearly shows that the former leads more often to stronger economic performance and lower unemployment than the latter.

Fiscal reforms based on tax increases can damage the economy, while those that rely mostly or entirely on spending reductions produce stronger recoveries. A study of every significant fiscal consolidation that took place in large economies over the last 40 years shows those countries that try to reduce the deficit be raising taxes experience slower growth. Policies based largely on spending restraint resulted in increases in average GDP growth while those that relied on higher taxes retarded growth.

Salim Furth

Response to Questions for the Record submitted by Senator Sheldon Whitehouse

I am pleased to have the opportunity to respond to Senator Whitehouse's extensive written and oral questions. In order to provide an overall summary of the data used and choices made in my testimony, I explain my sources, calculations, and choices in Appendix B.

1. **Regarding tax increases and spending cuts.**

   (a) On page 8 of your testimony, you included a graph you say shows that 13 OECD countries have increased their "revenue rates." This evidence purports to back up you claim that "to date, 'austerity' in Europe has consisted mainly of tax increases." "Tax increases" customarily means changes to tax law designed to increase the amount of revenue generated by the tax code. Does your definition depart from this plain-English definition? When you define a "tax increase" as when "a country increase[s] its tax receipts as a share of GDP," does that not allow a GDP decline at a constant tax level to be a "tax increase"?

   Throughout my testimony, I chose to use a data-analysis approach rather than a narrative approach. That choice facilitates cross-country comparison. The revenue rate is one measure of the average tax rate paid by all agents in an economy.

   The revenue rate also has the advantage of being clear and transparent.

   The revenue rate is an imperfect but reasonable indicator of tax policy change. In an environment of low growth, the revenue rate will often decrease despite increases in tax rates. Thus, countries which have a falling revenue rate in my data may have raised taxes.

   In fact, the U.K. is an excellent example. It increased its broadly applied value-added tax (VAT) by 2.5 percentage points.[1] But the downward pressure of its shrinking economy led to a small net drop in the revenue rate. My method undercounts tax increases.

   It is extremely unlikely that a country with a shrinking or stagnant economy could have a significant increase in the revenue rate without a tax rate increase or the expiration of a temporary tax rate cut.

   As with any economic phenomenon, there are many valid indicators and measures of tax increases. Other methods, applied over the same time frame (2007-2012), will likely indicate a similar diversity in tax policy.

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[1] "The standard rate of VAT increased from 17.5 per cent to 20 per cent on 4 January 2011." Source: GOV.uk, "VAT rates," https://www.gov.uk/vat-rates (accessed June 6, 2013).

(b) Similarly, you say, in "[the] countries routinely lumped as 'austere'" spending cuts are "rare." In its own *Restoring Public Finances, 2012 Update*, the OECD defines "fiscal consolidations" as "concrete policies aimed at reducing government deficits and debt accumulation, e.g. active policies to improve the fiscal position." In analyzing the "fiscal consolidations" of each nation, the OECD looked at "expenditure reductions" and "revenue enhancements." According to the OECD's own data (please see the attached summary prepared by my staff), of the 15 European nations with major austerity programs, 9 of those countries had more expenditure reductions than revenue enhancements, and only Estonia and Poland's austerity programs consisted of less than 40% expenditure reductions. How is that rare?

The discrepancy between my data and the Fiscal Consolidation Survey (FCS) data presented in *Restoring Public Finances, 2012 Update* is that my data is historical and the FCS was a self-reported survey of plans taken in early 2012.[2] The original wording of this question misrepresents the FCS data and puts words in the OECD's mouth.

Question 1 selectively and deceptively quotes from *Restoring Public Finances* in the sentence that reads:

> In analyzing the "fiscal consolidations" of each nation, the OECD looked at "expenditure reductions" and "revenue enhancements."

The quoted phrases are severed from context. In *Restoring Public Finances*, the first use of the words "fiscal consolidation" is in the phrase "fiscal consolidation strategies."[3] Just below that we have "fiscal consolidation need." The second paragraph mentions "progress in implementing fiscal consolidation and the further development of the consolidation plans." Chapter 1 is titled, "Fiscal consolidation targets, plans, and measures in OECD countries."[4] Each country's data is presented with a subsection titled "The government's fiscal consolidation plan." The plans are reported for dates as late as 2016.

But question 1 refers to "major austerity programs" in the past tense, using the verbs "had" and "consisted of."

But the original data reflect plans, and span dates in the past and the future. There is no conflict between my claim that spending cuts since 2007 have been rare and the FCS's claim that spending cuts will become common in the future.

[2] Organisation for Economic Co-operation and Development, *Restoring Public Finances: 2012 Update*, p. 72.

[3] Ibid., p. 3.

[4] Ibid, p. 17.

There is overlap between my data and the OECD data behind the Senator's spreadsheet (2009 in 2 cases, 2010 in 8 cases, and 2011 in 14 cases). But since both sets of data – mine and the Senator's – were presented in a summarized form, there is no reason the data could not be in harmony for those few overlapping years.

In addition, Question 1 refers to "the OECD's own data (please see the attached summary prepared by my staff)." But the FCS data is not, as a point of fact, OECD-originated data but data reported by the particular governments of the OECD member states. This is clear in the Foreword to the OECD's *Restoring Public Finances*:

> The survey is based on self-reporting from governments.... Some countries did not provide data on implemented consolidation (2009/10-11). The Secretariat has included implemented consolidation in 2009-11 based on last year's report for the most obvious cases. Some countries did not provide cumulative data, so the data have been recalculated into cumulative terms by the Secretariat wherever possible. Some countries did not provide quantified data for the total consolidation period, even if measures were specified.

The OECD has done an excellent job gathering and harmonizing the data gathered in its survey, and OECD staff has been helpful and prompt in responding to requests for documentation.[5] Knut Klepsvik, OECD Senior Policy Analyst, confirmed in personal communication, "The data of the *Restoring Public Finances, 2012 Update* are based on self-reporting from countries but the OECD Secretariat has performed a data quality control as we do on all surveys. The projections are still the governments' own estimates and may include more or less optimistic estimates." The insinuation that the FCS data is superior to data from Statistics OECD[6] is bizarre.

Worse, the summary prepared by your staff[7] and attached to the Questions for the Record is in direct conflict with Figure 1.15 in *Restoring Public Finances,*[8] which is the OECD's own calculation of the composition of the reported fiscal austerity plans.

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[5] For example, Knut Klepsvik, OECD Senior Policy Analyst, clarified the sources of Estonia's data in personal communication: "Concerning Estonia, we enquired if their figures were cumulative or incremental. The Estonia authorities confirmed that all the expenditure measures are cumulative but there are some one-off revenue measures that aren't cumulative. However, Estonia don't have a consolidation plan after 2010 (Box 1.6) but have implemented large front-loaded consolidation since 2008. We have interpreted their response as Estonia is withdrawing from fiscal consolidation and gradually are removing expenditure measures which may be considered as stimulating the economy." Reproduced as received.

[6] Statistics OECD, http://stats.oecd.org/.

[7] I have included the summary as Appendix A.

I successfully replicated the data in your staff's spreadsheet only by making the same error that they did: they treated cumulative data as non-cumulative, vastly overcounting the early years in each country's record, and grossly exaggerating the total fiscal consolidation in each country. This spreadsheet, while its proportions end up looking similar to the correct ones, is utterly meaningless and I will disregard it.

Turning instead to the OECD's own summary of the data, in Figure 1.15, the reason that my data do not match is that they are drawn from a different period. The data for 2012 through 2016 are all projections or plans of future changes. The OECD authors recognize the distinction, noting for example, "The OECD has calculated the deviation of the actual fiscal balance in 2010 and 2011 compared to the targeted fiscal balances described in last year's report."[9]

By contrast, my data, by design, are dated from before the crisis. Like Figure 1.15, it summarizes several years of data, and finds that spending cuts have been rare. According to OECD data,[10] government consumption grew in 20 of 27 countries from 2007 to 2012 (or 2011 where 2012 data was unavailable). Spending fell in six crisis countries plus the U.K.

As I note in the documentation, government spending as a share of GDP rose in 23 countries. I chose to use the indicator I deemed most accurate, not the one that yielded the most dramatic results.

What is important in determining that spending cuts have been rare is to use a dating convention that captures the full path of fiscal policy over several years. Some will disagree with that dating choice, but it is up to them to prove that their spending cuts do not merely represent the end of temporary spending measures undertaken in the worst years of the crisis.

2. **How do you define "austerity"? Under your definition, can "austerity" occur in the absence of government action?**

As I argue in the opening of my testimony, I do not like the term "austerity" because it is overly broad and has meant all sorts of things over the years. Thus, it should be no surprise that I do not favor any single definition of austerity. This debate should persuade observers that the label "austerity" should be dropped in favor of narrower terms like "tax increase" and "entitlement reform."

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[8] OECD, *Restoring Public Finances: 2012 Update*, p. 41. Data are downloadable in Excel format from *http://dx.doi.org/10.1787/888932696894*.

[9] OECD, *Restoring Public Finances: 2012 Update*, p. 27. Emphasis added.

[10] See Appendix B for the titles of the particular series I used and the calculations I performed.

For illustrative purposes, I labeled "austere" countries in my two charts. However, each chart does so using a different definition, and the purpose of the charts is more to show how diverse fiscal approaches have been, not to offer a taxonomy of austerity.

As a general rule, I would consider it unlikely that austerity would be an accurate description of a country that had made no policy changes, but perhaps some exception exists.

3. If, in the absence of government action, the ratio of revenue to GDP increases, would you consider that austerity in the form of a tax increase?

No.[11] This question is a good reminder of the importance of knowing the context. Had any of the four fast-growing economies in my sample had a revenue rate increase, I would have investigated the narrative to make sure I was not reporting a misleading statistic.

4. Using the OECD's own definitions of terms [from the OECD's *Restoring Public Finances*], do any of nations which have undergone major "fiscal consolidations" lack significant "expenditure reductions."

Because *Restoring Public Finances* is mainly a prospective, not retrospective, publication, its fiscal consolidations are primarily planned, not "undergone."

In Box 1.1, the OECD's definition of fiscal consolidation emphasizes the forward-looking nature of this particular report.[12]

> In this report, fiscal consolidation is defined as concrete policies aimed at reducing government deficits and debt accumulation.... Merely announcing an ambitious deficit target over the medium term with no accompanying consolidation plan on how to achieve the deficit target is not regarded as consolidation in this analysis. Consolidation plans and detailed measures are given as a per cent of nominal GDP.

The definition provided does not offer a measuring stick for evaluating which countries have undergone major fiscal consolidations.

This is not nit-picking. When the member countries provided data to the OECD, they did so for whatever years they chose, reflecting their different views and plans. That's why there is 2009 data for only two countries. These data are not designed to look backwards and are sparsely populated for the first two years.

[11] Given the recent "fiscal cliff," it is worth stipulating that policy expiration is a form of government action.

[12] OECD, *Restoring Public Finances: 2012 Update*, p. 18.

Finding spending cuts in 2010 and 2011 is like finding rapid U.S. GDP growth in 1933 and 1934: out of context, it will give the wrong impression.

5. **If the United States laid off 25% of the federal workforce to trim its budget, would you consider that to be an austerity measure? Does your answer depend on how much social-safety-net-program spending increases to support those now-unemployed workers and their families?**

    Yes, I would absolutely consider it an austerity measure. A major part of my testimony was to argue that one austerity measure – tax increases – was being counteracted by stimulus spending. The tax increase is an austerity measure, as would be mass layoffs. But I am interested in looking at the net effect.

    If the social safety net were so generous (or inefficient) that the government spent more on social services for a laid-off worker than it did to employ a worker, then austerity (or its lack) would be the least of the government's problems.

6. **In your testimony, you stated "higher tax rates slow the economy immediately and depress future growth." Are you familiar with the U.S. experience in the 1990s, during which tax rate increases in 1993 were followed by 7 years of economic growth at 4% per year, with 23 million new jobs created? How do you explain this prosperity following major tax increases?**

    The early 1990s are a great example of the success of structural reform and spending cuts. Fiscal consolidation from 1993 on featured 67 percent spending cuts and 33 percent tax increases. IMF economists recently quantified a detailed narrative of the tax increases and spending cuts during that era.[13]

    Again, cautioning against drawing too much from a single example, the early 1990s featured steady fiscal consolidation in the U.S., as well as welfare reform (a key structural reform) in 1996. The table below shows the fiscal consolidation undertaken each year, and the ensuing real per capita GDP growth.

    1990 had fiscal consolidation mainly on the tax side. A recession followed. Consolidation accelerated, with an even tax-spend split over the next two years and the economy recovered, but less rapidly than after most previous recessions.

    1993 continued the spending cuts but with few tax increases, and the economy boomed at 2.8 percent growth from 1993 to 1994.

[13] Pete Devries, Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, "A New Action-based Dataset of Fiscal Consolidation," IMF Working Paper 11/128, June 2011, pp. 81-85.

U.S. Fiscal Consolidation and Growth During the 1990s

	Tax Increases (% of GDP)	Spending Cuts (% of GDP)	Total (% of GDP)	Ensuing GDP growth (log difference, next year minus current year)
1990	0.26%	0.07%	0.33%	-1.6%
1991	0.29	0.29	0.58	2.0
1992	0.24	0.28	0.52	1.5
1993	0.08	0.23	0.32	2.8
1994	0.4	0.5	0.9	1.3
1995	0.2	0.33	0.53	2.5
1996	0.08	0.22	0.29	3.2
1997	0.06	0.24	0.3	3.1
1998	0	0.15	0.15	3.6

Source: Pete Devries, Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, "A New Action-based Dataset of Fiscal Consolidation," International Monetary Fund, June 2011, pp. 81-85, http://www.imf.org/external/pubs/ft/wp/2011/wp11128.pdf (accessed June 11, 2013).

The large spending cut and tax increase passed in August 1993 had its greatest effects during 1994.[14] In particular the OBRA-1993 sought major savings from Medicare and federal employee benefits,[15] which are good examples of the structural reforms I recommended in my testimony.

GDP per capita grew only 1.3 percent from 1994 to 1995. That's not bad, reflecting a private sector that rapidly picked up the slack as government's growth slowed.

From 1995 to 1998, fiscal consolidation was heavily on the spending side, and growth accelerated to a smoking 3.6 percent and the deficit turned to a surplus.

The fact that growth was strongest right after spending cuts preponderated and weakest when taxes increased most is an excellent exhibit of the case for preferring spending cuts. Using a regression to quantify the correlations,[16] I find that a 0.1 percent of GDP cut in spending is associated with 1.2 percentage point higher GDP growth. And a similar tax increase is associated with 1.4 percentage point lower GDP growth.[17] These coefficients have no applicability out of sample, but they tell us that in the 1990s U.S. higher taxes and lower growth went together like fire and smoke.

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[14] Devries, Guajardo, Leigh, and Pescatori, "A New Action-based Dataset of Fiscal Consolidation," p. 84.

[15] Congressional Budget Office, "The Economic and Budget Outlook: An Update," September 1993, p. 29, http://cbo.gov/sites/default/files/cbofiles/ftpdocs/76xx/doc7670/09-1993-outlookentirerpt.pdf.

[16] I am not claiming causation on the basis of these nine data points. I include a time trend.

[17] Both coefficients are statistically significant at the 95 percent level, but it's still only a correlation.

Good economists do not draw conclusions based on a handful of data points. The argument against spending cuts leans heavily on blaming Europe's failed recovery for austerity. Just as the U.S. experience in the 1990s does not prove that spending cuts are expansionary, the European experience in the 2010s cannot prove that spending cuts are contractionary.

7. **Though you warn against combating deficits by raising revenues, you cite a study (Alesina, Perotti, and Tavares, 1998) that found that successful consolidations have included 66% spending cuts. From where did the nations studied generate the other 34% of deficit reduction? Does this study not suggest that revenue has played a critical role in successful deficit-reduction plans?**

The successful consolidations consisted of 34 percent tax increases.[18] In unsuccessful consolidations (which are about twice as common), tax increases preponderate: 73 percent of the consolidation is on the tax side.

This paper is mainly about political outcomes, showing that you can get reelected even if you cut spending and raise taxes. "Moreover, cabinets that are willing to cut transfers and the government wage bill – traditionally considered the two most politically charged components of spending – are not punished by the voters."[19]

As such, the paper does not provide a detailed breakdown of taxation and expenditure splits in the fiscal consolidations it considers, nor does it advocate the 34/66 split as ideal. So it's hard to go beyond reporting the averages, as I did in my testimony.

The final question wants me to endorse non-linear effects of taxation in fiscal consolidation. But there is simply not enough evidence in any of the papers that I cited to argue for a general tipping point in the optimal mix. Nor can I prove it does not exist.

With a dozen years more data to work with, Biggs, Hassett, and Jensen are willing to put an upper bound on the optimal amount of revenue increases: 15 percent,[20] substantially lower than the average successful consolidation in Alesina et al.'s earlier data.

If these numbers seem contradictory, consider a contrived example:

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[18] Alberto Alesina, Roberto Perotti, José Tavares, "The Political Economy of Fiscal Adjustments," in *Brookings Papers on Economic Activity*, Vol. 1998(1), Maurice Obstfeld and Barry Eichengreen eds., 1998, p. 201.

[19] Alesina, Perotti, and Tavares, "The Political Economy of Fiscal Adjustments," p. 198.

[20] Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," American Enterprise Institute *Economic Policy Working Paper* 2010-04, December 2010, p. 13.

Suppose consolidations that are 5% tax succeed 75% of the time, if they're 25% tax they succeed 40% of the time, and if they are 100% tax they succeed 20% of the time. After 100 attempts with each policy (5%, 25%, 100%), the average successful policy will be close to 25% tax increases. But the optimal policy will remain 5% tax.

Appendix A: Spreadsheet from Senator Whitehouse's Questions for the Record.

Balance of Spending Cuts and Tax Increases In European Austerity Plans

Announced cumulative spending cuts / tax increases, 2009-2016

Country	Share expenditure reductions	Share revenue enhancements	Total announced fiscal consolidations as a share of GDP
Austria	61%	39%	17%
Belgium	46%	54%	13%
Czech Republic	44%	56%	27%
Estonia	26%	74%	29%
France	53%	47%	16%
Greece	53%	47%	85%
Iceland	72%	28%	46%
Ireland	66%	34%	95%
Italy	46%	54%	18%
Poland	38%	62%	22%
Portugal	47%	53%	31%
Slovak Republic	64%	36%	23%
Slovenia	100%	0%	16%
Spain	67%	33%	13%
United Kingdom	69%	31%	28%

European countries with major austerity plans	15
Countries with more spending cuts than tax increases	9
Countries with austerity plans consisting of 60% or more in tax increases	2

Sources: OECD Fiscal Consolidation Survey, November 2012 (consolidations); IMF (GDP); Federal Reserve Economic Data, Yahoo! Finance (exchange rates).

Appendix B: Documenting the tables in Furth's Senate Budget Committee Testimony

To inform the arguments made in testimony before the Senate Budget Committee on June 4, 2013, I used data published by the Organisation for Economic Co-operation and Development (OECD). In this note, I will detail my sources, choices, and calculations for the tables I presented.

My goal was to accurately portray the net fiscal effects of policy decisions taken during recent years. As I made very clear in my testimony, I find the word "austerity" too broad for meaningful discussion. I prefer the better defined "fiscal consolidation," and for policy evaluation, what is really important is distinguishing between tax changes and spending changes. I argue forcefully in favor of structural reform, cautiously in favor of spending cuts, and firmly in opposition to tax increases.

On "austerity" broadly, I have no opinion.

Throughout the testimony, I do not adhere to any particular definition of austerity. Where I labeled countries "austere" in graphs, it was to show that by that metric they were austere. I discuss other metrics that would yield different sets of "austere" countries.

In my testimony, I am careful not to draw any causal conclusions from recent data. I leave the causality to the academic literature, and complement it by documenting what has occurred over the past five years. I also do not discuss Europe's plans for future policies. Throughout the paper it is abundantly clear that I am discussing what has occurred since 2007, not what may occur next year.

As I will show, the choices I made lead to sober results, and other choices might have led to more exciting but less enlightening graphics.

I first discuss the main choices in the paper. Then I discuss in detail how and why I produced Chart 1 and Table 1. If a reader would like a copy of my data, I would be happy to provide it.

General approach

One of the truisms of academic economics is that "all papers make choices, and this one is no exception."

I chose to use a data analysis approach, not a narrative approach.[21] Both are valid and valuable. I believe the data analysis approach better lends itself to cross-country comparisons.

Most consequentially, I chose to begin my series prior to the onset of the 2008 financial crisis. This choice reflects the importance of viewing the crisis years as a whole. That is particularly important because many countries engaged in large, temporary deficit spending programs, such as the American

[21] A narrative approach involves cataloging, categorizing, and quantifying historical events – policy changes, in this case. Thus a narrative approach would record (for instance) each tax cut and tax increase, its rate changes, its expected or realized revenue gains, and the justification given by its enactors.

Recovery and Reinvestment Act. If one dates from 2009 or 2010, when temporary spending programs peaked, one comes away with the meretricious impression that new policies have cut spending even where policies have not changed but temporary spending has expired and transfer payments have fallen back from their peak.

Almost any data analysis will fail to find extensive austerity, by any definition, over the period from pre-crisis to the present. Likewise, almost any analysis that embarks from the peak of the crisis is likely to find rampant austerity, at least in the Euro Area.

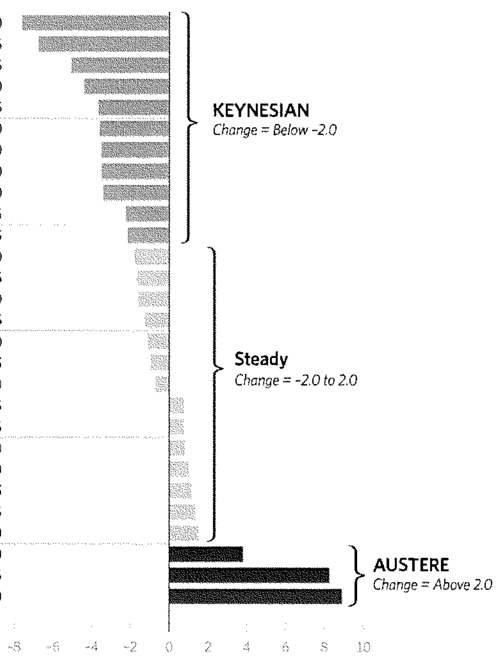
Another approach which I avoid would be to add up all the deficits (adjusted or not) of the past several years. That would be a cheap and easy way to display huge multi-year deficits, but would badly confound policy with relative crisis severity.

Perhaps some wish to make the case that austerity – however they define it – was not a major policy until 2010 or 2011. If so, they have the burden of using the narrative approach or of showing that their results do not mainly stem from policy decisions taken in the 2008-2009 crisis. They also must be careful not to blame economic performance in 2010 on decisions taken in 2011.

CHART 1

Few Governments Have Enacted Real Austerity

	Cyclically adjusted surplus or deficit as % GDP		
	2006 and 2007	2012 and 2013	Change
Japan	-2.30	-9.90	-7.60
New Zealand	4.20	-2.55	-6.75
Spain	0.55	-4.50	-5.05
Finland	3.05	-1.35	-4.40
Canada	0.80	-2.85	-3.65
Australia	1.45	-2.15	-3.60
Iceland	3.30	-0.20	-3.50
Israel	-2.30	-5.80	-3.50
Denmark	2.60	-0.80	-3.40
Ireland	-1.70	-3.95	-2.25
United States	**-3.65**	**-5.80**	**-2.15**
Netherlands	-0.20	-2.00	-1.80
Belgium	-0.95	-2.60	-1.65
United Kingdom	-4.10	-5.70	-1.60
Korea	3.85	2.60	-1.25
Sweden	1.00	-0.10	-1.10
Slovenia	-2.80	-3.75	-0.95
Poland	-2.90	-3.60	-0.70
Germany	-1.05	-0.30	0.75
Switzerland	0.35	1.10	0.75
Austria	-2.35	-1.55	0.80
Czech Republic	-3.40	-2.40	1.00
France	-3.95	-2.80	1.15
Portugal	-4.20	-2.85	1.35
Estonia	-0.85	0.65	1.50
Italy	-3.95	-0.15	3.80
Hungary	-9.40	-1.15	8.25
Greece	-9.60	-0.70	8.90



Source: OECD.

Chart 1.

Sources

Chart 1, "Few Governments Have Enacted Real Austerity," relies on data from the OECD's *Economic Outlook, Volume 2013, Issue 1,*[22] which is also referred to as *Economic Outlook No. 93.* Due to the very

[22] OECD iLibrary, *OECD Economic Outlook*, Volume 2013, Issue 1, May 29, 2013, http://www.oecd-ilibrary.org/economics/oecd-economic-outlook-volume-2013-issue-1_eco_outlook-v2013-1-en (accessed June 5, 2013).

timely publication date, I was working from the preliminary version (released May 29, 2013), which is publicly available as an embedded PDF online.[23]

Chart 1 is drawn directly from the table entitled "General government cyclically-adjusted financial balance: surplus (+) or deficit (-) as a percentage of potential GDP."[24] In order to have the data available in a timely manner, it was manually entered into an Excel spreadsheet and double-checked.

The only calculation in Chart 1 is subtraction to calculate the change in cyclically adjusted financial balance from 2006-2007 to 2012-2013.

Choices

Chart 1 reflects the broad view of fiscal consolidation. Although the measure is imperfect, it is intended to abstract from business-cycle changes in revenues, spending, and GDP. The implication is that it reflects policy, not economic conditions. However, there is always substantial uncertainty about potential GDP in very recent years, so recent (and projected) years are subject to substantial revision.

As mentioned in Footnote 9 of my testimony,[25] I excluded Luxembourg and Norway because their data may not be directly comparable. In Luxembourg's case, the country's large proportion of international commuter employees and heavy dependence on the financial sector make it exceptional. Norway's data excludes off-shore oil revenues, although those are (implicitly) included for other oil producers such as the U.K. and the Netherlands. The exclusions are trivial: both countries would have fallen around the middle of the table in Chart 1.

The only major choice I made in Chart 1 was my choice of beginning and ending years. I chose to average two years together in both cases, because the series is fairly volatile and the economic slowdown before the crisis occurred at different times in different countries. Nor did I want my results to be too heavily influenced by short-lived policies.

I chose to end the series with an average of 2012 and projected 2013 data. Although the OECD publication does not explicitly say so, one suspects that 2012 data, while close to accuracy, are not final numbers. However, the 2012 data were in several cases significantly revised from *Economic Outlook No. 92* (December 2012), indicating that new information is being taken into account. As 2013 unfolds and

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[23] OECD Publishing, *OECD Economic Outlook, Volume 2013, Issue 1*, http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-outlook-volume-2013-issue-1_eco_outlook-v2013-1-en (accessed June 5, 2013).

[24] OECD Publishing, *OECD Economic Outlook, Volume 2013, Issue 1*, p. 238. The previous edition of *Economic Outlook* labeled this data "Statistical Annex Table 28" and used the word "balances" instead of the phrase "financial balances."

[25] Salim Furth, "Testimony on the Fiscal and Economic Effects of Austerity before the Committee on the Budget," June 4, 2013, p. 4.

2012 data is finalized, the results I present may change, but probably not enough to alter the qualitative conclusions.

Likewise, I chose to begin the series with an average of 2006 and 2007 data.

The data in Chart 1 can be read in two ways relative to the question of austerity.

Some reasonable definitions of austerity could rely on the current size of the cyclically adjusted surplus. For instance, one might define countries with a surplus while at least 1 percent below potential GDP as "austere". Or one might define all countries with a surplus above 2 percent of GDP as austere, regardless of the business cycle.

Alternately, one can define austerity as a change in the underlying cyclically adjusted surplus. This approach implicitly takes politics into account, recognizing that once interest groups have become accustomed to government largesse, they will resist its withdrawal. Thus Greece, while it still has a cyclically adjusted deficit, has narrowed that from 9.6 to 0.7 percent of GDP.

For Chart 1, I chose a definition of austerity as at least a 2 percent tightening of the cyclically adjusted deficit. That takes advantage of a natural discontinuity in the data between Estonia and Italy. But for those who think that a better definition is, for instance, a 1 percent tightening, the data is easily readable and clearly labeled.

Note that the alternate definitions of austerity would give very different results. None of the countries that tightened budgets by at least 2 percent are actually running a structural surplus, by the OECD estimate. This supports my main points: experiences are diverse, austerity is vague, and by any measure it is not as widespread as reported.

TABLE 1

Changes in GDP, Government Spending, and Revenue, 2007-2012

		GROWTH IN GOVERNMENT SPENDING			
	GDP Growth	Government Consumption Growth	Transfers Growth	Change in Revenue Rate (share of GDP)	Actual 2012 Surplus or Deficit (% of GDP)
Eurozone					
Austria	3.0%	8.8%	11%	1.76%	-2.51%
Belgium	2.1%	14.5%	19%	3.33%	-4.08%
Czech Republic	1.4%	0.1%	10%	-2.41%	-4.15%
Estonia	-5.0%	13.9%	22%	4.48%	-0.28%
Finland	-2.8%	11.9%	19%	1.31%	-2.32%
France	0.5%	7.2%	12%	2.06%	-4.97%
Germany	3.5%	10.9%	6%	0.83%	0.16%
Greece	-22.4%	-20.6%	0%	4.55%	-10.05%
Ireland	-6.2%	-7.5%	20%	-4.05%	-7.38%
Italy	-7.1%	-3.4%	7%	2.18%	-3.06%
Netherlands	-0.3%	9.6%	14%	-0.11%	-3.99%
Portugal	-5.8%	-14.4%	12%	-0.36%	-6.60%
Slovak Republic	10.0%	9.8%	22%	-0.06%	-4.32%
Slovenia	-5.4%	7.7%	11%	0.60%	-3.72%
Spain	-4.3%	1.8%	19%	-6.31%	-10.94%
European Union, Non-Eurozone					
Denmark	-4.4%	11.1%	16%	3.25%	-4.51%
Hungary	-4.9%	-4.7%	0%	4.26%	-2.13%
Iceland	-5.3%	-1.2%	21%	-4.82%	-3.21%
Poland	16.7%	17.0%	18%	-1.54%	-4.00%
Sweden	5.1%	8.2%	7%	-4.48%	-0.72%
United Kingdom	-2.0%	-1.3%	12%	-0.72%	-5.90%
Others					
Australia*	13.0%	13.7%	17%	-2.11%	-4.16%
Israel*	17.6%	9.0%	14%	-5.47%	-4.12%
Japan*	-0.8%	5.4%	16%	-1.90%	-8.53%
Norway	3.2%	18.1%	17%	2.52%	15.60%
Switzerland*	6.1%	13.7%	17%	3.02%	0.56%
United States*	2.8%	7.2%	22%	-3.02%	-9.96%
Median	0.0%	8.2%	16%	-0.06%	-4.08%

* Incomplete OECD data for 2012 at the time of writing, so 2011 data was used where necessary.
Note: GDP, Government Consumption, and Transfers Growth are calculated as log differences.

Source: OECD.

Table 1 and Chart 2

Chart 2 is based on data from Table 1. These data are not cyclically adjusted.

Sources

Data for Table 1 come from Statistics OECD[26] and were accessed in the week prior to June 4, 2013. As noted in my testimony, data were not up-to-date for all countries. Switzerland and the non-European countries lacked 2012 data, and I excluded several countries which also lacked 2011 data. This panel is thus more heavily European than Chart 1.

"GDP Growth" is the log difference in GDP between 2012 and 2007, expressed in constant 2005 USD, current PPP (purchasing power parity). I record the log difference as a percentage change for expositional ease, as noted in a footnote. One factor I did not account for in this or other series is the growth of population.

"Government Consumption Growth" is derived from the OECD series "GP3P: Final Consumption Expenditure."[27] I convert it to constant 2005 USD using PPP exchange rates and the U.S. consumer price index, and take the log difference from 2007 to 2012 (or 2011).

"Transfers" is similarly derived from the sum of OECD series "GD62_631XXP: Social benefits + Social transfers in kind (via market producers), payable" and "GD7P: Other current transfers, payable."[28]

"Change in Revenue Rate (share of GDP)" is derived from "GTR: Total General government revenue."[29] The figures listed are the percent of GDP difference.

"Actual 2012 Surplus or Deficit (% of GDP)" is derived from "GB9: Net lending (+)/Net borrowing (-),"[30] and reported as the 2012 (or 2011) ratio of net lending to GDP. Because the OECD reports general government statistics, it would not have been accurate, for instance, to use the (available) 2012 U.S. federal deficit in place of series GB9.

Choices

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[26] Statistics OECD, http://stats.oecd.org/.

[27] Statistics OECD, *12. Government deficit/surplus, revenue, expenditure and main aggregates*, http://stats.oecd.org/Index.aspx?DatasetCode=SNA_TABLE12 (downloaded May 29, 2013).

[28] Ibid.

[29] Ibid.

[30] Ibid.

The most difficult choices in this exposition relate to presenting the growth of components of government income and spending. I chose the methods I best judged would give accurate comparisons across the various phases of the business cycle in which OECD countries presently find themselves.

I took my cue from the ways in which government spending and revenues are generally decided. Consumption is usually statutory, and – absent policy change – does not change drastically with the business cycle. Tax policy is a set of progressive rates, not lump sums, and as a consequence the revenue rate is procyclical. Transfers are composed of strongly procyclical income support and old-age pensions, which ought to be acyclical.

The current archetype of austerity is a country that has cut spending and raised taxes at the same time. Relevant to the present debate is just how much of each is taking place.

One expects consumption to fall, on net, in austere countries. After all, most forms of government consumption have spending levels set by statute, and some government consumption is specifically tied to a revenue stream, leading to mild pro-cyclicality (such as in American municipalities).

Another reasonable way to present these data would be to look at countries where government spending has fallen as a share of GDP. That yields similar results, but they are less illuminating: only the Czech Republic, Ireland, Israel, and Portugal saw a drop.

Thus, a definition based on government consumption as a share of GDP rather than the level of government consumption would find even less austerity than the measure I chose.

It was not obvious to me which was best to present changes in government transfer payments. A draft version of Table 1 presented both "Transfers Growth" and "Transfer Rate Change (% of GDP)." The results were very similar: only fast-growing Israel had transfers fall as a share of GDP.

Some have protested that high transfer growth reflects weakening economies. If that is the case, the data would show that the strongest economies had less transfer growth. There's a correlation between transfer growth and GDP growth, but it's in the wrong direction (0.5) and depends heavily on the Greece data point. Stipulating that the zero growth of transfers in Greece and Hungary strongly suggests statutory transfer cuts, there's little evidence of austerity in the sector beyond Greece, Hungary, and maybe Italy and Sweden. And even in those cases, the "cuts" still leave transfers growing as a share of GDP.

Presenting taxation as a revenue rate was the easiest choice. Revenue collection is roughly proportional to GDP and progressive in income. If one looked only at total revenue collected, one would find that growing economies increased revenues and shrinking economies lost revenue (proportionality). That sheds no light on austerity.

Instead, controlling for proportionality, I used the fact that progressivity generally pushes the revenue rate down in a slow economy. Thus, where I observed the revenue rate rising substantially in depressed economies, it would be strong evidence that tax rates have risen.

The change in the revenue rate is mixed, and the median change is just below zero. While that is what one might expect during an era of average growth, the many countries that raised revenue rates despite a shrinking overall economy are the strongest evidence of "austere" policies that I found in the data.

Philosophically, using revenue rates as an indicator of tax rates reflects my neo-classical economic beliefs. I believe that tax rates are the locus of the distorting, welfare, and growth effects of taxation. A Keynesian might be more inclined to focus on tax revenues.

The final column of Table 1 was included for reference, and is not mentioned in the text of my testimony.

INVESTING IN OUR FUTURE: THE IMPACT OF FEDERAL BUDGET DECISIONS ON CHILDREN

WEDNESDAY, JUNE 26, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Committee met, pursuant to notice, at 10:30 a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, Chairman of the Committee, presiding.

Present: Senators Murray, Whitehouse, Kaine, King, Sessions, Crapo, and Johnson.

Staff Present: Evan T. Schatz, Majority Staff Director; and Eric M. Ueland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. Good morning. This hearing will come to order.

Let me just say that my Ranking Member Senator Sessions will be joining us shortly. He is on the floor, and I want to thank him and all of our members who will be joining us off and on throughout this Committee hearing today, as well as the members of the public who are here and all those watching online.

I particularly want to thank our witnesses today. We have: Bruce Lesley, president of First Focus; Margaret Nimmo Crowe, the acting executive director at Voices for Virginia's Children; Shavon Collier, a parent from the Edward C. Mazique Parent Child Center, and her daughter, Sakhia Whitehead, who is with her today; and, finally, David Muhlhausen, a research fellow in empirical policy analysis at the Heritage Foundation. Thank you all so much for being here for this important conversation.

As I have often said, despite what you sometimes hear

here in Washington, D.C., our budgets are about a lot more than abstract numbers and political winners and losers. They are about our country's values and priorities. And they are about our visions for how Government should be serving its citizens today and for generations to come.

As we move forward with our budget negotiations, it is critical that we keep in mind the individuals and families across the country who are impacted by the decisions that we make. Their values and priorities need to be represented, and their stories need to be told. And there is one group in particular whose voices are not heard often enough when it comes to the Federal budget process, and that is our Nation's children.

They may not be walking the halls of Congress—or calling up their Senators—or strategizing with lobbyists about how to protect funding for their programs; but they deserve a seat at the table, even if they need a booster seat to get there.

As First Focus noted in a recent report, our Federal Government funds over 180 different children's programs, from health care, to education, juvenile justice, and nutrition. Their analysis found that spending on children makes up about 8 percent of the Federal budget. So I am glad we are having this important discussion today about a key group impacted by the budget decisions we make here in

Washington, D.C., especially because, in recent years, children have been particularly affected by our economic conditions and our fiscal policies.

In the wake of the Great Recession, millions of families lost their jobs, their homes, and their livelihoods, and the most vulnerable among us, including our children, were among the most impacted. And now, at a time when our economy is recovering, but far too slowly, and when too many American families are struggling with unemployment and underemployment, the automatic cuts of sequestration are hitting children and their families hard in communities across the country.

They are being asked to bear a large share of spending cuts, despite the fact that children clearly did not cause our debt and deficit challenges. And I think that is just simply wrong. In fact, I think it is a national embarrassment and we need to fix it.

We cannot and should not solve our debt and deficit problems on the backs of our children. It is wrong for our kids and it is not good economic policy.

Our children are the next generation of scientists, teachers, inventors, and leaders. If we cut out investments in them, we diminish our ability to lay down a foundation for long-term growth and prosperity and risk our position as a global leader in the 21st century economy.

When I worked with my colleagues on this Committee to write the Senate Budget that passed just 2 months ago, one of our highest priorities was investing in programs that would pay off for our country over the long term and ensuring the United States continues to lead for years to come. And I cannot think of anything more critical to that goal that protecting our investments in the next generation.

As a former pre-school teacher, I know that investments in our children are some of the smartest the Federal Government can make with some of the highest return on investment, especially when it comes to early childhood education.

Just ask Shavon, who is here with us today, about her two children who have been on the honor roll since graduating from their Head Start program. Or the single parent that I met at a Head Start facility in Seattle earlier this year. He was able to enroll his young daughter in Head Start, and the results were incredible. Within just a few weeks, he told me, she was more engaged and eager to learn.

Children in high-quality early education programs are less likely to be held back in school, require special education, engage in criminal activity, or use social safety net programs later in life. They are more likely to graduate from high school and have higher earnings as adults.

So if you are looking for an investment that is going to pay off, quality early childhood education is one of the best places you can put your money. We should be investing more in our children, but sequestration right now is really taking us in the wrong direction.

Hundreds of thousands of children across the country will lose access to these vital Head Start programs if those automatic cuts continue. For those reasons, and for many more, the Senate Budget fully replaces sequestration with an equal mix of responsible spending cuts and new revenue from those who can afford it the most. It prioritizes education, including expanding early learning programs, so that we are not unfairly hurting the children that we should be investing in.

The House Republican Budget takes a very different approach. It does not simply accept sequestration; it makes it worse. In order to keep defense spending at the pre-sequester level, it simply shifts the entire burden of the cuts onto children, families, and communities.

Their recently released spending levels for education programs come in at 18.8 percent below sequestration levels. And that does not make sense to me. In fact, I think it is pretty shameful.

As Secretary Arne Duncan, who testified in front of this Committee last week, said, and I quote, "America cannot win the race for the future without investing in education."

We should be investing in and supporting our future leaders so that we can compete and win in the 21st century economy, not slashing funding for programs that help them learn and grow.

It is not just education either. We need to make sure that our kids are getting other kinds of support they need to grow up to be healthy, successful adults.

I know firsthand what a huge impact a strong safety net can have on children when their families fall on hard times, because when I was growing up, my dad was diagnosed with multiple Sclerosis; he had to stop working. My mom, who had stayed home to raise seven kids, had to take care of him, but she also had to get a job so she could support our entire family. She found some work, but it did not pay enough to support all of us and a husband with growing medical bills. So, without warning, our family fell on very hard times.

And I know that the support we got from our Government was the difference between seven kids who might not have graduated from high school or college and the seven adults we have grown to be today, all college graduates, all working hard, all paying taxes, and all doing our best to contribute back to our communities.

Because our Government was there to help my family through a very hard time, those seven kids grew up to be: a firefighter, a lawyer, a computer programmer, a sports writer, a homemaker, a middle school teacher, and a United States Senator. I think that was a pretty good investment.

Now, I know my family is not unique. Similar stories are told all over this country, from coast to coast, in small towns and large towns. So it is critical that we maintain investments in other key safety net programs, like those that provide health care, nutrition, energy, and housing assistance to low-income families and children.

That is exactly why our Senate budget builds on the reforms of the Affordable Care Act, which mandates that children can no longer be denied health insurance based on pre-existing conditions and requires health insurance coverage to include pediatric services.

And the Senate budget protects programs like the Supplemental Nutrition Assistance Program and the Special Supplemental Nutrition Program for Women, Infants, and Children, which prevent hunger and malnutrition and provide healthy food and nutrition education to children and families.

Our budget also increases funding for the Low-Income Home Energy Assistance Program and protects housing assistance programs to make sure all children have access to safe and stable housing. Research has shown that children who have access to programs like those during their formative years are less likely to have health issues, go hungry, or be at risk for developmental delays.

The across-the-board cuts of sequestration make deep cuts to safety net programs, and the House budget takes those cuts even further. If they had their way, low-income children would be left more hungry and in less stable home environments, the number of Americans without health insurance would rise, and the most vulnerable families in our country would be put at greater risk.

I do not think that is fair or right. These are exactly the kinds of programs that are critical for our children, especially those who are hit hardest by the economic recession. Now, while I share many of my colleagues' goals of reducing our debt and deficit and reducing our debt-to-GDP ratio over the next 10 years, I do not share their beliefs that indiscriminate cuts are the answer.

We cannot ask our children, especially our most vulnerable children, to bear the burden of our spending cuts. The decisions that we make today about our Federal budget policy will have huge impacts on the next generation.

And to make the right choices for our children, I feel very strongly that we have got to stop lurching from crisis to crisis. The managing of our budget policy by crisis has not worked; it needs to end. And that is especially true when it comes to decisions that impact our kids.

We should not have to wait here in Congress until the last minute to sit down at a table, find common ground, and work something out. And that is why now that the House has passed their budget and the Senate has passed ours, Democrats have now gone to the floor 14 times to ask consent to go to conference so we can work out our differences and come to a deal.

Democrats are willing to make some tough decisions to find savings across the Federal budget, as long as it is done responsibly and fairly. If we end up headed toward another manufactured crisis this fall, the situation is only going to be made worse for our children and grandchildren.

As a mother and a proud grandmother, I know that I want to leave my kids and grandkids a better country than the one I received. We owe it to all our children to come together to find some fair solutions that help our economy grow and tackle our deficit and debt responsibly—solutions that call for responsible, sustainable spending cuts and that call on those who can afford it most to pay their fair share.

America has always been a country that strives to build a stronger country for the next generation, through investments in infrastructure and innovation and education and research. We know our future will be defined by the scientists who come out of our schools, by the businesses that we create, and the technologies that we invent. And that starts with investing in our children.

And at the very least, right now it starts with replacing sequestration and reversing the devastating cuts that are hurting children across the country as we speak.

So I look forward today to hearing from our witnesses about this important subject, and I really do appreciate all of you coming here to testify.

With that, I will turn it over to my Ranking Member Senator Sessions for his opening statement.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Madam Chair. You have firsthand experience in education, having been engaged as a teacher in an elementary school and, I guess, a pre-school teacher. You understand these issues.

I had one year of teaching sixth grade, but I learned a lot about education during that. My wife was an elementary school teacher, taught second grade, for a number of years. A lot of our best friends are teachers and have taught throughout their lives, and education is really important to us. So we are glad you are here, and we want to see if we can do a better job of utilizing the resources of the United States to improve education in America.

I thank all of our witnesses, and I look forward to hearing from you today. I am involved in the debate on the floor. We will have some votes a little later, and I had to speak this morning, and I came directly from there to here. I am sorry, Madam Chair, to be late. I respect your time, and I am sorry I could not be here at that beginning.

The impact of our present budgetary situation on children is an issue that we need to talk about. What we have learned is that over the years many of the programs that are intended to help low-income children and others in poverty have not had the positive impact we would like them to have. Indeed, the welfare reform act of the 1990s was said to be most damaging to children and others, but after it passed, poverty went down. Children living in poverty were reduced, and we had some positive advances from that, and it actually was done with less cost to the taxpayers in the process.

America spends $1 trillion today on welfare and poverty programs if you count the contribution that States make. Our Federal Government is well over $700 billion a year for these programs. That is larger than Social Security or our Defense Department, yet poverty is now increasing. And so something is wrong. We must start defining compassion and helpfulness, not by how much money we spend but how many people we actually help to remove themselves out of poverty, how many people we can help be lifted out of poverty.

Of the $1 trillion spent on Federal welfare, there is $780 billion alone spent in the Federal budget on 83 different programs that provide benefits for low-income families. That is a great deal of money, and we need to ask ourselves and spend some real intensive effort on how we can do better with the money we are spending at a time of serious budget deficits.

Now, the sequester does impact certain programs, but virtually all the larger welfare programs that provide benefits to families with children are exempt from the sequester. They are not being cut under the sequester. These programs include the Children's Health Insurance Program, child nutrition programs, the National School Lunch and School Breakfast Programs, Medicaid, food stamps. All have no reductions in their appropriations from the sequester. In fact, the sequester will reduce welfare spending in 2013 by less than 1 percent, about eight-tenths of 1 percent. And when we look at the effectiveness of some of the programs under review, we discover that even for the success stories that occur for individual families and children, overall programs themselves too often fail the children that they serve and do not produce the benefits we would like them to produce.

The Department of Health and Human Services in December of 2012—produced a report in October, but they revealed it on my birthday, in honor of my birthday—it just happened to be Christmas Eve when people were not paying much attention to it. Perhaps that was why they chose that date, not my birthday, to release the report. But what it found was that after a thorough evaluation, in December 2012, by the Department of Health and Human Services under President Obama's leadership, they found that the program does little to improve academic outcomes of the children it enrolls. So that is something that ought to cause us all to think. We have a great program. It spends lots of money nationwide, and we have little academic improvement.

So we will hear today from those who will suggest that programs like Head Start can help them to succeed, and I am sure that is true. Many people have been benefitted from this program. But, unfortunately, too often that is an exception.

So I encourage the exploration of ways to improve our situation. I would note that good reading programs like in Alabama based on scientific studies of reading actually improve reading scores at the level the Nation has never seen before. Other States are using that program. It does not cost much money at all. It is just a different method of teaching.

I note today's AP story for Philip Elliott, U.S. tops global list in spending for education: "The United States spends more than other developed nations on its students' education each year, with parents and private foundations picking up more of the costs than in the past, an international survey released Tuesday found." So we are spending more—the average in the OECD advanced nations is about $9,000 per student. In the United States, it is about $15,000, counting college, at the same level, the report says.

So the question is: Can we do more with the money we have and get better improvement?

Thank you, Madam Chairman, for the expertise you bring to this, and I look forward to the hearing.

Chairman MURRAY. Thank you very much.

We will now turn to our witnesses, and, Mr. Lesley, we will start with you and just move across the table.

STATEMENT OF BRUCE LESLEY, DIRECTOR, FIRST FOCUS

Mr. LESLEY. Thank you very much. I would like to thank Chairwoman Murray and Ranking Member Sessions for holding this hearing focused on the impact of Federal budget decisions on children, and I would also like to thank Senator Johnson, Senator Kaine, and Senator King for being here.

Chilean educator, poet, and Nobel Prize winner Gabriela Mistral wrote: "We are guilty of many errors and many faults, but our worst crime is abandoning the children, neglecting the fountain of life. Many of the things we need can wait. The child cannot. Right now is the time his bones are being formed, his blood is being made, and his senses are being developed. To him we cannot answer 'Tomorrow.' His name is 'Today.'"

Certainly, there is a clear and personal aspect to her sense of urgency. Parents and families are primary in the lives of children. And yet there is also an imperative for a strong public interest in ensuring children have the opportunity to achieve their full potential and a prosperous future or we will pay for our negligence.

So how are we doing? Last fall, First Focus and Save the Children, at the behest of Senator Chris Dodd, sought to do a comprehensive analysis by looking at a number of indicators across all domains of child well-being. Although there is some good news, including the fact that passage of the bipartisan Children's Health Insurance Program in 1997 has helped spur a dramatic drop in the number of uninsured children in this Nation so that today 91 percent of our Nation's children now have health coverage, a 47-percent reduction ion the uninsured children in this country, the news for children is far from positive across the board.

More than 8.5 million children lived in households where one or more child was food insecure, 1,560 children died due to abuse and neglect, and 1.1 million children were identified as homeless. Our Nation has the second worst infant mortality rate among industrialized nations, and a shocking 22 percent of our Nation's children live in poverty. In fact, child poverty now stands at its highest level in 20 years, and the effects of child poverty are lasting and deeply damaging.

At the Federal level, it is often said that our Nation's Federal budget is a reflection of our Nation's values and priorities. If so, children are faring quite poorly. According to our analysis in the soon to be released Children's Budget 2013, and on the first slide in the back of my testimony, it shows that since a peak in 2010, total spending on children has fallen by $35 billion after adjusting for inflation, a 16-percent drop. Total spending on children has now declined for 3 years in a row. As a result, children now receive less than 8 percent of the Federal budget.

With respect to discretionary spending, where Congress makes decisions every year, that has been cut by more than $11 billion, a drop of almost 13 percent. It is estimated that this year alone sequestration will cut a total of $4.2 billion out of funding for children, particularly in the areas of education, early childhood, and housing.

Though sequestration is a major reason for the drop in discretionary investments, it is making an alarming trend that began several years earlier become worse. As a result of sequestration, schools districts have been forced to lay off teachers and drastically reduce support services to needy students and students with disabilities. Some schools have eliminated athletics and all extracurricular activities as well as some bus routes, making it more and more difficult for children to get to school. Head Start programs have had to close weeks early or kick children out. One program in Columbus, Indiana, literally held a lottery drawing to decide which family would lose their seat. That is a contest no parent wants to win.

If sequestration remains in place, the pain is only going to get worse. As Chairwoman Murray noted, the House of Representatives passed a 302(b) allocation for their discretionary spending priorities that makes sequestration worse. Compared to pre-sequestration levels, the House allocations cut an additional 22 percent in the Labor, HHS bill, where most discretionary investments for children are made.

Over the long term, because of sequestration and other poor policy choices, additional budget analysis by the Urban Institute—and the Brookings Institution in the past—in their report entitled "Kids' Share 2012" finds that: interest on the national debt will eclipse our investments in children by 2017 and exceed investments in children by 50 percent by 2020; and also, if things do not change, the share of spending for kids as a share of GDP will drop by 24 percent over the next decade.

Moving forward, there are dramatic differences in the vision as to the extent of making investments or substantial budget cuts to children's programs. First Focus has analyzed both of the budget proposals that passed the House and Senate and has found that the budget produced by the Senate to be far superior for kids.

In every policy area, the Senate budget clearly places a much higher value on America's children and protects investments critical to them, while the House budget would make enormous cuts. And in our testimony, we highlight some of those impacts and various policy issues.

In addition to the recent Federal budget cuts, there are dramatic cuts at the State level that are compounding the problem, and some of those cuts both in early childhood and in early education are also highlighted in our budget. In fact, for the first time in decades, overall spending on public education has dropped.

So how does the public feel about these trends? According to recent polling, Americans are dismayed by our failure to address the needs of kids. By a nearly 3:1 margin—56 to 20 percent—Americans believe the lives of children have become worse over the last 10 years and are deeply pessimistic about their future. The group most concerned was Republican women, who believe that things have become worse over the last 10 years for children by a 74–10 percent margin.

Chairman MURRAY. Mr. Lesley, if you can wrap up.

Mr. LESLEY. Wrap it up? Sure.

Chairman MURRAY. Unfortunately, we have votes at 11:30, so I am trying to keep tight timelines.

Mr. LESLEY. Absolutely.

As we look at the myriad of challenges facing children, it is also important to examine whether funds are spent in the most efficient way possible. In our testimony we highlight a lot of the things—

Chairman MURRAY. And all of that will be put in the record.

Mr. LESLEY. —about the positive impacts. So here just to conclude, continued cuts from sequestration will only make the numbers fall even further. With support so low and outcomes as poor as they are, children should no longer be an afterthought in Federal budget and policy decisions. Our children cannot wait any longer.

Thank you.

[The prepared statement of Mr. Lesley follows:]

Senate Budget Committee

**"Investing in our Future:
The Impact of Federal Budget Decisions on Children"**

Testimony by

**Bruce Lesley
President, First Focus**

June 26, 2013

Bruce Lesley
President, First Focus

Written Testimony for Senate Budget Committee
Hearing on "Investing in our Future: The Impact of Federal Budget Decisions on Children"

June 26, 2013

Chilean educator, poet, and Nobel Prize winner Gabriela Mistral wrote:

> *We are guilty of many errors and many faults, but our worst crime is abandoning the children, neglecting the fountain of life. Many of the things we need can wait. The child cannot. Right now is the time his bones are being formed, his blood is being made, and his senses are being developed. To him we cannot answer 'Tomorrow,' his name is today.*

Certainly, there is a clear and personal aspect to her sense of urgency. Parents and families are primary in the lives of children. And yet, there is also an imperative for a strong public interest in ensuring children have the opportunity to achieve their full potential and a prosperous future or we will pay for our negligence. Jane Waldfogel of Columbia University says:

> *The care that children receive matters for their development and for the kind of adults they will turn out to be. To grow and thrive, children need not just food and material goods but also care and affection that promote their health, cognitive development, and social and emotional well-being. When children's needs in these areas are well met, all of us benefit. But when they are not, society suffers. So all of us have an interest in what happens to children...and in how well their needs are met.*

America's Report Card on Children

So, how are we doing?

Last fall, First Focus and Save the Children, at the behest of Senator Christopher Dodd, sought to do a comprehensive analysis by looking at a number of indicators of child well-being to assess how our nation is faring. In our report, *America's Report Card 2012: Children in the U.S.*, we found some points of success, including the fact that passage of the bipartisan "Children's Health Insurance Program" in 1997 has helped spur a dramatic drop in the number of uninsured children in this nation, so that today 91 percent of our nation's children now have health coverage.

But the news for children is not all good. More than 8.5 million children lived in households where one or more child was food insecure, 1,560 children died due to abuse and neglect, and 1.1 million children were identified as homeless. Our nation has the 2nd worst infant mortality rate among industrialized nations, and a shocking 22 percent of our nation's children live in poverty.

In fact, child poverty now stands at its highest level in 20 years and the effects of child poverty are lasting and deeply damaging, particularly to children's health, nutrition, education, housing, safety, and future earnings. Parental stress over finances during a child's early years can also result in what is known as "toxic stress," which can further threaten a child's future cognitive, social, emotional, and health outcomes in ways difficult to alter.

According to a 2012 study by UNICEF:

> *...failure to protect children from poverty is one of the most costly mistakes a society can make. The heaviest cost of all is borne by the children themselves. But their nations must also pay a very significant price – in reduced skills and productivity, in lower levels of health and educational achievement, in increased likelihood of unemployment and welfare dependence, in the higher costs of judicial and social protection systems, and in the loss of social cohesion.*

After reviewing all the domestic and international indicators, it was the conclusion of a distinguished group of experts advising First Focus and Save the Children in fall 2012 that, if our nation were graded for how well we are doing in support of our children, the United States would receive an overall grade of C- and failing grades in a number of specific areas.

Although a C- is not a failing grade, it is far from excelling. In fact, the United States now ranks 25th out of 29 nations, according to UNICEF, in terms of the percentage of 15-19 year-olds enrolled in schools and colleges and 23rd in the percentage not participating in either education, employment, or training. We are witnessing a rapid increase in the number of disconnected youth in our nation that is a consequence of our failure to help children reach their full and God-given potential.

We simply must do better. The poor outcomes children face are terribly unfortunate because we have models for success but often fail to act or even pay attention to the crisis at hand. Even worse, at all levels of government, our nation is cutting current investments and support for children.

Federal Budget Cuts to Investments in Children

At the federal level, it is often said that our nation's federal budget is a reflection of our national priorities. If so, children are faring quite poorly. According to our analysis in the soon to be released *Children's Budget 2013*:

- Children now receive less than 8 percent of the federal budget (7.8 percent).

- Since a peak in 2010, total spending on children has fallen by $35 billion after adjusting for inflation, a 16 percent drop. Total spending on children has now declined for three years in a row.

- Discretionary spending, where Congress makes decisions each year, has been cut by more than $11 billion, a drop of almost 13 percent.

- The share of the federal budget invested in children is also down 8 percent from 2010. Some might think this is due to all federal spending being reduced to combat the federal deficit, but the fact that the share of spending has declined shows that children have borne a disproportionate share of the cuts.

- It is estimated that this year alone, sequestration will cut a total of $4.2 billion out of funding for children, particularly in the areas of education, early childhood, and children's housing.

Though sequestration is a major reason for the drop in discretionary investments – it's underscoring an alarming trend that began several years earlier and making it even worse. As a result of sequestration, schools districts have been forced to lay-off teachers and drastically reduce support services to needy students and students with disabilities. Some schools have eliminated athletics and all extra-curricular activities as well as some bus routes, making it more and more difficult for kids to get to school. Head Start programs have had to close weeks early or kick children out. One program in Columbus, Indiana, literally held a lottery drawing to decide which family would lose their seat. That's a contest no parent wants to win.

According to the Annie E. Casey Foundation's *2013 Kids Count*, nearly 1 out of 3 children (32 percent) have parents who lack secure employment. Our own data shows that 2.8 million of those children have parents who have been unemployed for 6 months or more. Because of sequestration, states are cutting emergency unemployment compensation by at least 10 percent, with many cutting it by substantially more. Some states like North Carolina are eliminating it entirely.

If sequestration remains in place, the pain is only going to get worse. Already, families have lost housing supports and more children will face homelessness in the coming years. In anticipation of further cuts, schools in Idaho have already made plans to cut the school week from five days a week to four. We've heard from the National Association of Federally Impacted Schools, that some schools, particularly in rural areas, are likely to be forced to close entirely if cuts continue. How can we tell our children that we value them so little?

Even with these dire statements, the House of Representatives passed a 302(b) allocation for their discretionary spending priorities that makes sequestration even worse. Compared to pre-sequester levels, the House allocations cut an additional 22 percent in the Labor, Health and Human Services, and Education bill, where most discretionary investments are made for kids.

What does a 22 percent cut mean in real dollars? It means $3.2 billion in Title I cuts to support students. It means $2.5 billion less for students with disabilities. It means nearly $300 million less for schools that serve military families and Native American reservations. It means $140 million less for maternal and child health services. And it means $62 million less to protect children from child abuse and neglect.

Over the long term the because of sequestration and other poor policy choices, additional budget analysis by the Urban Institute in their report entitled *Kids' Share 2012* finds that:

- Interest on the national debt will eclipse our investments in children by 2017 and exceed investments in children by 50 percent by 2020.
- Defense spending is now triple the federal investment in our nation's children.
- Federal spending on the elderly exceeds that for children by a 7-to-1 ratio. When including state and local funding, seniors still receive twice as many public dollars as do children.
- The projected level of federal spending on children as a share of GDP will drop by 24 percent in the next decade if federal budget policy does not change.

Senate vs. House Budget for Children

Moving forward, there are dramatic differences in the vision as to the extent of making investments or substantial budget cuts to children's programs. First Focus has analyzed both of the budget proposals that passed the House and Senate and has found that the budget produced by the Senate under Chairman Murray's leadership to be far superior for children.

In every policy area, the Senate budget clearly places a much higher value on America's children and protects investments critical to them, while the House budget would make enormous cuts.

Key findings from the First Focus analysis include:

- Children's health: The Senate budget protects the Children's Health Insurance Program (CHIP) and Medicaid, which provide health care for millions of children. The House budget cuts Medicaid by $810 billion and converts the program into a block grant, which would compromise care for children, and eliminates the Affordable Care Act's protections for CHIP.

- Child nutrition: The Senate budget protects the Supplemental Nutrition Assistance Program (SNAP) and the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC), explicitly recognizing these investments' value for children. The House budget leaves "sequestration" budget cuts to WIC in place and cuts SNAP by $135 billion and converts the program into a block grant.

- Education and other non-defense discretionary investments: The Senate budget largely protects the "non-defense discretionary" component of the federal budget, which includes education, housing, child abuse and neglect prevention and response, child care, and other critical initiatives for children. The House budget extends sequestration cuts to such investments and expands their impact on children by more than $100 billion over 10 years. Some of those impacts I've mentioned above.

- Anti-poverty tax credits: The Senate budget makes permanent improvements to the Child Tax Credit and the Earned Income Tax Credit, which with those improvements, lift more than five million children out of poverty every year. The House budget allows those improvements to expire in 2017.

State Budget Cuts to Children

In addition to the recent federal budget cuts and future threats to children programs, there are dramatic cuts at the state level compounding the program and will undoubtedly harm the next generation. For example:

- The National Institute for Early Education Research (NIEER) recently released its annual yearbook and found that state funding for pre-K decreased by over $500 million in 2011-2012, adjusted for inflation, and this was the largest one-year drop ever. As a result, funding per child dropped by more than $400, and state spending per child has decreased by more than $1,100 since 2001-2002.

- The U.S. Census Bureau reported that per-student public education spending decreased in 2011 for the first time in four decades with accompanying stories of how school districts have been closing schools, cutting teachers, increasing class size, and cutting extracurricular activities across the country.

The Public Values Investing in Children – Our Future

How does the public feel about these trends? According to recent polling, Americans are dismayed by our failure to address the needs of children. In fact, by a nearly 3-to-1 margin (56-20 percent), Americans believe the lives of children have become worse over the last ten years and are deeply pessimistic about their future. The group most concerned was Republican women, who believe that things have become worse over the last ten years for children by a 74-10 percent margin.

And while voters recognize the need to make budget cuts to reduce the federal deficit, they overwhelmingly want policymakers to make real choices that reflect the importance children and families. Thus, in two separate polls conducted by Public Opinion Research and Greenberg Quinlan Rosner Research (one Republican and one Democratic firm), voters strongly opposed making major cuts to K-12 education, child nutrition, the Children's Health Insurance Program (which outpolled Medicare), Medicaid, early childhood education, funding to combat child abuse and neglect, and student loans.

In fact, Tea Party supporters expressed opposition to cutting critical programs for children, such as funding to prevent child abuse and neglect (35-64 percent), Medicaid (37-62 percent), education (42-58 percent), and tax credits for working families with children (40-56 percent), in order to reduce the federal deficit. Again, they chose a number of non-children's programs to cut instead.

Money Matters: Cost Effectiveness and Adequacy

As we look to address the myriad of challenges facing children, it is always important to examine whether funds are spent in the most efficient way possible. For example, in education policy, finance experts Michael Rebell and Joseph Wardenski have concluded that "money spent on qualified teachers, smaller class sizes, preschool initiatives, and academic intervention programs does make a substantial difference in student achievement...."

Bruce Baker at the Rutgers Graduate School of Education concurs:

> *To be blunt, money does matter. Schools and districts with more money clearly have greater ability to provide higher-quality, broader, and deeper educational opportunities to the children they serve. Furthermore, in the absence of money, or in the aftermath of deep cuts to existing funding, schools are unable to do many of the things they need to do in order to maintain quality educational opportunities.*
>
> *It is certainly reasonable to acknowledge that money, by itself, is not a comprehensive solution for improving school quality. Clearly, money can be spent poorly and have limited influence on school quality. Or, money can be spent well and have substantive positive influence. But money that's not there can't do either. The available evidence leaves little doubt. Sufficient financial resources are a necessary underlying condition for providing quality education.*

In contrast, it is far less clear that all the dollars spent on more and more student testing has had a positive impact on educational achievement.

Meanwhile, funding for high-quality, early childhood programs has been proven to have enormous positive outcomes for children. According to the Texas Equity Center in its report *Money Still Matters!*, these include:

- Improvements in school readiness
- Narrowing of the achievement gap
- Improvements in academic performance
- Reductions in retention-in-grade rates
- Reductions in dropout rates
- Reductions in incarceration rates
- Reductions in referrals to special education
- Prevention of academic failure
- Remediation of the negative effect of poverty
- Increased employment and earnings when adult
- Increased IQ
- Increased college attendance
- Improved vocabulary acquisition
- Improved self-esteem
- Stimulated intellectual curiosity
- Improved social skills

The promise of these significant changes in the life-trajectory of children from high-quality and effective early childhood programs has been proven to yield a substantial return on investment to national, state, and local economies.

In his book entitled *Investing In Kids: Early Childhood Programs and Local Economic Development*, economist Timothy Bartik concludes that high-quality universal pre-K education, high-quality child care, and the Nurse Family Partnership program all yield significant returns on investment and increased state earnings per capita, particularly in the long-term.

Arthur Rolnick and Rob Grunewald from the Federal Reserve Back of Minneapolis have concluded:

> *Compared with the billions of dollars spent each year on questionable economic development schemes, we think investment in early childhood is a far better and more promising economic development tool. We are confident that ECE investments, driven by a scalable market-based approach that focuses on at-risk children, encourage parental involvement, produce measurable outcomes, and secure a long-term commitment, will lower crime, create a stronger workforce, and yield a high public return. . . Not only will these efforts benefit children and families, they will benefit the taxpaying public and the national economy.*

And, in research for the Foundation for Child Development by William O'Hare at the Annie E. Casey Foundation and Mark Mather and Genevieve Dupuis at the Population Research Center, they also find that a strong correlation clearly exists between the well-being of children and state decisions to make investments in children.

As their study, entitled "Investing in Public Programs Matters: How State Policies Impact Children's Lives," concludes: "Public investments from federal, state, and local governments matter. . . When states invest in programs that benefit children and families and contribute to their well-being, children and families are better off. When states cut or neglect investing in these programs, the nation is worse off."

But lawmakers need not rely on academics for proof of the value of smart investment in kids. Each of your states administers a federal-state Children's Health Insurance Program partnership that proves it every day. CHIP, the creation of a Republican-controlled Congress and a Democratic president, works with Medicaid to provide cost-effective care for kids every day. That means spending a few hundred dollars for inhalers that keep asthma under control, rather than a few thousand dollars on a hospital admission when it gets out of control. It means kids don't fall behind in school because of vision or hearing problems. And it means parents climbing the economic ladder can spend more time at work and less time at home with sick children.

The evidence and our own experience are clear: the choices we make with respect to children and their future matters for both them and the nation.

Agenda for Action

As a result, we can make the right investments now to take advantage of our nation's greatest resource, its children, or we can fail them and our future. It is our choice to make and now is the time.

As President Barack Obama said at the prayer vigil in Newtown, Connecticut, in December, "This is our first task, caring for our children. It's our first job. If we don't get that right, we don't get anything right. That's how, as a society, we will be judged."

And, as House Speaker John Boehner said on CBS's *60 Minutes* in December 2010, "I have been chasing the American Dream my whole career. There are some things that I have a difficult time talking about – family, kids. . . Making sure that these kids have a shot at the American Dream like I did is important."

It takes a partnership of families, schools, communities, and yes, government to help children grow strong bodies and minds. And, Americans very much want to restore American leadership in the world and ensure that the next generation is better off than we have been.

But, the simple fact is that you cannot expect returns on investments you do not make. And children have just one childhood, so they cannot wait any longer for action. Now is the time for us to start making cost-effective and targeted investments in our children or we will bear the consequences of our inaction for decades and generations to come.

To reverse the three-year downward trend for America's children, a first step would be to renew the National Commission on Children, which finalized its call to action, *Beyond Rhetoric: A New American Agenda for Children and Families* in 1991.

That Commission, appointed by President H. W. Bush and chaired by Senator Jay Rockefeller, put forth a national blueprint to improve the lives and well-being of America's children and families. It successfully generated momentum toward the enactment of some critical policy changes, such as the Child Tax Credit and the State Children's Health Insurance Program. Building on the basic principle that every child should have the opportunity to develop to his or her full potential, the Commission sought to identify ways to ensure that parents have the necessary means and supports to raise healthy children. Now, 22 years after the Commission's final report, a fresh look at how our children are faring reveals a compelling need for an updated national action plan, ensuring the wellbeing of our youth with a focus on creating a bipartisan vision for America as a global frontrunner in child well-being.

Recognizing current budget constraints and that the budget deficit is also a children's issue, the President and Congress should consider some low-cost, immediate changes to make the systems, structures, and overall functions of government work better for children. These include, but are not limited to, the following ideas:

- Creation of a Children's Budget whereby the federal government commits to measuring and fully understanding whether children are gaining or losing ground in the federal budget, which is symbolic of our national priorities and commitment to our children.

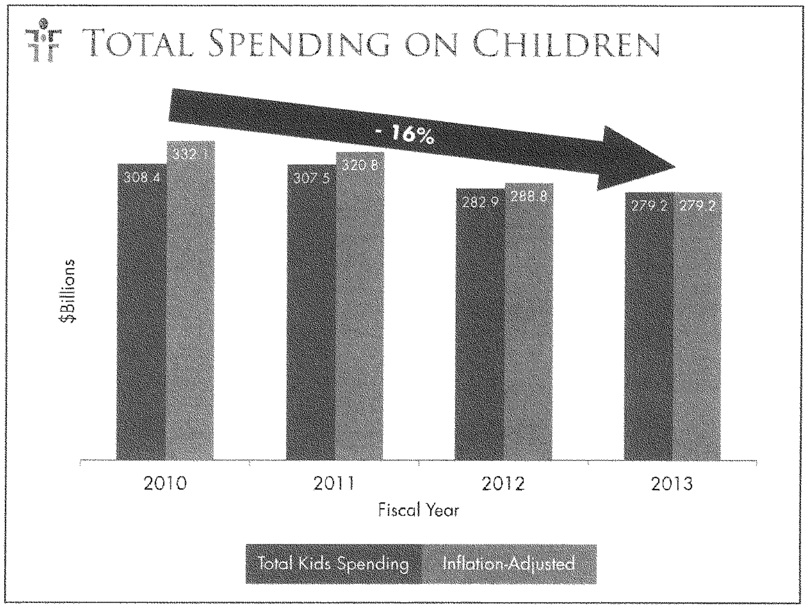
- Adoption of a Child Poverty Target that would commit the United States to the goal of cutting our nation's child poverty rate in half in 10 years, just like British Prime Minister Tony Blair successfully did after his pledge in 1999.

- Establish more Youth Councils, as have been created in a number of states across the country and in at least 93 countries spanning the alphabet from Anguilla to Zimbabwe, to give children and youth a voice in public policies that impact their lives.

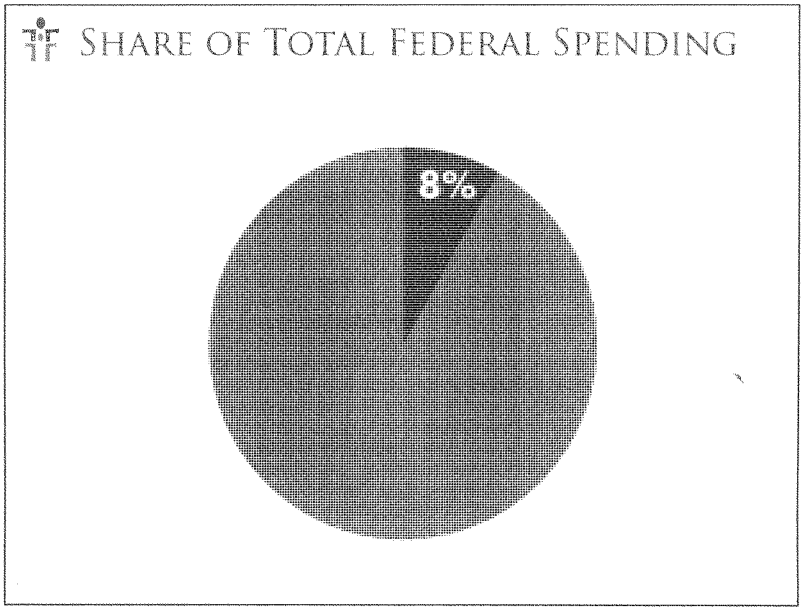
In short, less than 8 percent of the federal budget is currently dedicated to children and that amount is a fraction of the total provided to our nation's senior citizens. Continued cuts from sequestration will only make that number fall even further. With support so low and outcomes as poor as they are, children should no longer be an afterthought in federal budget and policy decisions. Our children cannot wait any longer.

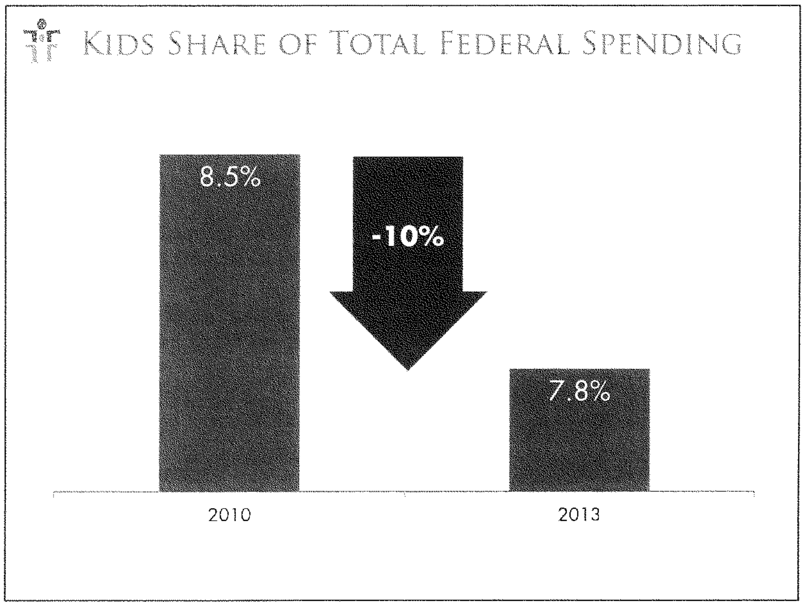
APPENDIX: Additional Materials

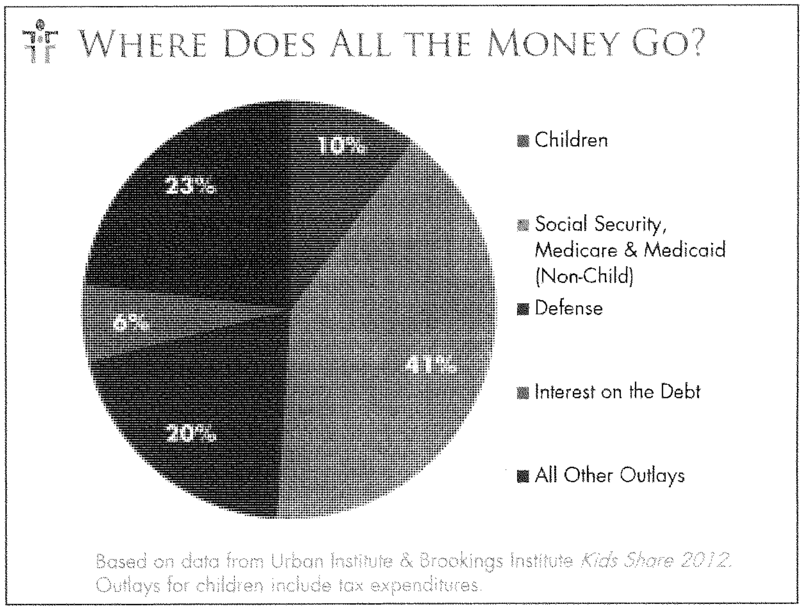
1. Slides – Kids & the Federal Budget
2. House 302(b) Puts Kids at Risk
3. Fiscal Year 2014 Budget's At A Glance

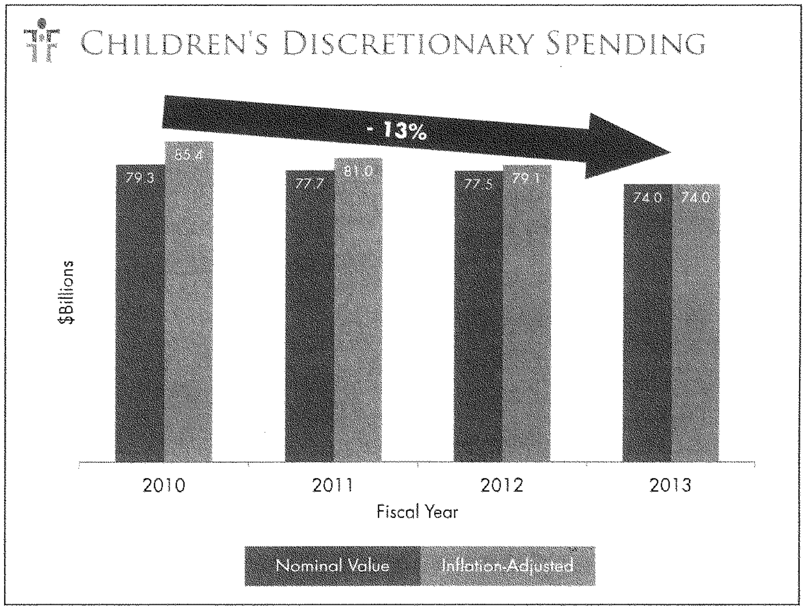


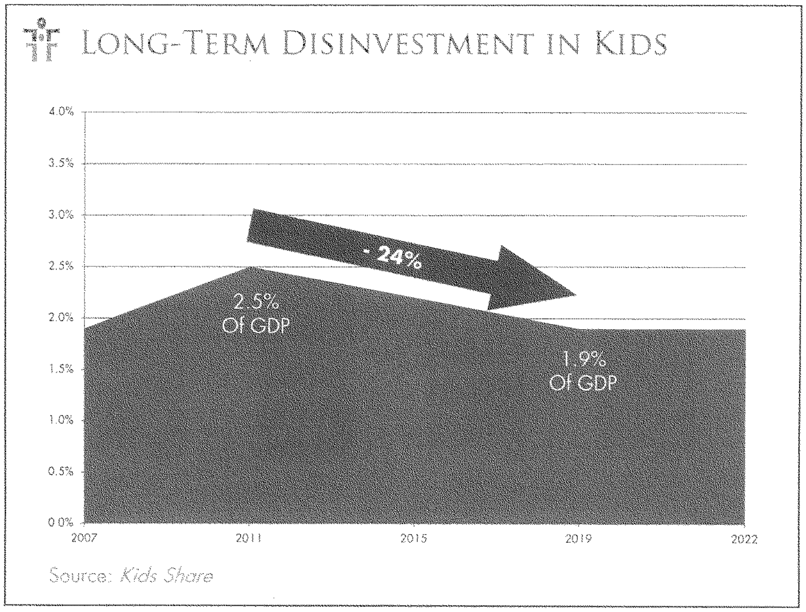
Total Spending on Children
- 16%
308.4
332.1
307.5
320.8
282.9
288.8
279.2
279.2
$Billions
2010
2011
2012
2013
Fiscal Year
Total Kids Spending
Inflation-Adjusted

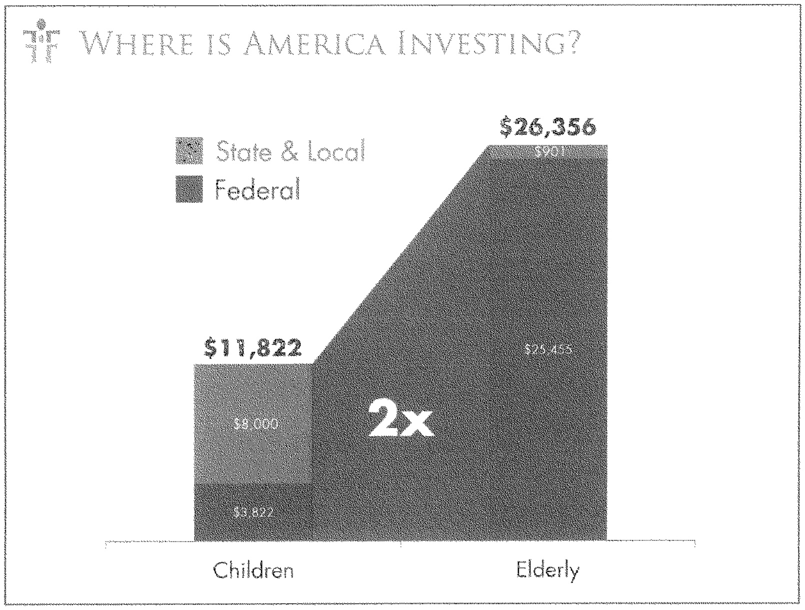

SHARE OF TOTAL FEDERAL SPENDING
8%

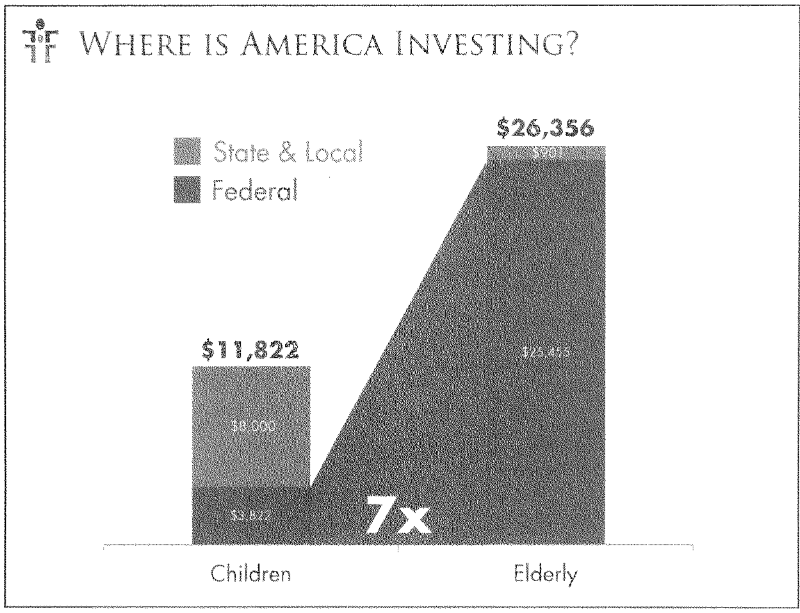

KIDS SHARE OF TOTAL FEDERAL SPENDING
8.5%
-10%
7.8%
2010
2013

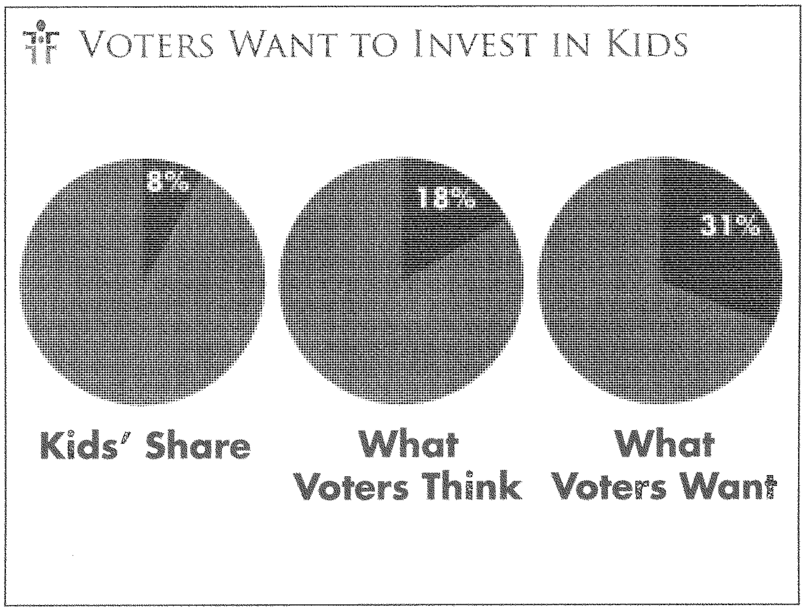

WHERE DOES ALL THE MONEY GO?
10%
23%
6%
41%
20%
Children
Social Security, Medicare & Medicaid (Non-Child)
Defense
Interest on the Debt
All Other Outlays
Based on data from Urban Institute & Brookings Institute Kids Share 2012.
Outlays for children include tax expenditures.

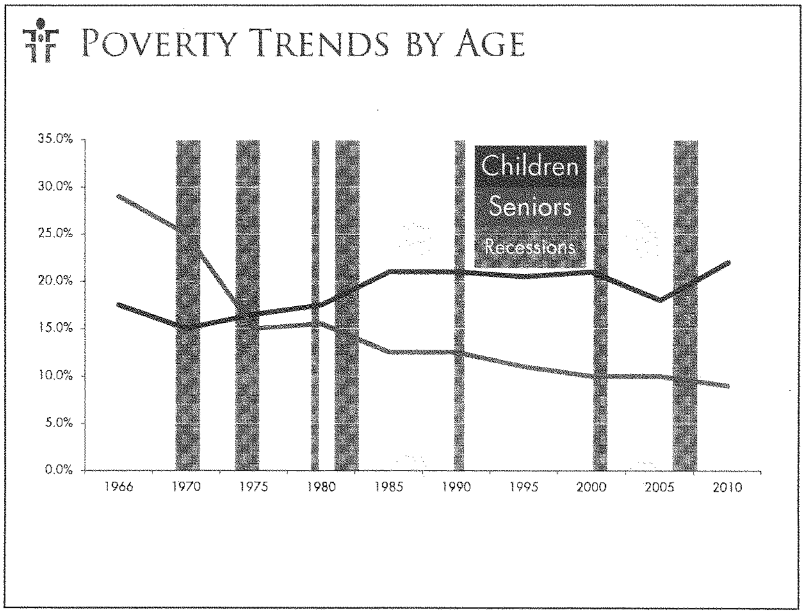

CHILDREN'S DISCRETIONARY SPENDING
- 13%
79.3
85.4
77.7
81.0
77.5
79.1
74.0
74.0
$Billions
2010
2011
2012
2013
Fiscal Year
Nominal Value
Inflation-Adjusted

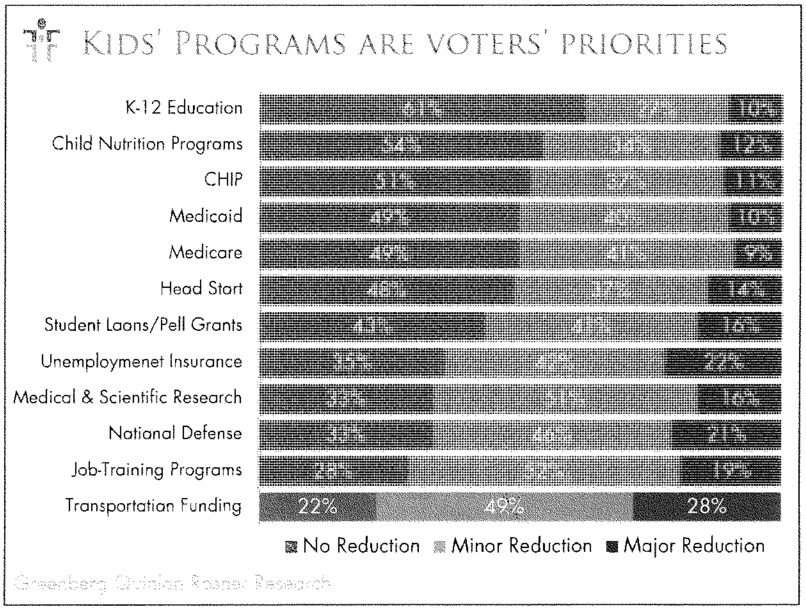

LONG-TERM DISINVESTMENT IN KIDS
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
- 24%
2.5%
Of GDP
1.9%
Of GDP
2007
2011
2015
2019
2022
Source: Kids Share

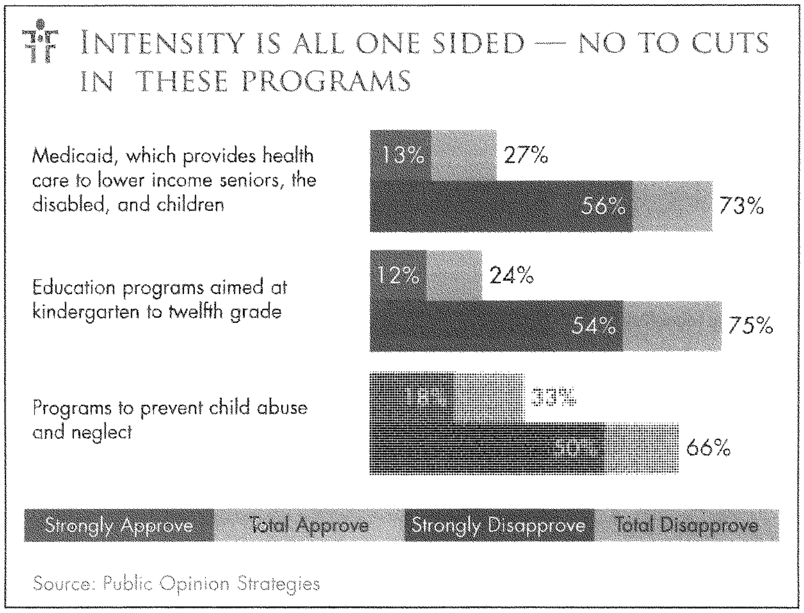

WHERE IS AMERICA INVESTING?
State & Local
Federal
$26,356
$901
$25,455
$11,822
$8,000
$3,822
2x
Children
Elderly

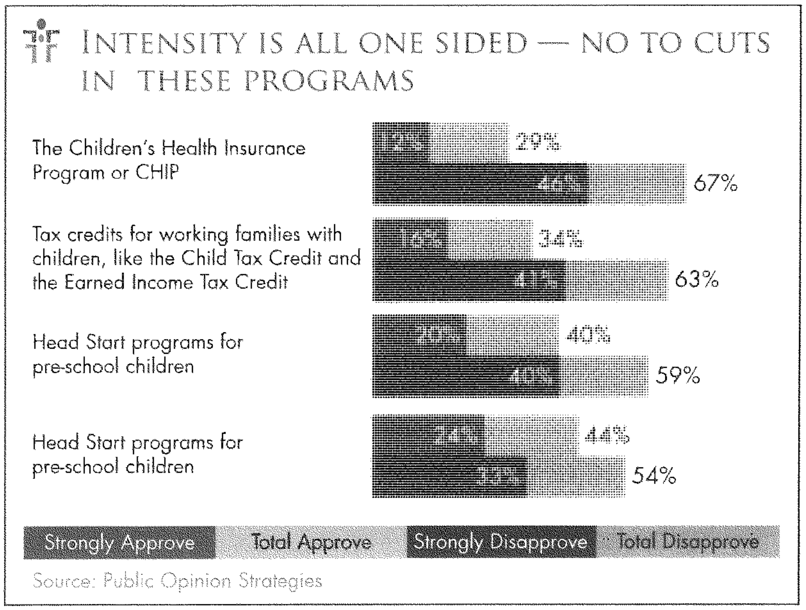

WHERE IS AMERICA INVESTING?
State & Local
Federal
$26,356
$901
$25,455
$11,822
$8,000
$3,822
7x
Children
Elderly


VOTERS WANT TO INVEST IN KIDS
8%
18%
31%
Kids' Share
What Voters Think
What Voters Want


POVERTY TRENDS BY AGE
Children
Seniors
Recessions
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
1966
1970
1975
1980
1985
1990
1995
2000
2005
2010


KIDS' PROGRAMS ARE VOTERS' PRIORITIES
K-12 Education
Child Nutrition Programs
CHIP
Medicaid
Medicare
Head Start
Student Loans/Pell Grants
Unemploymenet Insurance
Medical & Scientific Research
National Defense
Job-Training Programs
Transportation Funding
22%
49%
28%
No Reduction
Minor Reduction
Major Reduction
Greenberg Quinlan Rosner Research


INTENSITY IS ALL ONE SIDED — NO TO CUTS IN THESE PROGRAMS
Medicaid, which provides health care to lower income seniors, the disabled, and children
13%
27%
56%
73%
Education programs aimed at kindergarten to twelfth grade
12%
24%
54%
75%
Programs to prevent child abuse and neglect
18%
33%
50%
66%
Strongly Approve
Total Approve
Strongly Disapprove
Total Disapprove
Source: Public Opinion Strategies


INTENSITY IS ALL ONE SIDED — NO TO CUTS IN THESE PROGRAMS
The Children's Health Insurance Program or CHIP
12%
29%
46%
67%
Tax credits for working families with children, like the Child Tax Credit and the Earned Income Tax Credit
16%
34%
41%
63%
Head Start programs for pre-school children
20%
40%
40%
59%
Head Start programs for pre-school children
24%
44%
33%
54%
Strongly Approve
Total Approve
Strongly Disapprove
Total Disapprove
Source: Public Opinion Strategies

VOTERS DISAPPROVE OF CUTTING CHILDREN'S PROGRAMS

	Tea Party		Moderates	
	Approve	Disapprove	Approve	Disapprove
Medical & scientific research	52%	47%	36%	62%
Tax credits for working families with children	40%	55%	36%	62%
Programs to prevent child abuse & neglect	35%	64%	31%	67%
The Children's Health Insurance Program or CHIP	48%	48%	25%	71%
Medicaid	37%	62%	26%	74%
Education programs aimed at kindergarten to twelfth grade	42%	58%	23%	76%
Medicare, which provides healthcare to seniors	26%	72%	24%	75%
Social Security	29%	69%	24%	74%

Source: Public Opinion Strategies

FIRST FOCUS
MAKING CHILDREN & FAMILIES THE PRIORITY

House 302(b) Appropriations Caps Put Kids' Initiatives at Risk

May 2013

The Appropriations Committee in the House of Representatives recently approved subcommittee allocation levels, commonly referred to as 302(b) allocations, which will devastate investments to kids. The 302(b) allocation provides each appropriation subcommittee with the amount of money it has to spend on discretionary budget items – or programs that are not funded automatically through legislation.

Compared to the pre-sequester levels in the Fiscal Year 2013 Continuing Resolution passed in March, the Labor, Health & Human Services, & Education committee, which funds the majority of discretionary investments for kids will see a 22 percent cut. Investments in education, children's health, child abuse and neglect prevention, and early childhood education could be cut by almost $13 billion. The Transportation, Housing and Urban Development committee will see a 15 percent cut, meaning crucial investments in children's housing could be cut by as much as $1.4 billion.

Appropriations Bill	Selected Kids' Initiatives	FY2013 CR - Pre Sequester*	FY14 House 302(b)	Difference	Percent Change	Potential Cut to Kids
Labor, Health & Human Services, & Education	Head Start, IDEA, Title I	$156,872	$121,797	-$35,075	-22.36%	$12.7 Billion
Transportation, Housing & Urban Development	Assistance for Homeless Kids, Housing Supports	$51,817	$44,100	-$7,717	-14.89%	1.4 Billion
Agriculture	WIC, Child Nutrition	$20,531	$19,450	-$1,081	-5.27%	$388 Million
Interior	Indian Education	$29,827	$24,278	-$5,549	-18.60%	$158 Million
Defense	Schools for Military Families	$517,632	$512,522	-$5,110	-0.99%	$20 Million
Commerce Justice & Science	Juvenile Justice Initiatives	$50,210	$46,845	-$3,365	-6.70%	$18.8 Million
Financial Services	Consumer Product Safety Commission	$21,453	$16,966	-$4,487	-20.92%	$12 Million
					Total Cut	$14.8 Billion

*All figures in Millions unless otherwise noted.

In total, the cut to investments for kids could be $15 billion. Sequestration cuts, which took effect earlier this year, have already hit kids by nearly $4 billion. These allocations are another move in the wrong direction.

With child poverty at levels not seen for decades, it's not only short sighted but irresponsible to cut investments in kids. Congress must repeal sequestration and restore these cuts. Our children's futures are at stake.

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FIRST FOCUS
MAKING CHILDREN & FAMILIES THE PRIORITY

THE PRESIDENT'S 2014 BUDGET AT A GLANCE

April 2013

On April 10, 2013, President Obama released his Fiscal Year 2014 budget request. This document provides a comparison of President Obama's budget and the budgets passed by the House and Senate, looking at four key areas that impact children's well-being: health; nutrition; federal budget sequestration and non-defense discretionary investments like education; and family tax credits. It also provides a detailed analysis of the discretionary portion of his budget proposal from a children's perspective, highlighting notable increases, cuts, and new initiatives.

KEY ISSUES: SIDE-BY-SIDE COMPARISONS

Investments in Health

Federal investments in children's health go a long way in helping kids grow-up strong and happy. Medicaid and the Children's Health Insurance Program (CHIP) together help provide health services for nearly one third of the nation's children. Nearly half of all Medicaid beneficiaries are children, despite the fact that they only make up 20 percent of the cost.

House Budget	Senate Budget	Obama Budget
• Turns Medicaid into a block grant, **cutting $810 billion over the next 10 years, resulting in a cut of more than $160 billion to children's health.** Last year the Urban Institute estimated that a very similar proposal in the House budget **would result in 14 to 21 million individuals losing Medicaid coverage by 2022.**[1] • Defunds the Affordable Care Act (ACA), making it harder for low-income and middle class families to get health coverage. In last year's analysis, the Congressional Budget Office found that the ACA cuts would cause states to make considerable cutbacks including **CHIP and Medicaid eligibility restrictions, rationing the care children receive, and lower payments to providers – all of which would make it harder for children to get the care they need.**	• **Protects investments in Medicaid, CHIP, and the ACA** and highlights their importance for children. The budget plan also explicitly recognizes that half of the beneficiaries in Medicaid are children.	• **Protects investments in Medicaid, CHIP, and the ACA** and highlights their importance for children.

Tax Credits

The Child Tax Credit (CTC) and Earned Income Tax Credit (EITC) are two of the most effective anti-poverty investments for working families with children. **Combined, these credits lift 5 million children out of poverty annually. In 2009, Congress passed significant improvements to these credits, which alone kept nearly 1 million kids from poverty in 2011.**[2] The American Tax Relief Act, of January 2013 extended these credits with the improvements through 2017. With more than one in every five children in poverty, preserving these improvements is vital.

House Budget	Senate Budget	Obama Budget
• Assumes **the improvements will expire in 2017** and does not extend them.	• Calls for the improvements to be made **permanent**.	• Calls the improvements to be made **permanent**.

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Investments in Nutrition

One in every five children in America faces the possibility that they or a family member will not have enough food to eat tomorrow. Investments in child nutrition are critical to providing the help families need to put food on their tables. Nearly half of all resources in the Supplemental Nutrition Assistance Program (SNAP) go to children. **In 2011, SNAP alone helped lift 2.1 million children out of poverty.**[3]

House Budget	Senate Budget	Obama Budget
• Turns SNAP into a block grant and changes eligibility requirements, **cutting $135 billion over ten years. This would result in a cut of more than $63 billion to kids.** These cuts and changes would jeopardize the food security of millions of children.[4] • Leaves in place harmful sequestration cuts that could have had a dramatic impact on the Special Supplemental Nutrition Program for Women, Infant, and Children (WIC).[5]	• **Protects investments in SNAP and WIC.** The budget plan explicitly recognizes the importance of these programs for children and strongly supports their role in reducing hunger.	• **Protects investments in SNAP and WIC.** The budget plan explicitly recognizes the importance of these programs for children and strongly supports their role in reducing hunger.

Sequestration & Non-Defense Discretionary Investments like Education

Discretionary investments make up one third of all federal money that goes to children. These crucial investments include things like Head Start and child care assistance, special education services and help for low income students, as well as child abuse prevention and housing supports that prevent homelessness. **Discretionary investments provide some of the biggest bang for the buck, particularly in early childhood, where studies show a return of seven dollars for every one dollar spent.**[6] **From 2010 to 2013, discretionary investments for kids have already been cut by more than $5 billion dollars.**

House Budget	Senate Budget	Obama Budget
• Leaves in place and **extends harmful sequestration cuts that proportionally could cut investments to kids by more than $40 billion over 11 years.** These cuts fall heavily on investments in education, early childhood, and children's housing.[7] • Cuts non-defense discretionary spending by an additional **$650 billion over 10 years** by shifting all the scheduled cuts in defense spending onto non-defense areas. Applied proportionally, **these additional cuts could cost kids another $72 billion.**[8] • By protecting defense spending, in total, the House budget cuts non-defense discretionary investments **by nearly $1 trillion below the Budget Control Act over 10 years, meaning kids lose $112 billion.**	• **Eliminates sequestration,** including the restoration of all cuts currently in effect. This alone would **restore more than $4 billion in investments for kids for Fiscal Year 2013.** • Further lowers non-defense discretionary spending caps by $150 billion. Applying this reduction proportionally, this would result in a $17 billion reduction in funding for children's initiatives. However, the budget proposal emphasizes the importance of early education, child care, child nutrition, as well as other areas suggesting the intent to protect critical investments in children.	• **Eliminates sequestration,** including the restoration of all cuts currently in effect. This alone would **restore more than $4 billion in investments for kids for Fiscal Year 2013.** • Further lowers non-defense discretionary spending caps by $101 billion over 10 years, beginning in 2017. Applying this reduction proportionally, this would result in an $11 billion reduction in funding for children's initiatives. However, like the Senate budget, the proposal emphasizes the importance of early education, child care, child nutrition, as well as other areas suggesting the intent to protect critical investments in children even with the lowered caps.

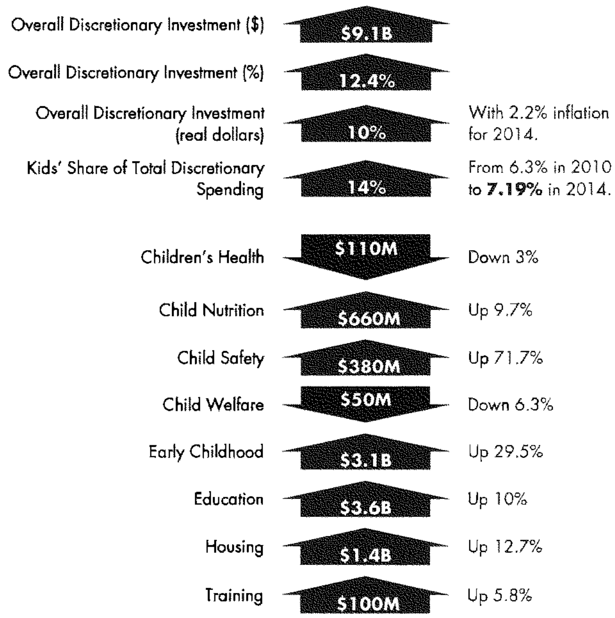
In addition to the categories above there are several other sharp distinctions between the budget plans that impact kids. The House budget also calls for significant cuts in mandatory programming, much of which serves low income children. Initiatives like Supplemental Social Security, which helps disabled and orphaned children, and Temporary Assistance for Needy Families are likely to be cut. The House budget also includes reconciliation instructions to eight committees calling on them each to produce legislation that saves at least $1 billion. **While details are unclear at this point, similar instructions last year resulted in at least another $40 billion in cuts to investments for kids over 10 years, including ending access to the CTC for up to 5.5 million kids.**[9]

The Senate budget includes no such reconciliation instructions and does not call for any additional substantial cuts in mandatory initiatives that impact children. **The Senate budget does sets aside an additional $100 billion worth of stimulus investments. Though not detailed, the budget calls for a large part of the stimulus to be invested in rebuilding schools, new education and training initiatives, and expansion of high quality early childhood initiatives.**

The President's budget calls for a number of new initiatives that will greatly benefit children. **These include a 10 year investment of more than $76 billion for universal pre-kindergarten, a push for higher minimum wage, a stronger unemployment insurance system, a renewed focus and investment in low-income housing, and a restoration of the TANF supplemental block grants.**

DISCRETIONARY BUDGET DETAILS

Changes below are denominated in nominal dollars, compared to 2013 appropriations, unless otherwise noted. The President's budget restores sequestration cuts, so discretionary increases to many investments for children are striking. **The kids' share of total discretionary spending would rise more than 14% under President Obama's budget, compared to 2010.**



Note: Totals reflect First Focus calculations on the share of spending in each program that goes to kids. 2013 spending totals assume current law, which means sequester has gone into effect. These cuts result in an approximate 5% cut to all non-defense discretionary items.

Selected Notable Increases

Initiative	Increase ($Nominal)	Relative to FY2013 (%)
Child Care Development Block Grant	$200M	12%
Head Start	$2.03B	27%
Healthy Homes Program	$15.5M	164%
Homeless Assistance Grants[10]	$454M	24%
Juvenile Justice Programs[11]	$73M	37%
Project Based Rental Assistance[12]	$1.4B	16%
Promise Neighborhoods	$243M	429%
Public Housing Operating Fund[13]	$560M	14%
Special Supplemental Program for Women, Infants, & Children (WIC)	$631M	10%
Tenant Based Rental Assistance[14]	$2.03B	11%
Unaccompanied Alien Child Program	$335M	210%

Selected Notable Cuts

Initiative	Decrease ($Nominal)	Relative to FY2012 (%)
Children's Hospital Graduate Medical Education	$166M	65%
Community Service Block Grant	$325M	48%
High School Graduation Initiative	$46M	100%
Low Income Home Energy Assistance[15]	$270M	8%

Selected New Proposals

Initiative	$ Proposed Increase
Preschool Development Grants	$750M
Preschool for All[16]	$1.3B
Project AWARE & Other School Based Mental Health Expansions	$130M

CONCLUSION

While President Obama's budget and the Senate budget plan are not perfect, they clearly place a higher value on investments in children than the House plan. The White House and Senate plan show it is possible to deliver fiscal progress while still investing in our children. As policymakers continue with the FY14 budget process, it is important to remember that investments in children make up less than 8 percent of the entire federal budget. Children are not the cause of our fiscal imbalance, and cutting the investments that help them grow is a poor decision that threatens their future.

The right budget for our nation is one that provides appropriate investments in our children's healthcare, housing, nutrition, and education. Every child deserves an equal chance at the American dream.

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[1] Children make-up 20 percent of the overall costs of Medicaid, which applied proportionally, equals the cut to children's investments.
[2] CBPP (February 1, 2013) "Policy Basics: The Child Tax Credit." http://www.cbpp.org/cms/index.cfm?fa=view&id=2989
[3] CBPP (March 15, 2013) Ryan Budget Would Slash SNAP Funding By $135 Billion Over Ten Years."
http://www.cbpp.org/cms/index.cfm?fa=view&id=3923#_ftnref17
[4] Children make up 47 percent of the overall costs of SNAP, which applied proportionally, equals the cut to children's investments.
[5] At the last minute the Senate approved a spending bill for the Department of Agriculture that restored much of the funding cut from WIC because of sequestration in 2013. Additional cuts were offset by tapping into transfer funds, as well as the WIC contingency fund, which is meant to be used for increases in food costs or additional enrollees during a time of high need.
[6] Heckman, James. Journal of Public Economics. "The Rate of Return to the HighScope Perry Preschool Program." 18 November 2009.
[7] Non-defense discretionary investments in children make-up 11.2 percent of all non-defense discretionary investments. Applied proportionally to the extended sequestration baseline as well as scheduled cuts for FY13 gets you to over $40 billion.
[8] Shifts the $55 billion each year for 10 years from the defense sequestration and shifts additional Pell resources onto the non-defense discretionary ledger.
[9] First Focus (April 20, 2012) "House Budget Forces Deeper Cuts to Child Tax Credit, Child Care, and Child Welfare."
http://www.firstfocus.net/library/fact-sheets/house-budget-forces-deeper-cuts-to-child-tax-credit-child-care-and-child-welfare
[10] Share dedicated to children is 50%.
[11] Includes Title II, Title V, & the Juvenile Accountability Block Grant.
[12] Share dedicated to children is 26%.
[13] Share dedicated to children is 41%.
[14] Share dedicated to children is 26%.
[15] Share dedicated to children is 23%.
[16] Preschool for All is a mandatory investment and is not included in the discretionary totals on page 3.

Chairman MURRAY. Thank you very much.
Ms. Nimmo Crowe?

STATEMENT OF MARGARET NIMMO CROWE, INTERIM EXECUTIVE DIRECTOR, VOICES FOR VIRGINIA'S CHILDREN

Ms. Nimmo Crowe. Good morning. Thank you so much for the opportunity, Chairwoman Murray and Ranking Member Sessions and members of the Committee.

Voices for Virginia's Children is a nonpartisan, privately funded child advocacy organization in Virginia. We have been working since 1994 with Republicans and Democrats, primarily at the State level, to pass commonsense solutions for the problems that face Virginia's children.

I would first like to give you a snapshot of how kids are doing in Virginia. We are the Annie E. Casey Foundation grantee in Virginia for the KIDS COUNT data, which just came out on Monday, and this shows that we rank 11th in child well-being overall in the country. That is consistent with the fact that Virginia is eighth in per capita income. So you can see that, relatively speaking, children are doing very well in Virginia, and we are proud of that. And some of that is due to the action of our previous Governors, as well as our current Governor—

Senator SESSIONS. Take a bow, Senator Kaine.

[Laughter.]

Ms. Nimmo Crowe. Senator Kaine, when he was Governor, put a particular focus on pre-K. Senator Warner had a particular focus as Governor on enrolling children in health insurance. And both of those indicators, education and health, we have improved in Virginia.

What is really worrying to us as child advocates in Virginia is the child poverty rate. Although our economy is starting to recover, the child poverty rate has been going up every year since 2005. We now have 280,000 children in Virginia who live below the poverty line, and the overall percentage is 15.6 percent, one in six kids. And that does not sound so bad, but that masks the fact that there are areas of Virginia which have a much higher poverty rate. Largely the rural Southside and southwestern Virginia have a rate of one in four children living in poverty, and in the relatively prosperous Richmond region, the city of Petersburg has a rate above one in three children living in poverty. So I just wanted to give you a picture of what that is like in Virginia, and the reason that we are so focused on the child poverty rate is because research has shown that, long term, children who spend a lot of time in poverty growing up have much poorer outcomes in terms of chronic health problems, including mental health problems, academic failure and dropping out of school, as well as they are much more likely to have lower-paying jobs as adults.

So I want to make two points to you today about the effects of the sequester and Federal budget on Virginia's children.

The first is that our economy is improving, but investments in children are still below where they were at the beginning of the recession. So this is despite the fact that we have more children in poverty every year.

Lower investments in kids have a double effect on our economy. They actually cut jobs currently for our current workforce, and they mean that our workforce of the future is not getting prepared in a way that they should be. I want to give you two examples.

The Head Start Association in Virginia predicts that this fall they will cut 112 jobs at Head Start programs and 647 children will lose their slots.

You also may not be aware that Virginia has the highest number of students who are eligible for Impact Aid. This is for primarily military children in Virginia. They predict $1.76 million in cuts from three school systems that have a large percentage of kids in military families. Prince George County school system is one of those. Since 2009, they have lost 41 jobs, including instructional staff, and this is while they have gained 150 students in their school system.

The second point I would like to make about the sequester cuts is that it is not just the cuts themselves, but those cuts are compounded at the State level. I want to tell you what Virginia's General Assembly has done over the last few years. For the last two General Assembly sessions, on top of our rainy day fund, the General Assembly has set aside $50 million to hedge against the sequester cuts. On the one hand, this is a very prudent thing to do. On the other hand, it reduces the already diminished pot of general fund dollars by $50 million. These are funds that go to K-12 education, social services, and health care.

A very concrete way that this has affected kids in Virginia is through the Early Intervention Program, which is part of IDEA, the special education law. This serves kids 0 to 3 who have developmental disabilities and delays. We are facing a 52-percent increase in the number of children identified for this service and a State funding gap of $8.5 million in the coming year. We have been advocating very hard about this at the State level, but we were still not able to make up that gap.

This affects kids like Tommy Mellett in Chesterfield, who had a brain hemorrhage before he turned 6 weeks old. He has been receiving physical therapy and occupational therapy to recover from this brain injury. If we cannot find the State funding to replace the dollars that are lost, his therapy is going to be cut in half. Not only is this bad for him and his family, but it is really shortsighted from a policy perspective because one in five children who receive early intervention services actually graduate from the program before they turn 3. They never need money spent on them in special education. And the remainder of those children catch up to their full potential, whatever that may be.

So, in conclusion, I would just like to make the point that the effects of the sequester are not hypothetical. They are very real, where the rubber meets the road. And they are affecting both our current and future workforce. We are very alarmed by the cuts in the House budget that would come on top of that, and we appreciate the fact that the Senate budget is preserving those investments in children.

Thank you very much for your time.

[The prepared statement of Nimmo Crowe follows:]

Voices For Virginia's Children

Testimony for United States Senate Budget Committee Hearing:
"Investing in our Future: The Impact of Federal Budget Decisions on Children"

June 26, 2013

Margaret Nimmo Crowe
Acting Executive Director
Voices for Virginia's Children

Thank you for the opportunity to testify to the Committee today. Voices for Virginia's Children is a nonpartisan, nonprofit child advocacy organization. Our mission is to champion public policies that improve the lives of Virginia's children, particularly those who are vulnerable. It is important for you to know that we achieve this mission strictly with private funding, which enables us to speak for children without any competing interests. Since 1994 we have worked with Republicans and Democrats alike, primarily at the state level, to find common-sense solutions to the problems affecting Virginia's children.

We are the Annie E. Casey KIDS COUNT organization in Virginia, and this Monday the Foundation released its 2013 KIDS COUNT data book, which includes indicators of child well-being across several domains for each state. In Virginia, kids are doing relatively well, giving us an overall ranking of 11th in child well-being. We have improved on several indicators in the domains of education, health, and family and community. And that is consistent with the fact that we are a relatively prosperous state: we rank 8th in per capita income.[1]

Some of the reasons for this high ranking go back to the actions of previous governors, including Senator Warner's push to enroll children in Medicaid and CHIP while he was Governor and Senator Kaine's emphasis on pre-kindergarten as Governor. Making children's issues a priority and funding programs that have a proven positive impact on children reap rewards into the future.

Where we continue to have the greatest struggle is on economic indicators for our children: one in six in 6 Virginia children live in poverty—that's 280,000 children. The number of children living in poverty has increased every year since 2005, and children are faring worse overall than the general population. (15% child poverty vs. 12% overall poverty rate.)[2]

We know from previous recessions that children thrown into poverty are likely to remain in poverty several years after a recession ends. So even though Virginia's economy is recovering,

[1] http://jlarc.virginia.gov/reports/Rpt438.pdf
[2] http://datacenter.kidscount.org/data/tables/5879-children-ages-0-17-living-in-poverty?loc=48&loct=2#detailed/2/any/false/867,133,38,35,18/any/12493,12494

children continue to suffer. Research shows that children living in prolonged poverty are more likely to develop chronic health problems, emotional and behavioral problems, experience academic failure and drop out of school, and have low paying jobs as adults.[3]

It's important to note that the one in six rate of child poverty statewide masks some areas of concentrated poverty. For example, the Richmond region has a child poverty rate of 16.5 percent, yet ranges from 7.3 percent in Hanover to 37.7 percent in Petersburg.[4] That means more than one in three children in Petersburg live below the federal poverty rate, which is $23,550 per year for a family of four. The regions with the highest child poverty rates are the mostly rural Southside VA, and Southwest VA, where roughly one in four children lives in poverty.

Now that you have the background of how children in Virginia are doing, I would like to tell you how the federal budget impacts these children.

<u>Federal budget cuts lead to lost opportunities for children, lost jobs for adults</u>

During the great recession, we had to make serious cuts to programs impacting children to balance our state budget. States are just starting to claw out of recession—many programs for children like home visiting have still not been restored to their pre-recession funding levels. Federal American Recovery and Reinvestment Act (ARRA) funds were used as a backstop to fill some of those holes, but of course those are gone. Now, Virginia is regaining its financial stability, and more federal cuts—even small ones – jeopardize our children's well-being. Since the sequester cuts are ongoing, states are going to continue to struggle to meet children's needs.

Unfortunately, the House of Representatives is proposing significant future cuts to children's funding: with the current subcommittee appropriation levels, kids programs in total would take an additional hit of up to $15 billion, while the levels in the Labor, Health and Human Services, and Education bill are cut 22% from pre-recession funding. Children would be affected negatively across the board, from special education to Title I funding in schools, to housing assistance and nutrition programs.

You've heard what a 22 percent cut means nationally in real terms, but what does it mean for Virginia? It means $51 million in additional Title I cuts to support students. It means nearly $8 million less for schools that serve military families. It means nearly $3 million less for maternal and child health services. And it means $1 million less for children to receive immunizations and vaccinations. Knowing that children continue to live in poverty at a disproportionate rate to the general population, we simply cannot afford to pile on further budget cuts to the programs that help lift them out of poverty.

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[3] Brooks-Gunn, J. & Duncan, G.J., "The Effects of Poverty on Children", The Future of Children – Princeton-Brookings – Volume 7, Number 2, Summer/Fall 1997

[4] U.S. Census Bureau, Small Area Estimates Branch, 2011

Significantly, as we lose programming that helps children—whether it's in pre-k to 12 education, Head Start, or home visiting, we also lose jobs. For example, according to the Head Start Association of Virginia, Head Start will cut 647 children this fall, as well as 112 jobs. Staff in seven programs who have retained their jobs have been furloughed- anywhere from ten days to eight weeks.

In York County, where Dennis Jarrett is chief financial officer, the school district has reduced 124 positions over the last four years. Jarrett explains: "One of them was a guidance counselor—a tough position to keep unfilled when 42 percent of the students are connected to the military or some other branch of federal government. Parents' deployment and frequent moves put unusual emotional strain on children. What we're concerned about...is the quality of life for our students."

Sequestration cuts are compounded at the state level

Virginia, as you know, is poised to take a huge hit from sequestration due to the impact of government contracts and military bases in our Commonwealth. In order to be good fiscal stewards, Virginia's General Assembly has put aside approximately $50 million in the last two years to protect against these cuts. This is above and beyond our rainy day fund.

What does that mean for kids? It means that on top of reduced state general funding during the recession, an additional $50 million was taken out of the pot as we were climbing out of the recession. These are dollars that go toward things like preK-12 education, case workers for kids in foster care, and early intervention services for babies and toddlers with developmental delays.

For example, Virginia has experienced a 52% increase in the number of infants and toddlers identified with developmental delays and disabilities since 2007. Virginia's Part C program – the part of the federal IDEA legislation that provides early intervention services to babies and toddlers with developmental delays or disabilities – faced an $8.5 million shortfall in fiscal year 2014 because funding has remained flat while the need has increased. During the past year, we have advocated that Virginia needs to meet this obligation and serve all of the infants indentified. While our policymakers easily made the decision to hold funds in reserve, they have to be convinced to serve families like Tommy Mellet's in Chesterfield, who participate in physical therapy and occupational therapy to help their son gain skills after experiencing a brain hemorrhage before he was even six weeks old. Tommy's therapy time would be cut in half without the additional state dollars. Providing early intervention services to babies like Tommy helps us save state and federal special education dollars in a few years—one in five of the children served in early intervention catches up to his peers by age three and never needs special education services.

Another example of the direct impact of sequestration is the reduction in Impact Aid to Virginia schools. Virginia serves the highest number of Impact Aid-eligible students in the country

(107,719 in FY2013). Most of these students in Virginia are part of military families. For the 2012-2013 school year, the National Association of Federally Impacted Schools estimates a total of $1.76 million in cuts to the Virginia Beach, Norfolk and Prince George County school systems. In Prince George, 41 administrative, instructional and support personnel have been lost because of the budget squeeze since 2009, and this has occurred while they have gained 150 new students. If sequester cuts continue, this situation and others mentioned earlier will only worsen.

Fragmented approach to federal funding leads to gaps in services for children

Getting a handle on the effect of the federal budget on children is further complicated because the federal government is simultaneously cutting funding for some programs due to the sequester but providing new funding for other critical programs. This disjointed approach makes it difficult for agencies and the local organizations they support to plan, and that means kids and families get left out. Let me give you an example.

Child Development Resources (CDR) is a nonprofit agency that serves young children and families in Williamsburg and James City County. Lisa Thomas, Deputy Director at CDR, explained that two years ago CDR lost all of its state funding for evidence-based home visiting because of recession-related state budget shortfalls. This year CDR was able to replace that funding and add the Parents as Teachers curriculum through the funding for the federal Maternal, Infant, and Early Childhood Home Visiting (MIECHV) Program, meaning that families will now be able to participate in a more comprehensive program to improve outcomes for children. However, as a result of sequestration, CDR must cut twelve families from the Early Head Start rolls, and child care subsidies in their community ran out months ago. As they try to plan for the future, they are wrestling with the possibility that federal MIECHV funding will not be reauthorized and it will be "déjà vu all over again" with a significantly reduced home visiting program. Lisa Thomas says they are in a "constant scramble" trying to match services and professionals to the funded programs, while ultimately trying to meet their mission of providing high quality early learning opportunities.

Programs for children that receive federal funding – from education to health to specialized services for particularly vulnerable kids – are a vital component to having healthy and productive communities and states. The children of today are the workforce of tomorrow, and we will see the results of our investments, or lack thereof, in the readiness of today's children to enter the workforce, contribute to their communities, and live up to their potential. For these reasons, Voices for Virginia's Children respectfully requests that this committee advocate for strong investments in children's services in the federal budget. We also ask that you support the "Children's Budget Act," that would require the President and the Office of Management & Budget to submit an annual children's budget, a detailed accounting of all federal funding for children and programs that serve them.

Thank you for the opportunity to provide testimony at this important hearing.

Chairman MURRAY. Thank you very much.
Ms. COLLIER.

STATEMENT OF SHAVON COLLIER, PARENT, EDWARD C. MAZIQUE PARENT CHILD CENTER, INC.

Ms. COLLIER. Chairwoman Murray, Ranking Member Sessions, and members of this Committee, thank you for holding this hearing on investing in children and for the opportunity to be here today. I want to tell you about my journey as a parent with children who have graduated from a local Head Start Program, the Edward C. Mazique Parent Child

Center here in Washington, D.C. I have one child in the program currently and two who are Head Start graduates now thriving in elementary school. You will also hear from my daughter, Sakhia, today, an honor roll student at Garrison Elementary School.

I found out about the Head Start program at the Edward C. Mazique Parent Child Center through a friend of mine. I was looking for child care for my daughter, but I could not find any options that were affordable with my income. My daughter was able to get enrolled, and I was able to continue working. But not everyone I know has been so lucky. Because there are so few affordable child care

options in Washington, D.C., there are 181 children on the waiting list; and people are turned away throughout the year. To put it in perspective, the Mazique Center serves 106 Head Start children and 166 Early Head Start children.

The program is high in demand because it is more than just a safe place for children while parents are at work; Head Start provides comprehensive child health and development to get them ready for kindergarten and lifelong learning. I could see the impact quickly. After only a few months in Head Start, I saw a tremendous gain in my children's learning skills and ability to focus. They were learning new words, and the two who are Head Start graduates were both able to spell by age 4. It also helped my children build social skills. My son, for example, was a bit withdrawn at the time, but after only a few months, he was playing and interacting with his classmates.

In addition, the Head Start staff demands that parents are invested in their child's education and have the tools at home to provide the best possible learning environment. They also helped me with developing a number of parenting and job skills like public speaking, healthy cooking, reading budgets, creating budgets, and how to best interact with my children. I have served on the Mazique Center's Policy Council, and I am a National Head Start Association board member. Without Head Start I would not be able to be here and speak with you today.

After graduating the Head Start program, my two older children arrived at kindergarten excited, prepared, and eager to learn. They were much better prepared than many of their classmates. Entering kindergarten already knowing how to read and write, they were also able to sit in a group and focus—something that is not easy for many of us, especially 5-year-olds. Today they are thriving, building on what they have learned and both still on the honor roll.

Head Start also helped to identify a developmental delay in my youngest daughter when she was very small. I was able to get speech therapy for her and the comprehensive services that she needed. Now she is also spelling her name and speaking a lot clearer than before. She will be ready for kindergarten, too, and I have no doubt she will one day be an honor roll student with her siblings. Without Head Start's ability to address a wide variety of needs, I do not know where my child would be today.

There are decades' worth of academic research that shows how Head Start positively impacts the lives of children and their parents. In fact, studies show that for every $1 invested in a Head Start child, society earns at least $7 back through increased earnings, employment, and family stability, as well as decreased welfare dependency, health care costs, crime costs, grade retention, and special education.

But I do not need these studies to tell me what I already know—that Head Start has given me and my children an opportunity to build a better life, and I am so grateful for it. I hope this Committee will continue to support this investment in our children. And now I would like to turn to my daughter, Sakhia, for her own story.

[The prepared statement of Ms. Collier follows:]

Statement of

Shavon Collier
Head Start Parent

Senate Budget Committee Hearing
Investing in our Future: The Impact of Federal Budget Decisions on Children
June 26, 2013

Chairwoman Murray, Ranking Member Sessions, and Members of this Committee, thank you for holding this hearing on investing in children, and for the opportunity to be here today. I want to tell you about my journey as a parent with children who have graduated from a local Head Start Program, the Edward C. Mazique Child Center here in Washington, DC. I have one child in the program currently, and two who are Head Start graduates now thriving in elementary school. You will also hear from my daughter Sakhia, today an honor roll student at Garrison Elementary School

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There are decades' worth of academic research that shows how Head Start positively impacts the lives of children and their parents. In fact, studies show that for every one dollar invested in a Head Start child, society earns at least $7 back through increased earnings, employment, and family stability;[i] as well as decreased welfare dependency,[ii] health care costs,[iii] crime costs,[iv] grade retention,[v] and special education.[vi]

But I do not need these studies to tell me what I already know-- that Head Start has given me and my children an opportunity to build a better life, and I am so grateful for it. I hope this Committee will continue to support this investment in our children. And now, I would like to turn to my daughter, Sakhia, for her own story.

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[i] Ludwig, J. and Phillips, D. (2007). The Benefits and Costs of Head Start. *Social Policy Report*. 21 (3: 4); Deming, D. (2009). Early childhood intervention and life-cycle skill development: Evidence from Head Start. *American Economic Journal: Applied Economics*, 1(3): 111-134; Meier, J. (2003, June 20). Interim Report. Kindergarten Readiness Study: Head Start Success. Preschool Service Department, San Bernardino County, California; Deming, D. (2009, July). Early childhood intervention and life-cycle skill development: Evidence from Head Start, p. 112.

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[iii] Frisvold, D. (2006, February). Head Start participation and childhood obesity. Vanderbilt University Working Paper No. 06-WG01; Currie, J. and Thomas, D. (1995, June). Does Head Start Make a Difference? *The American Economic Review, 85* (3): 360; Anderson, K.H., Foster, J.E., & Frisvold, D.E. (2009). Investing in health: The long-term impact of Head Start on smoking. *Economic Inquiry*, 48 (3), 587-602.

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Chairman MURRAY. Thank you.
Sakhia?

STATEMENT OF SAKHIA WHITEHEAD, STUDENT, AGE 10, EDWARD C. MAZIQUE PARENT CHILD CENTER, INC.

Miss Whitehead. Chairwoman Murray, Ranking Member Sessions, and members of this Committee, thank you for inviting me to speak to you today. My name is Sakhia Whitehead. I am 10 years old and just finished fourth grade at Garrison Elementary School.

I graduated the Head Start program at the Edward C. Mazique Child Center 5 years ago, but I do remember how much I liked it. I remember them teaching me how to read and write my name. I also remember sometimes seeing the doctor there to get a checkup.

Head Start helped me get prepared for kindergarten. When I got to kindergarten, I already knew how to read and write. But my new classmates did not. So kindergarten was pretty easy for me.

I tell my brothers all the time how much I loved Head Start. I tell them it can help them in school, because I know it helped me to be the honor roll student that I am today. I have been on the honor roll since I started elementary school, and I am very proud of that. I want my brothers to follow in my footsteps.

Today my favorite subject in school is math, which not many people enjoy. But when I grow up, I want to be a teacher so that I can continue to teach children like myself and help them to succeed.

Thank you again for listening to me today.

[The prepared statement of Miss Whitehead follows:]

Statement of
Sakhia Whitehead
Head Start Alumnus
Senate Budget Committee Hearing
Investing in our Future: The Impact of Federal Budget Decisions on Children
June 26, 2013

Chairwoman Murray, Ranking Member Sessions, and Members of this Committee, thank you for inviting me to speak to you today. My name is Sakhia Whitehead. I am ten years old and just finished fourth grade at Garrison Elementary School.

I graduated the Head Start program at the Edward C. Mazique Child Center five years ago, but I do remember how much I liked it. I remember them teaching me how to read and write my name. I also remember sometimes seeing the doctor there to get a checkup.

Head Start helped me get prepared for Kindergarten. When I got to Kindergarten, I already knew how to read and write. But my new classmates did not. So Kindergarten was pretty easy for me.

I tell my brothers all the time how much I loved Head Start. I tell them it can help them in school, because I know it helped me to be the Honor Roll student that I am today. I have been on the Honor Roll since I started elementary school and I'm very proud of that. I want my brothers to follow in my footsteps.

Today, my favorite subject in school is math, which not many people enjoy. But when I grow up, I want to be a teacher so that I can continue to teach children like myself and help them to succeed.

Thank you again for listening to me today.

Chairman MURRAY. Excellent. Thank you so much, Sakhia.
Dr. MUHLHAUSEN.

STATEMENT OF DAVID MUHLHAUSEN, PH.D., RESEARCH FELLOW IN EMPIRICAL POLICY ANALYSIS, THE HERITAGE FOUNDATION

Mr. MUHLHAUSEN. Thank you. My name is David Muhlhausen. I am a Research Fellow in Empirical Policy Analysis in the Center for Data Analysis at The Heritage Foundation. I thank Chairwoman Patty Murray, Ranking Member Jeff Sessions, and the rest of the Committee for the opportunity today to testify on the effect of sequestration on children. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

My testimony is based on my recently published book titled, "Do Federal Social Programs Work?"

Two types of Federal social programs—early childhood education and youth job training programs—are the focus of my testimony today. Some argue that sequestration cuts the budgets of domestic programs too deeply. For example, President Barack Obama has claimed that over 70,000 young children will be kicked off Head Start due to sequestration. The clear implication is that 70,000 children will somehow be harmed by not attending Head Start. This would be true if Head Start was an effective program that benefits the children it serves.

Calling for more spending on programs may seem morally compelling, but continuing to spend taxpayer dollars on ineffective programs is morally indefensible. Using evidence from scientifically rigorous evaluations of national programs, my written testimony makes the case that real reductions in spending on early childhood education and youth job training programs will not produce harm.

I will begin by briefly reviewing the effectiveness of two early childhood education programs. The first is Early Head Start, a program that serves low-income families with pregnant women, infants, and toddlers up to age 3. The results of a multi-site experimental evaluation of Early Head Start are particularly important because the program was inspired by a local program previously thought to be effective. By the time Early Head Start participants had reached age 3, Early Head Start had beneficial impacts on only a few outcome measures for child cognitive and socio-emotional development. However, by the time these children reached the fifth grade, all those effects had disappeared. The program had no lasting impact.

Perhaps the most well known early childhood education program is Head Start. Head Start is intended to help disadvantaged preschool children catch up to children living in more fortunate circumstances. The Head Start Impact Study found that almost all the benefits of participating in Head Start disappeared by kindergarten. Similar results occurred when the children were assessed in the first and third grades.

Moving on to youth job training programs, the Federal Government has spent decades trying to improve the earnings of disadvantaged youth through various programs. While my written testimony covers several youth job training programs, I will focus on Job Corps.

In 2011, then Secretary of Labor Hilda Solis claimed that "Job Corps program has a long history of preparing disadvantaged youth for a successful transition into the workforce."

Fortunately, we do not have to rely on Secretary Solis' personal opinion about the effectiveness of Job Corps. We have a multi-site experimental evaluation. The evaluation found that Job Corps participants were less likely to earn a high school diploma; they were no more likely to attend or complete college; and the ones that actually found jobs, they earned only 22 cents more per hour compared to similar youth who did not have access to the program. Job Corps does little to boost the skills of job training participants.

While we all agree on the importance of children having a solid foundation when entering school, this belief, no matter how noble, does not change the fact that Federal early childhood education programs have been found to be ineffective. The same holds true for youth job training programs.

Thus, concerns over the effects of sequestration on children are unwarranted. Reduced funding for ineffective programs will not harm children because these programs largely do not work in the first place.

Given the enormous amount of debt that Congress has accumulated. reducing Government spending now will likely decrease the financial burden that we are already leaving our children.

Thank you.

[The prepared statement of Dr. Muhlhausen follows:]

The Heritage Foundation
LEADERSHIP FOR AMERICA
214 Massachusetts Avenue, NE • Washington DC 20002 • (202) 546-4400 • heritage.org

CONGRESSIONAL TESTIMONY

Do Federal Social Programs for Children Work?

Testimony before
the Committee on the Budget
United States Senate

June 26, 2013

David B. Muhlhausen, Ph.D.
Research Fellow in Empirical Policy Analysis
The Heritage Foundation

My name is David Muhlhausen. I am Research Fellow in Empirical Policy Analysis in the Center for Data Analysis at The Heritage Foundation. I thank Chairwoman Patty Murray, Ranking Member Jeff Sessions, and the rest of the committee for the opportunity to testify today on the effect of sequestration on children. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

My testimony is based on my recently published book, *Do Federal Social Programs Work?*[1] This is a simple question. While the question may be straightforward, finding an answer is complicated. To answer in the affirmative, federal social programs must ameliorate the social problems they target. In essence, social programs seek to improve human behavior in ways that will make people better off.

Two types of federal social programs—early childhood education and youth job-training programs—are the focus of my testimony.[2] Determining the effectiveness of these social programs is particularly relevant given the current political debate over the federal government's persistent deficits and debt. For example, President Barack Obama has claimed that "70,000 young children would be kicked off Head Start" due to sequestration.[3] The clear implication is that 70,000 children will somehow be harmed by not attending Head Start. This would be true only if Head Start is an effective program that actually benefits the children it serves.

Before I review evaluations of federal early childhood education and youth job-training programs, the standards Congress should use in judging the effectiveness of social programs are discussed.

Standards for Assessing the Effectiveness of Federal Social Programs
Given the fiscal crises that the federal government is facing, holding federal social programs accountable for their performance is necessary to regain control over excessive spending. Operating with increasingly scarce resources, federal policymakers need to start denying funds to ineffective programs, even if calls for funding these programs *seem* morally compelling. Calling for more spending on social programs may seem morally compelling, but continuing to spend taxpayer dollars on programs that do not produce their intended results is morally indefensible. Americans, especially income tax–payers, deserve better.

Social programs should be carefully evaluated to determine whether they do, in fact, work. Determining whether these programs work requires reliably sorting out the effect of a social program from confounding factors, which is a difficult task. Unfortunately, Congress too often relies on self-serving anecdotal observations offered by individuals and organizations dependent on federal government funding.

Science Versus Anecdotal Observations. There are numerous methods of making sense of the world around us. We frequently make personal observations of events around us to bring order to our lives. We often assign cause-and-effect relationships to events we personally experience. For instance, learning that touching a hot stove will burn one's hand is an easy cause-and-effect association that does not need to be tested more than once. We can easily correlate the act of touching the stove with the pain felt. Firsthand experience is often instrumental to developing knowledge. Every day, we make personal observations that guide us in our activities. We often seek the advice of others based on their personal experiences.

Congress frequently seeks policy advice through hearings. At congressional hearings, congressional committees seek the testimony of experts. On many occasions, these committees are collecting advice on the merits of social programs. As is often the case at these hearings, the invited panelists offer their opinions of the pros and cons of the social program of interest. A frequent type of panelist is an administrator of a social program that is financially dependent on continued federal funding.

Members of Congress should take any claim of effectiveness from individuals dependent on federal funding with a healthy dose of skepticism. No one who comes before Congress with hat in hand seeking federal funding is going to admit that they do not know if their program works or that their program is ineffective. The same holds true for claims of impending doom if budget cuts occur, no matter how small or large. With the federal government spending hundreds of billions of dollars per year on social programs, we should expect Congress to not rely on personal opinions that are too often self-serving.

Further, the usefulness of personal observations or experiences can be suspect when assessing complex social interactions that can have multiple causes. This problem is particularly acute when assessing the effectiveness of social programs where multiple factors can cause the outcomes of interest.

Assessing the effectiveness of federal social programs should be based on evaluations with two important characteristics. First, policymakers should rely on experimental designs that use random assignment. Second, policymakers should rely on large-scale evaluations that assess the effectiveness of federal social programs in multiple settings.

Experimental designs. Impact evaluations often assess impacts by comparing treatment or intervention groups to control or comparison groups. Determining the impact of social programs requires comparing the conditions of those who received assistance with the conditions of an equivalent group that did not experience the intervention. However, evaluations differ by the quality of methodology used to separate the net impact of programs from other factors that may explain differences in outcomes between comparison and intervention groups.[4]

Experimental evaluations are the "gold standard" of evaluation designs. Randomized experiments attempt to demonstrate causality by (1) holding all other possible causes of the outcome constant, (2) deliberately altering only the possible cause of interest, and (3) observing whether the outcome differs between the intervention and control groups.

When conducting an impact evaluation of a social program, identifying and controlling for all the possible factors that influence the outcomes of interest is impossible. We simply do not have enough knowledge to accomplish this task. Even if we could identify all possible causal factors, collecting complete and reliable data on all of these factors would likely still be beyond our abilities. For example, it is impossible to isolate a person participating in a social program from his family in order to "remove" the influences of family. This is where the benefits of random assignment become clear.

Because we do not know enough about all possible causal factors to identify and hold them constant, randomly assigning test subjects to intervention and control groups allows us to have a high degree of confidence that these unidentified factors will not confound our estimate of the intervention's impact. Random assignments should evenly distribute these unidentified factors between the intervention and control groups of an experimental evaluation.

However, the benefits of random assignment are most likely to occur when large sample sizes are used. Randomized evaluations using small sample sizes do not have the same scientific rigor as randomized evaluations using large sample sizes. Random assignment helps to ensure that the control group is equivalent to the intervention group in composition, predispositions, and experiences. Randomization is supposed to result in the intervention and control groups having an identical composition. The groups are composed of the same types of individuals in terms of their program-related and outcome-related characteristics. In addition, the intervention and control groups should have identical predispositions. Members of both groups are similarly disposed towards the program. Further, the intervention and control groups should have identical experiences with regards to time-related internal validity processes, such as maturation, and history.[5]

Randomized experiments have the highest internal validity when sample sizes are large enough to ensure that idiosyncrasies that can affect outcomes are evenly distributed between the program and control groups. With small sample sizes, disparities in the program and control groups can influence the findings. For this reason, evaluations with large samples are more likely to yield scientifically valid impact estimates.

Multi-site designs. Congress can take several steps to ensure that federal social programs are properly assessed using experimental evaluations. These experimental evaluations should be large in scale and based on multiple sites to avoid the problems of simplistic generalizations. A multitude of confounding factors influences the performance of social program. Thus, the larger the size of the evaluation (e.g., sample size and number of sites), the more likely the federal social program will be assessed under all of the conditions under which it operates.

When Congress creates social programs, the funded activities are implemented in multiple cities or towns. While individual social programs operating in a single location and funded by the federal government may undergo experimental evaluations, these small-scale, single-site evaluations do not inform policymakers of the general effectiveness of national social programs. Small-scale evaluations assess only the impact on a small fraction of the people served by federal social programs. The success of a single program that serves a particular jurisdiction or population does not necessarily mean that the same program will achieve similar success in other jurisdictions or among different populations. Simply, small-scale evaluations are poor substitutes for large-scale, multisite evaluations. As will be detailed later in my testimony, Congress created the national Early Head Start program based upon the findings of the small-scale Carolina Abecedarian evaluation. After undergoing a multisite experimental evaluation, the federal government failed to replicate original effects of the Abecedarian Project on a national scale.

Thus, federal social programs should be evaluated in multiple sites so that social programs can be tested in the various conditions in which they operate and in the numerous types of populations that they serve. In addition, a multisite experimental evaluation that examines the performance of a particular program in numerous and diverse settings can potentially produce results that are more persuasive to policymakers than results from a single locality.[6]

The case of police departments performing mandatory arrests in domestic violence incidents is a poignant example of why caution should be exercised when generalizing findings from a single evaluation. During the 1980s, criminologists Lawrence W. Sherman and Richard A. Berk analyzed the impact of mandatory arrests for domestic violence incidents on future domestic violence incidents in Minneapolis, Minnesota.[7] Compared to less severe police responses, the Minneapolis experiment found that mandatory arrests lead to significantly lower rates of domestic violence. Sherman and Berk urged caution, but police departments across the nation adopted the mandatory arrest policy based on the results of one evaluation conducted in one city.

However, what worked in Minneapolis did not always work in other locations. Experiments conducted by Sherman and others in Omaha, Nebraska; Milwaukee, Wisconsin; Charlotte, North Carolina; Colorado Springs, Colorado; and Dade County, Florida, found mixed results.[8] Experiments in Omaha, Milwaukee, and Charlotte found that mandatory arrests lead to long-term *increases* in domestic violence. Apparently, knowing that they would automatically be arrested prompted repeat offenders to become more abusive. It seems that the following sick logic occurred: If the offender is going to automatically spend the night in jail, then he might as well beat his wife or girlfriend extra good. In a subsequent analysis of the disparate findings, Sherman postulated that arrested individuals who lacked a stake in conformity within their communities were significantly more likely to engage in domestic violence after arrest, while married and employed arrested individuals were significantly less likely to commit further domestic violence infractions.[9] Thus, mandatory arrest policies may be more likely to work in communities with high rates of marriage and employment, than communities with lower rates of marriage and employment.

Contradictory results from evaluations of similar social programs implemented in different settings are a product not only of implementation fidelity (the degree to which social programs are implemented as originally intended), but also of the enormous complexity of the social context in which these programs are implemented. Jim Manzi, a senior fellow at the Manhattan Institute, uses the conflicting results of experimental evaluations to explain the influence of "causal density" on the social sciences.[10] "Causal density," a term coined by Manzi, is "the number and complexity of potential causes of the outcomes of interest."[11] Manzi postulates that as causal density rises, social scientists will find greater difficulty in identifying all of the factors that cause the outcome of interest.

The confounding influence of causal density likely contributed to contradictory effects of mandatory arrest policies by location. To address causal density, experimental impact evaluations of federal social programs should be conducted using multiple sites. In fact, the total sum of the multiple sites should be nationally representative of the populations served by the social program being evaluated. Combined with random assignment, this approach is the best method for assessing the effectiveness of federal social programs.

Using evidence from scientifically rigorous multisite experimental evaluations of national programs, my testimony makes the case that real reductions in spending or slowing the rate in increase in spending on early childhood education and youth job-training programs will not harm children and youth. The reason for my conclusion is that the best research available finds that these social programs are highly ineffective. With the federal government's debt approaching $17 trillion, the American public has nothing to fear from reduced funding for ineffective social programs.

Early Childhood Education Programs

Proponents of expanding early childhood education programs make scientifically unsupportable generalizations regarding effectiveness based on two small-scale evaluations—the High/Scope Perry Preschool and Carolina Abecedarian Projects—that are nowhere near being the definitive studies on the subject.[12] Policymakers should be very skeptical about speculated payoffs to society based upon two small-scale evaluations of early childhood education programs.[13] For example, James Heckman of the University of Chicago and his coauthors estimate that the Perry program, an early childhood education program that primarily targeted black children, produced $7 to $12 in societal benefits for every dollar invested.[14] The major benefit of the program is derived from reduced crime.[15]

Based on Heckman's research, President Barack Obama during his 2013 State of the Union Address made the broad generalization that "Every dollar we invest in high-quality early childhood education can save more than seven dollars later on—by boosting graduation rates, reducing teen pregnancy, even reducing violent crime."[16] President Obama is making a narrow-to-broad generalization, where he assumes that a program implemented in Ypsilanti, Michigan will have the same effect everywhere else in the nation. There are several problems with making broad policy generalizations based upon the Perry and Abecedarian evaluation findings.

First, the results of these outdated evaluations have never been replicated. The evaluation of the Perry program began in 1962. Despite all the hoopla, the results have never been replicated. In more than 50 years, not a single experimental evaluation of the Perry approach applied in another setting or on a larger-scale has produced the same results. The same holds true for the Abecedarian program which began in 1972. There is no evidence that these programs can produce the same results today.

Second, as Amy E. Lowenstein of New York University points out, the Perry and Abecedarian findings are based on very small samples of children (123 and 111, respectively).[17] The small sample sizes pose serious drawbacks to making assertions about effectiveness.

Commenting on the Perry and Abecedarian evaluations, Charles Murray of the American Enterprise Institute correctly observes,

> The main problem is the small size of the samples. Treatment and control groups work best when the numbers are large enough that idiosyncrasies in the randomization process even out. When you're dealing with small samples, even small disparities in the treatment and control groups can have large effects on the results. There are reasons to worry that such disparities existed in both programs.[18]

Third, the sample children for the Perry and Abecedarian evaluations consisted almost entirely of low-income blacks.[19] Can these programs have the same effect on whites and Hispanics? There is virtually no evidence that the results of the Perry and Abecedarian evaluations can be generalized to other populations.

Fourth, the beneficial impacts of these programs appear to be restricted to females in the treatment group.[20] According to Lowenstein, "treated females showed sharp increases in years of schooling, improved economic outcomes, reductions in criminal behavior and drug use, and increased marriage rates, but there were no significant long-term effects for males."

Fifth, the findings cannot be generalized to other locations.[21] Lowenstein warns that "we must be cautious in drawing conclusions about crime effects based on the reductions in crime found in the Perry Preschool study, because there is no way to know if these effects were specific to Ypsilanti, Michigan, where the Perry Preschool was located, or if they would have emerged regardless of where the study took place."[22]

Sixth, Robinson G. Hollister of Swarthmore College has pointed out that while the Perry evaluation was initially supposed to be based on random assignment, "the researchers made several nonrandom adjustments to the assignment, for instance, moving siblings so that they would be together in the treatment or control group, or moving all children of working mothers to the control group."[23] As a result, 20 percent of the sample used to make inferences about the effectiveness of the programs was not randomly assigned. For Hollister, the failure to carry out the experimental design "greatly undermine[s] one's ability to take estimates of the 'impacts' as sound."[24] The bottom line is that the Perry evaluation is not really based on a true experimental design, and, thus, it does not benefit from the strong internal validity of true experimental designs.

Seventh, the impacts of the Perry program seesaw over time. According to Hollister,

> Further doubts about the reliability of the estimates arise from the fact that the estimated impacts in given areas, for example, academic achievement test scores, vary sharply over time (age of the child). For instance, the crime data suddenly show big differences in favor of the program in the age 27 data. The estimated impacts on crime play a large role in the overall high benefit-cost ratios that have been highly touted.[25]

Suddenly, the benefits of the program are prevalent long after the individuals participated in the program.

Last, the Perry and Abecedarian programs are not representative of the vast majority of early childhood education programs operating today. These programs were "carefully constructed, high quality, expensive programs" that "do not reflect the assortment of scaled-up [early childhood education] programs available to most low-income families with young children today."[26] The Perry and Abecedarian programs "represent the exception rather than the rule."[27] Thus, Lowenstein concludes that the claims of advocates are "somewhat misleading."[28]

The Perry and Abecedarian programs are not realistic models to draw conclusions about the effectiveness of federal early childhood education programs. Fortunately, we have ample evidence based upon multisite experimental evaluations.[29]

Early Head Start. Early Head Start, created during the 1990s, is a federally funded community-based program that serves low-income families with pregnant women, infants, and toddlers up to age three. The results of the multisite experimental evaluation of Early Head Start are particularly important because the program was inspired by the findings of the Abecedarian Project.[30] By the time participants reached age three, Early Head Start had beneficial impacts on two out of six outcome measures for child cognitive and language development, while the program had beneficial effects on four out of nine measures of child-social-emotional development.[31] While the short-term (age three) findings indicated modest positive impacts, almost all of the positive findings for all Early Head Start participants were driven by the positive findings for black children. The program had little to no effect on white and Hispanic participants, who are the majority of program participants. For Hispanic children, the program failed to have a short-term impact on all six measures of child cognitive and language development, while the program had a beneficial effect on only one of nine measures of child-social-emotional development. For white children, the program failed to produce any beneficial impacts on these outcome measures.

For the long-term findings, the overall initial effects of Early Head Start at age three clearly faded away by the fifth grade.[32] For the 11 child-social-emotional outcomes, none of the results were found to have statistically meaningful impacts.[33] Further, Early Head Start failed to have statistically measurable effects on the 10 measures of child academic outcomes, including reading, vocabulary, and math skills.

What happened when the long-term results were analyzed by race and ethnicity? There were only two beneficial impacts for black children on 11 of the child-social-emotional outcomes. For Hispanic and white children, there was no beneficial effects for all these outcomes.

For child academic outcomes, the long-term findings by race and ethnicity were consistent. Early Head Start failed to affect all 10 academic outcomes for each of the subgroups.

Head Start. Created as part of the War on Poverty in 1965, Head Start is a preschool community-based program intended to help disadvantaged children catch up to children living in more fortunate circumstances. Despite Head Start's long life, the program never underwent a thorough, scientifically rigorous evaluation of its effectiveness until Congress mandated an evaluation in 1998. The Head Start Impact Study began in 2002, and the immediate-term, short-term, and long-term results released in 2005, 2010, and 2012, respectively, are disappointing.[34] According to *CQ News*, the 2012 study "revealed that children who attended Head Start had lost most of its benefits by the time they reached third grade."[35]This assessment is entirely wrong. Almost all of the benefits of participating in Head Start disappeared by kindergarten.

Overall, the evaluation found that the program largely failed to improve the cognitive, socio-emotional, health, and parenting outcomes of children in kindergarten and first grade who participated compared with the outcomes of similar children who did not participate. According to the report, "[T]he benefits of access to Head Start at age four are largely absent by 1st grade for the program population as a whole."[36] Alarmingly, Head Start actually had a harmful effect on three-year-old participants once they entered kindergarten. Teachers reported that non-participating children were more prepared in math skills than the children who participated in Head Start.

The third-grade follow-up to the Head Start Impact Study followed students' performance through the end of third grade.[37] The results shed further light on the ineffectiveness of Head Start. By third grade, Head Start had little to no effect on cognitive, social-emotional, health, or parenting outcomes of participating children.

In addition to the failures of Early Head Start and Head Start, multisite experimental evaluations of the Enhanced Early Head Start with Employment Services, which provides early childhood care and employment training services to families, and the now-defunct Even Start Family Literacy Program, which was intended to meet the basic educational needs of parents and children, failed to produce beneficial impacts.[38] The scientific rigor of these evaluations clearly demonstrates that the federal government has serious trouble operating early childhood education programs. These programs have done a poor job of improving the cognitive abilities and socio-emotional development of children.

Youth Job-Training Programs
The federal government has spent decades trying to improve the earnings of disadvantaged youth through various employment and training programs, but the Government Accountability Office has concluded that little evidence shows that youth and adult training programs are effective.[39]

Job Training Partnership Act (JTPA). Conducted in 16 sites across the nation during the late 1980s and early 1990s, the JTPA evaluation tracked program effects for more than 20,000 adult men, adult women, and out-of-school youths over the course of 30 months.[40] The performance of JTPA programs is widely considered to be a failure, especially for youth.

Overall, JTPA programs failed to raise the incomes of female youth and male youth without an arrest record prior to random assignment. However, JTPA programs had a harmful impact on the incomes of male youth with prior arrest histories. Even more alarming, male youth nonarrestees were more likely to be arrested for crimes after participating in training, compared to similar counterparts not given access to training.

Job Corps. Created in 1964, Job Corps is a residential job-training program that serves disadvantaged youths aged 16 to 24 in 125 sites across the nation. Before the U.S. Senate Committee on Appropriations, Subcommittee on Labor, Health and Human Services, Education, and Related Agencies in 2011, Secretary of Labor Hilda L. Solis testified that the "Job Corps program has a long history of preparing disadvantaged youth for a successful transition into the workforce."[41] Is Job Corps an effective program? Its primary hypothesis relating to employment and earnings is that "youth who obtain Job Corps education and training will become more productive and, hence, will have greater employment opportunities and higher earnings than those who do not."[42] Fortunately, we have a multisite experimental impact evaluation of Job Corps ("2008 outcome study") to assess the program's effectiveness.[43]

The 2008 outcome study found:

- Compared to non-participants, Job Corp participants were less likely to earn a high school diploma (7.5 percent versus 5.3 percent);[44]
- Compared to non-participants, Job Corp participants were no more likely to attend or complete college;[45]
- Four years after participating in the evaluation, the average weekly earnings of Job Corps participants was $22 more than the average weekly earnings of the control group; and[46]
- Employed Job Corps participants earned $0.22 more in hourly wages compared to employed control group members.[47]

If the Job Corps actually improves the skills of its participants, then it should have substantially raised their hourly wages. However, $0.22 increase in hourly wages suggests that Job Corps does little to boost the job skills of participants.

Other impact evaluations of Job Corps have found similar results. In 2001, the *National Job Corps Study: The Impacts of Job Corps on Participants' Employment and Related Outcomes* ("2001 outcome study") measured the impact of the Job Corps on participants' employment and earnings.[48] While the 2001 outcome study found some increases in the incomes of participants, the gains were trivial. For example, compared to non-participants, the estimated average increase in the weekly incomes of all participants over four years was never more than $25.20.[49]

Another evaluation, the *National Job Corps Study: Findings Using Administrative Earnings Records Data* ("2003 study"), was published in 2003, but the Labor Department withheld it from the general public until 2006.[50] The 2003 study found that Job Corps participation did not increase employment and earnings. Searching for something positive to report, the 2003 study concludes that "There is some evidence, however, of positive earnings gains for those ages 20 to 24."[51]

Why Withhold the 2003 Study? Based on survey data, the 2001 cost-benefit study assumed that the gains in income for participants will last indefinitely, a notion unsupported by the literature on job training.[52] But included in the 2003 study is a cost-benefit analysis that directly contradicts the positive findings of the 2001 cost-benefit study.

The 2003 study used official government data, instead of self-reported data, and used the more reasonable assumption that benefits decay, rather than last indefinitely.[53] Contradicting the 2001 cost-benefit study, the 2003 study's analysis of official government data found that the benefits of the Job Corps do not outweigh the cost of the program. Even more damaging, the 2003 study re-estimated the 2001 cost-benefit study with the original survey data using the realistic assumption that benefits decay over time. According to this analysis, the program's costs again outweighed its benefits.

Is Job Corps Worth $1.7 Billion Per Year? According to Job Corps, the cost of the program per participant in program year 2009 was $26,551.[54] This estimate excludes program administration expenses, so it undercounts the true cost of the program on a per participant basis. The Office of Inspector General estimates that the actual cost per participant is $37,880—a difference of $11,329.[55] Perhaps a more important performance metric is the cost per successful job placement. For this measure, the OIG estimates that each Job Corps participant who is successfully placed into any job costs taxpayers $76,574.[56]

If Job Corps actually improves the skills of its participants, then it should have substantially raised their hourly wages. The 2001 study found participants earned $0.24 more per hour than nonparticipants.[57] Six months later, this difference had decreased to $0.22 per hour.[58] Job Corps does not provide the skills and training necessary to substantially raise the wages of participants. One is certainly within reason to question whether the program is a waste of taxpayers' dollars as it costs $76,574 per participant placed in any job with an average participation period of eight months,.

JOBSTART. The JOBSTART Demonstration evaluated the impact of 13 job-training programs that were offered by community-based organizations, schools, and the Job Corps across the nation.[59] The targets of the training programs were 17- to 21-year-old "economically disadvantaged" school dropouts with poor reading skills. Overall, the programs failed to increase the earnings of participants. Of the 13 sites, 12 were found to be ineffective at raising the incomes of participants.[60] However, one site—the Center for Employment Training (CET) in San Jose, California—had a positive impact on earnings. For policymakers, the important question is whether the CET results can be replicated at different sites and for different populations.

CET Replication. Based on the JOBSTART evaluation results for the CET program in San Jose, California, the U.S. Department of Labor, in 1992, sought to replicate the program at 16 other sites across the nation. Twelve of the sites were evaluated.[61] The key elements of the CET model include a full-time commitment to participate in employment and training services in work-like settings.[62] In addition, employers were involved in designing and delivering services.[63]

In a classic example of not being able to replicate the results of a "proven" social program, CET Replication job-training programs failed to increase the employment and earnings of participants. Over more than a five-year follow-up period, the CET model had little to no effect on the employment and earnings outcomes at these 12 locations. The multisite experimental evaluation of CET, according to its authors, "shows, that even in sites that best implemented the model, CET had no overall employment and earnings effects for youth in the program, even though it increased participants' hours of training and receipt of credentials."[64]

However, CET participation was associated with some harmful outcomes. Male youth experienced declines in employment, earnings, and number of months worked. Individual participants who possessed a high school diploma or GED at the time of random assignment experienced declines in the number of months worked and earnings.

Quantum Opportunity Program (QOP). The Quantum Opportunity Program (QOP) demonstration, operated by the U.S. Department of Labor and the Ford Foundation from 1995 to 2001, offered intensive and comprehensive services with the intention of helping at-risk youth graduate from high school and enroll in postsecondary education or training.[65] As an afterschool program, QOP provided case management and mentoring, additional education, developmental and community service activities, supportive services, and financial incentives.[66] QOP provided services to participants year-round for five years. The results of the QOP demonstration are particularly important because the program included several features of Workforce Investment Act's (WIA) youth programs' funding stream.[67]

QOP has many similarities with WIA youth programs, including:

- Case management and mentoring by adult staff;
- Basic education and study skills tutoring;
- Community service training;
- Year-round services, including summer jobs;
- An assortment of support services, including transportation, childcare, food, and emergency financial assistance; and
- Technical assistance to local service providers.[68]

According to the authors of the QOP evaluation:

> These similarities between QOP and WIA youth programs suggest that the findings from the evaluation of the QOP demonstration might reveal some of the implementation challenges that WIA youth programs might encounter and *indicate whether WIA youth programs are likely to be effective* [Emphasis added].[69]

Thus, the findings from the QOP experimental evaluation, according to its authors, provide some insight about the effectiveness of WIA youth programs.

The QOP demonstration was implemented at seven sites across the nation. Five sites were funded by the Department of Labor, while the remaining two sites were funded by the Ford Foundation.[70] The total cost per participant for the Labor-funded sites was $18,000 to $22,000, while the cost per participant in the Ford-funded sites ranged from $23,000 to $49,000.[71]

At the initial and six-year follow-up periods, participation in QOP failed to have beneficial impacts on the employment and earnings of participants.[72] The job skills learned from QOP apparently had no effect on earnings. However, youth participating in QOP were more likely to be arrested by the six-year follow-up period. In addition, these youth were less likely to find jobs that provided health insurance benefits.

Conclusion

Do federal early childhood education and youth job-training programs work? Based on the scientifically rigorous multisite experimental evaluations, the answer certainly cannot be in the affirmative. Despite the best social engineering efforts, overwhelming evidence points to the conclusion that these social programs are ineffective.

It cannot be just a coincidence that these multisite experimental evaluations overwhelmingly find failure. While we all agree on the importance of children having a solid foundation when entering school, this belief, no matter how noble, does not change the fact that federal early childhood education programs are ineffective. The same holds true for youth job-training programs.

Concerns over effects of sequestration on children and youth are unwarranted. Reduced funding for ineffective programs will not harm children and youth, because these programs largely do not work in the first place. Private companies are not hurt by eliminating inefficient divisions and neither are people when ineffective government programs are cut. In fact, reduced government spending will likely help children face a smaller financial burden of enormous debt that Congress's overspending has already imposed upon them.

Our nation faces a severe debt crisis that threatens our very future. Americans should not fear reductions in funding for these social programs. Now is the time for deep budget cuts to federal social programs.

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Chairman MURRAY. Thank you very much to all of our witnesses. We are going to rounds of questions, and, again, we have votes at 11:30, so I am going to hold everybody to 5 minutes here.

Let me just start with Ms. Nimmo Crowe and Mr. Lesley. You testified a little bit about sequestration. I am very concerned that this management from crisis to crisis has really put us in a bad place and sequestration is really harming our young kids. You talked a little bit, Ms. Nimmo Crowe, about the impacts of that. You gave us some good numbers. Tell us a little bit about how you see the effects of sequestration in the future if we continue to take things away from kids today. You talked about one child with disabilities and the costs later. Broaden that out and talk a little bit about some of the other costs you see.

Ms. Nimmo Crowe. Thank you. Well, I think that what we see is that demand is going up. Certainly with the increase in the number of children in poverty, the 52- percent increase in the number of children identified as needing early intervention services, the demand for the services that we are talking about is not going down. And so if sequestration is to continue, it does two things. It is whatever the percentage cut is that is passed down to the States and to the localities, but it is also going to be that ripple effect that State governments have. You know, we have to balance our budget at the State level, and we have to plan. Our sessions are short. We are not in session all the time. So in January and February of every year, our legislators have to make their best guess in terms of what is going to be available for these programs in the future. And in Virginia, we have a wonderful record of being very fiscally conservative, and so we are going to hedge on the side of pulling aside more money. And while that is smart on the one hand, on the other hand we are pulling services away from the very children who need them right now who are in front of us.

I think the other piece of that that comes out is the difficulties that, you know, this is all very nice when we are talking about it at a hypothetical level, but when you are a local program that is trying to serve families in need and children in need, it is very difficult to do your planning. There is an example of an organization, a nonprofit organization in Williamsburg and in James City County that serves vulnerable young children and their families, Child Development Resources. CDR was telling me about the juggling act that they have where, 2 years ago, State funding was cut for their evidence-based home visiting programs for vulnerable families that are for health promotion and also child abuse prevention and neglect prevention. And so those programs all went away.

Then the Federal Government came forward with new home visiting money, which is wonderful, and they have been able to start up those programs again. But at the same time they are starting up those home visiting programs, they are pulling 12 slots out from their early Head Start families, and their child care subsidies vanished months ago.

So it is a constant juggling act. It is very hard to plan, and vulnerable families are falling through the cracks right now and we know will continue to do that if these cuts continue.

Chairman MURRAY. And, Mr. Lesley, if you could just really quickly, because I want to get to a couple other questions, and I just have a short amount of time. For the record, if you could give us your information, but just quickly in 20 seconds, if you could tell me the top sequestration impact you have seen.

Mr. LESLEY. Absolutely. The big cuts thus far have been, you know, we have seen the cuts in Head Start and these lotteries and the loss of slots. But in the long term, we are also seeing that there are now cuts in military education, Indian health clinics—I used to work for Senator Bingaman, and those are devastating in States with Native American populations. And then in the fall, we are going to start seeing those impacts on public education, and those are going to be devastating, and because Federal money is predominantly to low-income programs like Title I and other things, what you are going to see is major disproportionate hits on schools that have high need and low resources.

Chairman MURRAY. And if you can get that to us in writing, I would appreciate it.

Mr. LESLEY. Absolutely.

[The information follows:]

/ COMMIT

Chairman MURRAY. Sakhia, I just wanted to ask you really quickly, thank you so much for your courage in coming and talking to us. Do you think the extra help that you got early on in Head Start would have assisted your classmates that you see that did not have it perhaps be on the honor roll?

Miss Whitehead. May you repeat that again, please?

Chairman MURRAY. So you got the advantage of having Head Start, and you are on the honor roll today. You have friends in your class who did not get Head Start that you probably know. Do you think Head Start would have helped them, too?

Miss Whitehead. Yes.

Chairman MURRAY. In what ways?

Miss Whitehead. Because I am on the honor roll, maybe I could help them get on the honor roll.

Chairman MURRAY. Okay. Well, I really appreciate your coming, and I just have a few seconds left. But, Mr. Lesley, I just have to ask you—I am sorry. Mr. Muhlhausen, I read your testimony and you criticized all of us in Congress who listen to people at hearings who, in your words, and I quote, "come hat in hand" and express their "self-serving personal opinions," and you question about personal observations or experience being useful. I happen to think that as a legislator, it really makes a difference when I go home and hear from families in my communities about the impacts that the Federal Government has on their lives, and I think it is really important that we listen to those kinds of people. You just had an opportunity to hear from two here, and I am just curious: Do you think what we heard from Ms. Collier and Sakhia was not worth it for us to hear today?

Mr. MUHLHAUSEN. Well, when you look at the effectiveness of programs, whether they work or not—

Chairman MURRAY. Do you want to turn your mic on?

Mr. MUHLHAUSEN. —which are funded on a national level, programs that are funded on a national level, the Federal Government does not just operate a program in a single location. It funds programs all over the country. And you have to look at the national effect, whether these programs actually work or not. And you can always find somebody who is going to praise the program, but Congress never invites anybody to say, "Well, you know what? I do not know if the program works or not or the program does not work." Congress never invites those people, because the idea is always they find people who are going to praise the program and ask for more money—

Chairman MURRAY. But do you think—

Mr. MUHLHAUSEN. —and right now we have a huge debt that we just cannot afford.

Chairman MURRAY. Do you think the perspective of Sakhia who lived through this program is important for us to hear?

Mr. MUHLHAUSEN. Well, I think it is important, but you cannot judge the national effectiveness of a particular program based on one person's opinion. You need to look at the scientific research.

Chairman MURRAY. Well, I would just say to you I am not trying to judge the entire program. I just think when I go home and hear people from all different kinds of walks of life, which is what every member of the legislature does, and we have the opportunity to hear from them today, it is important for us to hear. So I just wanted to clarify that. I was kind of offended by your remarks in your testimony.

Senator SESSIONS. Well, thank you, and thank you, Sakhia, for your testimony, and I am glad you are doing well in school. Congratulations and keep it up. We are not doing what we should do in math, and you are particularly to be congratulated for being good in that. And if you were a math teacher, you would have a lot of people who would want to hire you to go to work because we have a shortage of those in America today.

I am concerned—now, I will ask Mr. Muhlhausen and Mr. Lesley this question—well, first, Ms. Crowe, with regard to Virginia and the importance they placed on fiscal management, your remarks talk about the danger of reductions in spending. But based on your study, have you concluded that many of the programs that are operating could be operated better, that there could be better State-Federal coordination, that there might be activities that could produce better results than the current way we are doing it for even less money on occasion?

Ms. Nimmo Crowe. Well, I think that is a great question. Thank you. I think that there are ways in Virginia that we are looking at how programs are run. I think that is happening all across the country. I think continuous quality improvement and those types of initiatives are very important. I can tell you that in Virginia we have been funding evidence-based home visiting programs for a very long time, and I was just talking about those. The new Federal funding that has come out, the MIECHV funding for home visiting, includes very specific performance targets for those programs that are getting the funding. They can only go to particular areas that have a very high level of need. We welcome that in Virginia. That is what we have been doing.

I think we are looking at implementing coordinated care in Medicaid in Virginia and ways that we have not in the past, for example, in the behavioral health services. So I think there is certainly always room to be looking at how these things are working.

I think when it comes to being fiscally prudent and responsible at the State level, it is always a balancing act. And I do not pretend to have all the answers. I am merely a child advocate. But it is my job to be here today to let you all know that there are real consequences to these very difficult decisions, and oftentimes I am the only one in the room in Virginia who is pointing that out. So thank you for the opportunity to do that today.

Senator SESSIONS. Well, I thank you, and Governors Warner and Kaine and King work hard to deal with the budget issues that they face. And I can say I think without being contradicted that States are on a regular basis advancing new and better ideas to get results for the amount of money they spend. And the real truth is that the Federal Government is just continuing the programs that we have, basically sending the same money out. Maybe now it is going to be reduced some because of our financial crisis. But I just want to say the Federal Government, Madam Chair—and this hearing has some potential for us. We need to see if we cannot do better with the amount of money we spend, because the reality is we are not going to have large increases, and the reality is that even as a percentage of GDP, we are one of the highest nations in the whole world on—I think only Denmark maybe has a higher percentage of GDP on education than we spend. So we need to use every dollar wisely and try to get the most bang for the buck.

I am concerned, and I think we need to think about— maybe I will ask Mr. Lesley and Mr. Muhlhausen to answer, just give thoughts about it, because our time is short. This study that was produced by Health and Human Services, not by an independent group but their own Department, determined that by the end of the third grade, regarding Head Start, there were very few impacts. And in any of the four domains of cognitive, social-emotional health, and parenting practices of children granted access to Head Start during the period of the study. And it ultimately found that few impacts were found that showed a favorable or unfavorable impact on the children.

So I guess my first question is: We invest a lot in Head Start. Can we make it better to get the improvements that we would like to see in that area? Mr. Muhlhausen and Mr. Lesley. And I do not have much time. I am sorry—

Mr. MUHLHAUSEN. Well, I would say that one of the things—you are talking about the National Head Start Impact Study, and it really found that most of the cognitive benefits disappeared by kindergarten. So the effect of the program quickly faded away. And I am not sure if the Federal Government can run a program effectively from

Washington, D.C. I would say that a more effective program would let the States take the lead, let local governments take the lead. Let them raise the money to run their programs and have those programs live and die on the success the local perceive or find their programs to be operating. I think that is the best model. It allows for the greatest variation and experimentation to find out what actually works.

Senator SESSIONS. Thank you.

Mr. Lesley?

Mr. LESLEY. Thank you, Senator Sessions. I think it is important to point out with respect to Head Start that the numbers actually do improve in the short term, and there is a fade-out in terms of standardized testing, but in a lot of other areas, there is longitudinal data that shows that Head Start has been very effective in terms of less use of special education and, you know, graduating from high school, and in the long term things like employment have also been very positive effects of Head Start. And I also think we need to be a little bit careful about drawing the wrong conclusions. In terms of the fade-out, one of the things there is that in elementary school there are interventions that take place, like you had family members who are early education teachers, and there is enormous investments also that the Federal Government makes in terms of interventions. So while the Head Start kids, you know, as our witness testified, come to school reading in a better way, what happens is the kids that were behind then catch up because there are these interventions in terms of reading programs and other things.

So I think that the catch-up shows that Head Start works and that then K–12 actually kicks in and there is some catch-up. So the catch-up is an important thing to think about, and I do not think it says that Head Start does not work. I think it shows that Head Start worked and then K–12 then moves in and takes it, you know, into effect and then catches people up.

Senator SESSIONS. Well, thank you, and we have an absolute duty to serve the children effectively, and we need to make sure every dollar we spend is wisely used to get a good result. And I am confident we have a long way to go from our Federal Government.

Chairman MURRAY. Senator Kaine.

Senator KAINE. Thank you, Madam Chair. And to the witnesses, it is great especially to have Margaret Nimmo Crowe here from Virginia. I appreciate your great work with Voices. I have a comment and then a line of questioning.

I think the testimony of the witnesses—and maybe especially the written testimony—sheds some light on one of the challenges, Madam Chair, that we are having about trying to get the Senate budget into conference with the House. And this is not a comment about any of the members of this Committee. We all worked on a budget, and we amended it, and we might have voted yes or no. But when we passed it in March, I think it was with all of our expectation that we would go into a conference with a very different House budget.

Page 4 of Mr. Lesley's testimony and page of Ms. Nimmo Crowe's testimony talks about some of the comparisons between the House and Senate budget. And I think they really illuminate why a handful of Senators do not want the budget in conference, and that is not any of the members of this Committee. These Committee members are not standing and trying to block that budget from going into conference on the floor. But the handful it is, I am convinced are trying to block the budget from going into conference because the differences between the budgets, especially on issues like this affecting children, are so vast that they do not think the comparison will help their point of view and their House colleagues.

But I am glad that you have illuminated those differences, and I hope, Madam Chair, we might do some more things to illuminate the differences if that blocking of conference will continue. But, again, page 4 of Mr. Lesley's testimony and page 2 of Ms. Nimmo Crowe's testimony is helpful.

Ms. Nimmo Crowe, you and then Ms. Collier talked about an issue that I am really interested in, which is the reduction of funding for young kids with developmental delays, what that means. The reduction of funding to focus on children with special needs has an immediate effect on those children, and we are seeing those reductions very sizably based on sequester; and if the House budget were to go into effect, they would have a significant effect as well.

But both of you sort of from a statistical standpoint, and, Ms. Collier, from your own experience, you kind of shared the notion that it is also sort of penny wise and pound foolish if you reduce money for young kids with developmental delays, you block their ability to get that assistance at a young age and then basically get right back on the on ramp and be right where the rest of their colleagues are.

I learned that again and again in working on early childhood education issues in Virginia that just a little bit of early intervention for youngsters who have a developmental delay might mean years where they are not in special education classes when they are in the K–12 system that is both great for them and also saves us a lot of money.

So I would love it if you would each talk about it maybe a little bit from the system standpoint. And maybe, Ms. Collier, I will start with you. You just shared the story that, you know, one of your youngsters was identified with a developmental disability, and Head Start helped them get right back on track when they moved to elementary school.

Ms. COLLIER. The child that we are speaking of, she is still in Head Start, but she is reading—well, she is not reading now, but she is spelling her name, and without the services that she did get in Head Start, I do not think she would be able to do that. She has gotten speech therapy and also other therapy that helped her, and she is now on the level that she should be with the services that she got in Head Start.

Senator KAINE. And your feeling today is that when she starts kindergarten she will be—

Ms. COLLIER. She will be ready.

Senator KAINE. First, at a level with her colleagues, but in a place that she would not have been had she not had that assistance and that diagnosis of the developmental—

Ms. COLLIER. Exactly.

Senator KAINE. Great. Thank you.

Ms. Nimmo Crowe?

Ms. Nimmo Crowe. And I would just add to that, we cannot escape the fact that the first 5 years of brain development are absolutely critical for children. And so when we miss that window, we have missed a huge opportunity. And certainly the types of disabilities and delays that children have in early intervention run the gamut from horrible problems that are never going to be fully remediated, but those children can still live up to their potential to fairly minor but very troublesome problems that can easily be corrected with a little bit of physical therapy or occupational therapy that can then get that child right back on track to where they need to be.

And you are exactly right, it is important to remember that Part C, the Early Intervention Program, is part of IDEA, the special education program. So at age 3, those children transfer into Part B in the school system, and that is more Federal, State, and local money that we are spending on those kids, and that is the lifetime from age 3 until they graduate that we are spending that we could have in many cases ameliorated right before they turned 3.

Senator KAINE. Ms. Nimmo Crowe, I also appreciate about your testimony, and you were talking with Senator Sessions about this, that you are not coming and I do not view any of you as coming to this Committee and just saying, hey, you know, it is just all about more money. You are interested in the management and the effectiveness side, too. You have a part of your testimony about fragmentation of Federal funding and how that can create gaps and inefficiencies in the system. We saw that at the State level, too. We ought to be committed to investing in our kids, and we ought to be committed to making sure that the investments are done the best possible way. We ought to be a culture of continuous improvement, always wanting to be better tomorrow than we are today. And I appreciated that your testimony offered us some ideas about how we can not only invest the right amount but then get better about how we make the investments.

Thank you, Madam Chair.

Chairman MURRAY. Thank you.

Senator Johnson?

Senator JOHNSON. Thank you, Madam Chair, and I want to thank all the witnesses, particularly Sakhia. We are all proud of you. You should be proud of yourself, and we certainly hope that you go on to great things. We love the fact that you are also interested in math. We need a lot of that. So, again, congratulations.

We are a compassionate society. I think all Americans want a strong social safety net. I think all Americans certainly understand that education is vital and we have got to get the kids and provide them a good education.

But to a certain extent, we are whistling past a graveyard in terms of our financial situation in this country. We are talking about sequester. It is part of the Budget Control Act, which was, unfortunately, a minimal response to what is going to be over 30 years maybe $100 trillion worth of deficit spending. You know, my concern is if we do not address that, if we do not impose that fiscal discipline on ourselves, the markets will do it.

From 1970 to 1999, the average interest expense or interest rate the Federal Government paid was 5.3 percent. We have been paying about 1.5 percent. If we revert to that average, that is going to add another $600 billion per year to our annual interest expense. Of course, CBO is estimating we will be at that 5.3 percent.

So, you know, Mr. Muhlhausen, I agree with you. You have to look at the empirical evidence, and I have actually got the last 4 charts in my PowerPoint presentation I give all over America that kind of addresses this. So let us look at a little facts and figures.

You know, again, America is a compassionate society. In the mid-1960s, because we saw poverty rates too high, the number of people in positive too high, quite honestly it had actually been declining by the mid-1960s, but it was still too high, and unfortunately, out-of-wedlock birth rates had gone from 4 percent in the 1940s and doubled to 8 percent. So, again, America, very compassionate. We want to be able to help people help themselves. We embarked collectively on what has turned out to be a $16 trillion War on Poverty.

What were the results? Next slide.

We went from 23 million to 43 million Americans in poverty. You can say, well, the population grew, so let us take a look at poverty rates. They went from 12 percent to 14 percent. It is varied—and, Mr. Lesley, you remarked that we are at the highest level of child poverty today. Well, maybe, just maybe, on that very last metric, maybe all of our good intentions solved that problem. Let us check out—no, we went from 8 percent to 41 percent.

I think we have to start asking ourselves in this Nation the very hard questions. Have all the spending, have all the Government's intrusion into our lives, have they actually worked? I think you can argue—I think you need to consider maybe all of our good intentions have had some very harmful negative consequences.

And I will tell you what. If we do not get our debt and deficit under control—and sequestration is not a good way of doing it because Congress refuses to prioritize spending. We want to spend money on everything.

So, Mr. Lesley, I just want to ask you, do you acknowledge the danger in terms of our budget deficit and how harmful $600 billion of additional interest expense would be in terms of every Government program? Does that not concern you?

Mr. LESLEY. Yeah, no, absolutely. In my testimony, I talked about—I am sorry. In my testimony I talked about how interest on the debt will actually exceed all Federal spending on kids by 2017, so I do believe that deficit reduction is a children's issue and something that is very important.

But I also note that what is happening is in these cuts, the share of spending for kids—kids are 25 percent of the population, and we are spending less than 8 percent of our funding on them. And so when we do across-the-board cuts, disproportionately those cuts are falling on kids. We exempt other areas, and so—

Senator JOHNSON. Yes, because two-thirds of the budget is off budget. It is on automatic pilot. It is not subject to appropriations, so the only thing that Congress can have any effect on is a very small slice, you know, a third of the budget, $1 trillion, which is difficult.

Mr. LESLEY. Right, which is disproportionately kids.

One chart in my testimony also to point to is on page 10 of the appendix. In my testimony what we show is the poverty rates for seniors from 1966 to 2010, and kids—

Senator JOHNSON. It has declined and poverty rates for—

Mr. LESLEY. —have not. And it is the difference between what Social Security means for seniors and what TANF does not mean for kids. And—

Senator JOHNSON. Okay. Before I run out of time, Ms. Nimmo Crowe, you are operating at the level that I think we really ought to be trying to solve these problems, the State and local levels. I would like you to just speak, you know, to your concern about the Federal mandates and the costs that the Federal mandates impose on the States. And how big a factor is that in terms of the States trying to grapple with these very serious issues?

Ms. Nimmo Crowe. Federal mandates on particular programs or just across the board?

Senator JOHNSON. Education—well, it is across the board, but particularly on education.

Ms. Nimmo Crowe. Well, I think that the Federal mandates are certainly something that the States grapple with. What I mostly hear, though, is frustration that there are mandates coming down from the Federal level to the State level or the State level to the local level without the appropriate funding to go with them.

Senator JOHNSON. Because we do not have the money to fund them.

Ms. Nimmo Crowe. Understandably. But it is a catch-22 if you are the person stuck trying to implement whatever the program is. So I think that that is certainly a concern. I think that we need to look broadly. There are obviously some decisions that have to be made, but I think Bruce is right that when we look at the disproportionate share of the burden that children are taking in terms of budget cuts, in terms of rising poverty, those are facts that simply cannot be ignored.

Senator JOHNSON. Well, I have a great deal of faith in individuals, in local governments, State governments, local teachers, school administrators. We see the Federal Government has not been particularly effective at it, so, again, thank you for what you are doing, and, again, I thank all the witnesses.

Ms. Nimmo Crowe. Thank you.

Chairman MURRAY. Okay. The vote had been called. We have two more Senators with time. Senator King?

Senator KING. I will try to be very brief.

Mr. Muhlhausen, I am very interested in your testimony because I, too, believe programs should work. And we are spending the taxpayers' dollars, and we should be sure that they are effective.

Do you believe that there is a possibility of an effective pre-school education, early childhood education program?

Mr. MUHLHAUSEN. I certainly do believe it. I just think that it is hard for the Federal Government to implement an effective program on a national scale. I think you can probably find throughout the country some small-scale local programs that are doing a wonderful job. But when you look at the programs on a national level in the Federal Government and say that—when the Federal Government created Early Head Start, it was based on the Carolina Abecedarian Project at a small-scale randomized experiment found to be effective. Well, we know that Early Head Start does not work today. So the Federal Government—

Senator KING. Excuse me. Is it all Early Head Start programs or is there a variation between programs?

Mr. MUHLHAUSEN. Well, you are going to have a variation, but when the Federal Government did an analysis of several Early Head Start programs across the country, they found that the program largely did not work. And so the Federal Government has a lot of trouble scaling up local—

Senator KING. But what I am trying to get at is what do we draw from that: that programs cannot work or that this particular one in the aggregate did not work, but where there are successful ones—I am interested in improvement, not elimination.

Mr. MUHLHAUSEN. Well, it is very hard for the Federal Government to take a small-scale program and blow it up on the national scale and have it be effective. Since 1990 there have been about 20 large-scale randomized experiments of Federal social programs. Only one of those evaluations finds a positive consistent effect, and that was welfare reform. All the other job training programs, the early childhood education programs, the various multitude of other programs that were looked at—housing vouchers—all failed the test of being effective.

The Federal Government has a hard time taking an effective idea done at the local level and blowing it up on the national level.

Senator KING. What if it simply provides funding and allows the local levels to determine how the program worked?

Mr. MUHLHAUSEN. Well, I think in many cases the Federal Government is doing that, and the problem is that when we assess the—we need to assess the effect of whether it works or not. We need to actually go in there and evaluate it and see if it works. And there are far too many programs today that are operating that do not get assessed. We maybe have some real good programs that we do not know about because we have never evaluated them. But the thing is, when we do do a national large-scale evaluation of Federal social programs, we almost always find disappointing results.

Senator KING. But I get back to the idea of is the concept good but the execution not good, assuming—I am assuming, by the way, the validity of the study, and I think there are questions about that study and what the more persistent grounds are that do not necessarily get picked up in various kinds of tests. But assume that if the—I mean, I cannot believe you would testify that early childhood education does not matter.

Mr. MUHLHAUSEN. Let me say—let me give you a good example of a good concept. In the 1980s, Minneapolis experimented with mandatory arrest for people who were committing domestic violence. What they found in Minneapolis, Minnesota, was that when they made a mandatory arrest, the offender was less likely to commit future domestic violence crimes in the future. Everybody was amazed. They replicated that policy across the country. And when they evaluated it in other sites, they found in some sites across the country the offender—and this is horrible—said, well—he had some sick logic where he ended up beating his spouse or girlfriend even more because he knew he was going to get a mandatory arrest, and he was going to spend the night in jail.

So a good idea that actually reduced harm in Minneapolis did not work in other localities. So sometimes programs work for specific localities because the circumstances are right. The people who are running the program are the best at doing it. The local conditions are right. So you are going to find success. But taking that idea and dropping it into other communities does not mean we are going to have the same success. And sometimes we have failure.

Senator KING. Let me make a general point I have made at this Committee before. The problem with the debts and the deficits is not Head Start. It is not Pell grants. It is not the national parks. It is health care, period. The driver of the Federal deficit over the next 25 years, with all these charts that show it going up, is health care. And I said this at a Committee before. Attacking Head Start when the real problem is health care is like invading Brazil after Pearl Harbor. We really should be talking about what is the real problem driving Federal debts and deficits.

Now, having said that, I do not disagree that we need to hold programs that we fund to a standard of effectiveness. And I think we need to continue to study them and continue to try to improve them. But to say because a study says we cannot find a numerical result from Head Start, says let us forget about Head Start, I just think defies common sense.

Do you have children, Mr. Muhlhausen?

Mr. MUHLHAUSEN. No, I do not.

Senator KING. Well, I have five children and five grandchildren. You cannot tell me that all the hours I spent reading to those kids when they were 1 and 2 and 3 years old did not matter. I know it matters. Early childhood education is probably one of the best investments we could make. The challenge, it seems to me, is not to say we should not do it but that we should do it better.

Thank you, Madam Chair.

Chairman MURRAY. Thank you very much.

And, Senator Whitehouse, you can wrap up.

Senator WHITEHOUSE. Thank you very much, Chairman.

Let me focus on Job Corps for a second, and, Mr. Muhlhausen, let me ask you about your testimony. About three-quarters of people who enroll at Job Corps, when they get started, before Job Corps kicks in, when they show up, when they first enroll, about three-quarters of them are high school dropouts. On average, they read at an eighth-grade level. Most have never had a full-time job. Do you believe that when a child first shows up at Job Corps they are facing more challenges, equal challenges, or fewer challenges than their peers?

Mr. MUHLHAUSEN. Well, I think they are facing a lot of challenges, but—

Senator WHITEHOUSE. A lot of challenges, right?

Mr. MUHLHAUSEN. Well, the research that I use in my testimony took Job Corps applicants who wanted to participate in the program. They all had similar backgrounds. They randomly assigned some of the students, some of the kids to be in Job Corps, and other students could not be in Job Corps. Then they looked at the success, whether the program worked—

Senator WHITEHOUSE. But you will concede—

Mr. MUHLHAUSEN. —and they found the program does very little.

Senator WHITEHOUSE. You will concede that a child showing up for Job Corps is in a different set of—facing a different set of challenges than their age group peer?

Mr. MUHLHAUSEN. Well, when I say "peer," when I think of peer, I mean a similar—

Senator WHITEHOUSE. Well, I am asking the question—

Mr. MUHLHAUSEN. —someone with a similar background.

Senator WHITEHOUSE. —so that the way I say "peer," which means that their peers in their age group, the common definition of the word.

Mr. MUHLHAUSEN. All right. But when you look at effectiveness, we are comparing them to kids with similar socioeconomic backgrounds.

Senator WHITEHOUSE. I am not asking you about effectiveness. I am asking you about—

Mr. MUHLHAUSEN. Well, of course.

Senator WHITEHOUSE. —this question.

Mr. MUHLHAUSEN. That is why we have the programs for disadvantaged kids.

Senator WHITEHOUSE. Bingo. And when you describe Job Corps participants in this data, you are including folks— the kids who never made it through Job Corps, correct? You are counting the ones who washed out and did not complete the program?

Mr. MUHLHAUSEN. No. We are counting kids who were not granted access to the program. It was a randomized experiment where—

Senator WHITEHOUSE. Now, when you say somebody is a Job Corps participant—right?—you are included people who participated but did not complete the program. Correct?

Mr. MUHLHAUSEN. I am talking about—when I saw Job Corps participant, I am talking about individual kids who participate in the Job Corps evaluation—

Senator WHITEHOUSE. But did not necessarily complete the program, correct?

Mr. MUHLHAUSEN. I would have to get back to you on that.

Senator WHITEHOUSE. Okay.

[The information follows:]

Question for the Record
By Senator Sheldon Whitehouse
June 26, 2013
Senate Budget Committee

On page 9 of your testimony, you cited findings of a 2008 study comparing the educational and vocational status of "participants" and "no-participants" of Job Corps. Did the "participants" group include individuals who enrolled in Job Corps for a time, but who dropped out before attaining a GED or vocational certificate? If so, would a more useful comparison look at differences between those who successfully completed Job Corps and those who did not participate at all or who dropped out before attaining a GED or vocational certificate?

Answer
By David B. Muhlhausen, Ph.D.
July 1, 2013

The section of my written testimony that refers to Job Corps is based on the findings of a Department of Labor-sponsored multisite experimental evaluation that assessed the impact of the youth job-training program using program (intervention) and control groups. For the evaluation, eligible youth who applied to participate in Job Corps were randomly assigned to intervention and control group. The program group members (participants) gained access to Job Corps services, while the control group members (non-participants) were not allowed access to the program. According to the 2001 Job Corps evaluation, "The random assignment design ensures that no systematic observable or unobservable differences between program and control group members existed at the point of random assignment, except for the opportunity to enroll in Job Corps. Thus, simple differences in the distributions of outcomes between program and control group members are unbiased estimates of program impacts for eligible applicants."[1]

The findings for Job Corps summarized in my written testimony are based on the comparisons between the program and control groups. For example, 48 months after random assignment, 5.3 percent of the program group had earned high school diplomas, while 7.5 percent of the control group earned the same credential—a statistically significant harmful impact of 2.2 percent.[2] This finding is based upon what is called an intent-to-treat (ITT) effect. ITT assesses the average effect of being offered access to a program and does not assess the effect of actually participating in the program. Approximately 73 percent of members of the program group participated in Job Corps.[3] These individuals, on average, participated in Job Corps for about 8 months with about 25 percent participating for over a year and 28 percent participating for less than three months.[4] The ITT technique is commonly used for large scale evaluations because the method utilizes the scientific rigor of random assignment that yields unbiased impact estimates. When the "real world" impacts of a program are sought, ITT impact estimates are considered the most policy relevant. This relevancy occurs because the assumption that every eligible person will actually participate in the program is unrealistic.

However, in some cases, evaluators estimate impacts by focusing only those individuals who actually participated in the program. These estimates, called treatment-on-the-treated (TOT) often use quasi-experimental methods to estimate program impact. When TOT estimates are used in a study originally based on random assignment, the TOT estimates no longer hold the same scientific rigor of ITT estimates. The evaluator can no longer make the assumption that members of the TOT group are equivalent to the control group in composition, predispositions, and experiences. Researchers cannot be sure that TOT estimates are unbiased.

The 2008 study did estimate TOT effects. For example, 48 months after random assignment, the TOT method estimates that 4.4 percent of actual Job Corps participants earned high school diplomas, while 7.5 percent of the control group earned the same credential—a statistically significant harmful impact of 3.1 percent.[5] Thus, the use of TOT for this outcome measure increased the harmful effect of Job Corps.

The second part of your question asks whether it would be more useful to compare successful Job Corps graduates to either youth who did not participate at all or who dropped out before obtaining a GED or vocational certificate? The short answer is absolutely not.

The long answer is that such faulty comparisons will likely yield biased impact estimates due to what is referred to as "selection bias." Selection bias is, perhaps, the most problematic threat to internal validity for evaluations of social programs.[6] When systematic differences in the characteristics of intervention and comparison participants are present, the observed outcomes may be the result of selection bias and not the effect of the social program. This threat is common in quasi-experimental designs when the estimate of the counterfactual derives from a comparison group. Pre-existing differences can become confounded with the effects of the intervention.

Selection bias would be present in an evaluation of Job Corps that compared program graduates to non-participants or program dropouts. If the intervention group is comprised of those participants who successfully completed Job Corps, while the comparison group consists of Job Corps dropouts, then the findings would only show use that successes succeed and the failures fail. This type of "cream skimming" comparison is incapable of providing a scientifically valid assessment of the effectiveness of Job Corps. The successful graduates may have been just as likely to have had successful outcomes without participating in Job Corps. The individuals graduating from Job Corps may have been more motivated to better themselves, so such comparisons would not yield scientifically valid estimates of program effectiveness. The same problem of selection bias would occur if graduates were compared to youth who did not participate at all in Job Corps.

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[1] Peter Z. Schochet, John Burghardt, and Steven Glazerman, *National Job Corps Study: The Impacts of Job Corps on Participants' Employment and Related Outcomes* (Princeton, NJ: Mathematica Policy Research, Inc., June 2001), p. 35.
[2] Peter Z. Schochet, John Burghardt, and Sheena Mcconnell, "Does Job Corps Work? Impact Findings from the National Job Corps Study," *American Economic Review*, Vol. 98, No. 5 (December 2008), p. 1872.
[3] Ibid., p. 1871.
[4] Ibid., p. 1871.

[5] Ibid., p. 1872.

[6] For detailed discussion of selection bias and other threats to internal validity, see David B. Muhlhausen, *Do Federal Social Programs Work?* (Santa Barbara, CA: Praeger, 2013).

Senator WHITEHOUSE. Ms. Nimmo Crowe, you did not talk about Job Corps in your testimony, but I suspect you deal with it in Virginia. Do you have any thoughts about how Job Corps works for kids who face it? And, by the way, greetings from Elizabeth Burke Bryant of Rhode Island, who is your colleague at Rhode Island KIDS COUNT.

Ms. Nimmo Crowe. Thank you.

Senator WHITEHOUSE. We love her and her program.

Ms. Nimmo Crowe. Thank you. She does an excellent job. I would love to tell you that I did know something about Job Corps, and I am sure that we have it in Virginia, but I personally have not had any experience with it, so I cannot answer that question.

Senator WHITEHOUSE. Mr. Lesley?

Mr. LESLEY. We do a little bit of work on that, but it is not—I could get back to you in writing with some—to answer your question.

Senator WHITEHOUSE. I think it would be helpful to have a more balanced record on this.

Mr. LESLEY. Absolutely.

Senator WHITEHOUSE. Thanks very much.

I think we have to leave for the vote, so I will yield back my time.

Chairman MURRAY. We do. Thank you very much.

I want to thank all of our witnesses for being here today, Sakhia, especially you. You did a great job, and I think we owe her a round of applause.

[Applause.]

Miss Whitehead. Thank you.

Chairman MURRAY. As a reminder to my colleagues, additional statements or questions for any of the witnesses from today's hearing are due in by 6 o'clock today to be submitted to the Chief Clerk, and with that I will call this hearing to a close.

[Whereupon, at 11:47 a.m., the Committee was adjourned.]

THE IMPACT OF SEQUESTRATION ON NATIONAL SECURITY AND THE ECONOMY

TUESDAY, JULY 23, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Committee met, pursuant to notice, at 10:32 a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, Chairman of the Committee, presiding.

Present: Senators Murray, Whitehouse, Warner, Kaine, King, Sessions, Crapo, and Wicker.

Staff Present: Evan T. Schatz, Majority Staff Director; and Eric M. Ueland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. This hearing will now come to order, and I want to thank my Ranking Member, Senator Sessions, and all of our colleagues who are joining us here for this Committee meeting with me today.

I also want to thank all of our witnesses: Bob Work, who is CEO of the Center for a New American Security; Mark Klett, president and CEO of the Klett Consulting Group; Jennifer Green, a secretary at Madigan Army Medical Center in my home State of Washington; Baker Spring, F.M. Kirby Research Fellow in National Security Policy at the Heritage Foundation; and Tom Donnelly, co-director of the Marilyn Ware Center for Security Studies at the American Enterprise Institute. Thank you all for coming today and joining us for this very critical discussion on the impact of sequestration on our economy and our national security.

Sequestration is having serious impacts across the Federal budget, but today we are going to focus on the automatic cuts and future spending reductions that impact defense spending specifically.

As the daughter of a World War II veteran, I believe we have a sacred obligation to keep the promises we have made to our men and women in uniform. They deserve our support while they serve, as well as when they come home.

But, unfortunately, the indiscriminate cuts from sequestration are threatening our fragile economic recovery, as well as our national security.

At a time when too many Americans are struggling to find work, civilian defense employees are being furloughed, and small businesses are struggling to stay afloat, our economic recovery and our military preparedness is suffering.

While I believe there are responsible spending cuts to be made in defense programs, the current across-the-board cuts and future arbitrary spending reductions over the next 8 years as part of sequestration are not the answer.

Especially during this time of global uncertainty, we need to maintain a strong national defense that allows us to meet today's international threats and be prepared for those of the future. And we need to be investing in job creation and long-term economic growth—not causing furloughs that in turn hurt our families and the economy, as well as small businesses and service members alike across our country.

Defense sequestration is hurting small businesses like Mr. Klett's, who is here today, which does work on critical areas like cyber security and the new aircraft carrier. As he will tell you, his company has lost a substantial portion of its income and has been forced to lay off 30 percent of their staff. He has even reduced his own salary so he is now one of the lowest paid employees in his company in order to keep his workers on the payroll as long as possible. Even though his company is a service-disabled veteran-owned small business, and even though they do work important to our national security efforts, they are not protected.

Sequestration is also impacting people like Ms. Green. She is dealing with furloughs and the loss of at least 20 percent of her income for the rest of this fiscal year, while still doing her own work as well as filling in for a second full-time position in another department. On top of this, she is a single mother and a full-time college student dealing with high health insurance premiums, college costs that are not all covered by her Pell grants, and daycare on the base for her son that, because of sequestration, cannot stay open late enough.

Mr. Klett and Ms. Green, you are both sacrificing immensely and doing your best to get through some very difficult times. And we thank you and admire you for your determination and really appreciate your being here today, especially Ms. Green, who has come all the way across the country to share her story.

I hope that all of our colleagues take note of your examples, because there are other parents, students, and business owners struggling to make it through in every one of our home States. And if sequestration continues next year, there are going to be a lot more stories like the ones we hear today.

Now, sequestration is not just impacting individuals and their families. Those cuts will also have a serious national and international consequence if they are allowed to continue.

Earlier this month Secretary Hagel sent a letter to the Armed Services Committee describing some of the expected impacts if sequestration happens in fiscal year 2014 and DOD is forced to cut another $52 billion. For DOD personnel, civilian employees would face continued furloughs or layoffs, and a hiring freeze would remain in effect. For military members, involuntary separations, a freeze on promotions, and other actions would be required.

Training, which keeps our forces the most capable in the world, would see dramatic cuts. For instance, earlier this year, the Air Force was forced to ground a third of its squadrons. They just managed to redirect some funds to get those squadrons flying again, but under a fiscal year 2014 sequester, that work would be undone, and an even larger percentage of Air Force squadrons would be grounded.

Critical research and development of new tools to maintain our technological advantage and better protect our service members would also be cut dramatically—all while our competitors around the world increase their investment to try to reduce the advantage we now have.

Secretary Hagel stated that, if sequestration continues, "The Department will have to make sharp cuts with far-reaching consequences, including limiting combat power, reducing readiness, and undermining the national security interests of the United States." And he called on Congress to, "Pass a balanced deficit reduction package that the President can sign that would replace these deep and arbitrary cuts in fiscal year 2014 and in future years."

Secretary Hagel also noted that this kind of comprehensive replacement would help not just DOD but many other agencies, including those with a role in supporting our troops and veterans. So I really hope that we can come together to address this in a bipartisan way. It is simply wrong, and it does not make sense, as our world remains a complex and dangerous place.

With the end of the war in Afghanistan approaching and the rebalance to Asia beginning, this is not the time to allow irresponsible defense cuts to impact our security.

In Secretary Hagel's letter he warned that if sequestration remains in place for fiscal year 2014 and beyond, "The size, readiness, and technological superiority of our military will be reduced, placing at much greater risk the country's ability to meet our current national security commitments."

Now, it is critical to understand that we are only just beginning to see the impacts of these cuts. And as we all remember, they were never intended to be implemented. Sequestration was meant to be so terrible that both sides would come to the table and compromise.

Democrats and Republicans spent a lot of time over the last 2 years talking about how devastating these cuts would be. A number of our Republican colleagues traveled around the country to talk about the ways that sequestration would "hollow out the military."

And Republican members of this Committee joined Democrats in saying that the cuts from sequestration should be reexamined by Congress. But despite all of our efforts, and despite Democrats' willingness to make some tough decisions to find responsible savings to replace sequestration, we have not come to an agreement yet. And if sequestration is not replaced, the effects on our economy and our national security over the long term will only get worse.

Cuts to other parts of our budget also make us less secure. For example, our international trade not only helps the economy, but it also creates stability around the world. But sequester cuts to commerce and agriculture put that in jeopardy.

Cuts to foreign affairs hurt critical work to build stability, create good will towards America, and defuse conflict. Ultimately, as experts like General Mattis have testified, and as we will hear more about today, that retreat from the world will make us more vulnerable.

House Republicans say they are adhering to the BCA with their budget, but we all know they are doing the opposite and replacing sequestration only for defense.

Senate Democrats, on the other hand, have said if we replace sequestration for defense, we also have to protect the Departments of Veterans Affairs and Homeland Security, the FBI and other law enforcement agencies, and vital efforts to ensure our competitiveness through investments in education, innovation, and infrastructure from deep, unsustainable, and often arbitrary cuts over the next 8 years.

Both the House and Senate appropriation allocations require a replacement of sequestration to prevent another round of across-the-board cuts.

So I hope my colleagues on both sides of the aisle are ready to work together to address this and end this arbitrary system that really hurts our prosperity, because we all know we can replace these cuts with smarter choices that are better for our national security and long-term growth, as well our fiscal health.

And it should be clear that we need to work together to invest in keeping America strong and secure and to keep the promises we have made to our veterans that their country will be there for them when they come home.

We owe it to the American people to come together around a real and comprehensive solution to this problem that is hurting our economy, is hurting our national security and our families and communities. We cannot afford to keep these cuts around for 10 more years. And we cannot keep governing from crisis to crisis.

I especially appreciate the views of members like Senator McCain and so many others on the other side of the aisle who have joined us in that simple request, that we return to regular order, start a bipartisan budget conference, and work together to tackle the challenges we face.

There is bipartisan agreement that sequestration is the wrong way to cut spending, and a bipartisan agreement needs to be made to fix it. So there is absolutely no reason for us to get closer and closer to October 1st—and closer and closer to another manufactured crisis—before we come to a solution on this.

It is not going to be easy, but the families we represent are looking to us to end the constant artificial crises and political brinksmanship that is threatening our fragile economic recovery and our national security, and work together to replace sequestration responsibly.

So I am very glad that this Committee is having this extremely important discussion today, and I thank all of you for being a part of this conversation.

I want the members of our Committee to know that I am going to have to step out. My THUD bill is on the floor, and I have to manage that. Senator Warner has agreed to chair the Committee in my absence, but I just think this is so important and really appreciate everybody being here today. These are critical issues, and we need everyone's perspectives. So I look forward to this hearing and the testimony, and I will turn it over to my Ranking Member, Senator Sessions, and I want to thank Senator Warner for helping me out this morning.

Thank you very much.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Chairman Murray. I know you are always here first, but you also have a bill on the floor, and you have to be there, so we fully understand that.

I join you in welcoming our distinguished panel to discuss the impact of sequestration on our national security. It is a very serious matter. We are here for reasons that I have a different view of than the Chairman, and we have got to deal with the realities of where we are. And I take it very, very seriously.

The matters that we are facing today have been made substantially worse by the fact that the President has blocked defense planning to make this happen. Sequestration was passed in August of 2011, yet this year, 2013, all the cuts occurred in 7 months. And I asked General Dempsey, the Chairman of the Joint Chiefs, just a few days ago at the Armed Services hearing, how that happened and didn't it make it worse. He said it did make it worse. And I said, "How did that happen?" And he said, "We were told basically from the White House not to start planning and not to start phasing in the reductions." And I have heard from many people that the furloughs that may be necessary to some degree could have been avoided in many instances, but it was determined to do the furloughs, I suppose, as a way to politically drive the issue.

So we have not done a good job of this, and I believe the Commander-in-Chief of the United States of America has a high duty. He promised in a debate during the last election that this would not happen, and all he has proposed is eliminate sequester and pay for it by raising taxes which is what we know would not happen, and it is not going to happen. He raised taxes in January $600 billion, but we agreed as part of deficit reduction to reduce spending by $2.1 trillion in that Budget Control Act.

So we have got a difficult situation, and we are not having any leadership. I am beginning to wonder if the President is not quite happy to see the Defense Department take this much cuts. If he was sincerely worried about it, why isn't he providing more leadership to confront it? I know a lot of his supporters are quite happy to see the Defense Department take these cuts.

In August, Congress and the President came to an agreement that $2.1 trillion needed to be cut from our projected growth in spending. And we must stick to that agreement. We need to spread the spending cuts around. Under the agreement, spending would increase from the then level of $37 trillion over 10 years to $45 trillion over 10 years rather than a projected growth to $47 trillion over 10 years. Why then is there so much intense turmoil about this issue?

First, it is important to realize that spending on national defense is not the root cause of our financial difficulties.

Secondly, the Department of Defense has already contributed to the Nation's deficit reduction efforts by cutting its proposed spending by nearly $500 billion over 10 years to accommodate the initial round of budget control caps.

So now, even before one considers the impact of sequestration, we have defense spending that is lower as a share of the budget and a share of the economy than it has been in the past and it is continuing to go lower.

As a share of the Federal budget, just 17 percent of Federal spending will go to defense this year. Just 50 years ago, defense spending made up 46 percent of all Federal spending. As a share of the economy, spending on defense will average 3 percent over the next 10 years, which is down from the post-World War II average 7 percent. By fiscal year 2023, the last year of the President's 10- year budget, defense spending as a percentage of GDP will hit an all-time World War II low of 2.4 percent of GDP.

Now, defense spending, which is already on the decline and makes up only one-sixth of the entire Federal budget, is being required to take another $500 billion in cuts due to the sequestration provisions, and this drawdown is not occurring in an era of peace and stability but a time that General Dempsey, Chairman of the Joint Chiefs, has said is "actually more dangerous than the era we are just leaving."

In fiscal year 2013, we saw $40 billion in across-the- board cuts to national security spending, $37 billion of which came out of the Department of Defense through the sequestration. As a result, our troops and the men and women of DOD's civilian workforce are paying a price. The uniformed leadership of our military have expressed dire consequences on training and readiness arising from these reductions.

General John Campbell, Army Vice Chief of Staff, said, "The reality is that if sequestration continues as it is, the Army simply will not have the resources to support the current defense strategic guidance, and we risk becoming a hollow force." Others have said the same, and I think that is an honest evaluation.

As for the civilian workforce, we are all aware of the budget pains they are personally feeling as over 650,000 have received furlough notices, taking away 11 days of work from July until the end of the fiscal year. These men and women, who are critical partners for the troops, deserve better.

After two consecutive budget submissions from this administration, with no credible plan to turn off sequestration, we are headed on a dangerous path of an additional $52 billion in cut for fiscal year 2014 and similar cuts in subsequent years to the Department of Defense budget. These reductions that Secretary Hagel has said would reduce the size, readiness, and technological superiority of our military need to be reexamined.

Next year will be the worst year as we deal with this for sure. As we move forward, let us work together to stave off these unwise levels of cuts to defense spending. It is important that we hold to the reasonable reductions in the rate of spending growth as set forth in the Budget Control Act. However, Congress should modify the mechanism to ensure shared sacrifices. Too many agencies were not required to tighten their belts at all. They were allowed to continue to grow without restraint.

It is time for the Commander-in-Chief to provide certainty in the defense budget and explain the dangers of these large defense cuts. The Commander-in-Chief should do that.

It is also time to examine the large protected programs that have outpaced DOD in spending by many times. Food Stamps have increased 4 times in just 11 years, from $20 to $80 billion, and Medicaid has increased at a rate nearly twice DOD increases in recent years. Yet those programs and others were not required to even minutely control their rate of growth.

It is time to adopt a balanced approach, as my colleagues say, to deficit reduction. Remember, half these sequestration cuts are falling on one-sixth of the Federal budget. That is the Defense Department. They are having more cuts than anyone else.

Chairman Warner, I am just looking at the numbers, and all of us should—I hope you would join me in considering what is happening. When they laid out the 5-year budget plan for the Defense Department in fiscal year 2012, we projected to spend $571 billion in fiscal year 2013. What actually occurred was $495 billion was spending. That was $76 billion off the projection. It was a growth path, but that is what was projected. But it is even worse next year. Next year, we were projected to spend $586 billion; whereas, the cap would bring us down to $475 billion. So that is a $111 billion reduction, and that is where we are hitting an unsustainable situation that is just difficult to absorb. And if you look at the numbers over time, they begin to go back up from next year. But for the next 2 years, we are having a very serious, unwise reduction in spending that does more damage than should occur.

Thank you.

Senator WARNER. [Presiding.] Thank you, Senator Sessions. I would simply add that while these cuts are remarkable on the defense side, they are equal to some of the cuts on the domestic discretionary side that took place even before the BCA, and I will come back to that in my comments. But I would like to get to this panel, because I think what we are going to see is—I would say what Chairman Murray said. It is even worse. Sequestration was set up to be so stupid that no rational group of people would ever let it happen. Yet it is happening. And I think we are going to hear from this panel that this is stupidity on steroids and that we are going to actually see that,in many cases under the guise of "cutting spending," we are actually costing the taxpayers more money.

So I am anxious to get to this panel. I appreciate everyone being here.

Senator SESSIONS. Mr. Chairman, we will work with you to see where we can find other areas that the budget can be tightened, and I think that is the approach.

Senator WARNER. And I have put forward some of those approaches in past efforts, as you are aware, on both sides of the ledger.

We are going to start with Mark Klett, who is from the Commonwealth of Virginia. He was Small Businessman of the Year back in 2011. He will speak to the questions of the effect of sequestration to his business.

We are going to then hear from Bob Work, who is the Chief Executive Officer of the Center for a New American Security, and a former Under Secretary of the Navy. He will testify about the strategic level impacts of sequestration.

Ms. Jennifer-Cari Green, who is a civilian employee from Washington State, will talk about some of the direct impacts some of these furloughs and others will have on her family.

Mr. Baker Spring, the Kirby Research Fellow in National Security Policy at the Heritage Foundation, will talk about the strategic impact of these cuts.

And, finally, Tom Donnelly, co-director of the Marilyn Ware Center for Security Studies at AEI, will talk about the strategic impact.

Mr. Klett, if you could start, and then we will go down the line.

STATEMENT OF MARK N. KLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KLETT CONSULTING GROUP, INC.

Mr. KLETT. Thank you, Senator Warner, and good morning to all the great Senators here in the room today. It is a distinct honor for me to be able to address you on this critical issue of national security and our economy from a small business perspective.

I have been in business for over 11 years. We have had some very good growth years in our company, and I have got some tremendous employees. Over 60 percent of our employees are veterans. Most of them are subject matter experts. Most of them have advanced degrees. We have developed a national resource in our company where we do work in cybersecurity, information assurance, and have worked on some very sensitive programs that help our national security.

In the last couple of years, 2011, 2012—well, 2013, because of the continuing resolutions, because of sequestration, the funding and the planning just has not been there that is needed on some of these critical programs. The result is for the small businesses that are out there, as we have—it is stop and go, it is herky-jerky, if you will, to try to get the funding to keep personnel working.

In the last year, for example, I have had to put 30 percent of my personnel, critical personnel, to programs not because anyone wanted them to be there on the bench, but they have had to sit on the bench and not be able to follow our model. The best way to predict the future is to create it. We have not been able to do that in some critical programs, in command and control for cybersecurity. We have had to go in for 90 days to 120 days, come off and do it. And who pays for those folks to sit on the bench? That comes out of our company overhead. And I gladly pay that because they have bills to pay, and that has reduced our profit margin, which I call ourselves a nonprofit company anyways, although we are not, but that is what you have to do. You have to maintain your people and your core capabilities, because it is a national resource. And that is what you do as a small business.

We do not have any pink paper in our company. Okay? There are no pink slips.

Sequestration creates inefficiencies and delays. Sequestration—and Senator Sessions very eloquently described a whole bunch of numbers, a lot of percentages of things. Sequestration only reduces our budget—or its intention is to reduce our budget 2 percent. Two percent. But the majority, it is defense and national security centric. Most of that 2 percent is in the Defense Department, as I think all of you well know. So it is critical that it is affecting our national defense and our national security. That is where most of the cuts are. That means when we have large programs that cannot be started or continuing, like building new aircraft carriers, which we are intimately involved in, in integrating all those systems, ensuring their information assurance programs are like they need to be, doing some of the cybersecurity things that we are intimately involved with in many programs, some of those things are new. They cannot be funded or turned on when you have to stop and you do not have a budget and you do not have approval for appropriations. That is what a budget and a plan does to make sure the appropriations start on 1 October. They do not start on 1 October. This year they started in April. Now, from April to September, now you have it.

What happens then? A lot of people have to sit on the sidelines waiting for that money to drip out of the different program offices so that people can do the work that needs to be done. That is the process. And who gets hurt? Large companies, mid-sized companies, and small companies—in all agencies. I am not just talking DOD. All agencies. And then what happens, we have not seen the impact of all that yet because the furloughs just started. And we are going to see our economy go down. We are going to see other things happening.

These are serious problems. I know you all work extremely hard together to try to get a budget put together. I know you all work very hard to try to do the jobs that you are trying to do. But in business, it is all about relationships. If you do not have relationships with other people—because no one company can do everything, no one company can do all those things. Work on your relationships with both sides, with the House, and get things done. And that is what I do to be successful, and I ask you all to do the same.

Thank you.

[The prepared statement of Mr. Klett follows:]

TESTIMONY OF
Mr. Mark N. Klett
President and CEO Klett Consulting Group, Inc
Tuesday, July 23, 2013

Distinguished members of the Senate Budget Committee, it is an honor for me to speak to you regarding the impacts of sequestration on national security/economy from the perspective of a veteran owned small business

I am a small business owner, and a disabled veteran who proudly served my country in the U.S. Navy for over 20 Years as a Surface Warfare Officer – I dedicated my life to national security when I was 18 years old and enrolled in the U.S. Naval Academy.

After serving my Country, I transitioned into the Defense Contracting industry. After working for three large Defense Contractors – I found that my entrepreneurial passion could only be satisfied by going out on my own. With the unwavering support of my family, I established Klett Consulting Group in August of 2002. Since then my company has created over 50 jobs, purchased an office building in my hometown, and expanded into federal, state and municipal marketplaces.

Klett Consulting Group has grown into a multi faceted Professional Services Firm with a specialization in Department of Defense System Engineering & Cybersecurity. We provide government-industry teams with technical solutions, program management, and operational expertise. As a small business, we have written the Open Architecture Implementation Strategy for the US Navy, led the Enterprise Architecture and Information Assurance efforts for the next generation aircraft carrier - CVN-78, and was a significant contributor to the Presidential Executive Order on Cybersecurity this past February. We deliver these projects with an efficient team of professionals who understand the government's missions and requirements.

As a Service Disabled Veteran Small Business owner, approximately 60% of my workforce is veterans. This presence of veterans is consistent with the geographic area in which I represent – South East Virginia, Hampton Roads. With the presence of the Norfolk Naval Station, Joint Chiefs of Staff, Oceana Air Station, NASA Langley, and a collection of the world's largest ship yards; it makes sense that Hampton Roads has the highest veteran density in the country and thus is significantly more susceptible to the effects of sequestration.

Thankfully, these Veterans served a country where the government didn't just say "tough luck."

Sequestration creates inefficiencies and delays

In a time in which efficiencies need to be created, Sequestration introduces inefficiencies and delays that are making a bad situation worse for companies of all sizes – large, mid and small businesses. 2012 and 2013 have been the most difficult business years in my 11 year existence. Instead of focusing on fulfilling the work requirements necessary for critical national security and warfighter resources, I have been forced into an increased amount of paperwork and waiting periods for contract and purchase order awards. Because of the perpetual continuing resolutions and lack of decisions, Contracting Officers lack the proper foundation or backbone of their program – A BUDGET and acquisition authority. Without the proper budget authority contained in the appropriations bills the contracting officers and Program Officials cannot obligate any new work to be performed. Because of this uncertainty in budgets, Programs can not plan to execute to meet missions efficiently, even if they have the resources to do so. Many programs have adopted the model of "Incremental Funding" as a way of life during this uncertainty. This means instead of going through the contractual approval process once every year we are going through it every 30 – 60 days. This has often led to gaps in workforce which means gaps in capabilities. Contractors are left with no access to work while incremental funds can be released 2-4 weeks later. The government's inability to execute timely contracts for what is needed in critical areas leads to overall waste of funds and the government is getting less products in the end.

Our small business has seen gaps of two weeks to one month on contracts due to this inefficient funding methods – and this is very manpower intensive on both the government and industry side. This practice costs a lot of time and dollars just to get critical work done.

Example 1: According to VADM Myers (Deputy CNO N8), the Continuing Resolution and sequestration will lead to inefficiencies caused by loss of learning; productivity losses; cost increases driven by lengthening schedules; he added that increased burdens on military personnel and lower morale – all translates to reduced readiness.

Example 2: Devastating effects have already been caused in the ship building industry. The uncertainty of the looming sequestration has caused a civilian-hiring freeze at Shipyards which have already caused non-recoverable impacts to the shipyards' ability to execute many assigned workloads and nuclear submarine availabilities while threatening to impact Docking Planned Incremental Availabilities for the USS Eisenhower (CVN 69) and the USS John C. Stennis (CVN 74).

Deputy Secretary of Defense Ashton B. Carter, said it best – "Right now, for example, we are in the absurd position that it is only lawful to build the ships we already built last year!"

Sequestration creates competitive disadvantage for small businesses

It is often said small businesses are the backbone of the economy and it is true. Many of my business peers have had their backs broken. Sequestration creates a competitive disadvantage for small businesses. Due to the aforementioned delays and gaps in work, I have had to put nearly 30% of my work force on the bench or overhead for as little as two weeks and as long as two months this year. With no approved budget, or appropriations bill - no government agency, prime contractor or subcontractor can plan beyond a few months. No one can plan beyond 30 September 2013. The impact will be even greater on subcontractors, who lack the capital structure to withstand uncertainty. 60 to 70 percent of defense dollars are subcontracted, and many of the subcontractors are small businesses like myself.

As a small business owner – and an American citizen – I ask Congress to work together for the good of the country to help sustain jobs by giving us a combined budget that results in the expeditious passing of appropriations bills that can be executed. This is a complicated process that needs to be done for the benefit of all our citizens to ensure our National Security and our place in the Global Economy.

Veterans are out of work

In my company alone, I currently, have an Air Force Veteran, and Navy Veteran and a Marine Corps Veteran who are out of work because of Congress' indecision. In the last 3 months all three of those vets were on long term contracts that were not executed, or have been told to hold off until year end. These vets are Subject Matter Experts in their field performing critical support for the warfighters. There is an entire work force of military vets out of work, on the verge of losing work or have been furloughed. I receive a Stack of resumes every week of military vets looking for work. Back in February, a large shipyard in Norfolk, VA sent warning letters to 1,600 of its workers, advising that layoffs were a possibility, amid concerns over sequestration defense-cuts.

Thankfully, they live in a country where the government didn't just say "tough luck."

According the economist Stephen Fuller of George Mason University, sequestration could cause a total of 2.14 million jobs lost (both directly and indirectly caused by sequestration), resulting in a 1.5 point increase in the unemployment rate.

As DoD draws down its forces and spending – we need to develop a strategy to be ready to fight and win the next war not the last one. A big part of that preparation is having a ready agile Force that is equipped to meet our nation's strategic security requirements and our trained veterans can fill much of those strategic niches with small business capabilities. My Company like many others has created a strategic capability for our national security – but must fight everyday to keep it alive due to the government processes in place that serve no competitive or compliant purpose – just delays the award and increases the price of doing business. A PLAN – A CONGRESSIONAL BUDGET – and ASSOCIATED APPROPRIATIONS BILLS are required to get our talented veterans work force working and all our American force moving forward. Only 0.03% ($1.4B) of our budget is committed to the Small Business Administration – I certainly think we can do better for the engine of our economy – small businesses.

Conclusion

Thank you for the opportunity to share a view from the trenches of how small veteran businesses are affected by sequestration. Sequestration is affecting the economy evidenced by increased inefficiencies which is affecting national security. We are less secure now than we were a year ago. The cuts are tough on everyone, but the larger problem is the uncertainty caused by not having a budget plan. No one, government, military nor industry can plan and move out without knowing where the government wants to put its resources.

Recommendation – Relationships are critical to success in the business world – in running this great country of ours, Congress has been entrusted with putting a budget and appropriations together each year to ensure that the our country meets and honors all our commitments to our citizens to ensure their security and our economic strength in the global economy. I plead with all of you here in the senate to commit to all Americans to work for the best interests of our Country and work to foster a working relationship with all members of Congress to put both an executable budget and appropriations bills together so that sequestration can be avoided at all cost and our National Security and Economic Stability of all Americans can be safe. We do not need a government of inaction that just says tough luck to our hard working citizens.

Leon Panetta said it best - letting the sequester go into effect would be "shameful and irresponsible," and it would "damage the readiness" of the U.S.

Senator WARNER. Thank you, Mr. Klett.
Mr. Work?

STATEMENT OF THE HONORABLE ROBERT O. WORK, CHIEF EXECUTIVE OFFICER, CENTER FOR A NEW AMERICAN SECURITY

Mr. WORK. Senator Warner, Ranking Member Sessions, distinguished members of the Committee, thanks for the opportunity to be with you today and speak about the potential effects of sequestration.

It is hard to imagine improving upon the two opening statements or Secretary Hagel's letter, so what I would like to do is just try to put what is happening into context and explain why sequestration could potentially be so damaging.

Sequestration is part of the fifth defense drawdown since World War II. Each of the four previous drawdowns had their own unique character, and this one will be no different. This drawdown comes on the heels of the longest sustained defense buildup since World War II.

In hindsight, Secretary Gates' efficiency effort during the formation of the fiscal year 2012 budget was an attempt to get ahead of the inevitable downturn that occurs after wars. However, just as the efficiencies drill ended, the Department was levied a last-minute $78 billion cut, which was incorporated in the final fiscal year 2012 budget, and this budget thus marked the start of the drawdown.

Now, preparation of the 2013 budget was focused on accommodating the cuts that were addressed from the 2012 Budget Control Act, which ultimately came to about $489 billion apportioned over 10 years. I believe this effort was generally well led and executed. The output, as outlined in "Sustaining US Global Leadership: Priorities for 21st Century Defense," published in January 2012, is in my opinion one of the more cohesive and coherent documents published by DOD since the end of the Cold War.

Now, this was followed by the year-long "debate" over sequestration. We were told not only from the White House but all of the signals from Congress and the Office of the Secretary of Defense was that sequestration could and would not happen because it was indeed stupidity on steroids. But as a result, for better or worse, we did not plan, and it was implemented, which will cause another $520 billion apportioned over the next 10 years to cut.

So with this as background, what might be the effect? First and foremost, for Congress, these cuts are certain to cause a further alteration to our basic national military policy and force-sizing construct. From 1993 through 2012, our stated policy was to have a joint force size and ready to fight two regional wars in overlapping time frames. This policy helped to underwrite our conventional deterrent. However, "Priorities for 21st Century Defense" announced a future joint force would be sized to fight only one major contingency while simultaneously denying the objectives of— or imposing the unacceptable costs on—an opportunistic aggressor.

Now, one might have expected this important change to spark a serious debate in Congress because of its national security ramifications. But it did not happen. In my view, right now maintaining the policy we have now, fighting one major war and denying an opportunistic aggressor, is the absolute minimum requirement for a global superpower. But sequestration is undoubtedly going to make this very difficult to achieve this minimum standard. And if it could not, I would hope that Congress and this body would carefully consider the strategic ramifications.

Second, sequestration's associated defense cuts will likely result in a less capable future joint force that is less ready. The problem, in my view, is not necessarily about the overall size of the cuts, however painful they may be. It is the mindless way they are being apportioned. The problem begins in 2013. When the timing came late in the year, the services were forced to cut maintenance, training, and slow buying parts. This started a downward spiral in readiness that continues to play out. This spiral will continue through 2014 and 2015 as the Department's scrambles to hit the $52 billion sequestration marks. Manpower is exempted from sequestration. And in any event, in an all- volunteer force, you do not get savings in the year that you cut the people primarily because you likely have to buy them out or have early retirements, which may actually cost money in the near term. This means that services will inevitably have to go to research and development, procurement and military construction, and all of these will make the force less capable. But more problematically, they are going to have to cut operations and maintenance further. The cuts in 2013 will roll into 2014. The cuts in 2014 will roll into 2015. We will continue to dig a very deep readiness hole.

What will happen is we will prioritize the forces that are deploying, but all of the forces that back them up, our so-called surge forces, will be less resilient and less ready, which will be very problematic in the case of a crisis.

There is also not a lot of freedom of action for DOD. DOD needs a BRAC. It needs to get a handle on personnel costs. It needs to get a handle on health care costs. We need to be able to give DOD those flexibilities.

Now, I have personally been involved in three drawdowns. As a young second lieutenant in 1975, I arrived on Okinawa at the very tail end of the Vietnam drawdown. I saw firsthand its debilitating effects. I lived through the entire fourth drawdown and started the fifth as the Under Secretary. My worry is that what is the worse effect of sequestration is it will—the readiness effects it will have in 2014 and 2015, and I urge this Committee and Congress to at least give DOD flexibility in those 2 years.

Thank you.

[The prepared statement of Mr. Work follows:]

Statement of

The Honorable Robert O. Work
Chief Executive Officer
Center for a New American Security

Before the Committee on the Budget of the United States Senate

Delivered July 23, 2013

Thank you for the opportunity to speak with you today about the potential wide-ranging effects sequestration could have on the U.S. defense establishment.

Before explaining why and how sequestration could be so damaging to national security, however, I'd like to first put what is happening into historical context.

The Fifth Drawdown

We are well into the fifth major defense drawdown since World War II. Each of these drawdowns commenced at or near the end of either a hot or cold war. The first came on the heels of the Second World War, before the menace of communism had become clear. The second and third came towards the end of the Korean and Vietnam Wars, respectively. The fourth came as the long Cold War was winding down. And this fifth drawdown began roughly with the end of the war in Iraq, and will likely continue at least through our disengagement in Afghanistan, if not beyond.

Each of the previous four drawdowns had their own unique character. The first drawdown was coincident with the massive post-World War II demobilization, with the size of the defense budget falling over 80 percent off the wartime high. For example, the Navy went from over 6,700 ships in commission in September 1945 to just 634 ships five years later. The other services coped with similar dramatic reductions. Unsurprisingly, given the magnitude of the cuts, our forces were generally unprepared when the North Koreans invaded South Korea in June 1950.

The post-Korean and Vietnam War drawdowns were similar in that they followed hot wars waged during the broader national emergency known as the Cold War. Both wars were fought with large conscript forces, which were shed at the end of the conflicts without regret. The final post-war cuts to defense topline averaged between 30 and 40 percent off the wartime highs, spread out over four to eight years. Thereafter, the demands of containment and for forces ready to respond to communist aggression arrested the cuts and led to subsequent defense buildups.

The post-Cold War drawdown was much different than the three relatively short, sharp downturns that preceded it. It was the first drawdown in the era of the all-volunteer force, and occurred over a much longer period. The downturn started after FY1985, as the threat of communist expansionism seemed to be moderating. It then accelerated with the dissolution of the Soviet Union. Through much of this period, even as the defense topline was being reduced year after year, successive administrations worked with the Department of Defense (DoD) and Congress to establish a post-Cold war floor in defense spending. The floor's foundation was laid during the 1993 Bottom Up Review, which adopted a national military policy and force-sizing construct that called for a Joint Force capable of fighting and winning two regional wars in over-lapping time frames. By FY1998, after thirteen years of declining defense budgets and a 33 percent drop off the FY1985 spending peak, it was clear that this policy was being underfunded. The next year thus saw a real increase in defense spending, as did each year of following ten years.

I was confirmed as Undersecretary in May 2009. When I arrived, the FY2010 President's Budget (PB) was being debated in Congress. The Pentagon was in the midst of the 2009 Quadrennial Defense Review (QDR). Despite the sharp national economic downturn in 2007-2008, the Department's general mindset was that it would continue to see real increases in yearly defense spending, if at more modest rates than seen over the previous decade. Based on this assumption, the 2009 QDR and the supporting FY2011 PB submission affirmed and sustained the two-war strategy.

This mindset began to change the following year. Because personnel costs and operations and support costs consistently outpaced inflation, Secretary of Defense Gates reckoned the Department would need to see real defense increases of 2-3 percent per year to sustain the two-war policy and supporting force structure. However, he believed the defense budget would flatten by FY2015. He therefore ordered each of the Military Departments to come up with at least $30 billion in "efficiencies" in overhead or "tail," and divert it to force structure and program "tooth."

In hindsight, this laudable goal was a last ditch effort to stave off the inevitable defense downturn that was coming as we ended the war in Iraq. However, just as the efficiencies drill ended, DoD was levied a last minute $78 billion cut in the final budget pass back, which was incorporated in the FY2012 PB submission. This budget thus marked the official start of the fifth post-World War II drawdown.

The drawdown accelerated in a big way with the passage of the 2011 Budget Control Act. The associated cuts to future defense toplines ultimately came to $489 billion apportioned over ten years. I believe the strategic review to accommodate these cuts was generally well led and executed. The President, Secretary and Deputy Secretaries of Defense, Service Secretaries and Undersecretaries, and Service Chiefs and Vice Chiefs were all personally invested and involved in the process. The output of this effort was outlined in *Sustaining US Global Leadership: Priorities for 21st Century Defense*, published in January 2012 in advance of the FY2013 PB submission. In my opinion, it stands as one of the more cohesive and coherent documents published by DoD since the end of the Cold War.

That said, *Priorities for 21st Century Defense* announced a major change to our national military policy and force-sizing construct that had been modified but never substantially altered since 1993. Instead of being sized and ready to fight two simultaneous regional wars in overlapping timeframes, the document announced the future Joint Force would be sized to fight one major regional combined arms campaign while simultaneously denying the objectives of—or imposing unacceptable costs on—an opportunistic aggressor. I, for one, hoped this important change in policy might spark a serious debate in Congress over its ramifications. But I was disappointed in the response, which might be best summed up as a collective "ho hum."

In any event, the 2011 strategic review was followed in 2012 by the yearlong "debate" over sequestration. Through late Fall 2012, all of the signals coming from the White House, Congress, and the Office of the Secretary of Defense suggested sequestration could and would not happen. As a result, for better or worse, the Department did little to prepare for it. However, as we now know, no grand bargain was struck and sequestration was triggered on 1 January 2013, although it did not take effect until 1 March. If fully implemented, future defense spending will be cut another $520 billion, apportioned equally over the next ten years.

I provide this background not only to put sequestration into proper historical context, but to make an important point. The Pentagon is suffering from intense change fatigue. The staff completed a QDR in 2009, a major efficiencies drill in 2010, and a major strategic review in 2011, requiring the development of two alternative budgets; and a year of playing "what if?" On top of this, DoD's civilian workforce has been progressively demoralized due to several years of pay freezes, cuts in bonus pools, and now furloughs. These patriots provide much of the brainpower and energy behind the Planning, Programming, and Budgeting System. As a result, unlike the strategic review following the 2011 BCA, DoD is behind the planning power curve and is finding it hard to catch up.

Sequestration: Piling On

With this as background, what might be the effect of sequestration's additional $520 billion in planned spending cuts? First and foremost, the cuts will surely cause a further alteration to our national military policy and force-sizing construct. For a global superpower, maintaining a force capable of responding to two crises—such as fighting one major war and denying the objectives of an opportunistic aggressor in a different theater—would seem to be the absolute minimum requirement for a credible conventional deterrent. However, sequestration will make it very difficult to maintain this minimum standard, at least to a credible degree.

Second, the associated defense cuts will inevitably result in *a less capable future Joint Force* that is *less ready and less resilient*. The reasons for this are quite easy to understand. The problem is less about the overall size of the cuts, however painful they might be. Instead, it is the mindless way the cuts are being apportioned and applied.

To begin with, the cuts were triggered nearly half way into FY2013, on top of a continuing resolution in effect since October 2012. Thankfully, Congress quickly resolved the CR and later approved a generous reprogramming of Department of Defense funds. These actions helped stave off more serious carnage to programs and damage to readiness in FY2013. However, the way the cuts were apportioned and applied inevitably forced all of the Services to take big cuts in operations and maintenance by deferring maintenance, cutting training, and slowing the buying of spares and parts. Make no mistake, although the effects might not be immediately obvious, these actions mean the readiness of the Joint Force has already started a downward spiral.

This spiral will continue and accelerate through FY2014 and FY2015, as the Department scrambles to hit the abrupt $52 billion yearly sequestration budget marks. And once again, the way the cuts are apportioned and applied will compound the problems encountered in FY2013. For example, military manpower was exempted from sequestration. Regardless, because this is an all-volunteer force, any savings associated with manpower cuts would not be seen in the year of execution. Sequestration means the Services will likely have to involuntarily separate volunteers, not conscripts, many of whom want to remain on active duty. This will likely require buy-outs and early retirements, which may actually impose additional personnel costs in the near term.

This means that the Services will only be able to hit their share of the $52 billion sequestration mark by turning to two major accounts. The first will be the investment account, which includes research and development, procurement, and military construction. Funding for promising technologies, key to making the Joint Force ready for future challenges, will be cut. Weapon buys will be cut to minimum sustaining rates, which will increase the unit price for all munitions, making it more expensive to buy less weapons. Aviation "tails" will be cut, increasing the average age of already old aircraft inventories. Ground combat equipment accounts will be cut. Our restoration and renovation efforts to upgrade our aging barracks and infrastructure will be slowed, if not stopped altogether for a period of years. When taken together, all these cuts will inevitably make the future Joint Force less capable, at least in the near to mid-term.

The second place Services will be forced to cut will be in their operations and maintenance accounts. All the maintenance deferred in FY2013 will roll into FY2014. All the maintenance deferred in FY2014 will roll into FY2015. And so on, and so on. We will simply keep digging ourselves deeper and deeper into a readiness hole. The result will be that maintenance and training will be prioritized to those units deploying. Those that aren't scheduled to deploy won't train, at least to the levels to which they are accustomed. Consequently, while our forward deployed forces may be ready, their backup—our so-called "surge" forces—won't be. The Joint Force will thus be less resilient and ready if a major crisis erupts.

The effects of sequestration will not be all bad. One of the first rules of strategy is that all resources are scarce. The past decade of sustained defense budget increases has helped to obscure this enduring principle. Thus, inside the Pentagon, nothing will sharpen the debate and analysis more than the prospect of budget cuts and the need for DoD to become more efficient. One would thus expect the entire Department to take advantage of the opportunity provided by sequestration to better balance strategic ends, ways, and means; streamline business operations; and shed unneeded overhead. The recent announcement by Secretary Hagel that staffs will be reduced by 20 percent is a step in the right direction.

However, this process will be made more difficult by DoD's reduced freedom of action. For example, the Department urgently needs a new Base Realignment and Closure Round, to shed unneeded infrastructure. It needs to reduce personnel costs by shaving back some of the generous benefits given to the force over the past decade. It needs to charge our service members a bit more for the terrific health care benefits they are receiving, in order to halt the growth in costs of military health care. Yet, DoD is being precluded from pursuing these options as aggressively as it might. By working with DoD to address these difficult issues that are beyond their control, the White House and Congress could help reduce overhead costs, thereby making the effects of sequestration on investment and readiness far less onerous.

Pursuing Defense Budget Cuts in a More Responsible Manner

I have been personally touched by three of the five post-World War II defense drawdowns. As a young Marine Second Lieutenant in 1975, I arrived on Okinawa at the very tail end of the Vietnam War drawdown, where I saw firsthand its debilitating effects. I was on active duty throughout the thirteen years of the post-Cold War drawdown, observing both its start and finish. And as Undersecretary of the Navy, I was on hand to see the start of the current drawdown and helped fashion the initial programmatic response to it.

My greatest fear is that the way we are implementing sequestration could lead to many of the problems I found when I arrived on Okinawa. I initially lived in a barracks infested with rats and vermin. Our equipment was in shambles. We had little money to train with and even less to spend on things like toilet paper or office supplies. We were not remotely ready, and it was utterly demoralizing. It is hard for me to imagine things getting as bad as they were in 1975. However, unless we change the mindless way sequestration has been implemented, I see us headed into a similar downward spiral in readiness. And, once you dig into a readiness hole, it takes several years to climb back out, no matter how much money your throw at the problem.

I thus urge Congress to find a way to achieve the sequestration savings targets in a more responsible manner. Reducing DoD's sequestration targets in FY2014 and FY2015 and providing it with greater degrees of freedom to cut its overhead would help delay the near-term investment and readiness problems outlined above. More importantly, it would also allow the Department time to take a breath, conduct a full-blown Quadrennial Defense Review to better align its strategic ends, ways, and means, and better plan a responsible way to achieve its targeted savings.

I hope this Committee, and the entire Congress, will consider doing so.

Thank you.

Senator WARNER. Thank you, sir.

Ms. Green?

STATEMENT OF JENNIFER–CARI GREEN, SECRETARY, NEUROSURGERY AND PLASTIC SURGERY SERVICES, MADIGAN ARMY MEDICAL CENTER, REPRESENTING THE AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES

Ms. GREEN. Mr. Chairman, members of the Committee, thank you for the opportunity to testify today about the impact furloughs at the Department of Defense will have on my family's budget. My name is Jennifer-Cari Green. I am 26 years old. I am the divorced mother of a 6-year-old boy.

I have worked at Madigan since 2007 where I serve as a secretary for the neurosurgery service. I study full time at Pierce Community College and hope to earn my associate's in 2014. My ex-husband does live in the area but was terminated from AAFES in 2010, so his employment since then has been intermittent and part-time, likewise with his parental involvement and financial support.

My current budget is already stripped to bare bones, but we have been making it. Before furloughs, my finances were already such that I have to rent a small apartment in a not so great part of town. The car I drive and rely on to get to and from work, college, and my son's school or daycare is financed through a loan with a relatively high interest rate. I pay almost $360 a month for a 2011 Chevy Aveo. It is not a luxury vehicle by any means.

I live without luxuries. I do not have cable in my home. I do not go get my nails done or eat out frequently or any of the things that people think of that they will have to cut back on when times are tough. For my family, times have already been tough for quite a while. My salary has been frozen for the last 3 years, and because of the hiring freeze at DOD, I have been expected to do the work of two positions for over a year.

However, I have been able to provide a life for my son and myself without depending on others or public assistance, and that is something I have always been proud of.

I keep hearing 20 percent as the size of the pay cut that 11 furlough days creates when people talk about DOD furloughs. But that is really a misrepresentation of what being on furlough will mean for my household, and I am sure I am not the only one.

Based on a furlough calculator distributed at work, I will actually be losing 32 percent of my take-home pay because most of the deductions from my paycheck do not change just because my earnings go down. My take-home will go from $1,477 per month to $1,008 at a 32-percent reduction. So I will be losing—or I will be at least $215 short for monthly budget expenses that I cannot control. I do not know where I will make up that cost at this time let alone find room for anything extra. And by "extra," I do not mean entertainment costs or gifts or leisure activities. I mean car maintenance, medical prescriptions, school supplies, household goods. This furlough will likely cause me to slip below the line into poverty, and it feels punitive, and I worry that it will make me become a beggar. I am afraid that I will be forced to seek handouts, Government assistance, or food bank donations.

I have attached a chart to illustrate the impact that the furlough will be having on my budget. My gross will go down by $580 per month. That is the 20 percent that everyone talks about. The only reductions that go down with my salary are taxes and FERS. Everything else stays the same. So everything becomes a bigger percentage of my pay, and that is how I have a personal loss that is greater than 20 percent.

Even before furloughs, I have only been able to save $25 per pay period for TSP, which is not enough to receive maximum employer match, but it is what I can afford. So before furloughs, I was not able to fully participate in FERS either.

I often hear people talk about tightening your belt. I looked into dropping my medical insurance, but was told that I could not do that in the middle of a plan year. I cannot get to work without my car, and selling it for a cheaper car has other costs associated with it. I cannot find less expensive child care, although I have tried. I earn too much for my son to be eligible for free or reduced lunch or food stamps. I already declined to participate in employee- payall "benefits" like vision and dental insurance. There is really very little I can do to close the gap between what I earn and my expenses.

It is extremely difficult to come to work and to do justice to this job, to care for our patients with the level of compassion and concern and courtesy they deserve when you know you do not even have enough money to buy bare necessities as a working adult. To know that your efforts at being hardworking self-reliant, and dependable are for naught, to know that you had an implicit contract, a promise to receive a certain level of pay for your work, and that you accepted a job under those conditions, and then to spend all day away from your child, struggling against seemingly impossible odds to meet a mission and provide quality care in less time than seems fair.

To overextend yourself, to try to be helpful and as understanding as possible, and to make the patients are not the ones who suffer when so much of what determines their fate lies far beyond your own control. And at the end of the day, you still have to worry about whether or not your lights will be shut off or if you even have enough gas to make it to pick up your child and to take him home for supper.

And the mission only gets harder. Providing the type of care we are expected to provide and indeed owe to our service members and their families becomes almost impossible, surely improbable. I am trying to—and pretending like it is not is stressful.

Again, I thank you for this opportunity to testify. I ask you to end the austerity budgeting that led to sequestration and ultimately these furloughs. I am just one example of hundreds of thousands of Federal employees whose lives are being drastically damaged by these policies. We and service members who rely on us are the victims of these budget policies, and I ask you to remember that when you vote on policies that make it impossible for us to support ourselves and our families.

[The prepared statement of Ms. Green follows:]

AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES,
AFL-CIO

STATEMENT BY

JENNIFER-CARI GREEN
AFGE LOCAL 1502
MADIGAN ARMY MEDICAL CENTER
TACOMA, WASHINGTON

BEFORE THE

SENATE BUDGET COMMITTEE

ON

THE IMPACT OF SEQUESTRATION ON NATIONAL SECURITY AND THE ECONOMY

JULY 23, 2013

Madam Chairman and Members of the Committee, thank you for the opportunity to testify today. My name is Jennifer-Cari Green. I am 26 years old. I am a divorced mother of one. My son is six years old. I have worked at Madigan Army Medical since December 2007. I originally began at Madigan as a volunteer in the Surgical Services Center, starting in February 2007, and was hired as a medical support assistant to work in Orthopedics ten months later. After two years and a promotion to secretary, I moved to Neurosurgery, and that is where I have been working ever since. I am also a full time student at Pierce Community College, and alternate between night, evening and online classes. I hope to earn my associates degree by 2014.

My ex-husband does live in the area, but was terminated as an Army Air Force Exchange Service (AAFES) employee in 2010. Since then his employment has been intermittent and part-time. Likewise, his parental involvement and financial support are intermittent and frankly not very helpful.

My current budget is already stripped to bare bones, but we've been making it (barely). Before furloughs, my finances were already such that I have had to rent a small apartment in the not-so-great part of town. The car I drive and rely on to get to and from work, school and my son's school or daycare is financed through a loan at a relatively high interest rate; I pay almost $360 a month for a 2011 Chevrolet Aveo. It's not a luxury vehicle by any means. It's the smallest and least expensive car that GM makes. It's what I could afford and what I bought because I needed a safe and reliable car to get me from "point A" to "point B". (I was in an accident in January, hit by an uninsured motorist and my current budget did not have room for me to pay the deductible to have my car repaired. So I am paying monthly for a damaged car.)

I live without luxuries. I don't have cable in my home. I don't go get my nails done, eat out frequently or do any of the things people generally think they will have to cut back on whenever times are tough. For my family, times have already been tough for quite a while. My salary has been subject to the three year federal pay freeze. Because of the hiring freeze at DoD, I have been expected to do the work of two positions for over a year. However, I have been able to provide a life for my son and myself without depending on others, or public assistance and that is something I have always been proud of.

I keep hearing twenty percent as the big number – the size of the pay cut that eleven furlough days creates – when people talk about Department of Defense furloughs. But that's really a misrepresentation of what being on furlough will mean for my household, and I'm sure I'm not the only one. Based on a furlough calculator that was distributed from hospital administration in order to help employees figure out and anticipate the furlough's impact, I will actually be losing 32 percent of my take home pay because most of the deductions from my paycheck don't change just because my earnings go down. My take-home pay will go from $1,477.58 per month to $1,008.76 per month, a 32% reduction. This means I will be at least $215 short for monthly budgeted expenses that I cannot control. I don't know where I will make up that cost at this time, let alone find room for anything extra. By extra, I am not even talking about entertainment costs, gifts or leisure funds. I mean money for car maintenance, medical prescriptions, household good, and school supplies. This furlough will likely cause me to slip below the line into poverty. It feels punitive and I worry that it will make a "beggar" out of me. I am afraid that I will be forced to seek handouts, government assistance, food bank donations, etc.

I have attached my furlough calculator to illustrate the impact that the furlough is having on my budget. My gross pay will go down by $290.24 per pay period, or $580.48 per month. That is the twenty percent that everybody talks about. But the only deductions that go down when my salary goes down are taxes and the FERS; everything else stays the same. So everything else becomes a bigger percentage of my pay, and that's how I get a bigger than twenty percent cut in my take-home pay.

I want you to see that even before the furlough, I have only been able to afford to save $25 per pay period for the Thrift Savings Plan. That amount isn't enough for me to receive the maximum employer match, but it is all I can afford. So even before furlough I was not able to participate fully in the Federal Employee Retirement System (FERS).

I often hear people talk about "tightening your belt" but I have very few options available to me. I looked in to dropping my health insurance, but was told that I could not do that in the middle of a plan year. I cannot work without my car, and selling it and buying another less expensive one has other costs associated with it. I cannot find less expensive childcare, although I have tried. I earn too much for my son to be eligible for free or reduced lunch or Supplemental Nutrition Assistance Program (SNAP) or food stamps. I already decline to participate in the employee-pay-all "benefits" like vision and dental insurance. There is really very little that I can do to close the gap between what I earn and my expenses.

It is extremely difficult to come to work, and do justice to this job, to care for our patients with the level of compassion, patience, concern and courtesy they deserve when you know you don't even have enough money to buy the bare necessities as a working adult. To know that all your efforts at being a hardworking, self-reliant, and dependable woman and mother are for naught. To know that you had an implicit contract, a promise to receive a certain level of pay for your work, and that you accepted a job under those conditions, and then to spend all day away from your child, struggling against seemingly impossible odds to meet a mission and provide quality care in less time than seems fair.

To overextend yourself to try to be as helpful and understanding as possible, to make sure the patients aren't the ones who suffer when so much of what determines their fate lies far beyond your own control. And then at the end of the day, to have to still worry about whether or not your lights will be shut off, or if you even have enough gas to make it to go pick up your child and take him home for supper.

And the mission only gets harder. Providing the type of care we are expected to provide, and indeed owe to our service members and their families, becomes almost impossible, surely improbable. So much so, in fact, that even trying to pretend like it is possible is stressful.

I thank you for the opportunity to testify today. I ask that you end the austerity budgeting that led to sequesters, and ultimately, to these furloughs. I am just one example of hundreds of thousands of federal employees whose lives are being so drastically damaged by these policies. We and the service members who rely on us are the victims of these budget policies, and I ask you to remember us when you vote on policies that make it almost impossible for us to support ourselves and our families.

FURLOUGH PAY ESTIMATOR
IN THE EVENT SEQUESTRATION OCCURS

Complete the blue/green areas as reflected on your CURRENT Leave and Earnings Statement (LES). Estimated FURLOUGH amounts will automatically compute.
Enter adjustments to deductions in the red/orange areas to show new FURLOUGH amount with different voluntary deductions.

HOURLY PAY RATE $18.14

	CURRENT		FURLOUGH	FURLOUGH w/ADJ	
	%	$ Amount	(No Adjustments)	%	$ Amount
GROSS		$1,451.20	$1,160.96		$1,160.96
NONTAXABLE INCOME		$183.85	$183.85		$183.85
TAXABLE INCOME		$1,242.35	$952.11		$977.11
TAX DEFERRED		$25.00	$25.00		$0.00
DEDUCTIONS					
FEGLI		$6.00	$6.00		$6.00
OASDI *(FERS = 6.2%, CSRS = 0%)*	6.2%	$78.58	$60.58		$60.58
Tax, Federal	10.8%	$134.00	$102.69		$105.39
Tax, State	0.0%		$0.00		$0.00
Medicare	1.45%	$18.38	$14.17		$14.17
Retirement Plan *(CSRS = 7%, 7.5% or 8%)* *(FERS prior to 2013 = 0.8%, after 2013 = 3.1%)*	0.8%	$11.61	$9.29		$9.29
FEHB		$183.85	$183.85		$183.85
Dental			$0.00		$0.00
Vision			$0.00		$0.00
FSA			$0.00		$0.00
TSP (Traditional using percentage)		$0.00	$0.00		$0.00
TSP (Roth using percentage)		$0.00	$0.00		$0.00
TSP Catchup (using percentage)		$0.00	$0.00		$0.00
TSP (Traditional using dollar amount)		$25.00	$25.00		
TSP (Roth using dollar amount)			$0.00		
TSP Catchup (using dollar amount)			$0.00		
Allotment 1 (or other)		$240.00	$240.00		
Allotment 2 (or other)		$15.00	$15.00		
Allotment 3 (or other)			$0.00		
Allotment 4 (or other)			$0.00		
Allotment 5 (or other)			$0.00		
TOTAL DEDUCTIONS		$712.41	$656.58		$379.28
NET PAY		$738.79	$504.38		$781.68
CURRENT NET - FURLOUGH NET			$234.41		-$42.89
NET = % OF GROSS		51%	43%		67%
% OF LOST GROSS			-20%		-20%
% OF LOST NET			-32%		6%

Senator WARNER. Thank you, Ms. Green, for your story.
Mr. Spring?

STATEMENT OF BAKER SPRING, F.M. KIRBY RESEARCH FELLOW IN NATIONAL SECURITY POLICY, THE HERITAGE FOUNDATION

Mr. SPRING. Senator Warner, Senator Sessions, it is an honor for me to testify before the Senate Budget Committee on this pressing topic of the impact of sequestration under the Budget Control Act of 2011, which is currently in effect, on the ability of the Government to meet existing national security requirements and, finally, its impact on the economy. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation. With your permission, I will summarize my testimony. I have made my full statement available to the Committee pursuant to its rules, which the Committee may use as it sees fit.

I believe Congress at this point realistically has three options for future defense budgets. Unfortunately, all three would impose significant damage on the Nation's defense posture. This is because even the highest level of funding among the three options would shrink the portion of the economy committed to defense, shrink force structure, reduce the number of people serving in the military, impose slower increases in military compensation, reduce the scope of training and maintenance, and deprive the military of significant portions of the new weapons and equipment it needs. Most importantly, the budget reductions would result in a military of insufficient overall strength to meet the established security commitments the Federal Government has made to the American people and U.S. friends and allies around the world.

Let me go into the scope of these reductions under the three options.

I think that the three options that are available to Congress start with the Obama administration's fiscal year 2014 defense budget proposal: about a $100 billion reduction over 10 years from the spending caps imposed on defense under the BCA.

The second is something that is roughly equivalent to what the Senate has approved in its budget resolution, which I calculate as being in the neighborhood of a $300 billion reduction over 10 years from the spending caps imposed by the BCA.

And, finally, the sequestration level itself, which, as has been pointed out before, is roughly $500 billion over 10 years.

For practical reasons, however, I am going to limit my comparisons to the remaining period covered by the BCA— fiscal year 2014 through fiscal year 2021—because this is the best means of comparison for Congress as it drafts legislation on a defense program in the course of this year.

The following are the funding levels for the total defense program under the three options for the 8-year period. That includes overseas contingency operations and mandatory as well as the discretionary.

Option 1 would be $4.865 trillion, Option 2 would be $4.684 trillion, and Option 3 would be $4.489 trillion.

Accordingly, Option 2 provides about 4 percent less for total defense program than Option 1, and Option 3 provides about 8 percent less than Option 1.

It is important to understand, however, that the defense reductions have been going on for several years at this point. Even Option 1 in 2014 is more than 11 percent below what the Nation spent on defense in fiscal year 2010.

Let me speak about the economy here briefly.

Defense spending, like all Federal spending, imposes a direct burden on the economy. On the other hand, it provides essential indirect support for the economy both domestically and globally by providing the secure environment necessary for productive business activity. Further, as I described before, defense absorbs a relatively small share of the economy, and the share is expected to shrink in future years even under the best of circumstances. Unfortunately, this does not stop the critics of the defense program from asserting that the burden it imposes on the economy is intolerably high, and they are only too happy that the sequestration imposes a disproportionately high share of funding reductions on defense.

This circumstance leads directly to the question: If defense expenditures impose an intolerably high burden on the economy, how is it possible to explain that entitlement expenditures do not do so at an even much greater degree? In reality, defense is not now and in the future will not become the source of Federal Government's fiscal woes.

I believe that Congress needs to go back to square one, which is to establish a strategy first defense program based on the upcoming Quadrennial Defense Review, and through a strategy-drive approach, arrive at the proper funding figures which I think would be higher than all three of these options, and if put in the proper context, allow for U.S. economic growth.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Spring follows:]

TESTIMONY OF BAKER SPRING

F.M. KIRBY RESEARCH FELLOW IN NATIONAL SECURITY POLICY

THE HERITAGE FOUNDATION

BEFORE

THE SENATE BUDGET COMMITTEE

ON

THE IMPACT OF SEQUESTRATION
ON NATIONAL SECURITY AND THE ECONOMY

July 23, 2013

Madam Chairman, Senator Sessions, it is an honor for me to testify before the Senate Budget Committee on this pressing topic of the impact of sequestration under the Budget Control Act of 2011(BCA), which is currently in effect, on the ability of the government to meet existing national security requirements and its impact on the economy. My name is Baker Spring. I am the F.M. Kirby Research Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation. With your permission, I will summarize my testimony. I have made my full statement available to Committee pursuant to its rules, which the Committee may use as it sees fit.

Madam Chairman, as you know, the Department of Defense (DOD) has examined its options for proceeding under the extension of the ongoing automatic reductions in defense expenditures under the process of sequestration through fiscal year 2014, the outline of which Secretary of Defense Hagel has provided to the Chairman and Ranking Member of the Senate Armed Services Committee in a letter dated July 10. Given this outline, I believe Congress has three options for future defense budgets. Unfortunately, all three would impose significant damage on the nation's defense posture. This is because even the highest level of funding among the three options would shrink the portion of the economy committed to defense, shrink force structure, reduce the number of people serving in the military, impose slower increases in military compensation, reduce the scope of training and maintenance, and deprive the military of significant portions of the new weapons and equipment it needs. Most importantly, the budget reductions would result in a military of insufficient overall strength to meet the established security commitments the federal government has made to the American people and U.S. friends and allies around the world.

The Scope of the Reductions Under the Three Options

The three options available to Congress are:

1. The Obama Administration's fiscal year (FY) 2014 defense budget proposal: a $100 billion reduction over 10 years from the spending caps imposed on defense under the BCA;
2. A $300 billion reduction over 10 years from the spending caps imposed by the BCA; and
3. The level of funding for defense provided by the BCA in accordance with sequestration, which is a $500 billion reduction over 10 years.

The best starting point for comparing the three options is President Obama's request for defense in FY 2014 and beyond, which Secretary Hagel has confirmed as the Administration's preference. However, the DOD has also revised the request to provide a firm number of a bit over $79 billion for the defense portion of overseas contingency operations (OCO) in FY 2014, but it omits OCO funding levels for any year beyond FY 2014.

For practical reasons, however, I will limit the comparisons to the remaining period covered by the BCA (FY 2014 through FY 2021) because this is the best means of comparison for Congress as it drafts legislation on the defense program in the course of this year. The following are the funding levels for the total defense program under the three options for the eight-year period:

- Option 1: $4.865 trillion;

- Option 2: $4.684 trillion;
- Option 3: $4.489 trillion.

Accordingly, Option 2 provides about 4 percent less for the total defense program than Option 1. Option 3 provides about 8 percent less than Option 1. It is important to understand, however, that the defense reductions have been going on for several years at this point. Even Option 1 in FY 2014 is more than 11 percent below what the nation spent on defense in FY 2010.

By way of analysis, there are eight bases for comparing the three options and their impact on defense. Each basis provides Congress a different means for assessing the impact. All of the comparisons apply the spending amounts in percentage terms and on a straight line across elements of the defense program:

1. **Percent of GDP devoted to defense.** Option 1 would reduce the share of the economy devoted to defense to 2.6 percent in FY 2021, as measured in budget authority. Option 2 would reduce it to a little more than 2.5 percent. Option 3 would reduce it to somewhat less than 2.5 percent. By way of comparison, the U.S. devoted 5 percent of gross domestic product (GDP) to defense in FY 2010.
2. **Modernization funding.** Modernization funding is defined here as the sum of procurement and research and development. The Administration's current budget is proposing to spend roughly $200 billion in FY 2021 on modernization. Option 2 would reduce it to around $190 billion in FY 2021. At best, Option 3 would leave it at about $184 billion. The latter figure depends on the formula for sequestration being eliminated, which would end its exemption for military personnel funding.
3. **Active-duty manpower levels.** It appears that the Obama Administration wants to stabilize active-duty manpower in the military. Accordingly, Option 1 appears to support a total active-duty manpower level of 1,326,000. Option 2 would reduce it to 1,273,000. Option 3 would reduce it to 1,220,000. Comparatively, the military requested 1,401,000 total active duty personnel in FY 2013.
4. **Air Force force structure.** The Obama Administration has an objective of retaining 40 combat-coded Air Force fighter squadrons in the active service. This represents the Air Force active force structure under Option 1. Option 2 would reduce it to 38. Option 3 would reduce it to 37.
5. **Army force structure.** The Obama Administration's objective is to retain 37 active brigade combat teams (BCTs), which represents the active army force structure under Option 1. Option 2 would reduce it to 35 or 36. Option 3 would reduce it to 34. By way of reference, the army currently has 45 active BCTs. It should be noted that Army Chief of Staff Raymond Odierno announced that the Army intends to reduce active BCTs to 32 or 33, but this is being done, in my judgment, for structural as well as budget reasons.
6. **Navy ships.** The Obama Administration's objective is to retain 291 ships. There is considerable uncertainty regarding the viability of this objective under Option 1 funding levels. Option 2 would reduce this number to no more than 279. Option 3 would reduce it to no more than 267. These numbers could be significantly lower.

7. **Missile Defense Agency (MDA) funding levels.** The Administration's current budget proposal, which is in keeping with Option 1, looks to fund the MDA at about $7.5 billion annually later in this decade. Option 2 would reduce this amount to $7.2 billion. Option 3 would fund the MDA at $6.9 billion. The MDA budget for the current fiscal year is $8.3 billion—prior to the application of sequestration.
8. **Funding for atomic energy defense activities.** These activities are largely under the Department of Energy (DOE) and the National Nuclear Security Administration, which is under the DOE. The Obama Administration is proposing to fund these activities at $20.5 billion in FY 2021. This funding level is in accordance with Option 1. Option 2 would reduce this amount to $19.7 billion. Option 3 would reduce it to $18.8 billion. It should be noted that nuclear weapons delivery vehicle acquisition programs are under the purview of the DOD and are funded under the modernization accounts described above.

Defense Spending and the Economy

Defense spending, like all federal spending, imposes a direct burden on the economy. On the other hand, it provides essential indirect support for the economy both domestically and globally, by providing the secure environment necessary for productive business activity. Further, as I described earlier, defense absorbs a relatively small share of the economy and the share is expected to shrink in future years even under the best of circumstances. Unfortunately, this does not stop the critics of the defense program from asserting that the direct burden it imposes on the economy is intolerably high; they are only too happy that sequestration imposes a disproportionately high share of funding reductions on defense.

By contrast, the major entitlements – Social Security, Medicare, and Medicaid – already absorb a much larger share of the economy now and will absorb increasing shares of the economy for decades to come. According to my colleagues at The Heritage Foundation who do economic and broader budget analysis, these three programs will outstrip projected economic growth so that by the middle of this century their share of the economy will almost double. They also forecast that these three entitlement programs will absorb 100 percent of historical levels of federal revenue by about the same time. Finally, they assess that even eliminating defense spending completely would not balance the budget, assuming other existing elements of their budget projections remain intact. This circumstance leads directly to the question: If defense expenditures impose an intolerably high burden on the economy, how is it possible to explain that entitlement expenditures will not do so to a much greater degree? In reality, defense is not now and in the future will not become the source of federal government's fiscal woes.

Does the Obama Administration Want Sequestration for Defense or Not?

As I alluded to earlier, among the three options, the Obama Administration has publicly endorsed Option 1. In reality, however, I believe it has chosen Option 3.

Since the enactment of the BCA in 2011, the Obama Administration has consistently stated that it does not want sequestration cuts to apply, and the President's current defense budget proposal does not account for it. On the other hand, the White House has just as consistently opposed proposals from the House of Representatives to set sequestration aside by issuing veto threats. I believe it is becoming clear that President Obama's position against the application of sequestration to defense is being driven more by tactics and less by a genuine commitment to protecting his defense proposal. Specifically, it is entirely plausible that he and

Secretary Hagel are decrying the impact of sequestration on defense for the purpose of ramping up pressure on the House of Representatives to permit the further acceleration of the rate of growth in domestic spending, particularly for entitlements, and to raise tax rates. After all, Secretary Hagel called the defense budget "bloated" in 2011, and it is difficult to imagine that his view in 2011 was uninformed. Logic dictates that the about-face he has taken regarding the negative impact of further defense budget reductions in his July 10 letter stems from reasons other than a realization that his assertion in 2011 was wrong.

The Role of Congress

Looking ahead, Congress should set aside the ongoing budget-driven exercise for defense in favor of proceeding with the Quadrennial Defense Review (QDR) through a strategy-driven approach. Further, it should demand that the QDR establish a national security policy that meets the needs of the nation and then recommends funding the defense program at the necessary level. More immediately, however, Congress should not sit by passively as the Obama Administration claims that it supports adequate funding for national security while behaving in ways that effectively block such funding. National security requires setting aside sequestration and imposing restraint on domestic spending, most particularly by adopting carefully planned reforms of the major entitlement programs, which is necessary to the purpose of accelerate U.S. economic growth.

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Senator WARNER. Thank you, sir.
Mr. Donnelly?

STATEMENT OF THOMAS M. DONNELLY, RESIDENT FELLOW AND CO–DIRECTOR OF THE MARILYN WARE CENTER FOR SECURITY STUDIES, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. DONNELLY. Thank you very much, Senator Warner and Senator Sessions. It is an honor to be here. I say that as somebody whose previous congressional service was on the other side of the Hill, so I will try to bury my House hostility towards the senior body for a moment or two, if I may.

I would also like to deviate a bit from my prepared testimony and try to bring together some of the themes that I have heard in some of my colleagues' testimony.

I would begin with the observation that even though sequestration makes the problem much, much worse and late sequestration in 2013 doubled that effect and, as Bob Work said, will ensure that it extends for a year or more to come, the problem began before sequestration. One thing I hear particularly from Jennifer's testimony and Mr. Klett's testimony was that they were not exactly living the high life before sequestration happened. He described his business as a nonprofit, and it is clear from Jennifer's story that she was not exactly mailing it in at her job either. And I think that observation can be made broadly about the Defense Department. The taxpayer has received extraordinary value for the cost of the U.S. military, and so the idea that there is a lot of waste, fraud, and abuse that will allow us to make cuts in an easy way without consequences I think is disproved by the testimony of both Mr. Klett and Ms. Green.

The other point I would like to make is to pick up on a subject that Bob raised about the genuine strategic effects, and I think he is quite right to observe that the President's defense guidance did represent the crossing of the Rubicon for this country in the years actually going back before World War II.

To be a global power, to play the role the United States has played since that time, requires us to be able to do two things at once, to fight two major campaigns at once. And it is not surprising that back in the late 1930s the Congress passed the Two-Ocean Navy Act. Two is the right answer for a global power. We have crossed that threshold again, as Bob observed, with that debate. And we see the consequences of not only the strategic change in course that has been made, but by the steady erosion in the ability of the U.S. military to execute the strategy that has long been accepted by Presidents of both parties. We see it every day in the headlines from the Middle East where the U.S. withdrawal is precipitate, and the absence of American power is probably the most important influence on events that are happening there. It is also true particularly in Southeast Asia but in East Asia more broadly. Bob mentioned the Pacific pivot. The United States has been less and less present in the Pacific, particularly since the late 1980s when we withdrew from the Philippines. It took a long time. We had established a genuinely durable peace and set of security arrangements there that has allowed for the economic transformation of that region and to the benefit of both America and the rest of the world. But now it has become a contested area as the Chinese elbow their way back across the South China Sea and begin to intimidate not only our partners out there but our treaty allies in the region.

So I would argue we already see the consequences not just of what sequestration has done. That will be visible, it is already visible in small businesses, in Madigan Hospital, certainly on the training ranges where small units should be doing their business. I had recently visited Fort Carson in Colorado Springs, and I was appalled to see soldiers flipping burgers in the chow hall again. I had not seen that since the late 1970s. So these effects have opportunity costs as well as strategic costs as well.

But there is no way that the world is going to stay the same if the United States plays a lesser role in the world. It will be more violent, it will be less secure, it will be less prosperous, and it will be less free.

Sequestration is the first problem to fix, but only the first problem to fix. And if we fixate on the trees rather than looking at the forest, we will miss the larger picture of which sequestration is only a slice.

Thanks for your time.

[The prepared statement of Mr. Donnelly follows:]

MARILYN WARE
CENTER FOR SECURITY STUDIES

Testimony of Thomas M. Donnelly

Resident Fellow and Co-Director of the Marilyn Ware Center for Security Studies
American Enterprise Institute for Public Policy Research

Before the

Senate Budget Committee

On "The Impact of Sequestration on National Security and the Economy"
Tuesday, July 23, 2013

There is, when viewed from a distance, an undeniable "Chicken Little" character to statements about sequestration coming out of the defense community. Even before the 2013 cuts took effect, former Defense Secretary Leon Panetta warned of "the most serious readiness crisis" in more than a decade.[1] Gen. Martin Dempsey, chairman of the Joint Chiefs of Staff, predicted that the effects would "incur an unacceptable risk."[2] And now Secretary of Defense Chuck Hagel has taken his turn on the chorus, arguing that unless the Congress accedes to the administration's 2014 budget request, that the Pentagon "would be required to make major changes" in its plans.[3]

Secretary Hagel's July 10 letter, however, does represent a crack in the administration façade – at least compared to last year, when the Defense Department was enjoined either from specifying the effects of sequestration or in formulating contingency budget plans. And, of course, as a result, the late-in-game enactment of the 2013 cuts much multiplied the amount of pain they are causing.

But sequestration is sequestration; that is, the mechanism will be basically the same regardless of what political process produces the cuts. This also includes cuts arrived at through a "normal" congressional budget process. It may be that sequestration is a mindless way to reduce spending – and delayed sequestration the most mindless – but what matters most are the numbers. Even if managed "rationally," a further reduction of 10 percent per year for the next decade, coming on top of the cuts already made in the past, will have, in my judgment, a crippling effect on the American military, on the United States' ability to shape a peaceful, prosperous and free world, and ultimately, on our national security. Secretary Hagel's letter is a useful yardstick to measure these effects.

Hagel begins by discussing the personnel effects; quite rightly, with a very small "all-volunteer force," with less than half of one percent of Americans serving on active duty, "people issues" are and must be front and center. But, as the secretary notes, the personnel system established over the last generation was designed for the purposes of stabilizing the force. Notably, President Obama chose to exempt military personnel accounts from sequestration in 2013, predictably exercising the authority in the law. Thus, Hagel observed, in a 2014 sequestration,

> [m]ilitary personnel funding cuts would be disproportionately small (probably only a few percent of total military personnel funding) because reducing the size of the military yields relatively small savings in FY 2014. Even involuntary separations of military personnel save little in the year they occur because of added costs associated with separation payments….Achieving a proportional, 10 percent cut in military personnel funding in FY 2014 would require that DoD put in place an extremely severe package of

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[1] Elisabeth Bumiller, "Panetta Warns of Dire Consequences to Military From Budget Cuts," *The New York Times*, February 6, 2013, http://www.nytimes.com/2013/02/07/us/politics/panetta-warns-of-dire-consequences-to-military-from-cuts.html.

[2] US Senate Committee on Armed Services, Hearing to Receive Testimony on the Defense Authorization Request for Fiscal Year 2013 and the Future Years Defense Program, February 14, 2012, http://www.armed-services.senate.gov/Transcripts/2012/02%20February/12-02%20-%202-14-12.pdf.

[3] Letter to Chairman Carl Levin and Ranking Member James Inhofe from Secretary Chuck Hagel, July 10, 2013, http://projects.militarytimes.com/pdfs/hagel-letter-sequestration.pdf.

> military personnel actions including halting all accessions, ending all permanent-change-of-station moves, stopping discretionary bonuses, and freezing all promotions.

The only way to offset these problems of inflexibility in personnel spending would be to accelerate the overall force drawdown now underway in an attempt to forestall similar sequestration headaches in the future.

The most immediate effect of sequestration would be in operations and maintenance accounts, and particularly those elements of O&M that fund unit readiness. In his letter, Secretary Hagel reiterates the need to increase readiness funding in FY 2014 to make up for the problems created in FY 2013 – not reduce it further. Moreover, these budget accounts pay for civilian personnel, facilities maintenance and many health care benefits that are governed by laws, rules and regulations that constrain budget flexibility. This, in essence, places an even greater burden on true readiness accounts. Thus Hagel predicts that, under a 2014 sequestration,

> military training and readiness would remain at currently degraded levels or, in some cases, would even continue to decline….[T]wo Navy air wings might not be able to achieve full flight hours and special operations units, which are key to counter terrorism activities, would experience declining readiness. The Army…has cancelled many of the culminating training events at its combat training centers, would have difficulty avoiding similar cutbacks in FY 2014. The Air Force…. has had to stop all flying at about one third of its combat-coded active squadrons….

But the longest-term effect of sequestration would be to further erode the technological edge U.S. military forces have long enjoyed, reflected in cuts to weapons procurement and research. These accounts have been profoundly underfunded since the end of the Cold War. Almost without exception, a whole generation of systems has been canceled, produced in severely limited quantities before termination or seen stretched schedules that have resulted in years of delay and multiplied costs. The Air Force bought only 21 B-2 bombers and 187 F-22 fighters. The Navy aborted submarine and destroyer projects as well as its first attempt to produce a stealthy carrier aircraft. The Army has not bought a single major new system of any sort.

The Real-World Effect

Yet none among this flurry of figures is a direct measure of how Americans view their national security: their physical safety, their political liberty, and their economic prosperity – securing "life, liberty and the pursuit of happiness," as the Declaration of Independence reckoned the proper business of legitimate government.

The smaller, less well-trained, less well-equipped force that will be the inevitable result of past cuts – the "baseline" cuts contained in the Budget Control Act and the Act's sequestration provision – will not be able to fulfill the missions long demanded of it by the nation. The Joint Chiefs have said that if they were forced to make deeper cuts they would have to "adjust their strategy."[4] Such a formulation makes it sound as though American strategy were endlessly adjustable and variable, as though all one had to do was dial back the "strategic rheostat" in relation to budget and force levels, and that the machine would keep humming along.

But what it means in the real world is that the world will have to get along without what has been the reassuring presence of U.S. military forces and without the deterrent certainty that, in a crisis, the United States would be the first to respond and be capable of applying decisive military power. There are some – most notably our adversaries – who view American military presence and power as a problem. On the other hand, there is a remarkable correlation between the energetic exercise of American global military power and the absence of direct great-power conflict since 1945. The world America has made has been, to my historically-inclined mind, exceptionally peaceful. Absent that presence, the world will certainly be different, and almost certainly more violent; we see this every day across the Middle East, where the American withdrawal has been most precipitate, but we also see it in the South China Sea, a region from which the United States drew back in the late 1980s.

Nor can we imagine that the unprecedented progress of democratic forms of government will continue at the pace it has since the end of the Cold War, or that the growth of prosperity that has come from accelerated and open global trade – a system that has lifted hundreds of millions of human beings out of what was millennia of abject poverty and misery – will continue as it has either. While liberty and prosperity are themselves complex phenomenon, they are linked to – indeed dependent upon – international security.

The peaceful, free and prosperous world that America has made, and that the U.S. military has secured, is a robust and fundamentally healthy thing. It is easy to assume that it can survive sequestration or another round of budget cuts. And, of course, no one can say with certainty which straw will break the camel's back. What is certain, however, is that no amount of defense spending cuts – not even eliminating the Department of Defense entirely – would do much to remedy the federal government's fiscal woes; neither balancing the annual budget nor much affecting the national debt. When former JCS Chairman Adm. Mike Mullen worried that the debt and deficit were his top national security priorities, what he meant was that it was these fiscal woes that were threatening U.S security, not that the cost of security was bankrupting the nation.

[4] General Martin Dempsey, House Committee on Armed Services, Hearing on the Recent Developments in the Middle East: The Security Situation in the Syrian Arab Republic, April 19, 2012, http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg74473/html/CHRG-112hhrg74473.htm.

Senator WARNER. Thank you, Mr. Donnelly, and I think you did a good job of hiding your House biases in those comments.

[Laughter.]

Senator WARNER. Let me start by acknowledging that I think, like most of us, I agree we need to get rid of sequestration. I believe that it is going to require revenues and entitlement reforms. I believe there are smarter cuts that can be made. And while today I think the appropriate focus is on the defense side of the house, I think it is also just as important for the record to remind my colleagues and others that, in the aggregate, cuts since the beginning of this Presidency on the domestic side have been equally large. As a matter of fact, Senator Sessions cited defense at 17 percent spent, domestic discretionary at 16 percent. And if we were ever to adopt the House plan, which takes that 16 percent down over a little over past a decade to around 4 percent, I simply ask, not as a Democrat or Republican, but as a former business investor, would you ever invest in a business that spent less than 5 percent of its revenues on training and educating its workforce; staying ahead of the competition in research and development; and investing in its plant and equipment; which as a Nation is our infrastructure? That is a bad business plan for America. So I do hope, as all of us said, that we can find some common ground here.

I want to start my questioning with Mr. Klett on the question of how stupid this is in terms of operations. We are running the largest enterprise in the world on 30-, 60-, 90-day continuing resolutions. And I guess what I would ask you to speak to a little bit, Mr. Klett, is, you know, what kind of added bureaucracy is there in this starting and stopping of your workforce? What kind of additional paperwork do you have to submit? What kind of inefficiencies are being built into your processes without having any kind of ability to predict when you are going to receive the revenues you need to operate your business?

Mr. KLETT. Yes, sir, Senator, a very good question. Although we are a small business, we have a number of prime contracts with a number of the large agencies, and sometimes we can—and most of the time they are renewed annually. However, sometimes they cannot renew them annually. Sometimes they fund them for 6 months. When we have subcontracts with large companies, we have to redo things from the very get-go. I mean, these are the reasons why I have to put people on the bench for 2 weeks to 2 months, because the paperwork comes to the large companies, then we have to put somewhere between 50 to 60 pages of paperwork that they already have, but these are requirements of the bureaucracy. Unintended consequences, this is not anything that I think anyone in this room or in Congress or anywhere—but you have to start all over again.

Senator WARNER. I think that this question of starting and stopping, the added costs that that has added in—and one of the things we have not been able to get is a good handle on that.

I guess the other thing I would like to ask Mr. Work, Mr. Spring, and Mr. Donnelly on this, I actually believe this undermining of readiness is almost a cancer inside. And, again, if we can speak to that on a cost basis, the notion of what it would take to kind of get Navy pilot Senator Kaine and I met ith down in Oceana, to kind of get their skill level back up if it has decayed is going to cost more than maintaining it on a regular basis. Do you want to speak to that comment?

Mr. WORK. Yes, sir. As I said, I was a marine second lieutenant in 1975 right at the end of the Vietnam War drawdown. I was assigned—my first barracks was infested with rats and vermin. We did not have enough money to train. Our equipment was in a shambles.

Once things started getting better in the early 1980s, I think as a battery commander later, it probably took until 1985 for the force really to dig itself out of the hole. And it is hard for me to imagine that things would get as bad as they were in 1975, but because of the way sequestration is triggered, where you start in a hole in 2013 and start digging deeper in 2014 and start digging deeper in 2015, as you said, pilots start to lose their quals on a carrier after a week. And after 90 days, it takes a long time to get those skills back.

So the cost of maintaining readiness is far less than the danger of putting a non-ready force in combat.

Senator WARNER. I want to get one last question in. I apologize. And I think Senator Sessions mentioned this. I think actually what I keep hearing—and in many ways, Virginia is ground zero on this issue because we have such a high preponderance of defense, whether it is civilian workforce or others— they just cannot believe we will allow this to continue. So in many ways, fiscal year 2013, people have been kind of covering their bets and moving around, the last little amounts, as you pointed out, 2014 is exponentially worse than 13 because there is nothing left.

The last comment, I just simply want to ask maybe Ms. Green, what is the effect beyond this it is having in terms of your livelihood? What is effect is this having not only on you but the many other folks you work with in terms of morale?

Ms. GREEN. Well, we have already lost a lot of staff when sequestration passed and they announced that furloughs were going to be happening. A lot of the staff either retired, if they were eligible to do so, or just simply quit and looked for employment elsewhere. And personally I love my job, I love working at Madigan, but my supervisor has already come to me and said, "If you need a letter of recommendation, I would be more than happy to give you one, although I would be very upset to see you go because we cannot ask you to stay with this burden." And so that is probably what I would be looking at doing.

Senator SESSIONS. Thank you. Well, Admiral Mullen said the greatest threat to our national security is our debt, and I think one of the things he was anticipating was that we would be in a situation where we unnecessarily and improperly reduce our defense spending, leaving us more vulnerable than we should be. I think that it is a very serious matter we are dealing with.

There are some things, I think, Senator Warner, that we could do. I do believe the most important thing you suggested was in the next 2 years if we can avoid the more dramatic cuts that the private businesses and all are having to take.

As I look at the numbers over 10 years, here is what they are: for 2014, as I noted, we were projected to spend $586 billion. That was projected spending in the 2012 FYDP. We will actually spend, unless something changes, $475 billion. So that is $111 billion less. That is a dramatic reduction. If you had to reduce any private business' expenditures by 20 percent in one year, it would be in trouble. I am upset about the White House. They have told the military not to plan for these cuts. They have directly told them not to. We asked them in Committee, "What is your plan?" We tried to pass legislation to mandate that they produce a plan, and we still have not really gotten that.

But then in 2015 it goes up from 475 to 488; in 2016, 499; 2017, 511; and so on. It goes on up. But over net, in inflation-adjusted dollars, my Budget Committee staff concludes that it is a net reduction of 11 percent in the Defense Department. And then we also had some residual benefits, I suppose, from the OCO spending that will be gone shortly.

Remember, now, for anyone listening, the costs we are talking about do not include the war costs. That is entirely separate, funded by emergency spending. And, in fact, one thing we might could consider, Mr. Chairman—you are Acting Chairman—$4 billion is OCO money, is hammering the Defense Department at this time, too. Maybe we could all agree that that ought to be funded as we have the rest of OCO and not out of the base defense budget. But that is just one of the things that could add together to put us in a place where we could get out of such dramatic reductions.

Mr. Donnelly, I am of the view that there is some ability to reduce spending in the Defense Department without reducing our ability to provide our global role. But I believe these reductions are too great. But I thank you for sharing this fundamental question that we have to wrestle with: What will be the role of the United States in the world to come? Are we going to continue this leading from behind or this reduction of our presence? And sometimes I think so. Sometimes I think maybe we are too engaged. But then, again, a vacuum of leadership from the United States you believe, you have expressed, could impact the stability, the prosperity of the world.

Mr. Work, would you comment on Mr. Donnelly's comment in that regard?

Mr. WORK. Well, I do not believe that we have crossed the Rubicon yet. As I said, I believe that the "Priorities for 21st Century Defense" was a very cohesive and coherent document. But I agree with my good friend Tom that a global superpower needs to be able to respond to two crises simultaneously. We are at that level right now. I consider it to be the minimum standard.

Sequestration I think will make it more difficult to achieve that, but I agree with you that I think that further cuts could be taken, responsibly, provided we had some time to really prioritize and think about the cuts and keep from digging a readiness hole that we simply would take too long to dig out of. So I believe there are—

Senator SESSIONS. Well, let me just—a couple things.

First, I believe our first responsibility, Senator Warner, would be to see what we can do about the next 2 years and see if there are not some ways that we can work together to lessen the irrational impacts that would happen.

Second, Mr. Work, do you have a number in your mind about where we ought to be.

Mr. WORK. I agree with Baker that it really should be driven by a strategy, so we have the QDR first. Then I would be able to answer that question intelligently.

I personally believe that the $520 billion would be a really difficult swing, but I think it should be developed by strategy, and that should inform how much we should spend to implement that strategy.

Senator SESSIONS. Mr. Spring, I guess my time is up. I would ask you to respond. If you had a brief comment, maybe the Chair would let us do that.

Mr. SPRING. Let me say that—

Mr. SPRING. It should be driven by the strategy, and that number, in my judgment, will be significantly higher than even what the President has proposed as the first option that I described. But we also need to do look at this from a fiscal policy perspective—this is the Budget Committee, after all—and what is the effect on the economy. In my judgment, I think the United States can easily afford up to 4 percent of GDP for defense. But we are on our way to basically 2.5. So that I think that the economic argument that defense is the source of our fiscal problems is really wrong. What we need to do—and I have a slightly different opinion than Admiral Mullen. Clearly the debt is a really serious problem, but I would still outrank the future expected growth in the entitlement programs to be the greatest threat to the U.S. national security.

Senator SESSIONS. Thank you.

Senator WARNER. I would simply add, Senator Sessions, I would concur that maybe the defense planning for sequestration was not that good. I have to say I do not think the domestic agencies did much better planning because I think there was this great hope that perhaps—again, I just recall the discussions back when this took place. This was such a bad option that no rational group of people would ever let it happen.

Senator SESSIONS. I just talked to an agency person, I said, "Will you be having layoffs?" They said, "No. We planned early, and we are not going to have to have layoffs." So some of the layoffs and furloughs are a result of lack of planning. There is no doubt about that.

Senator WARNER. Senator Whitehouse.

Senator WHITEHOUSE. Thank you. Yes, I think for those who say that Congress cannot get anything right, the sequester certainly disproves it. It was intended to be stupid, painful, and damaging, and sure enough, it has been stupid, painful, and damaging. What we did not foresee was that there would be a hard-edged group of people in Congress who wanted cuts at any price, cuts at any cost, and were willing to allow the sequester to go into effect. And there is still work going on. I know that Chairman Levin and Senator McCain, who are two of the defense experts in this, are trying to continue to work towards a way to fund an end to the sequester. It probably will involve raising taxes. That should not come as a surprise because Domenici-Rivlin, Simpson-Bowles, all of the independent groups that have taken a look at the debt problem, have had revenues built into that. But we want to be pretty clear about what we are looking at. What we are looking at mostly is, for instance, the offshoring of revenues so that companies hide revenues overseas. That has been the subject of the Levin-McCain effort.

I am from Rhode Island. CVS is a great American corporation. It pays a 35-percent tax rate. Carnival Cruise Lines hides its revenues overseas and pays a 0.6- percent tax rate. Why we need to be defending a 50:1 discrepancy in corporate tax rates and preventing the sequester from going forward makes no sense.

Hedge fund billionaires pay often a lower tax rate than a Rhode Island brick mason. I mean, literally you are making $1 billion a year, and you are paying a lower tax rate than a brick mason? That does not make any darn sense.

So what we have got to remember is that the Tax Code is not just rates. It is also riddled with loopholes and with special favors that people have carved out for themselves over time. And if we cannot even look at those, yeah, then the sequester is going to continue. But when Rivlin- Domenici, when Simpson-Bowles, when every independent person that has taken a look at this has said revenues have to be a part of it, when the revenues that you are protecting are lower tax rates for billionaires than for brick masons, and continued rights for certain corporations to cheat on taxes and disfavor the American corporations that pay their taxes here by hiding their revenues overseas, pretending that their intellectual property is in Ireland, all those gimmicks and games, I mean, we have got to be willing to look at that, I think, if we take this problem seriously, and if it is, in fact, the number one issue that we have got in this country that the debt is too high.

Well, if that is the number one issue, then protecting those things presumably is a number two or a number three or a number 250 issue and should yield to the number one issue.

We see this in Rhode Island right now happening. This past weekend was the Save the Bay's annual swim across Narragansett Bay, and because we could not use Naval Station Newport, we could not swim across Narragansett Bay. So they went out and back around buoys instead.

We have canceled the annual air show at Quonset. Water Fire brings huge crowds to Providence and is a wonderful, wonderful civic event. Canceled in many cases because of the Army Corps' inability to play their role in it. The National Guard Leap Fest, which is a parachuting display and competition, also canceled. But as Ms. Green pointed out, you know, these symbolic things take place and are very visible effects of sequestration.

But when it hits home with a 20- to 30-percent reduction in your take-home and you have got expenses and you have got a family to take care of, that is really where the rubber hits the road. We have seen 90 layoffs among the top ten defense contractors in Rhode Island just March to July. I do not know that they are all sequester, but I strongly suspect that the timing would indicate that.

We have got 4,200 civilians at Naval Station Newport now subject to furlough, and the whole darn thing is unnecessary.

I want to appreciate particularly Ms. Green's testimony because she really made it so clear how, when it comes right down to people, this is really hurting people. We deal with statistics very often here, Ms. Green, and sometimes they are nowhere near as compelling as a personal story. Yours was really valuable, and I appreciate it. I appreciate all the witnesses' testimony and the agreement we have that the sequester has indeed been stupid, painful, and damaging. Now let us hope that we can get beyond it.

But if one party is going to draw a bright line and say, no, billionaires paying lower tax rates than brick masons is more important than solving the sequester, that is a sticking point. If they are going to say that corporations should be able to offshore their income places and pay a 0.6-percent tax rate, yeah, that is going to be a sticking point, because we have got to be able to look at those inequities and be reasonable about this.

So I thank the witnesses, and I appreciate the Chairman for the hearing.

Senator WARNER. Thank you, Senator Whitehouse. I did not ask the question, but I am sure Ms. Green did not get a sequestration discount from daycare, car payments, or rental payments.

Senator Kaine?

Senator KAINE. Thank you, Mr. Chairman, and to all the witnesses, thank you for being here for your testimony and for your agreement on the proposition that we need to be strong as a Nation and we need to have that national defense that is both strategic and funded at an appropriate level.

I think that still is a bipartisan view among folks in this building in both chambers. How we get there is a challenge, and I just want to begin by saying, you know, some of—I have a polite difference of opinion with my friend Senator Sessions about where the blame in this lies and with at least one of the witness' written testimony.

It would be comforting to say that the President and the administration is to blame for this. It would be comforting as a Member of Congress to put the blame on the administration for sequester. But it is squarely on the shoulders of Congress.

The Budget Act of 1974, it is the Senate and the House that pass the budget. It does not even go to the President for signature. It is a resolution. We have not passed one for a number of years.

The role of the Congress in appropriating money, it is a congressional role. There is not an appropriations bill that gets to the President's desk if Congress has not passed it. And so if the funding levels are not what they ought to be or if the budget is not what it ought to be, it is not the President's fault.

I could find instances of leadership where I think the President should have done more to force this, but the President cannot make an ill-behaved Congress behave. He does not have that power and no President has that power. We are the first of the three branches in the Constitution. We are the one that was meant to be the most powerful. And we have fallen down so badly on this budgetary job that while it would be comforting to put the blame on somebody else, I do not think we can.

We had a February vote in the Senate to avoid the sequester completely. It got more than 50 votes in the Senate, but because of the choice of the minority, which was their choice, to use filibuster procedures, a majority was not enough in that instance to turn off the sequester.

We had a budgetary vote in March that restructured the sequester to much better effect, and the budget passed in the Senate for the first time in 4 years.

We had a markup of an NDAA in the Armed Services Committee in June, and a unanimous Committee vote in that instance that the sequester was a bad thing for national defense and should be replaced.

And we are currently in a battle. We are in a battle about compromise. About compromise. There is a House budget, and there is a Senate budget. If you know nothing about either of these budgets, let me tell you one thing. The Senate wants to go into a budget conference, to sit down at a conference table with our House colleagues, to bring our budget to the table and have them bring their budget to the table, and to listen to each other and see if we can find compromise.

The House does not want to go into a conference, and they have used what a few Senators have described themselves in the Senate—we are a handful of Senators who are blocking a conference, and they are blocking it at the request of their House colleagues. If you knew nothing about the two budgets, House and Senate, and all you knew is that one side wanted to go into a conference room and sit down in a conference and find an answer, and one side did not, that should tell you something. And what it should tell you is that one side has a confidence in their position and in their budget and they are open to finding an answer, and one side lacks the confidence in their position and they are afraid of sitting down at a conference table where there will be a spotlight shining on both budgets that the American public can see in a way that will then produce an outcome.

The right answer for this problem is dialogue and compromise. Mr. Klett, you said that. You said, look, this is what we do in business; you need to do it in conference. That is the right answer for this problem. We ought to be having a budget conference. We ought to be sitting down and listening to one another, just as all Senators did a week ago tonight. We got in a room when we had a tough problem, and we listened to each other, and we found a solution that we might not have known we would find when we walked into the room.

We need to listen. We need to compromise. A side that is unwilling to conference is unwilling to listen. A side that is unwilling to conference is unwilling to compromise. We need to listen and we need to compromise.

I believe that the right answer is an answer budgetarily that will involve us making targeted cuts to deal with our budgetary challenges, those mentioned by other Committee members, including reforms to entitlement programs, that will do, as Senator Whitehouse suggested, close unnecessary tax loopholes and that will make investments to grow the economy.

But we are not going to get to the right answer, we are not going to get to a mediocre answer, we are not going to get to a wrong answer, if we cannot sit down as two Houses and listen to one another and compromise.

So while it would be comforting, I think, to say as a Member of Congress that this big sequester problem is something I can point a finger at the Executive and say, “It is your fault,” I just think that is a hollow argument. It is on us. We have got to show a willingness to listen to each other and compromise. And it is my strong, strong hope that the members of this Committee, that the Members of the Senate, will eventually convince the House that that is the right way to proceed.

Thank you, Mr. Chairman.

Senator WARNER. Senator King.

Senator KING. Thank you, Mr. Chair. Thanks to all the witnesses.

At one point in this room today, there were a majority of Senators who were also on the Armed Services Committee, so nothing you were saying was news.

This whole situation as a newcomer is extraordinary. I have not yet heard anybody say a good word about the sequester in this building for the past 6 months, but we still have it. It is like we are all standing out in a rainstorm and everybody is looking at each other and saying, “Have you noticed this rain?” “Why, yes, it is raining. But nobody puts their umbrella up or goes inside. You know, what is it? You do not have sense enough to come in out of the rain.

Well, you know, I would slightly disagree with the Chair. I think the most—and Senator—I mean, Leon Panetta said this at one of our hearings. “The most serious threat

to national security today is the United States Congress”— because of our inability to pass a rational budget. And the problem is, I think, worse than many of you outlined, because you said this sort of in a little bit more vague way. 2013 was relatively easy. There was low-hanging fruit. There were unexpended balances. There were all kinds—there was money that could be found.

2014 is going to be different. I heard yesterday from some people at the Pentagon. Their calculation is it is more like 14 percent this year, and it is going to be—and we are paying a national security price. And what bothers me is that this institution is pretty good about laying the blame when something goes wrong. Well, when something goes wrong in national security and we have not adequately funded our defense, we should look at ourselves.

A famous philosopher of the 1950s named Pogo once said, “We have met the enemy, and he is us.” And truer words were never spoken. And it just seems to me—I want to echo Senator Kaine’s remarks. There has got to be a solution here. And I guess I want to ask at least one question.

Mr. Spring, you are at the Heritage Foundation. The Heritage Foundation is a very influential group in this city, a conservative think tank, a lot of quality work. How do we get out of this? I mean, you have told us that the sequester is bad, but we have got to get out of this. Do you have a strategy? Would you suggest to the Congress where we can—how we could get to a place where we have compromise and we have a solution so we are not continuously hollowing out our defense as well as the rest of the Federal Government?

Mr. SPRING. Yes, absolutely. I think—

Senator KING. Microphone, please.

Mr. SPRING. Yes, I think you have to do that on two levels. The first one I described in my testimony, which is to have a strategy-driven approach as to what you need for the defense budgets.

Senator KING. No, but I am talking about the overall budget.

Mr. SPRING. Overall, what you need to do is have a comprehensive fiscal plan that we have spelled out, the Heritage Foundation, called "Saving the American Dream Plan," that includes tax reform because we agree with Senator Whitehouse that you need to do tax reform.

Senator KING. Does it include revenues from tax reform or just a rate cut?

Mr. SPRING. No—well, in terms of rates, no. What it does is it says that we will lower the rates by closing the loopholes.

Senator KING. But that does not do anything for the deficit. That is deficit neutral.

Mr. SPRING. Right, and we think that the heart of the problem is the future growth in entitlement spending. I mean, we could—a decade or two from now, we could eliminate the defense budget entirely, and you still would not balance the budget.

Senator KING. I agree with that, and I have said this several times in this Committee. The problem with the Federal budget is health care costs—Medicare, Medicaid, pensions, health care costs across the board. It is not the defense budget. It is not Pell grants. It is not national parks. It is not Head Start. It is health care costs. And we are sitting here talking about cutting the defense budget—and I have said this before—it is as if after Pearl Harbor we invaded Brazil. It is the wrong target. And we ought to be talking about health care costs.

But to get back to the point, I have not yet figured out a way you can make all these pieces come together without some additional revenues, given the demographics of the country, people getting older, aging, demands on Medicare. We can shift costs out of Medicare, but they are just going to go to other people unless we deal with health care costs.

But it just seems to me we need entitlement reform, we need some revenues, we need cuts. And there is a package there, and if we do enough tax reform, we could do both some revenues and rate cuts, and that could be a deal. Is that something—is that anathema to you?

Mr. SPRING. Well, let me say I am not the expert on the econometric modeling that was done at the Heritage Foundation. I am a defense analyst, so I am not going to try and pretend that I can answer that question in a direct and quantitative way.

I do believe that there is a package there that reduces tax rates, closes loopholes, imposes restraints on the growth in entitlement spending, maintains a reasonable level of investment in defense, and eventually balances the budget. When I say we are not going to do that immediately, it is going to be like a decade-long process. But, yes, we think that we can do that, and in general terms, if I recall correctly from the Saving the American Dream Plan, we are talking somewhere in the neighborhood of a target for that, which I think is the easiest way to do it, which is, as an percentage of GDP, somewhere in the neighborhood of I think it is 18 percent in the Saving the American Dream Plan.

Senator KING. Well, that is the problem, because 18 percent is not going to do it in an age of aging baby boomers. You cannot make the numbers work unless you drastically reduce defense and all the other areas of the Federal Government. And when you talk about reforming entitlements, you are cutting—you want to cut Medicare. But if you do not do anything about health care expenses, you are just shifting those costs to the States or to the seniors.

Mr. SPRING. Well, again, the Saving the American Dream Plan includes a comprehensive approach to health care, not just with regard to Medicare and Medicaid alone. So that it involves, you know, how people would actually obtain their insurance and so forth and so on.

Again, I am a defense analyst, so I do not want to misrepresent inadvertently something that is in that plan. But obviously there is another element to this that is extremely important, which is that we tie it to GDP because GDP can be whatever. And so the economic growth is not the total answer to the problem, but it is an essential answer to the problem.

Senator KING. Of course it is.

Mr. Chairman, I appreciate your indulgence. I think just one other point, to get back to defense. All the testimony we have had at Armed Services is that this is the most complex and dangerous world that any of our experts in the intelligence community and the military have seen in their careers. And at the same time, we are gutting our military and hollowing out our readiness. I think it is a tragedy.

Thank you.

Senator WARNER. Thank you, Senator King, and I want to call on Senator Sessions for a quick comment. Then I will make a quick comment, and then I will bring this hearing to a close.

Senator SESSIONS. Thank you.

Senator WARNER. We have got a vote at noon.

Senator SESSIONS. Right. Well, I do agree that 2014 is going to be a particularly problematic time because the cuts come so fast that there is no real way to phase them in, and you have to breach contracts that run up costs for private companies, Mr. Klett and others. And you end up, Ms. Green, with people like you having to take furloughs.

So this is not a healthy way to do business, and somehow we can fix that. And then we will have to wrestle, Mr. Donnelly and Mr. Spring, on what kind of defense level we can sustain.

Senator Kaine, with regard to the Budget Control Act, what happened was, in 2011, in August, we hit the debt ceiling, and we were on a path to spend $37 trillion over 10. But the projected growth was to $47 trillion over 10. So the Congress agreed, the President signed off on, that we would have this mechanism that would reduce spending by $2.1 trillion and there would be no tax increases unless the Committee somehow fixed entitlements and whatever and did some tax increases. The Committee did not perform.

So that is in law, and that is what the current baseline is. And so the Republicans have been saying constantly, look, there are a lot of areas in this Government that had no reduction in spending, let us spread this out and it will not fall so hard on the Defense

Department. The President's view is we eliminate the sequester and we raise taxes to pay for it.

Now, he got taxes in January, $600 billion. Not a dime of that went to fix the sequester. So it does not seem to me that the President is very interested in fixing the sequester.

So I would say, Senator Warner, that I do not believe this sequester is going to be fixed with new taxes. I do not believe the House is going to pass it, and I will oppose it. We told the American people we will raise the debt ceiling $2.1 trillion, but we will at least reduce the growth of spending that was going to be $10 trillion, we would only let it grow to $8 trillion. And then we cannot find how to do that?

Now, of course, the Defense Department's numbers have been not growing much in the last 3 or 4 years, even before the sequester, at 3 percent or less for 3 or 4 years here. But Medicare, Medicaid, and Social Security are increasing at 5, 6 percent a year, and that is where we are out of control. And you know these numbers so well. Senator Warner has invested so much time in wrestling with the reality of it.

Senator WARNER. With not a lot of results.

[Laughter.]

Senator SESSIONS. You never know. The apple might fall out of the tree if you keep shaking it, which you are doing.

So the growth there is such that interest on our debt will pass the Defense Department expenditure by 2019 or so. Now, this is unbelievable. And the means-tested Government benefit programs, all 83, now net more than Defense Department, more than Social Security, more than Medicare, $750 billion. We have not dealt with those means-tested programs very well.

So we have a difficult challenge, and all of us have dug in our heels pretty hard, certain things that will happen. So my simple view is that sequester needs—and the reduction of $2.1 trillion needs to be there without more revenue, and if we need more revenue, that fixes our entitlements and it reduces deficits. That is what I would say. But others can have a disagreement.

You are very patient. Thank you.

Senator WARNER. Well, thank you, Senator Sessions. I would simply, again, reiterate a couple of points.

One, you are right, interest payments could exceed the defense budget. But since the defense budget already exceeds the domestic discretionary budget, it will also exceed the domestic discretionary budget. I 100 percent believe, Mr. Spring, you have got to grow this budget. I do believe an educated workforce, infrastructure, and research and development, that unfortunately has moved more and more from the corporate side onto the public side, are ways that any country grows in a knowledge-based economy. And that undermines that ability to grow.

I would add—I mean, I am a bit obsessed about these numbers. I do think, Mr. Spring, I would simply point out the last 13 years, when we were going from surpluses to these remarkable deficits—and I would argue both sides bear a burden here—we cut revenues $4.5 trillion over 10 years. That was unsustainable when you take into consideration, as I think we have here, we live in a very dangerous world. We have seen a doubling of defense spending. We have gone to war not once but twice, entirely on the credit card. Unprecedented in American history. And we are all growing a lot older, which is a blessing, but it does mean the math around our entitlement programs is fundamentally flawed. Senator King pointed this out. You know, when I was a kid, 16 people paying in for every 1 person on retirement, Social Security and Medicare. Now the ratio is 3:1. Medicare and Social Security are the best programs ever. The math does not work anymore.

So I respectfully believe that you cannot—and we did $600 billion on New Year's Eve. I agree with Senator Sessions. I say there is no way to run this Government, even with entitlement reform, on that revenue base. I say there is no way to run this Government without reforms to the entitlement programs. There ought to be a rational way to get here. What we have heard today is what happens and the consequences if we fail to act. What we are doing to our ability to maintain America's preeminent role in an extraordinarily dangerous world, what we are doing to Mr. Klett's business not only in terms of what it does to his employees but what drives me as a former business guy just crazy is the amount of money we are costing under the guise of saving money by starting and stopping, and what we are doing in the very human terms of people like Ms. Green who said that she wanted to work with our military veterans and work with folks helping out in a hospital that does not get- -you said it correctly. You had an implied contract. If you did your job, we were going to honor that contract. You entered into obligations based upon that implied contract. You are not getting a daycare discount or a car payment discount or a rental discount. I can assure you—and I know Senator Kaine has got—and I am sure Senator Sessions and Senator King has got as well, the letters I am getting from people all across the Commonwealth of Virginia, people most of whom served our Nation in the military who feel like that basic trust has been broken. And they look at us and say, you know, you seem to break into red team/blue team when the relative amount of change on the entitlement programs, on revenues, on a relative basis—I mean, we have got to get about $2 trillion in additional deficit savings over the next 10 years with the $2 trillion we have done, putting sequestration aside, based upon Simpson-Bowles and Domenici- Rivlin. The amount of revenue and entitlement change—and the more rational approach on spending cuts, is so small on a relative basis when you look at that $47 to $45 trillion number, that candidly shame on all of us if we do not do a better job of that.

So I want to thank the witnesses for appearing here today, for very provocative testimony, and as a reminder to my colleagues, additional statements and/or questions for the record for today's hearings are due in by 6:00 p.m. today. Please have them signed and submitted to the clerk in Room 624.

And with that, again, my thanks to you colleagues and my thanks to the witnesses. The hearing is adjourned.

[Whereupon, at 12:01 p.m., the Committee was adjourned.]

Responses to Congressional Questions
Mr. Mark N. Klett
President and CEO Klett Consulting Group, Inc.

Committee on the Budget
Questions for the Record
The Impact of Sequestration on National Security and the Economy
Submitted by Chairman Patty Murray
July 23, 2013

Mark Klett

1) Impact on DoD Capabilities
Your company does a great deal of work in cyber security, as you discussed in your testimony. I think both you and Mr. Wark would agree that the cyber threat continues to grow, and we need to prioritize our investments in that area.

- ***If your company and other small businesses like yours cannot survive another year of sequestration, what happens to our ability to meet this critical threat?***

Response:

Chairman Murray,

Klett Consulting Group has a sizeable percentage of its personnel involved in programs or projects related to the defense industry. We are located in Hampton Roads where multiple centers of defense industrial excellence exist. Though I cannot speak to the totality of the impact small businesses have on the defense industry, I can provide insight into the kinds of issues that will result if another round of sequestration forces small business to close and some specific examples if Klett Consulting Group were to close.

The first impact would be the migration of key skilled workers to new occupations. For example, in one project that KCG members support for the Department of Defense, approximately 60 percent of the contract personnel are already gone; many of whom have gone on to other projects – unrelated to defense. The on-again-off-again breaks in funding due to sequestration and Continuing Resolutions create unfunded periods that were too long for companies to endure and those highly skilled contract employees have moved on to other projects where their intellectual capital could be leveraged. Those that could stay in their current company had to move to other projects in non-defense related business sectors. As a result, even if the project defense funding can be stabilized, the expertise of these contractors cannot be readily restored, and may be lost as part of our national capability permanently.

Another example of this bleeding of highly skilled defense workers is demonstrated when the US Joint Forces Command shut down. Two thousand of two thousand five hundred contractors lost their jobs. About half were able to find work supporting projects, some at other defense organizations, but many others in the commercial sector. Others still had to geographically relocate.

Additionally, the lack of clear guidance for the Department of Defense regarding what to skills and core competencies to preserve and where to refocus efforts has had a serious impact on the entire defense industry's ability to meet critical threats. Sequestration has put everyone, civil service and defense contractors alike, into a "bunker mentality. New projects or projects that rely on Department of Defense funding are paralyzed- as no new projects or programs can be funded without the appropriations bills being signed into law. Many of these efforts are high priority projects supporting the forward operating warfighters. Because Sequestration cut across the board, the kind of guidance that comes from the established budget processes, Quadrennial Defense Reviews, and a National Military Strategy Review are lacking. The result is indiscriminate cuts without the ability to adequately focus on future critical threats to develop requirements to retain vital skills while repairing and retaining the proper capability sets for our future National Security.

My company may not survive another year of Continuing Resolutions and Sequestration. It stops the cash flow to small business and the acquisition process and does not allow the government to get what it needs, only what it may be able to procure through existing outdated, time consuming procurement processes. Many small businesses and many talented people have been put out of work the past two years and it does affect our National Security and Economy. I ask that the leadership in the Senate and the House work together to help stop the drain on our National Security and work to create jobs that will produce a vibrant economy for all Americans.

Responses to Congressional Questions
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The Impact of Sequestration on National Security and the Economy
Senate Committee on the Budget
July 23, 2013
Senator Sheldon Whitehouse
Questions for the Record

Economic Effect on Local Communities *(for The Honorable Robert O. Work, Mr. Mark N. Klett, Mr. Baker Spring and Mr. Thomas Donnelly): In my home state, we are seeing the effect of sequestration in reduced wages as a result of furloughs, reductions in the scope of defense contracting work, and losses felt by local businesses due to restrictions on government travel and community relations events. We know that the effects of sequestrations on government travel and community relations events. We know that the effects of sequestration are being felt across communities that do business with the government – to prime defense contractors and their suppliers. However, the magnitude is difficult to quantify. How can Congress better understand the ripple effect caused by sequestration and how can information about the effects be captured and quantified?*

Response:

The full impact of sequestration is far reaching yet difficult to envision. The ripple effects we see today are anecdotal, but require a comprehensive effort to collect and interpret. If we fail to adequately survey this impact, we are doomed to repeat and amplify the damage to the Nation's primary strength; a vibrant economy. As the jobs are eliminated in the defense industry, we bleed intellectual capital and vital capabilities within our industrial base of both small and large companies. Many families must leave the Hampton Roads and other areas where the Department of Defense is a significant engine of economic activity to seek new employment, there is a downward pressure on this economy who relies on over half of its local revenues from Defense related industry. Fewer children are in the schools, causing fewer jobs for teachers at all levels, fewer jobs in retail sales and other goods and services. Many of my fellow small business owners and I have lost employees from teams due to the sequestration cut backs over the past year.

These secondary and tertiary impacts of sequestration on our economy take time to develop and are difficult monitor. The loss of our most precious commodities, the highly experienced and educated defense industry workforce, has started in south eastern Virginia. We maintained a great national capability to design, manufacture and repair defense equipment in support of all the military services, agencies of the Department of Homeland security, and other federal agencies in this area. We have enjoyed a lower than average unemployment here in eastern Virginia because of this industrial base, but as sequestration takes hold, these highly skilled workers are on the move to provide for their families – as there is no economic development plan in place as the defense industrial draws down the economy will not be able to sustain the newly unemployed. Additionally, regaining this strategic capability will take even longer, if ever, when the need is recognized again. Not only will we lose those valuable skills and abilities, but highly skilled individuals often have spouses who work in a variety of professions, service industries, volunteer work, and community activists.

In order to better understand these ripple effects, Congress needs to aggressively pursue meaningful forward looking economic analysis. The Congressional Budget Office and private organizations should be encouraged to review existing economic indicators and put the "big picture" together. As sequestration impacts the defense industry and industrial base, those lost or reduced wages impact home sales, major purchases (both individual and business), spending on education, and discretionary spending. By looking at the entire impact of sequestration on regions such as Hampton Roads can enable Congress to focus efforts on exercising mature fiscal restraint to help grow our economy by creating jobs while ensuring that our National Security is not put at risk.

***Damage to Readiness** (for The Honorable Robert O. Work, Mr. Thomas Donnelly, and Mr. Baker Spring): Secretary Hagel has warned about the harmful effect of a $52 billion cut to the DoD in FY14. His letter to the SASC outlined the damage sequestration would have on military readiness, both long and short-term. Given the instability in Egypt, the worsening situation in Syria, and other emerging threats around the globe, how would sequestration limit our options and ability to respond to the range of threats we could face in the foreseeable future?*

Response:

While this may not have been directed at me, I would like to take the opportunity to share some thoughts. Let me start by relating what a member of my company learned while supporting a readiness study. He was part of a team investigating the US Navy's flight hour program which was realizing a dip in readiness between scheduled air wing deployments. The study found that an improvement in readiness could be obtained if flight hours in the aircraft where traded for cheaper training hours in the simulator. This seemed like the way to get a quick increase in readiness without having to commit additional resources. The analysis found that for a mere two flight hours per month for all aviators the readiness could be dramatically improved for a subset of qualifications. However, the rub was that the hours could not be taken from the flight crews on deployment. We would have to "double up" on the crews that where in between deployments. Also, crews working up would need priority on flying hours as well. So the flight crews standing down just after deployment would have to give up almost half of their already dwindling flight hours and fly more simulator hours. Additionally, some of the other qualifications and maintenance of proficiency to fly the aircraft would diminish, since the simulator could not replace the dynamics and fidelity of training that comes from flying the aircraft. These are second and third order effects of a decision to make changes that effect readiness.

We believe that similar issues will arise from sequestration. Units back in stateside/not deployed will not be able to maintain as high a level of readiness. It will take longer to deploy a unit from garrison due to the time to elevate their readiness to ensure combat effectiveness. This may be limited by weapons, practice ranges, and all the other resources required to create the proper fidelity of training.

There is the other issue of materiel readiness. Spare and repair parts and other support will be prioritized to the operating forces forward. The replacement forces and manpower will be prioritized to the front lines as well. Units in the rear probably will not be able to maintain as high a readiness. This it known by some as the bath tub effect – a unit's readiness rapidly falling off after redeployment and staying low until work up training commences just in time to provide relief to the off going units.

An unfortunate fact is that sequestration forces skilled contractors out of defense contracting. Insourcing the skills to government are ineffective and the retraining needed for the government workforce is slow and costly. Skills like system engineering take years to gain proficiency and nearly a decade to gain the breadth and expertise necessary to manage the system engineering for a project. Unfortunately when faced with drastic unplanned cuts in funding, one of the first skills to go is system engineering. System engineering is like building the foundation of a tall building. It is not glamorous and it takes time but if it is done right the building is erected quickly and soundly. If cut short the building may still go up, but there will be problems and it will be unsound and unsafe for occupancy.

The Impact of Sequestration on National Security and the Economy
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July 23, 2013
Senator Sheldon Whitehouse
Questions for the Record

Economic Effect on Local Communities (for The Honorable Robert O. Work, Mr. Mark N. Klett, Mr. Baker Spring and Mr. Thomas Donnelly): In my home state, we are seeing the effect of sequestration in reduced wages as a result of furloughs, reductions in the scope of defense contracting work, and losses felt by local businesses due to restrictions on government travel and community relations events. We know that the effects of sequestration are being felt across communities from local companies that do businesses with the government to prime defense contractors and their suppliers. However, the magnitude is difficult to quantify. How can Congress better understand the ripple effect caused by sequestration and how can information about the effects be captured and quantified?

Answer:

The Congressional Budget Office (CBO) addressed this question of the economic impacts of sequestration, including for defense, in a July 25, 2013, letter to Representative Van Hollen of Maryland. The analysis described in the letter assumed the cancelation of a portion of sequestration for the current fiscal year and all of it for fiscal year 2014. On this basis, CBO concluded that the cancellation of sequestration would increase real gross domestic product in the by .7 percent and the level of employment by 900,000 in the third quarter of calendar year 2014. However, the analysis goes on to state that these short-term economic gains would be undone over the longer term by consequences of increased deficits and debt and prospects of accelerated federal spending. It is also important to point out that the short-term gains resulting from the cancellation of sequestration for defense will be more pronounced than this for local communities where defense-related activity makes up a larger share of the local economy.

My personal view, however, is that CBO's assessment somewhat overstates the short-term economic benefits of cancelling sequestration in the way it describes. This is because I believe that market forces will respond quickly to the prospect of higher levels of federal debt and deficits and the further acceleration of federal spending by restraining investment and employment. In short, sequestration may inflict marginal economic pain in the short term, but have a positive impact on the economy over the longer term. These long-term economic advantages, however, would be much more pronounced if the federal government would seriously address the matter of restraining the projected growth in entitlement spending, which unfortunately is largely left out of the sequestration process.

Damage to Readiness (for The Honorable Robert O. Work, Mr. Thomas Donnelly, and Mr. Baker Spring): Secretary Hagel has warned about the harmful effects of a $52 billion cut to the Department of Defense in FY14. His letter to the Senate Armed Services Committee outlined the damage sequestration would have on military readiness, both long and short-term. Given the instability in Egypt, the worsening situation in Syria, and other emerging threats around the globe, how would sequestration limit our options and ability to respond to the range of threats we could face in the foreseeable future?

Answer:

As sequestration provides marginal economic advantages over the long term, its negative consequences for the national security posture of the United States, both in the short term and the long term, are profound. This is because the scope of the cuts imposed by sequestration is disproportionate for defense. As pointed out in your question, the international security environment is not getting more benign. As a result of sequestration for defense, the military options available to the United States will be diminished to a dangerous degree. This is because under defense sequestration the military will in some combination become too small, lack modern weapons and equipment, prove unable to recruit and retain high quality personnel and have low levels of combat readiness to perform a number of vital military missions effectively. These missions include projecting military power, maintaining a forward presence in vital regions, deterring aggression in these same vital regions, providing for security on the high seas, in international airspace, outer space and cyberspace, and even deterring and defending the people and territory of the United States against strategic attacks. The degree to which these mission capabilities will be undermined in any one area will depend on whether the across-the-board application of sequestration to defense accounts, outside those for military pay, has a disproportionate impact on some elements of the overall military posture.

My biggest concern, however, is that U.S. military leadership is the foundation of today's stable international political environment. Lacking this foundation, the possibility of an emerging instability dynamic increases, and with it the prospects for a large scale conflict between the major powers. As the experiences with World War I and World War II demonstrate, the humanitarian and economic consequences of such a conflict would be catastrophic.

Committee on the Budget

Questions for the Record
Hearing on The Impact of Sequestration on National Security and the Economy

Submitted by Chairman Patty Murray
July 23, 2013

Robert Work

1) Global Capabilities
The defense strategic guidance shifts DoD's baseline for readiness away from the ability to win two major theater wars to the ability to win one while deterring a second. But continued sequestration could compromise DoD's ability to meet even that revised standard. At the same time, we face many potential threats. Recently, the situation with North Korea seemed more dangerous than it had been in many years. We have committed to protecting Israel, especially as Iran continues to be provocative. And several members of this body want to do more to stop the bloodshed in Syria.

- **How would a $52 billion cut in defense funding next year affect our ability to intervene in these scenarios if we decide it is necessary?**

A $52 billion cut in FY 2014 defense funding comes on the heels of the FY 2013 sequestration cut. Because this latter cut was applied on 1 March 2013, fully five months into the fiscal year, its effects were greatly magnified on targeted accounts. One of the accounts most affected was operations and maintenance (O&M). To reach the full cut by 30 September, flying squadrons had to be grounded. Flying hours for the remaining operational squadrons were cut. Army and Marine Corps unit training rotations were eliminated or deferred. Aircraft and ground equipment depot work and ship availabilities were cancelled. All of these steps began to impact force readiness. In essence, the only parts of the Joint Force being trained to their typical standard of readiness were those scheduled to deploy.

The $52 billion FY 2014 cut will simply compound this problem. This cut represents a 10 percent reduction to the President's budget submission. This will be one of the biggest one-year reductions in annual defense spending since the post-Korean War drawdown. However, because the military personnel account is not impacted by sequestration, the reduction will have an even greater disproportionate hit on procurement, research and development, and operations and maintenance (O&M). The further cuts to O&M will simply accelerate the force-wide decline in readiness that began in FY 2013.

The cumulative impact of these cuts will inevitably mean two things. First, readiness for our CONUS-based surge forces will decline in the near-term. Second, the continued deferment or elimination of aircraft and ground equipment depot work and ship availabilities will mean this readiness decline will extend over the long term.

Our forward-deployed forces will continue to be ready. But their backup—our surge forces—will be less trained and ready. Thus, while we will still be able to respond to small crises, it will make preparations for any larger intervention take longer than normal, with potentially negative consequences.

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- **Does sequestration make us more vulnerable by hurting our credibility and our ability to deter competitors abroad?**

Hard to say. In the near term, we will still have the best-equipped and technologically advanced military on earth. Our people will still be the equal of any in the world. Unquestionably, our overall readiness will be degraded. But we will still be engaged in Afghanistan, and our forward-deployed forces will still be present in every theater.

Over the long term, the only way sequestration will impact credibility and deterrence is if it ultimately leads to a chronically underfunded and less ready, less technologically advanced force and a major and protracted retrenchment of American power and influence.

Committee on the Budget

Questions for the Record
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Submitted by Chairman Patty Murray
July 23, 2013

2) Replacing Sequestration
Mr. Work, as I mentioned in my opening statement, Secretary Hagel has called on Congress to pass a comprehensive package to replace the sequester cuts across the whole budget. Additionally, as Secretary Hagel has discussed, even full flexibility will not prevent serious harm to the Department under further sequestration. Only a full replacement will protect defense spending, and not trigger another round of sequestration by breaking the defense spending cap.

Do you believe there is any step we could take more critical to protecting our national security than replacing sequestration?

In the near-term, no. The problem is less the size of the cut than the abrupt way it has been applied. Secretary Hagel has said that we could continue to execute our national military policy and strategy with a $150 billion cut in defense spending, back-loaded toward the end of the ten-year planning period. He has also said while a back-loaded $250 billion cut would "bend" the strategy, it would not break it. However, even if Congress agreed to reduce defense spending cuts to these lower levels, if they were to be applied as abruptly in FY 2014 and FY 2015 as now planned, they would still cause major force-wide disruptions.

A better way to approach this problem would be for the White House and Congress to agree on the final levels of defense spending cuts, and to impose more modest cuts in FY 2014 and FY 2015. This would give DoD time to conduct a deliberate Quadrennial Defense Review, and for the National Defense Panel to assess its conclusions and recommendations. The resulting drawdown would then be shaped more by strategy than by mindless budget reductions.

Committee on the Budget

Questions for the Record
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3) Allies and Partners
The national security strategy and defense guidance emphasize the importance of working with allies and partners abroad. This includes building their capabilities, and relying on them to do more to provide security. As we put higher priority on these partnerships – in part due to our own budget problems – many of our partners are also cutting their defense budgets. In fact, the NATO Secretary General recently revealed European nations have slashed $45 billion from defense spending.

- **What is the right balance between asking more of our partner nations while recognizing they have serious budget challenges as well?**

The so-called "free rider" problem is nothing new. Since the end of the Cold War, many of our allies have reduced defense spending and become more reliant on U.S. assistance, particularly in the shape of logistics, mobility, and intelligence, surveillance, and reconnaissance. The United States has actually contributed to this problem by emphasizing "partnership building capacity," which too often has simply meant spending U.S. defense dollars for regional security problems.

However, many of our allies provided forces in Iraq and Afghanistan, even in the face of domestic opposition. Moreover, many of our allies in the Pacific and in Asia are considering improvements to their national capabilities.

The United States should continue to work close with its regional allies and encourage them to allocate the requisite resources needed for their own defense needs.

Committee on the Budget

Questions for the Record
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July 23, 2013

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Two ways. First, continue to have hearings with witnesses like Mark Klett and Jennifer-Cari Greene, who testified alongside me before the Senate Committee on the Budget on 23 July 2013. Mr. Klett testified about the impact sequestration is having on small businesses, while Ms. Greene testified about the impact on her family budget. Both provided the committee with a compelling, first-hand view of sequestration's impacts.

Second, establish a Congressional commission to conduct town halls in communities with a large military or DoD presence, and report back to both the House and the Senate on their findings.

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The Congressional Budget Office (CBO) addressed this question of the economic impacts of sequestration, including for defense, in a July 25, 2013, letter to Representative Van Hollen of Maryland. The analysis described in the letter assumed the cancelation of a portion of sequestration for the current fiscal year and all of it for fiscal year 2014. On this basis, CBO concluded that the cancellation of sequestration would increase real gross domestic product in the by .7 percent and the level of employment by 900,000 in the third quarter of calendar year 2014. However, the analysis goes on to state that these short-term economic gains would be undone over the longer term by consequences of increased deficits and debt and prospects of accelerated federal spending. It is also important to point out that the short-term gains resulting from the cancellation of sequestration for defense will be more pronounced than this for local communities where defense-related activity makes up a larger share of the local economy.

My personal view, however, is that CBO's assessment somewhat overstates the short-term economic benefits of cancelling sequestration in the way it describes. This is because I believe that market forces will respond quickly to the prospect of higher levels of federal debt and deficits and the further acceleration of federal spending by restraining investment and employment. In short, sequestration may inflict marginal economic pain in the short term, but have a positive impact on the economy over the longer term. These long-term economic advantages, however, would be much more pronounced if the federal government would seriously address the matter of restraining the projected growth in entitlement spending, which unfortunately is largely left out of the sequestration process.

Damage to Readiness (for The Honorable Robert O. Work, Mr. Thomas Donnelly, and Mr. Baker Spring): Secretary Hagel has warned about the harmful effects of a $52 billion cut to the Department of Defense in FY14. His letter to the Senate Armed Services Committee outlined the damage sequestration would have on military readiness, both long and short-term. Given the instability in Egypt, the worsening situation in Syria, and other emerging threats around the globe, how would sequestration limit our options and ability to respond to the range of threats we could face in the foreseeable future?

Answer:

As sequestration provides marginal economic advantages over the long term, its negative consequences for the national security posture of the United States, both in the short term and the long term, are profound. This is because the scope of the cuts imposed by sequestration is disproportionate for defense. As pointed out in your question, the international security environment is not getting more benign. As a result of sequestration for defense, the military options available to the United States will be diminished to a dangerous degree. This is because under defense sequestration the military will in some combination become too small, lack modern weapons and equipment, prove unable to recruit and retain high quality personnel and have low levels of combat readiness to perform a number of vital military missions effectively. These missions include projecting military power, maintaining a forward presence in vital regions, deterring aggression in these same vital regions, providing for security on the high seas, in international airspace, outer space and cyberspace, and even deterring and defending the people and territory of the United States against strategic attacks. The degree to which these mission capabilities will be undermined in any one area will depend on whether the across-the-board application of sequestration to defense accounts, outside those for military pay, has a disproportionate impact on some elements of the overall military posture.

My biggest concern, however, is that U.S. military leadership is the foundation of today's stable international political environment. Lacking this foundation, the possibility of an emerging instability dynamic increases, and with it the prospects for a large scale conflict between the major powers. As the experiences with World War I and World War II demonstrate, the humanitarian and economic consequences of such a conflict would be catastrophic.

CONTAINING HEALTH CARE COSTS: RECENT PROGRESS AND REMAINING CHALLENGES

TUESDAY, JULY 30, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:30a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, chairman of the committee, presiding.

Present: Senators Murray, Wyden, Stabenow, Whitehouse, Baldwin, Kaine, King, Sessions, Grassley, Johnson, and Ayotte.

Staff Present: Evan T. Schatz, Majority Staff Director; and Eric M. Ueland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. This hearing will come to order. I apologize to everybody for being a few minutes late. We had votes and I am also managing the THUD bill on the floor and we had to get that going, but I appreciate everybody's patience in getting this hearing started.

I want to thank my Ranking Member, Senator Sessions, all of our colleagues who are joining us here today, as well as the members of the public here or who are watching online.

I also want to thank our witnesses for coming today, Dr. Len Nichols, he is the Director and Professor at the Center for Health Policy Research and Ethics at the College of Health and Human Services at George Mason University; Dr. Kavita Patel, who is a Fellow and Managing Director at the Engelberg Center for Health Care Reform at The Brookings Institution; and Dr. Joseph Antos, Wilson H. Taylor Scholar in Health Care and Retirement Policy at the American Enterprise Institute. Thank you all for coming and joining us today for this very important conversation about health care costs in the United States and the implications recent cost trends have on our Federal budget decisions.

Almost five years now after the greatest economic crisis since the Great Depression, our economy is recovering, but far too slowly. Millions of workers are still looking for jobs. Millions of families are still worrying about staying in their homes or putting food on the table. We do have serious long-term deficit and debt challenges we need to tackle, since we certainly do not want to leave our children and grandchildren with an unmanageable pile of bills. And we have serious short-, medium-, and long-term economic challenges that we cannot ignore.

But there has been some good news recently. The Congressional Budget Office released its latest forecast, which gave us an updated view on our debt and deficit. This latest outlook shows we have made substantial progress when it comes to our short- and medium-term deficits. It made clear that there is no short-term debt crisis and the deficit reduction we have done in the last few years, combined with the growing economy, is making a difference.

Recent trends in the health care sector have played an important role in this improved fiscal outlook. Medicare and Medicaid are two of the three largest Federal budget items, so trends in health care costs have major implications for our nation's fiscal policy. Health care cost growth outpaces our economic growth, and it also grows at a faster rate than household incomes.

The cost of health care affects every kitchen table and conference table conversation in the United States, as American households and American businesses face the question of how to pay for the health care coverage they want for their families and their employees. It remains a huge challenge for our businesses to stay competitive in a global market where their competitors have lower health care costs and continues to limit economic growth by reducing the investments businesses and families can make, whether it is starting a new venture or buying a new car.

But there has been some positive news on this front lately. Over the last several years, health care costs have grown slower than at any time in our history. CBO now projects the Federal Government will spend well over $500 billion less on Medicare through 2020 than it had predicted just a few years ago. The recently released Medicare Trustees Report showed an improvement in the Trust Fund, extending its solvency by two years until 2026 due to lower projected spending. And as the White House noted yesterday, consumer health care spending has increased this year at the lowest rate in 50 years. That is welcome news, and continuing these trends is going to be absolutely critical.

There is an emerging consensus that the economic recession is not the only reason for the slowing of cost growth, which is also good news. There is evidence that structural changes in the way health care is delivered are underway and appear to be having an impact. And while the slowdown started before the Affordable Care Act was enacted, the law has set clear expectations for how health care will be financed and delivered in the future, and importantly, health care coverage is increasing at the same time and will continue to for the future.

This is critical not only for families and communities, but also for our economy. Lower health care costs mean families and communities are getting care at a lower total cost to the system, and it means lower deficits and debt. By enacting comprehensive health care reform law, Congress took a critical step towards improving our health care system. And as I mentioned earlier, recent trends in the slowing of health care cost growth suggest we are moving in the right direction.

But serious, long-term challenges remain. Right now, Americans still spend far more per person on health care than any other nation. But spending more on care has not made us any healthier. Our current system focuses far too much on healing sick people instead of prevention and wellness. This is not just bad for patients. It is bad for our economy.

So we need to make sure we are moving towards a system where we prioritize prevention and quality. Fortunately, there are a number of reform ideas, many of which were included in the Affordable Care Act, that can help us address these problems and put us on track towards greater quality with lower cost. And the work that providers across the country, including my home State of Washington, are doing is making a difference.

Accountable Care Organizations, like the one run by Polyclinic and the one being launched by Providence Health, both in my home State of Washington, help ensure better communication between providers. Patient-centered medical homes, like the one run by Group Health in Seattle, aim to combine the personalized approach of a family doctor with innovative technology. And by creating fixed payments for all the care a patient is expected to need during a period of time, bundled payments could help incentivize coordination and efficiency between providers. These reforms will help us move towards a system where we are spending less on care and are healthier as a country.

Increasing quality and encouraging efficiency and transparency is going to take all of us, providers, policy makers, and patients working together. But it is so important for the well-being of our families across the country as well as for the long-term strength of our economy.

Now, more than ever, we need to be thoughtful about the reforms we are enacting and work together to ensure we are laying down a foundation for future growth and prosperity, both when it comes to enacting key health reforms and also when it comes to future budgetary policy. That is especially true when it comes to the complexities of health care and the consequences of decisions we make when it comes to the future of Medicaid and Medicare.

We cannot lower health care spending simply by shifting these costs from the Federal Government onto seniors and States and the most vulnerable families. Unfortunately, that is exactly what the approach the House Republicans took in their budget. If they had their way, seniors would immediately see an increase in what they pay for routine doctors' visits, the number of uninsured Americans would rise, and the most vulnerable families would be put at greater risk. That is not the right way to address our long-term challenges in health care spending.

Now, Republicans claim that Democrats do not want to tackle health care costs. That is simply not true. We agree—we agree—we need to address this significant part of our Federal spending. But we believe we need to do so by coming together around a solution for real, lasting reform, not just by shifting costs and shifting risks.

This is a complex issue and we should not have to wait until the last minute now to sit down at the table and try to find some common ground and work something out. And that is why, now that the House has passed their budget and the Senate has passed ours, I truly hope—truly hope—we can move forward with going to conference and working together to solve these major, complex issues that are facing our country.

As everyone in this room knows, we have tried many times now to go to conference. Every time, we have been blocked. In fact, the latest threat coming from my colleagues Senators Rubio and Lee is that they want to actually defund health care reform or they will shut down the government. Well, I do not think that is a good solution and we do not want anybody, including Tea Party Republicans, to push us into a crisis, because if they do, they are going to cut off health care coverage for 25 million people. They are going to end free preventive care for our seniors. And they are going to cause seniors to pay more for prescriptions.

Those political games might play well with a particular base, but the reality is that not only is the Affordable Care Act already helping millions of Americans stay healthy and financially secure, but it is also helping slow health care cost growth. Instead of fighting what is now the law, I hope we could all be working together right now to make sure Obamacare is implemented in the best way possible for our families and businesses and communities. Continuing to manufacture crisis after crisis is only going to make the situation worse for our economy, whereas coming together to tackle these tough issues will help create jobs and keep America on its path to economic recovery.

So I am hopeful Republicans will join us at the table in a budget conference under regular order and work with me and other Democrats to address our long-term debt and deficit challenges as well as our long-term health care challenges. I just believe we owe it to the American people to come together around some solutions that help our economy grow, tackle our deficit and debt responsibly, and ensure we have a health care system that delivers high-quality affordable care.

So I am very glad we are having this important discussion today. I look forward to hearing from all of our witnesses on this critical issue and really appreciate your being here and all our members being involved in this important discussion.

With that, I will turn it over to my Ranking Member, Senator Sessions.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Thank you, Chairman Murray, and I look forward to the hearing this morning on an interesting topic, an important topic, and welcome our guests today.

I would like to see us go to conference. We just have a number on the budget, but we have a number of members who believe that the debt limit should not be part of a conferenced item. Senator Durbin said on the floor when I was there that he did not think it could be. If that is so, why would you not agree to not make that a part of any conference report and then the conference would occur. That is apparently the disagreement some of our members have.

This year, our country is projected to spend $2.9 trillion on health care, almost 18 percent of our nation's economy. I would note that we have the greatest health care in the world. You simply cannot judge our health care only on life expectancy and the choices people make, whether it is smoking or other issues that cause earlier death in the United States than in some countries. You go to any area of America, you can get first class health care, heart surgery, lung surgery, kidney surgery, cancer treatments, all over this country. It is a fabulous health care system we have, but it is expensive.

Our hearing will focus on cost and the trends which brought us here. Looking at the data, it is clear that while the increase in health care costs, the rate of increase, at least, has slowed significantly over the last decade, health care costs will continue to rise, and today, for the most part, they still outpace the growth of inflation.

Indeed, in the year 2000, health care costs increased 9.7 percent. They dropped every single year since then until when President Bush left office it was 4.7 percent. It is now, in 2011, the latest numbers I have, the increase was 3.9 percent. So we have had a real change in the increase, but I do not think facts can justify any allegation that it is a result of Obamacare, and we will talk about that as time goes by.

So, we are now looking at the economic recovery that we are involved in. It is the slowest since the Great Depression. We are just not growing fast enough and not creating enough jobs. GDP growth last quarter was only 1.8 percent. It was 0.4 percent in the fourth quarter last year. It has averaged two percent or less since the end of the recession in 2009, and that is not a job creating growth rate.

After six years, since the beginning of the recession, we still do not have as many jobs as existed in December of 2007. Americans are working fewer hours, and the fastest growing type of work today is part-time employment. Over 352,000 part-time jobs were created last month compared to only 195,000 full-time jobs. Last month alone—in May, at least, we lost 7,000 manufacturing jobs. In June, the June report shows we lost 6,000 manufacturing jobs.

It is clear that this health care law has had a job effect and it is not for the better. There has been plenty of anecdotal evidence about hiring concerns, and according to the Federal Reserve's Beige Book, the health care law has been cited as a job market concern.

Along these lines, this month's report from the Chicago Fed District stated, quote, "Several retailers reported that the Affordable Care Act would lead to more part-time and temporary versus full-time hiring." Folks are being held back from full-time work due to this law. That is just a fact. We are hearing it all over the country.

Last month, the President held up premium decreases in States like New York as evidence that his health care law is working. But as one fact checker put it, quote, "He does not make clear that that kind of premium decrease is likely to be the exception rather than the rule among all the States."

Actuaries estimate the monthly premiums in New York's individual market after the health care law is in effect will still be 37 percent higher than the national average. And what the President does not say is that people in other States, like my State of Alabama, will likely see their premiums skyrocket once the law takes effect.

The President argued at the bill's signing that it would bring all sorts of benefits, but when it comes to the topic of this hearing, health care spending trends, it is fair to say there has been no benefit from the President's health care bill. After all, much of the decline took place long before the President's policies and long before he was elected.

And actuaries at the Centers for Medicare and Medicaid Services have looked at the impact of his health care law and concluded that, to date, there is, quote, "no discernible impact of this legislation" on aggregate health care spending trends. That is obvious, I would think, but it needs to be said because there has been a real attempt to try to suggest that the decline in the rate of growth in health care spending is attributable to the President's health care plan.

And looking into the future, its costs will be real while the promised savings will be illusory, I am afraid. Against claimed benefits, there are serious costs. If left unchanged, the President's health care law could deal a devastating blow to the Federal budget. Earlier this year, the nonpartisan Government Accountability Office—just this year—released a report which estimates that under a realistic set of assumptions, the President's health care law will increase the deficit by 0.7 percent of GDP, or roughly $6.2 trillion over the next 75 years. That is almost as much as Social Security's projected deficit over that period of time.

So we are just about to add a new program to the Federal Budget of this country that will add almost as much unfunded liabilities over the long term as the Social Security program that we need desperately to be fixing. Adding more debt to a government which already cannot pay its bill is how a country goes broke, and it was hidden, basically, when this bill was passed.

Addressing health care costs now, before this bill is fully implemented, can save trillions of dollars in new debt to our country and our people. That is a lot easier than having to change an existing program that people have been depending on, like Social Security and Medicare.

So, colleagues, I believe that we need to work as hard as possible to head in a better direction, one that responsibly corrals spending excesses in Washington and creates the conditions for a more robust economic growth, helping people recover from the economic damage of the last five years. Blanket spending and risky programs will not meet the real needs of our constituents. We need to go step-by-step, and enact common sense health care reforms that lower costs and that the American people can support, not a bill that is widely opposed by the American people and will likely add trillions in new debt.

I thank our witnesses for attending this morning and await their testimony. This is a most interesting subject. Thank you.

Chairman MURRAY. Well, thank you very much, and I want to turn to our panel. We will have time for questions after that.

Let me begin with Dr. Nichols. We will start with you.

STATEMENT OF LEN M. NICHOLS, PH.D., DIRECTOR AND PROFESSOR, CENTER FOR HEALTH POLICY RESEARCH AND ETHICS, COLLEGE OF HEALTH AND HUMAN SERVICES, GEORGE MASON UNIVERSITY

Mr. NICHOLS. Chairman Murray, Ranking Member Sessions, other distinguished members of this committee, it is an honor and privilege to offer my thoughts on health care cost growth for your consideration as you seek to balance our vital priorities as a nation.

My name is Len Nichols. I teach health policy and direct health system research at George Mason University in Fairfax, Virginia. I will answer the two key questions as quickly as I can and spend the rest of my time on the remaining challenges before us.

Question number one, is health care cost growth reduction real? Yes.

Question number two, can the recent health care cost growth slowdown be sustained? This is the key question. The correct answer to this, I believe, is maybe, sliding into probably, and I am going to tell you why I am optimistic.

The first point is, the slowdown in cost growth began before the Great Recession and the ACA. The evidence is very clear on this point. The evidence is also clear that post-ACA Medicare payment policies and increases in private sector cost sharing have also affected spending growth, along with lagged GDP growth.

Point number two, the key to actually bending the cost growth curve is to enable stakeholders to gain from reducing cost growth, to align their incentives with the trip aim, and I am optimistic about this because the private sector in every State of our Union is adopting the same kinds of incentives that are being tested by the Center for Medicare and Medicaid Innovation, pursuant to the ACA. These incentives make sense and it is the congruence between public and private efforts that makes delivery system reform far more feasible than I have seen in my lifetime of studying this system.

I included in my written testimony a map maintained by America's Health Insurance Plans that makes the point worth a thousand words.

I also describe three promising examples of individual private health insurers which have combined creative incentives with information and care management systems and they each report positive early results. Massachusetts Blue Cross-Blue Shield, Blue Shield of California, and CareFirst here in the Mid-Atlantic area have each lowered cost growth and improved quality enough that each is expanding their programs, in some cases before definitive formal evaluation results are complete. This is a market test that shows they think it is working. This is the promise of health reform 2.0.

Even more exciting, we are starting to see multi-payer payment reform experiments, some led by the public, some by private payers, and some by clinical catalysts. This is great news because you all know nothing holds back progress more than conflicting incentives within the same clinical practice.

So, yes, slower cost growth can be sustained if we encourage these kinds of arrangements.

I will now emphasize four of the seven challenges I mention in my written testimony. Challenge number one: Tell the American people the truth. The plain truth is, we can solve our current fiscal woes without abandoning our commitment to our most vulnerable citizens and to ourselves, but you would not know it from watching TV at night or on Sunday mornings.

Health care cost growth, our most serious long-run fiscal problem, is coming down and will stay down if we are smart and disciplined about it. Not every payment model or pilot will work perfectly. We can learn from failures. We always have. But our country is large and diverse. We will need different models to reflect different local values, conditions, and strengths. But the evidence is clearly building. We can achieve the triple aim in a number of cases and we should stop this loose talk of draconian benefit cuts and ruinous tax rates.

Challenge number two: Enable clinicians to lead the transformation we need. Compared to 20 years ago, way more physicians, nurse leaders, hospital executives, and health plan executives are actually eager to help reform our expensive system. They know it is too expensive to maintain. But they are frustrated by the familiar roadblocks that make the status quo seem like the only operational choice, flawed though it is.

In my view, all these folks have essential parts to play, but physicians need to be in the front of the reform bus, not in the back. For physicians to drive this thing, four things have to happen. The first two are relatively simple. You must improve the malpractice environment, and you must remove the scourge of SGR from our policy discourse. I do not really care how, just do it. The price of SGR repeal is at an all time low now and malpractice issues are not beyond your capacities.

Third, for physicians to lead, they must have access to total cost of care data. Not all plans in our country are as enlightened as the ones I named. In some States, the only way to gather essential data is to require all payer claims databases to be created and appropriately shared. Only 12 States have them now. I urge you to provide powerful incentives to the other 38. Markets cannot and never have worked well without transparent cost, price, and quality data. We should give our health markets the tools they need over the objections of those who profit from our ignorance today.

The fourth prerequisite for proper physician leadership of our reform enterprise is to upgrade our sense of urgency and make Medicare a true partner with them in health system reform. Only three of those all payer claims databases have access to Medicare data. Everyone should benefit from the lessons that Medicare and private sector data together can teach, as Senators Wyden and Grassley have recently argued. More generally, we should turbocharge CMMI into something more like the Manhattan Project, which, you may have read about, focused our best scientific minds to produce an atom bomb before the Germans got one. Like then, we cannot afford to fail, and like then, we are kind of in a hurry. We need to harness our best physician minds with a liberated CMS as a true partner to get those incentives right systemwide in real time.

Challenge number three: Engage consumers and patients. I do not know why we are so afraid of telling patients what they know in their hearts. They have a huge role to play in their own health and in making our system sustainable for all. Provider organizations should be allowed to offer incentives to remain with the group for a year. An honest discussion of personal responsibility for behavioral choices might help bridge some of our partisan divides.

Finally, I encourage you to focus health policy more on communities and less on States and the nation as a whole. In my experience these last few years of talking about health reform in virtually every State in our country, red, blue, and purple, communities are the one geographic area where people are able to put politics aside and focus on what needs to be done to make their own health system work where they live and work and play and pray.

HHS and some States have made local data available and more user friendly than ever before, and I am proud to say that the National Committee for Vital and Health Statistics, on which I serve, has been learning how some communities are using data to promote local health improvements consistent with their own priorities. I can think of no better example of democracy in action.

But we could do much better and go way beyond all payer claims databases. I sincerely urge you to ask HHS to think creatively and expansively about how to use existing government data and resources to empower communities to lead conversations about health and health system improvements they want rather than what some experts want or fear for them.

In the end, our political system is based on the principle that the people are the experts who matter most, at least about what they want their government to facilitate. We should think more often about how government can help people inform and empower themselves.

I thank you for the opportunity to be here this morning and I welcome any questions.

[The prepared statement of Mr. Nichols follows:]

Containing Health Care Costs: Recent Progress and Remaining Challenges

Statement of

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For the Committee on the Budget

United States Senate

July 30, 2013

Washington, DC

Containing Health Care Costs: Recent Progress and Remaining Challenges

Len M. Nichols, Ph.D.

July 30, 2013

Chairman Murray, Ranking Member Sessions, other distinguished Members of this Committee, it is an honor and a privilege to have been invited to offer my thoughts on health care cost growth containment for your consideration. You do have a daunting task, to shape public policy toward our vital public insurance programs, our health system generally, and our nations' key priorities through your budget making, including balancing our commitments to the most vulnerable among us with sound fiscal prudence, so that we may honor commitments made over time.

My name is Len M. Nichols. I am a health economist, Professor of Health Policy, and Director of the Center for Health Policy Research and Ethics in the College of Health and Human Services at George Mason University in Fairfax, Virginia. I conduct research about and help create public-private partnerships to pursue incentive realignments that can sustain a more efficient, effective, and humane health care system. I am an advisor to the Virginia Center for Health Innovation[1] and to the Patient Centered Primary Care Collaborative,[2] two organizations committed to improving the health systems of Virginia and the nation, respectively. I am also on the governing boards of the National Committee on Quality Assurance[3] and Academy Health,[4] and am a member of the National Committee on Vital Health Statistics.[5] I do want to make clear though that my written testimony and spoken views are mine and mine alone.

I organize my remarks around two key contextual questions and then address the most important challenges before us.

Question #1: Is the recent health care cost growth reduction real?

Though reform opponents do not like it much, there is little doubt that health care cost growth has been slowing lately. Rarely have important facts been so difficult to push to their proper

[1] http://www.vahealthinnovation.org/
[2] http://www.pcpcc.org/
[3] http://www.ncqa.org
[4] http://www.academyhealth.org
[5] http://www.ncvhs.hhs.gov

central place in the public mind. The Office of the Actuary (OACT) at the Center for Medicare & Medicaid Services (CMS), with expertise that spans health economics, actuarial science, and financial accounting, has long been our nation's official arbiter of health spending levels and trends. Table 1 is an excerpt from their most recent report on historical health care spending, per capita.

Table 1: Growth per capita, compared to the prior year

	1990	2000	2007	2008	2009	2010	2011
NHE	9.9	5.5	6.6	3.7	3.0	3.1	3.1
GDP	6.6	4.4	4.1	0.9	-3.1	2.9	3.2

NHE = national health expenditures; GDP = gross domestic product. Source: Hartman et al,[6]

Clearly, health care cost growth per person has been much lower lately than its historical record of growing 2.6 percentage points faster than GDP per capita since 1960.[7] Importantly, even as the economy has recovered from the Great Recession in 2010 and 2011, health care growth relative to GDP has held steady. Equivalent growth rates in health costs and national income per capita is a good definition of a sustainable health system.

These trends are reflected in public insurance program growth rates as well. Table 2 is also excerpted from the recent OACT report.

[6] Hartman, M., et al. "National Health Spending in 2011: Overall Growth Remains Low, but Some Payers and Services Show Signs of Acceleration," *Health Affairs* 32(1):87-99 (Jan 2013).
[7] Kaiser Family Foundation, "Assessing the Effects of the Economy on the Recent Slowdown in Health Spending," http://www.kff.org/health-costs/issue-brief/assessing-the-effects-of-the-economy-on-the-recent-slowdown-in-health-spending-2/

Table 2: Growth rates, compared to the prior year

	2005	2006	2007	2008	2009	2010	2011
Medicare	9.2	18.8	7.4	8.0	6.9	4.3	6.2
Enrollment	1.8	2.0	2.1	2.6	2.4	2.5	2.5
Per enrollee	7.2	16.5	5.1	5.3	4.3	1.8	3.6
Medicaid	6.4	-0.9	6.3	5.8	8.8	5.9	2.5
Enrollment	2.9	-0.6	0.1	3.5	7.3	4.9	3.2
Per enrollee	3.4	-0.3	6.2	2.2	1.4	1.0	-0.7

Source: Hartman, M., et al, see note 6.

There is no question that health care cost growth has recently slowed broadly across the health care system.

Question #2: Can the recent health cost growth slowdown be sustained?

This question has become the subject of considerable commentary, as well it should. It really matters. The Congressional Budget Office, another group of non-partisan analysts with crucial expertise and standing, has lowered their estimate of federal Medicare and Medicaid costs for 2020 by 15% from what they had forecast three years ago, just as the Patient Protection and Affordable Care Act (ACA) was passed. For Medicare alone, that equates to nearly $400 billion lower projected spending over the next seven years.[8] If these trends continue to 2022, public sector health spending could be over $750 billion lower than recent projections.[9] As this committee knows, that would represent serious progress toward a sustainable federal fiscal structure.

The main argument advanced by pessimists (who are also typically ideological or at least political opponents of health reform) is that the health spending slowdown is an artifact of the reduction in demand for care that inevitably accompanies job and coverage losses in a recession and thus will disappear as the recovery continues to pick up steam. The first major empirical

[8] Cutler, D. and Sahni, N. "The Forecast Slowdown in Medicare Spending: Is More Coming?" *Journal of the American Medical Assocation Forum* 2/21/13, http://newsatjama.jama.com/jama-forum-the-forecast-slowdown-in-medicare-spending-is-more-coming?/

[9] Cutler, D. and Sahni, N. "If Slow Rate of Health Care Spending Growth Persists, Projections May Be Off by $770 Billion," *Health Affairs* 32(5):841-850 (May 2013).

hole in that argument was established in 2012 when Roehrig and colleagues at the Center for Sustainable Health Spending of the Altarum Institute[10] showed that the health cost growth slowdown pre-dated the recession's onset by two or more years.[11] (The slowdown also pre-dates the ACA). This issue is sufficiently important to state the obvious: if cost growth reductions preceded the recession, then the recession cannot have been the major cause of recent cost growth reductions. The second major empirical hole in the pessimists' argument was provided by the Medicare data of Table 2. Why and how exactly would the recession lead Medicare beneficiaries, whose benefits have not been reduced, to lessen their demand for care enough to lower spending growth per enrollee?

This is not to suggest that our long struggle with health cost growth in the US is over. And that judgment, shared by virtually all serious analysts of our health care system, has led to a number of recent important analyses of factors that might explain patterns in health spending growth, with particular emphasis on the recent slowdown. These studies are different and important enough to understand where and why they differ, and how they should be interpreted in their totality.

The first one was published by the Kaiser Family Foundation in collaboration with the Altarum economists and systems engineers. That study's authors developed a model that can "explain" 77% of health care spending growth solely with variables that measure general (economy-wide) inflation, lagged inflation, GDP growth, and lagged GDP growth. The fundamental contribution of the paper was to show that the effect of GDP on health spending occurs with as much as a 5-year lag, and that the lagged effects are much larger, cumulatively, than the statistical effects of current GDP. Since the cost-growth slowdown clearly occurred before the recession it cannot have been primarily caused by the recession, and the model predicts that lingering dampening effects of the (lagged) recession on demand for health services will last for a while but will be counterbalanced as the economy continues to recover. The authors conclude that "Increases in health expenditures are likely to trend upwards over the coming decade as the economy returns

[10] http://altarum.org/cshs

[11] Roerhig, C., et al. "When the Cost Curve Bent: Pre-Recession Moderation in Health Care Spending," *New England Journal of Medicine* 367(7) (August 16,2012).

to a more normal rate of growth."[12] This is surely true, if nothing else matters to health system cost growth.

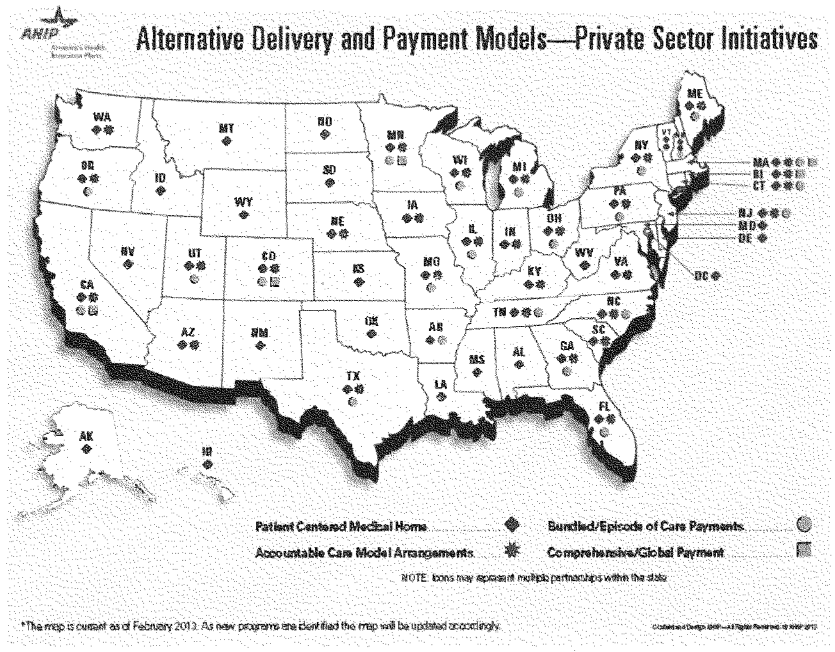
Two other peer-reviewed studies take more traditional approaches of isolating the impact of GDP growth (or job losses) while controlling for health system impacts like Medicare payment policy (which changed substantially in the ACA), changes in insurance coverage, and benefit generosity.[13] They conclude that the economy alone explains at most a third of health spending growth reductions in recent years. These results combined with the Kaiser study suggest that other, possibly structural factors are also at work lowering cost growth rates in the health care system. The authors infer from various data points that slower technological advance (more generic drugs, slower adoption or use rate of new diagnostic technologies, etc.) and greater efficiencies in hospitals have and may continue to contribute to health cost slowdowns.

There is thus a consensus that the economy affects health care spending growth, but so do health policy and general market trends in the health care sector. Therefore, a return to robust economic growth does not mean we are doomed to repeat our health care cost growth past. It all depends on whether forces in the system now that dampen cost growth are stronger than forces in the system – including recovering demand – that increase cost growth, as they have been these last two years.

I am personally and professionally optimistic that cost growth lower than long run trend *could* be maintained, because of the illustrative examples I am about to describe (briefly), which add to up to one overarching reality: private and public payers are developing congruent incentive structures for clinicians and hospitals, frequently in tandem, that have the potential to link the self-interest of all major health system stakeholders with the social interest in cost growth containment, quality improvement, and better health for our population (the triple aim).[14] To see this congruence vividly, look at the following map, which we can call Figure 1.

[12] Cf. note 7.
[13] Cutler and Sahni, cf. note 9; Ryu, A., et al. "The Slowdown in Health Care Spending in 2009-11 Reflected Factors Other Than the Weak Economy and Thus May Persist," *Health Affairs* 32(5):835-840 (May 2013).
[14] Berwick, D., et al. "The Triple Aim: Care, Health, and Cost," *Health Affairs* 27(3):759-769 (May/June 2008).

Figure 1.



This map is maintained and regularly updated by America's Health Insurance Plans, and is available from its website.[15] Each symbol represents examples of patient centered medical homes, bundled payments, accountable care arrangements, or comprehensive global payments, designed and implemented by private plans with willing provider partners, but similar in spirit and detail to the demonstration projects underway at the Center for Medicare and Medicaid Innovation (CMMI) pursuant to the ACA. The larger point is that in every state in the union payment reforms and incentive realignments are taking place outside the government program that reinforce the care transformation objectives of current public policy. Coupled with the extensive array of CMMI initiatives,[16] the US health care system has not seen this much change

[15]http://www.ahip.org/

[16]http://innovation.cms.gov/. One of my co-panelists today, Dr. Kavita Patel of the Brookings Institution, will discuss selected CMMI initiatives in some detail, so I will not, except in response to questions at the hearing or afterward.

oriented around incentive realignments since Medicare switched from cost-based hospital reimbursement to diagnosis-based prospective payments in the early 1980s. If you remember the award-winning movie about the Von Trapp family, *The Sound of Music,* a good metaphor for the US health care system today is the opening sweeping panorama followed by the crescendo of Julie Andrews' voice singing "The Hills are Alive" with the sound of care process redesigns and incentive changes designed to make better outcomes sustainable at lower total cost.

This alignment of public and private goals – made possible by the ACA and the private contracting innovations that preceded and have followed it – is by far the most humane way to get the health spending portion of our long-run budget priorities where it needs to be. The alternative to incentive realignment is draconian benefit and price cuts, which would be income-based rationing in reality if not in euphemistic name. Severe cuts are also wholly unnecessary if we choose to support and nurture those already on the path to a better aligned American health system that is within our imagination and our grasp.

The examples I will describe deliberately exclude the many exemplary integrated systems of care, for though they are beacons in more ways than one, we have to make our health system work in all places, including where for various reasons fully integrated systems – like Group Health Cooperative and Virginia Mason Medical Center in Seattle, Intermountain Health Care in Salt Lake City, Geisinger Health System in Danville, Pennsylvania, the Baylor Health System in Dallas, Kaiser Permanente in Oakland, San Francisco, Los Angeles, Denver, Maryland, Northern Virginia and DC, etc., – simply will not come to be anytime soon, if ever.

The first promising example I will cite is the Alternative Quality Contract (AQC) implemented in 2009 by Blue Cross and Blue Shield of Massachusetts. That arrangement is essentially a global budget with willing provider groups that are rewarded for their quality and cost performance. They also bear financial risk and reap rewards if they do well. Hallmarks of this arrangement include a multi-year contract, technical and data support by the plan, and incentives tied to explicit quality metrics (roughly similar to those used by Medicare ACOs) as well as to reductions in the total cost of care of enrolled patients, even if some of the care is delivered by providers not covered by the AQC. Participating provider groups include large multi-specialty medical practices, small physician groups, and large physician-hospital organizations. Peer reviewed and published results for the first two years' performance indicate that costs were reduced (1.9% in year one, 3.3% in year two) while quality increased, and the results were larger for groups that were in the AQC longer.[17] This makes perfect sense since care innovations to improve care coordination and communication among teams of providers, patients with complex needs and their families – the essence of what payment reform is trying to incentivize – take time to implement and require adjustments by all concerned. The really good news is this program is expanding and now has 1,600 primary care physicians and 3,200 specialists involved.

Two more non-profit Blues' plans' innovations that are designed to advance the goals of the triple aim while meeting providers where they are on the ground are worthy of note, partly because they are in very different places, California vs. the Chesapeake region (Maryland, DC, and Virginia).

In 2009 Blue Shield of California (BSCA) signed an ACO-like arrangement with the Hill Physicians' Medical group (a large IPA with 3,800 affiliated physicians) and with the hospital system Dignity Health (formerly Catholic Healthcare West) that uses a global budget for a designated set (41,000) of California Public Employees Retirement System (CalPERS) enrollees living in or near Sacramento, California. As in the AQC, providers can share in savings if they materialize and if quality targets are met. CalPERS was given an immediate "rebate" for these enrollees of $15.5 million, consistent with holding premium cost growth to zero, and this in turn both required and incentivized the plan, hospital system and physician group to cooperate so that they could save more than that to break even. In the first year, according to an internal analysis conducted for BSCA by Milliman, the Blue Shield ACO saved $20.5 million, so $5 million was distributed among the partners. Year two results were even better for all concerned, saving $22 million more for CalPERS and $8 million more for the partners. Blue Shield has now expanded the program to seven more ACO-like arrangements serving 90,000 more enrollees.[18]

CareFirst, the Blue Cross and Blue Shield plan in the mid-Atlantic region serving Maryland, DC, and northern Virginia, launched a very ambitious patient centered medical home program in

[17] Song, Z. et al, "The 'Alternative Quality Contract,' Based on a Global Budget, Lowered Medical Spending and Improved Quality," *Health Affairs* 31(8): 1885-94 (Aug 2012).
[18] Markovic, P. "A Global Budget Pilot Project Among Provider Partners and Blue Shield of California Led to Savings in the First Two Years," *Health Affairs* 31(9):1969-76 (Sept 2012).

2011.[19] Early results are promising, the more so because the mid-Atlantic region, unlike California and Boston, has not had a history of care coordination and large multi-specialty groups (which are typically in a better position than small physician practices to adapt care processes to better manage the relatively seriously chronically ill). The CareFirst design is tailored to make it easy for previously isolated small practices to join the program, by supplying an information and care coordination infrastructure to facilitate participating practices' focus on the right patients, providing an upfront increase in FFS payment rates for participating in the program, and for sharing savings according to cost and quality performance but with *no* downside risk to the primary care physicians. As a consequence of these features, over 80% of CareFirst participating primary care providers (PCPs) have joined the program, until by now, nearly 3,600 PCPs treating over 1 million commercial (non-Medicare) patients are involved. According to internal CareFirst calculations and analyses, the program, net of PCP bonuses, saved CareFirst 1.5% total expected expenditure on (voluntarily) participating enrollees in year one and 2.7% in year two.[20] Even before formal external evaluation results have been compiled, CareFirst is confident enough to expand the program to the Medicare population, and recently secured a CMMI grant and negotiated a cooperative agreement to do just that.

Creative experiments in this vein are not confined to the private sector. Since 2006, 26 state Medicaid programs have also enabled and encouraged primary care practices to begin functioning as medical homes for Medicaid enrollees, through new or revised payment systems and reporting requirements.[21] Indeed, Medicaid has been central to some key multi-payer initiatives of the CMMI, including the multi-payer advanced primary care practice demonstration and the comprehensive primary care initiative, which have engendered support and participation of over 3000 PCPs in 15 states .[22]

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[19] In the interests of full disclosure, I am the Principal Investigator of a 5-year evaluation of CareFirst's PCMH program, leading a team centered at George Mason University. Two other evaluation teams, centered at Harvard and Westat, Inc., respectively, have also been retained by CareFirst to conduct independent evaluations of their program. All formal evaluations are just getting under way, so the results referenced in my testimony are from Care First's internal calculations and assessments that have been released to the public.

[20] CareFirst press releases. "CareFirst BlueCross Blue Shield Announces First Year Patient Centered Medical Home Results, June 7, 2012; "Patient Centered Medical Home Program Trims Expected Health Care Costs by $98 Million in Second Year," June 6, 2013.

[21] Takach, M "About Half of the States are Implementing Patient Centered Medical Homes for Their Medicaid Populations," *Health Affairs* 31(11):2432-2440 (Nov 2012).

[22] http://innovation.cms.gov/Files/x/Comprehensive-Primary-Care-Initiative-Frequently-Asked-Questions.pdf

A noteworthy and recent version of multi-payer payment reform was the Colorado Multi-payer Patient Centered Medical Home pilot coordinated by HealthTeamWorks, which ran from 2009-2012, and included 16 small physician practices and seven health plans including United, Aetna, Cigna, Anthem-Wellpoint, Humana, CoverColorado (the state's high risk pool carrier) and Medicaid. Formal evaluation results have not yet been published, but preliminary findings indicate that the pilot significantly reduced emergency department visits and hospital admissions.[23] In addition, most participating practices moved right into Colorado's successful application and implementation of the Comprehensive Primary Care Initiative of CMMI. The most useful part of this pilot may have been the wealth of lessons learned they have passed on to others, including how to (and how not to) sort through thorny data and payment change issues in multi-payer settings, especially when self-insured employers have control and (sometimes) less knowledge about new payment and incentive models' promise. Change takes time and concerted effort on multiple fronts, i.e., it is *not* easy, even though the potential payoff is large.

Which brings me to what I think are the seven most important challenges to sustained cost growth reduction across our health care system. Three are more political than policy-specific, but precisely because of that you on this committee and in this Senate can do something about all of them, if you so choose.

Challenge #1: Excess partisanship

All politics is partly and unavoidably partisan, but surely we have set new records lately. The sad truth is our current state of partisanship mostly serves to divert focus from how the reform law and implementation process should and could be improved. Democrats are afraid to admit the law has flaws and Republicans are afraid to admit the law has some really good ideas and provisions, and just might work as advertised in some states. In addition, it appears to me that Republicans have no consensus among themselves for a viable alternative to the ACA, for if they did would they not have proposed and passed it in 2001-2006 when they controlled the White House and the Congress? To move forward toward solidifying cost growth reduction, which I know both parties support, the charade of repeal and de-funding should stop and all of you

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[23] Harbrecht M. and Latta, L. "Colorado's Patient Centered Medical Home Pilot Has Met Numerous Obstacles, Yet Saw Results Such As Reduced Hospital Admissions," *Health Affairs* 31(9):2010-2017 (Sept 2012).

should get on with the serious business of working together to improve the existing law of the land so that more of our people will be better served.

Some traditional Republican ideas that have more support on the Democratic side – and in the health system – than may be well-known include: malpractice reform; more state flexibility (like Arkansas is undertaking through a waiver); and a budget failsafe which would reassure people who fear the long term budget consequences of the ACA by linking coverage expansion and generosity with savings performance and financing alternatives. But these and a host of other legitimate design and implementation issues cannot be addressed under constant threat of total repeal. There is a long and distinguished tradition of bipartisanship on this and on the Finance Committee on which some of you also serve, and in the Senate generally,[24] and our country and the legitimate pursuit of bipartisan health policy to support cost growth containment would be well-served if you could help resurrect that tradition sooner rather than later.

Challenge #2: Tell the American people the truth.

It is stunning to me how hard it is in the present day to move facts and logic to their proper places in the public mind. The truth is we can solve our current fiscal woes without abandoning our commitment to our most vulnerable citizens and to ourselves. Health care cost growth, our most serious long-run fiscal problem, *is* coming down and will stay down if we are smart and disciplined about it, and encourage and spread the kinds of programs and models I described above. This is not to say every payment model or application of it has to work or the whole enterprise of health reform is doomed to saddle our children with unbearable debt. We can learn a lot from failures and mixed successes, indeed, we rarely learn enough any other way. Our country is large and diverse, and we will surely need different models in different parts of it, to reflect our differing values, if nothing else. Proponents of reform are asking extremely hard working and dedicated health professionals to effectively re-design the airplane they are flying without landing the plane, because patients keep coming every second of every day, and we cannot change our payment and information systems overnight. But the evidence is clearly building that we can achieve the triple aim in many cases and the number of those cases is

[24] Nichols, L. "Government Intervention in Health Care Markets is Practical, Necessary, and Morally Sound," *Journal of Law, Medicine and Ethics*, Fall 2012.

expanding every day, if we but free our imaginations and creativities (a bit more on this last point later) to pursue what is possible.

Furthermore, we are the least taxed advanced nation on the planet. Our federal and state governments take ***TEN PERCENTAGE POINTS*** less of our GDP than the OECD average, and we have a larger military than all of them combined. The idea that our economy cannot tolerate reasonable tax increases and keep growing robustly is contradicted by so much evidence I do not know where to begin. We may yet *choose* to keep taxes below what they would have to be to support a decent social safety net in an aging society that must also invest in children and economic infrastructure and peace in a complex world, but that would still be a choice, not a necessity, and the debate should be more properly framed and conducted that way.

Challenge #3: Be honest about what it costs to take care of the poor.

Why do hospital associations uniformly support taking advantage of the Medicaid expansion provision in the ACA? Because they have to contend with our implicit but unstated policy of forcing them to partially make up for our collective Medicaid underpayment – and what it takes to take care of the uninsured – by charging private payers more than it costs to take care of their patients. We do this because we would apparently rather force hospitals to levy this implicit tax out of the public eye than to have an honest discussion about what it really costs to take care of the poor and what we are and are not willing to pay for that.

Well, you might have heard this rumor, but private employers are tired of paying this implicit tax because their own health care costs too much even before the surcharge. Furthermore, hospitals know they have to become more efficient and invest in information systems and care coordination infrastructures that will enable them to thrive in the emerging payment environment, but they cannot invest to become more efficient when they have to spend so much energy and resources on the under- and uninsured.

Interestingly, state chambers of commerce, like the one in Virginia, have done the math and have publicly endorsed the Medicaid expansion along with the local hospital association because the evidence is overwhelming that it would be good for the fiscal situation of the state government, good for the economy of the state, good for the local health care system, and good for the people of Virginia. They, and courageous governors like the ones in Arizona, Ohio, Florida, Nevada and New Mexico have laid down their ideological opposition to the ACA and taken up the quest to have a more honest discussion about costs and benefits and priorities. Surely this discussion would be more widespread and impactful if the Senate Budget Committee started exploring the implications of Medicaid expansion vs. not in an intellectually rigorous environment, focused perhaps on economic and budget impacts. This would enable more public officials to deal more openly with the twin truths that Medicaid "costs too much" and that we pay less than it costs to treat the poor (under current sub-optimal care coordination conditions) in virtually every state in the nation.

Challenge #4: Enable clinicians to lead the transformation we need.

A major difference in the health care system today compared to 20 years ago, and possibly a reason the ACA passed and the Clinton Health Security Act did not, is that *way* more physicians, nurse leaders, hospital and health plan executives now know and admit we have to reform our health care system because our society and our people increasingly cannot afford the system we have built. Many are quite eager to help re-shape it, but they are frustrated by many roadblocks which make the status quo seem like the only operational model, flawed though it is. In my view, all have essential parts to play, but physicians need to be in the front of the reform bus, not in the back.

For them to take the driver's seat, you must first remove the two major diversions that keep them from focusing completely on the task at hand: malpractice reform and repeal of the SGR. I don't really care how, just do it. You would in those two strokes engender tremendous good will in the essential physician community. And I'm sure you know, SGR reform is at an all-time bargain basement price right now, because of recent cost growth trends. Malpractice reform is more complicated, but not beyond your capacities, I am quite confident.

Next, for physicians to lead in system and incentive redesign, they have to have access to total cost of care data. I have cited examples of health plans willing to share total cost of care and quality data, and in some cases, to build information and care coordination infrastructures to support better physician and patient choices. Unfortunately, not all health plans are similarly enlightened about sharing data, and in some cases the only way to ensure that clinicians and even employer-payers have access to total cost of care data is through legally compelled all payer claims data bases (APCDs). Twelve states have those now. I would encourage you to give the other 38 states powerful incentives to follow suit within a very short time frame. Markets cannot work without transparent cost, price and quality data and signals. They never have, and they never will. We should give health markets the tools they need, over the objections of those who profit from our ignorance today.

By the way, at the moment only three of those APCDs include Medicare data, yet Medicare is almost always the single more important buyer of health care services for many providers. This raises a general point about enabling Medicare to become more of a partner in private system reform. Some current law and internal interpretations of current law restrict CMS' ability to partner in ways that current and recent leadership (going back at least to the first President Bush) would like. Medicare beneficiaries and taxpayers, and therefore the program, will surely gain if the entire health care system becomes more efficient through appropriate data sharing. CMS has recently taken welcome steps in this regard (the release of MEDPAR hospital and physician pricing data is a salient a case in point), but many will acknowledge it could do much more. So I urge you to examine ways Medicare in particular and CMS in general could aid the cause of system redesign but is hampered today by statute, regulation, internal interpretation, or overly parsimonious administrative support budgets.

In my view, CMMI overall has done a good job of launching many experiments we needed to test for delivery and payment reform. But given the urgency of the problem, amplified by the centrality of health care cost growth to our current budget debates, something more on the order of the Manhattan project may be in order. Like the project that developed an American atomic bomb before the Germans got one near the end of WWII, we really cannot afford to fail here. The Health Care Innovation Challenge grant program (applications for round 2 of which are due August 15) is a creative way to tap the spirit of innovation in the private sector, but a more systematic sampling of private sector opinions, priorities and perceived impediments, including a frank discussion of why CMS is sometimes perceived as less than an ideal research partner today, could take the delivery and payment reform effort to a whole new level, where it needs to be, at least until more people are more confident that we have truly bent the cost curve for at least a generation. This probably needs to happen at the Secretarial level, or at least at the level of the CMS Administrator, for the proper focus to be brought to bear. The absolute key to bending the curve, in my opinion, is implementing realigned incentives that link clinician self-interest to the social interest in the triple aim, with a special emphasis on cost containment, since if we cannot afford access and quality, we cannot sustain them. Clinicians must be involved in those incentive design discussions, and to do that all must share all relevant data.

Challenge #5: Acknowledge that some local market power must be countered.

I and others have written on this topic for years,[25] but the reality is that some plan, hospital, and physician service markets are not very competitive today, and when that is the case, it is impossible for market forces alone to drive us to the efficient state we need to reach. Antitrust law and policy can be helpful in some cases, but typically, at least in its current forms, antitrust is a rather blunt instrument not well suited for the fluid subtleties of evolving health service market competition and collaboration. As an economist, I am reluctant to "give up" and recommend unit price regulation when we have yet to seriously try price transparency and domestic medical tourism (some health plans now pay for travel to a center of excellence that is also typically cheaper than the local monopolist), but an openness to rate regulation as a last resort should probably be in our cost containment arsenal as well.

Challenge #6: Engaging consumers and patients

We have to overcome our fear of telling consumers and patients that they have a huge and essential role to play in their own health and in enabling our system to afford good care for all. In my view the administration missed a major opportunity in the original ACO regulation by not enabling participating provider organizations to at least offer a positive incentive (a "carrot" like reduced Part B premium) to remain with the organization for a year. Signaling such a willingness to engage consumers would have made many providers much more comfortable about moving to a world in which their payment levels will be determined in part by how compliant patients are with their recommended regimens. Honest discussions of personal responsibility for health choices and financial responsibility could also help bridge some of our partisan divides. We have to be careful about it, of course, but if we do not get consumers

[25] Nichols, L., et al. "Are Market Forces Strong Enough To Delivery Efficient Health Care Systems? Confidence is Waning," *Health Affairs* 23(2):8-21 (March/April 2004).

appropriately engaged, we are unlikely to be as successful in reducing costs as we need to be. Charging more in premiums for smoking and less for participation in wellness programs, as the ACA permits, is a good start, but enabling medical homes and ACOs to offer incentives for sticking with them and penalties for going "out of network" would also add useful tools and send appropriate "we are all in this together" signals at a critical time.

Challenge # 7:Focus health policy more on communities and less on either the nation as a whole or on the individual states.

Health care markets, like political markets, are ultimately local. In my experience these last few years of talking about health reform in virtually every state in the union, red, blue and purple, communities are the one geographic area where most people today are capable of putting aside their politics and focusing on what needs to be done to make their own health care system work where they live and work and play and pray. HHS and some states have done an amazing job lately making local data more available and user friendly than ever before, and I applaud them for that. I'm proud to say that the National Committee for Vital Health Statistics on which I serve has been learning to listen to communities and has produced reports about how communities are using data to promote local health improvements consistent with their own priorities.[26] I can think of no better example of democracy in action than that.[27]

Yet I have also learned that despite all the recent efforts, many communities have far more questions than answers, and often lack basic capacity to organize and use the data they do have in productive local conversations with all relevant stakeholders. Part of the barrier is the absence of cost data, and so I will refer back to the APCD discussion above. But I would sincerely urge you to ask HHS to think creatively and expansively about how to use existing governmental data and resources to empower communities to lead conversations about the health and health system improvements they want, rather than the ones well-intentioned reformers might imagine they want or should want, given the way the data look to experts. In the end, our political system is based on the principle that the people are the experts who matter most, at least about what they

[26] National Committee for Vital Health Statistics, *The Community as a Learning System: Using Local Data to Improve Local Health* http://www.ncvhs.hhs.gov/111213chip.pdf

[27] San Diego has done inspirational and translatable work in this area. http://www.sdcounty.ca.gov/hhsa/programs/phs/documents/CHS-EconomicBurdenofChronicDisease2010.pdf

want that government may or may not be able to facilitate. We should think more often about how government can help people inform and empower themselves.

I thank you again for the opportunity to share thoughts with you today on our health care cost growth realities and prospects, and I would be glad to answer any questions my testimony may have engendered.

Chairman MURRAY. Thank you.
Dr. PATEL.

STATEMENT OF KAVITA K. PATEL, MD, MS, FELLOW AND MANAGING DIRECTOR, ENGELBERG CENTER FOR HEALTH CARE REFORM, THE BROOKINGS INSTITUTION

Dr. PATEL. Thank you. Chairman Murray, Ranking Member Sessions, and members of the committee, thank you for the opportunity to offer my thoughts on the recent progress as well as challenges ahead in containing health care costs. My name is Kavita Patel and I am currently a Fellow and Managing Director at The Brookings Institution as well as a practicing primary care physician.

From 1965 to 2007, health care spending increased at an average rate of 4.4 percent per year. Over that same period of time, the Gross Domestic Product grew an average of about two percent per year. This disparity in the rate of increases in health care spending and increases in our Gross Domestic Product have created an untenable situation which has eroded our wage growth, diminished our ability to invest in our children's education, and challenged our overall global competitiveness.

In 1970, specifically, national health expenditures were $74.9 billion, or 7.2 percent of the GDP. In 1990, total spending increased tenfold to $724 billion, or 12.5 percent of our GDP. It is worth noting that in the mid- to late-1990s, there was a brief period of respite in cost growth when managed care exerted significant cost controls, primarily in the form of budget constraints. I bring that point up because those efforts were short-lived, as all of us will recall, primarily, as I posit, because we did not change the delivery system, a very important lesson that we should learn from as we think about how to move forward.

In 2013, our health care costs, as both of you have said, consume 18 percent of our GDP at a $2.9 trillion price tag. But there are promising signs. Amidst rapidly escalating prices, the annual rate of cost growth has slowed in recent years. Since 2009, costs have escalated by just 3.9 percent each year and have been trending downward since prior to that, in 2002. Explanations are greatly debated. Unfortunately, this debate has broken down into absolutist arguments which take on a partisan orientation. However, in all likelihood, the decline is multi-factorial, as all things tend to be, part economy, part policy interventions, and then part private sector innovations which have taken place prior, during, and immediately after the Affordable Care Act passed.

Given the relentless march of health care spending and our demographic trends, the fact that we have actually engaged in reforms with impact after four decades of little progress is a very important milestone and something that we should stop and acknowledge, which brings me to my first critical point. The key to the future of health care in the United States is not only how we budget for it, but how we change the delivery system itself to become more productive and more efficient.

So I want to just highlight several Affordable Care Act provisions. I have written more of this in my testimony, but I did want to point out that there have been things that have been potentiated, not just by what we have done in the Affordable Care Act, but by the private sector, which has been, as I had mentioned, not only matching the progress, but in some cases outpacing it.

One is hospital readmissions. According to the Centers for Medicare and Medicaid Services, one in five Medicare beneficiaries discharged from a hospital is readmitted within 30 days. This amounts to about 2.6 million seniors and more than $26 billion in what could be avoided if simple interventions, such as coordinating care, were allowed right after a patient was discharged.

One of the provisions within the Affordable Care Act set up a partnership with patients so that programs which reach out upon discharge and coordinate care with primary care doctors such as myself are strengthened, amplified, and are currently resulting in savings back to the Trust Fund in the amount of hundreds of millions of dollars and are on target for expansion to reach billions of dollars at the end of this decade.

The next program that has been directly impacting patients has been around what was released from the White House yesterday as well as past reports around decreased premiums. Not only New York State, but 13 States in total have reported around the country that their average of their lowest cost plan's premium is 20 percent lower than the Congressional Budget Office projections. We can all talk about whether or not this is sustainable and what the impact might be, but this really translates to dollars in patients' pockets, and there is nothing more strong for our economy than actual translation of these dollars in a way that patients can spend.

Point number two, all of these reforms lead me as not only a physician but someone who studies health reform to bring to you the fact that patients actually like having their care coordinated. They like it when their doctors talk to each other. They like it even more when they understand what has happened to them. Our ability to invest in infrastructure, such as health information technology and these coordination programs like Accountable Care Organizations and patient-centered medical homes, is of the utmost importance.

So, as we look to the future, I wanted to highlight more opportunities. What is in front of the Senate Budget Committee is not only the fiscal responsibility for the budget, but the impact that that budget will have on the actual delivery of our care. We have a great number of opportunities in many sectors, and as we move—if you think about how a patient moves through the health care system, we start with what we know best, our primary care workforce, our Accountable Care Organizations, which should be and can be strengthened in order to help allow for more seniors to benefit from these programs. There is not an ACO in the State of Alabama and there should be, and we need to make sure that the program works so that that can happen.

The second point is around inpatient care. We still have—as much progress as we have made with hospital readmissions, any of us who have had a personal member of our family or a loved one in the hospital understands that the system still could use improvement. These improvements can come in the form of better coordination between the inpatient sector and the post-acute sector, which, unfortunately, gets that label of post-acute but is everything from home health care all the way through hospice care, and within each of these places, the communities that our patients live in would like to see stronger reforms in these areas.

And then a final area that I will touch on is around transparency and information. Information is power. That is a very basic consumer premise. But in health care, as Kenneth Arrow and other economists have pointed out, in health care, our information ability is misaligned and we do not have the basic information and transparency to give us the power we need as consumers. I would say as a caveat, though, giving and making the data transparent alone is not enough. We must make sure that these link back to the very reforms that I think have helped us in slowing down the cost growth.

So my final point as you head to August recess, you are going to hear stories from people who are confused in moving through our chaotic health care system and you will also hear stories of success from the private sector and the public sector, as well as the invaluable workforce delivering this care. Our challenge ahead of us is to make sure that we can marry this and take this opportunity to put sensible policy forward.

Thank you, and I welcome your questions.

[The prepared statement of Dr. Patel follows:]

July 30, 2013

Testimony of Kavita K. Patel M.D, M.S.
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The Engelberg Center for Health Care Reform
The Brookings Institution

Before the Committee on the Budget
United States Senate

Chairman Murray, Ranking Member Sessions, and members of the Committee, thank you for the opportunity to offer my thoughts on the recent progress made in containing health care costs and the challenges that still lie ahead. Our nation has struggled with the burden of our health care costs and spending, approximately 18% of our GDP and rising, which has eroded wage growth, diminished our ability to invest in our children's education, and challenged our global competitiveness. There are promising signs that federal programs and policies, as well as aggressive private sector activities, have helped to curb cost growth in Medicare and overall health expenditures. However, even if we continue to reduce the growth of health care costs and improve overall value, demographic trends and constrained state and local budgets will drive health and retirement spending toward an even larger share of the economy. By 2030, one in five Americans will be over age 65, compared with only one in eight today, and per capita medical costs in a given year are approximately three times greater for those 65 and over than for younger individuals. We must make difficult decisions in the coming years to encourage system-wide cost containment and sustainable health care transformation. Today, I am honored to present some solutions from my work at the Engelberg Center for Health Care Reform at The Brookings Institution, as a Commissioner on the National Commission on Physician Payment Reform[1], and perhaps most importantly, as a practicing internal medicine physician.

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[1] Frist W, Schroeder S, et al. *Report of The National Commission on Physician Payment Reform.* The National Commission on Physician Payment Reform. http://physicianpaymentcommission.org/wp-content/uploads/2013/03/physician_payment_report.pdf. Accessed July 24, 2013.

Overview of Health Care Cost Trends

Health care costs have dramatically escalated over time, though the rate of that growth has slowed in recent years. In 1970, national health expenditures totaled 74.9 billion dollars, or 7.2 percent of GDP. In 1990, total spending increased ten-fold and amounted to 724.3 billion dollars or 12.5 percent of GDP. Based on the most recent figures from the Centers for Medicare & Medicaid Services (CMS), as of 2011, costs have ballooned to more than 2.7 trillion dollars and account for approximately 18 percent of GDP.[2] The Institute of Medicine (IOM) estimates that almost 30 percent of these costs, or 765 billion dollars, are attributable to wasteful spending in poor care delivery, excessive administrative costs, unnecessarily high prices, and fraud.[3]

Amidst rapidly escalating prices, the annual rate of cost growth has slowed in recent years. Each year between 1980 and 1990, costs rose an average of 11 percent. From 2000-2007, annual costs grew by an average of 7.6 percent. But since 2009, costs have escalated by just 3.9 percent each year[4,5], and have been trending downward since 2002. The reason for this recent decline is likely multi-factorial. Possible explanations include sustained unemployment and lower overall spending during the recession; structural improvements to the health care system codified in the Patient Protection and Affordable Care Act in 2010; and an increase in out-of-pocket spending due to less generous employer-provided insurance plans.

In looking more closely at spending trends by payer, **Figure 1** highlights how quickly expenditures in the public and private sectors have risen in recent years:

- From 1970-2000, the costs of Medicare and Medicaid rose 217.1 billion dollars and

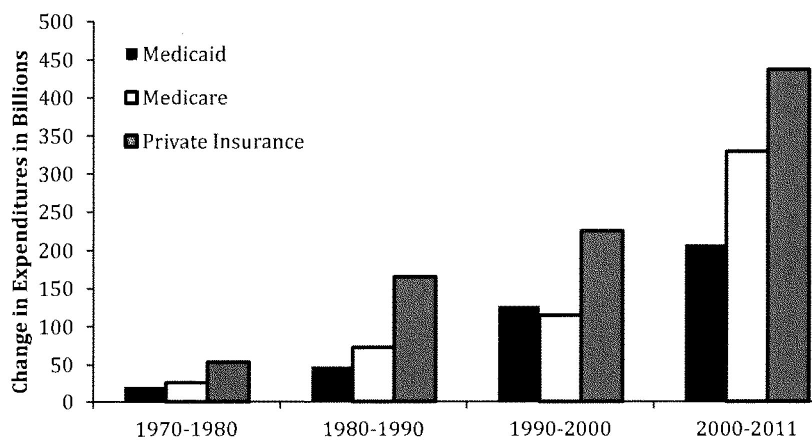
[2] Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, Historic National Health Expenditure Data. http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf. Accessed July 24, 2013.
[3] Institute of Medicine, *The Healthcare Imperative: Lowering Costs and Improving Outcomes: Workshop Series Summary*. http://www.iom.edu/Reports/2011/~/media/Files/widget/VSRT/healthcare-waste.swf. Accessed July 24, 2013.
[4] Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, Historic National Health Expenditure Data. http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf. Accessed July 24, 2013.
[5] Hartman M, et al. National Health Spending in 2011: Overall growth remains low, but some payers and services show signs of acceleration. *Health Affairs*, 2013; 32: 87–99.

195.2 billion dollars, respectively[6]

- From 2000-2011, costs in Medicare increased 329.5 billion dollars and in Medicaid, 207.2 billion dollars
- Private sector costs rose 443.8 billion dollars from 1970-2000 and 437.1 billion dollars from 2000-2011[7]

Based the data presented in **Figure 1**, the increase in overall combined expenditures in the public and private sectors over the past eleven years are greater than the total expenditures during the preceding 30 years. Across all payers, Medicare spending has increased most drastically over that time.

Figure 1: Change in overall national health care expenditures in billions of dollars over time range indicated



Based on the current state of health care legislation, the Congressional Budget Office (CBO) estimates that the cost of the Medicare program will be approximately 6.4 trillion dollars from

[6] Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, Historic National Health Expenditure Data. http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf. Accessed July 24, 2013.
[7] Ibid.

2013-2022.[8]

Historical Trends of Health Care Expenditures Across Care Continuum

Examining the variance of costs across the continuum of care is important for understanding where and how health care costs distribute. **Table 1** provides longitudinal Medicare data on physician and clinical services (largely the outpatient setting), hospital care (inpatient), post-acute care spending, spending on prescription drugs and medical products (durable medical equipment, and other non-durable medical products). **Table 2** provides analogous data for the private sector.

Table 1: Medicare Spending Across the Continuum of Care[9]*

Care Domain	2001	2003	2005	2007	2009	2011
	Amount in Billions of Dollars					
Physician and Clinical Services	70.2	81.0	95.0	107.0	131.5	139.9
Hospital Care	135.0	150.9	176.4	193.8	216.4	231.3
Post-Acute Care and Other	25.2	31.7	42.2	53.1	64.8	75.6
Pharmaceutical	2.4	2.5	3.9	46.0	54.6	63.7
Durable Medical Equipment	4.5	6.0	6.4	7.0	7.5	7.7
Other Non-Durable Medical Equipment	1.6	1.9	2.1	2.5	2.8	3.2

*Figures do not include administrative costs or the net cost of health insurance

[8] Congressional Budget Office. How Have CBO's Projections of Spending for Medicare and Medicaid Changed Since the August 2012 Baseline? February 21, 2013. http://www.cbo.gov/publication/43947

[9] Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, Historic National Health Expenditure Data. http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf. Accessed July 24, 2013.

Table 2: Private Sector Spending Across the Continuum of Care[10]*

Care Domain	2001	2003	2005	2007	2009	2011
	Amount in Billions of Dollars					
Physician and Clinical Services	166.3	196.6	222.5	245.3	262.6	275.8
Hospital Care	154.0	185.6	217.5	249.4	281.1	306.9
Post-Acute Care and Other	17.0	17.8	18.7	20.1	22.0	23.9
Pharmaceutical	70.6	86.5	101.8	107.7	118.3	122.2
Durable Medical Equipment	3.1	3.3	3.7	4.0	3.9	4.6
Other Non-Durable Medical Products	--	--	--	--	--	--

*Figures do not include administrative costs or the net cost of health insurance

There are a couple of notable trends in spending across the continuum of care based on payer. First, Medicare's total expenditures are highest for inpatient hospital care, whereas outpatient care consumes the largest portion of private sector spending. However, the rate of growth is inverted—the growth rate of inpatient expenditures is greater in the private sector when compared to Medicare and the outpatient or ambulatory costs have risen at a greater rate in the public sector. Second, growth in pharmaceutical spending, while certainly explained by the introduction of Medicare Part D, continues to be a growing share in both the private and public sector. These trends illustrate both challenges and opportunities for savings—namely, that while attention is being paid to costly inpatient admissions, we must also look thoughtfully at innovations and utilization in the ambulatory setting in Medicare. Additionally, as inpatient costs decrease in Medicare, yet hospital bed growth is increasing in certain geographic areas, it will be important to understand the relationship between capacity and spending in both sectors. Regardless, mechanisms to coordinate care and extract inefficiencies across the continuum offer the greatest promise at curbing overall growth.

[10] Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, Historic National Health Expenditure Data. http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf. Accessed July 24, 2013.

The Affordable Care Act and Effects on Spending

The Affordable Care Act includes a number of reforms that have transformed the health care system and decreased overall spending. Enhanced access to coverage, consumer protections, and payment reforms provide important direct and indirect economic benefits to millions of Americans and also extend the life of the Medicare Trust Fund by at least eight additional years. Increased coverage in the form of Medicaid expansions and Health Insurance Marketplaces translates to improvements in the labor market with more people working, working productively, and less job lock from those who fear losing access to health insurance when switching jobs. As a result of restrictions to the amount of money spent on administrative costs or marketing, Americans have received rebates totaling 1.1 billion dollars from insurers over the past two years.[11] With respect to payment reform and other changes to the delivery of care, I will highlight several provisions that have already demonstrated cost savings or offer great promise for continuing to curb cost growth in the Medicare program. In addition to direct consequences to the Medicare Trust Fund, programs and policies in the ACA have also had a significant effect within the private sector, which has partly contributed to the reduction in overall national health expenditures through care transformation.

Accountable Care Organizations

The Accountable Care Organization (ACO) model is an example of a delivery system reform that fosters greater coordination of care while concurrently aligning financial incentives to encourage organizations to deliver more efficient care. The Centers for Medicare & Medicaid services (CMS) recently reported that organizations participating in the Pioneer ACO program achieved lower cost growth (0.3 percent) for their 669,000 beneficiaries than the growth observed (0.8 percent) for similar beneficiaries in the fee-for-service model during the same period. Of the 32 Pioneers, 13 Pioneers with significant savings generated gross savings of 87.6 million dollars in 2012. Of those gross savings, Medicare netted nearly 33 million dollars as the Trust Fund share of the ACO savings. Reduced hospital admissions and readmissions were

[11] U.S. Department of Health and Human Services. Health care law saved an estimated $2.1 billion for consumers. http://www.hhs.gov/news/press/2012pres/09/20120911a.html, Published September 2012. Accessed July 26, 2013.

reportedly principal drivers of overall cost savings.[12]

Additionally, private sector accountable care contracts are becoming more commonplace, with some demonstrating early results through a shift from volume-based payment to a value-based financing mechanism.[13] Private sector ACO efforts are noteworthy for their direct engagement with providers to redesign workflows and impact care coordination at a population level. A joint partnership between United HealthCare and Tucson Medical Center (TMC) centered on accountable care has led to more investments in ways to test care coordination tools. As a result of ACO efforts, TMC and its affiliated physician groups created a management services organization (MSO) as a business entity to develop and test ACO-specific clinical and administrative tools. The MSO then engaged Optum—a subsidiary of United HealthCare—to contribute clinical, administrative, and technical support to the enterprise.[14]

Bundled Payments

In order to achieve meaningful savings in the inpatient setting, the Center for Medicare & Medicaid Innovation (CMMI) has introduced bundled payments[15] as a model for hospital payment and delivery reform. A bundled payment is a fixed payment for a comprehensive set of hospital and/or post-acute services, including services associated with readmissions. Moving from individual payments for different services to a bundled payment for a set of services across providers and care settings encourages integration and coordination of care that will raise care quality and reduce readmissions. Variants on bundled payments are being demonstrated and differ in the scope of services included in the bundle and whether payment is retrospective—based on shared Medicare savings—or prospective, which intensifies the financial risk and return to investing in changes to the efficiency and quality of care. Currently, 467 health care

[12] Patel K and Lieberman S. Taking stock of initial year one results for Pioneer ACOs. Health Affairs Blog. http://healthaffairs.org/blog/2013/07/25/taking-stock-of-initial-year-one-results-for-pioneer-acos/. Published July 25, 2013. Accessed July 26, 2013.
[13] Markovich P. A Global Budget Pilot Project Among Provider Partners And Blue Shield of California Led to Savings in First Two Years. Health Affairs. September 2012; 31(9): 1969-1976. http://content.healthaffairs.org/content/31/9/1969.abstract. Accessed July 23, 2013.
[14] Carluzzo K, Larson B, Van Citters A, et al. Tucson Medical Center: A Community Hospital Aligning Stakeholders for Accountable Care. The Commonwealth Fund. http://www.commonwealthfund.org/~/media/Files/Publications/Case%20Study/2012/Jan/1575_Carluzzo_Tucson_case%20study_01_12_2012.pdf. Published January 2012. Accessed July 23, 2013.
[15] Centers for Medicare & Medicaid Services. Bundled Payments for Care Improvement Initiative. http://innovation.cms.gov/initiatives/bundled-payments/

organizations across 46 states are engaged in the bundled payment initiative.

Readmissions and Transitions in Care

According to CMS, one in five Medicare beneficiaries discharged from a hospital is readmitted within 30 days. Annually, that amounts to 2.6 million seniors and a cost of more than 26 billion dollars.[16] It is likely that multiple factors along the care continuum, from discharge inefficiencies to post-acute care issues, affect readmission rates. The Affordable Care Act includes two major efforts to improve coordination and reduce the costly inefficiencies of care. October 1, 2012 marked the beginning of the Hospital Readmissions Reduction Program (HRRP), an effort to reduce the frequency of re-hospitalization of Medicare patients. The program consists primarily of financial penalties levied against hospitals with readmission rates that are deemed to be excessive in several clinical areas such as congestive heart failure and pneumonia. According to CMS, approximately two thirds of U.S. hospitals will receive penalties consisting of up to 1 percent of their reimbursement for Medicare patients. These penalties will increase to 3 percent by 2015. CMS expects to recoup 280 million dollars from the 2217 hospitals penalized in 2013 alone.

Another effort at curbing the cost of care incurred by inefficient transitions is the CMMI Community-based Care Transitions Program (CCTP)[17], which addresses the transition from the inpatient hospital setting to the post-acute care setting. The CCTP initiative is important because it is not a demonstration project or pilot, but instead reflects a change in payment. The 112 participating organizations are paid an all-inclusive care management fee per eligible discharge that is based on the cost of providing care to the patient and implementing the systemic reforms at the hospital level.

While these and many other provisions within the Affordable Care Act offer an important foundation for reducing overall spending in healthcare, additional opportunities exist to go further toward bending the cost curve. As we identify in **Table 3,** it is important to look at the continuum of care and apply appropriate reforms that can have an impact within each sector. A

[16] Centers for Medicare and Medicaid Services. Community-based Care Transitions Program.
[17] Ibid.

combination of financing reforms that move us away from fee-for-service, delivery reforms that improve coordination in the inpatient and outpatient setting, and structural reforms that can lower the purchasing price for the goods and supplies of health care offer significant opportunities for savings.

These opportunities are neither partisan nor do they involve a radical redefinition of the Medicare benefit package. Rather, they build on lessons from the introduction of Medicare, the advent of capitation and managed care, physician hospital organizations (PHOs), state-based reforms, the implementation of the Medicare Part D program, and the aforementioned initiatives in the Affordable Care Act.

Opportunities for Savings

Within and across the continuum of care, there exist savings opportunities which can promote value, reduce cost and engage patients. These reforms will not only protect our nation's long-term fiscal growth but will also improve the quality of care delivered to our patients. An important caveat is that although savings opportunities are presented by sector, it would be a mistake to assume that policies affecting each sector do not have a significant interaction effect with each other; in other words, policies affecting inpatient readmissions will affect outpatient care, post-acute care, etc. In fact, some of the strongest drivers of sector utilization are often the result of policies affecting other sectors.

Ambulatory Care Savings

The principal opportunity in the outpatient or ambulatory sector is the shift in physician payment from a volume-based fee-for-service system to one that would allow for better care coordination and shared financial risk outside traditional medical borders. While the cost of repealing the Sustainable Growth Rate is not insignificant, it reflects an opportunity for policymakers to place an investment in shifting care from the current siloed state to one that will help to enhance the important investments in coordination of care, such as patient-centered medical homes and accountable care organizations. Our work under the Merkin Initiative on Payment Reform and Clinical Leadership and additional efforts at Brookings have identified opportunities for such savings within physician payments[18,19]. First, a set of services currently reimbursed for a particular episode of care or part of chronic care management are bundled together into a single payment to physicians as a *case management payment*. For example, in clinical oncology, a case management payment would include after hours phone care for breast cancer or a palliative care counselor for patients with lung cancer. This enables clinicians to focus less on volume and more on tighter coordination among providers and settings for patients. In addition, a proportion of FFS payments would become a fixed *care coordination payment* paid to physicians, which is built on concepts such as quality improvement and could qualify physicians to meet requirements for the Physician Quality Reporting System and Meaningful Use. These fixed care coordination payments allow flexibility for physicians to invest in clinical practice transformations that maximize their ability to treat patients in clinically appropriate ways while not reducing their income due to the reductions in billable procedures that would otherwise occur

The Accountable Care Organization model should also be modified to allow for primary care physicians and specialists to work together and care for a population of patients with chronic diseases in a differentiated manner; after all, one size does not fit all when it comes to care and there is certainly no exception to the ACO. The rule of attribution should be modified to allow for providers of all types (including mental health and behavioral health specialists) to work together to care for patients with chronic disease; members of this committee have also echoed this recommendation. [20] Additionally, financial benchmarks must also point towards a longitudinal budget, especially if we replace fee-for-service payments in Medicare. Currently, ACOs are financially assessed year-to-year despite the longer time trajectory that some savings efforts might take (enhanced prevention efforts, etc). Assessment at a longer interval as well as the ability to potentially benefit from first dollar savings (as opposed to savings accrued after a certain threshold) could strengthen overall impact and add even more savings back to the

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[18] Statement of Kavita K. Patel on Physician Payment Reform Before the Senate Finance Committee. 14 May 2013. Full transcript available at: http://www.finance.senate.gov/imo/media/doc/Kavita%20K%20Patel%20Senate%20Finance%20Testimony%20FINAL.pdf

[19] Bending the Curve: Person-centered Health Care Reform: A Framework for Improving Care and Slowing Health Care Cost Growth. The Brookings Institution. April 2013. http://www.brookings.edu/~/media/research/files/reports/2013/04/person%20centered%20health%20care%20reform/person_centered_health_care_reform.pdf

[20] http://www.wyden.senate.gov/news/blog/post/wyden-outlines-major-medicare-reforms-at-aco-summit

Medicare Trust Fund. Finally, as long as Medicare beneficiaries enjoy the ability to see any provider of their choosing, we must seek methods to actively engage patients to understand the promise of PCMHs, ACOs and all of the other acronyms/nomenclature placed upon them. By doing so, we can ensure that beneficiary choice is protected while also allowing ACOs and other risk-bearing entities to have more certainty with regard to their patient populations. As illustrated in **Table 3**, experts have estimated that additional enhancements to the ACO model beyond what I have described could accrue billions of dollars in savings.

Inpatient Savings

There is no question that given the proportion of expenditures in the inpatient/hospital setting, any opportunity to increase efficiencies and garner savings should be explored. The aforementioned experience with readmissions penalties can be built upon further. Currently the penalties apply to acute myocardial infarction, pneumonia, and heart failure. Expansion to a wider number of conditions will have a multiplicative impact on budgets as well as patient care. Thus far, we have seen significant investments in improved information flows at time of admission and discharge as well as increased vigilance to factors which drive readmissions—adherence to medications, poor follow-up after discharge, and lack of coordination between providers. In a similar vein, the bundled payment efforts hold great promise, but much like the Accountable Care Organization initiatives, will likely need modifications and flexibility in order to achieve full potential. Finally, a driver in the growth of hospital-based outpatient care has been the differential site of service payment within Medicare. Medicare payments for evaluation and management (E&M) were 80 percent higher in outpatient hospital settings than physician offices for same services. For example, Medicare pays $450 for an echocardiogram done in a hospital and only $180 for the same procedure in a physician's office. As noted by the National Commission on Physician Payment Reform, this trend has only exacerbated cost growth and increased income differential between primary care and other specialties.[21,22] Meaningful reforms must eliminate this differential and focus on how best to align financial incentives with

[21] MedPAC. Report to the Congress: Medicare Payment Policy. March 2013. Page 48-49.
[22] Frist W, Schroeder S, et al. *Report of The National Commission on Physician Payment Reform.* The National Commission on Physician Payment Reform. http://physicianpaymentcommission.org/wp-content/uploads/2013/03/physician_payment_report.pdf.

the quality of care provided to patients. The site of care should take into account clinician judgment and patient preference and not the associated reimbursement.

Post-Acute Care

The term "post-acute care" is often a disservice to this extremely diverse and important sector. While the care is often delivered after an episode in the hospital (hence the label), it can take place in a variety of ways and in a variety of settings, everything from home health to hospice. Given the changing demographics of our population, care delivered in settings such as skilled nursing facilities or in the home will be a more common occurrence. As noted earlier, the proportion of post-acute care expenditures in Medicare is growing and care transformation in these settings will require the same degree of coordination, if not more. The expansion of payment bundles in Medicare to include more post-acute organizations as well as longer episodes can result in billions of dollars in savings and also ameliorate the vast cost differentials in this sector. A recent IOM study points to a great deal of variation in the post-acute setting, which supports payment reform in this sector as well.[23] Another area that deserves more attention is hospice care. Half of Medicare's expenditures in hospice were for beneficiaries whose length of stay was over 180 days.[24] At the other end, for many beneficiaries, admission into hospice is often too late—each situation is untenable, highlighting the need for meaningful payment reforms that are at least budget neutral and can allow for appropriate care to beneficiaries during an almost universally difficult time for patients and their loved ones.

Additional Savings in Pharmaceuticals, Supplies and Administrative Simplification

As highlighted in **Table 3** there are additional opportunities to further simplify our already lean Medicare administrative costs and thus hopefully have an effect on the private sector as well. Such reforms include standardization of claims forms, processing actions and electronic transactions (which becomes easier now that over half of providers are meaningful users of

[23] Institute of Medicine. *Variation in Health Care Spending: Target Decision Making, Not Geography.* http://www.iom.edu/~/media/Files/Report%20Files/2013/Geographic-Variation2/geovariation_rb.pdf Accessed July 26, 2013
[24] Neuman K. and Sadownik S. MedPAC Presentation: Medicare Hospice Policy Issues. April 4, 2013. http://www.medpac.gov/transcripts/hospice_April_2013_presentation.pdf

electronic health records). In keeping with the theme of building on current initiatives within Medicare, extension of competitive bidding beyond durable medical equipment for other supplies offers potential savings along with demonstrating the importance of providing CMS with flexible authorities and resources to implement a competitive program that will accrue savings to the Trust Fund and beneficiaries. Finally, many expert bodies and analysts have discussed the role of pharmaceuticals and savings within—everything from price negotiations to low-income subsidies. Two common themes have emerged: savings from the payment for physician-administered drugs such as oncolytics or immunologic drugs, and savings from reducing brand-name drug usage. While I illustrate the potential savings by decreasing the Average Sales Price (ASP) adjustment from ASP+6 to ASP+3, it is critical that the Committee pair this with a concomitant reform to physician payments and eliminate the fee-for-service payments that usually accompany the administration of such pharmaceuticals in the Part B Medicare program. Encouragement of therapeutic substitution also offers promise. Researchers recently estimated that up to 1.4 billion dollars would have been saved in 2008 alone if generic drug usage in the Medicare population were equivalent to that of the Veterans Affairs System.[25]

While I illustrated opportunities for savings in the Medicare program, there are a number of similar and related reforms that should be implemented in the Medicaid program and given the projected growth in Medicaid enrollment over the next decade, the Committee should also consider how best to align such opportunities. Our nation's economic prosperity will be intrinsically linked to our ability to benefit from alignment of Medicare and Medicaid while learning from the true pioneers in these areas- states such as Oregon, Washington, Colorado and New York are leading the way in identifying patient-centered efforts to improve delivery to our nation's poor and elderly.

[25] Gellad W.F., Donohue J.M., Zhao X., Mor M.K., Thorpe C.T., Smith J., Good C.B., Fine M.J., Morden N.E. Brand-Name Prescription Drug Use Among Veterans Affairs and Medicare Part D Patients With Diabetes: A National Cohort Comparison. Annals of Internal Medicine. 2013. http://annals.org/article.aspx?articleid=1696030

TABLE 3: Summary of Savings Opportunities by Sector

Sector	Savings Opportunity	Potential Economic Impact
Ambulatory Care	Payment models that minimize fee-for-service care: • Episodic payments for chronic conditions/case management fees • Care coordination fees that replace portions of FFS	Repeal of the Sustainable Growth Rate (SGR) will cost approximately 139.1 billion dollars[26]
	Extending the ACO Model[27] • Financial benchmark calculation • Enhance ACO ability to manage care for chronic conditions • Allow ACOs to accept increased accountability and financial risk • Improved patient engagement to avoid "leakage"	Experts have projected possible savings of up to 192 billion dollars from 2014-2023[28] through replacement of physician fee cuts with an inflation-based adjustment and increased financial risk/accountability.
Inpatient Care	Extension of hospital readmissions penalties for a broader number of conditions	While it is not clear exactly how much money would be saved, it is clear that the current program has generated significant savings (280 million dollars in 2013 alone), thus expansion would have a strong budgetary impact
	Elimination of site of service differential payments in Medicare for same services performed in hospital-based settings vs office-based settings.	In 2011, Medicare and beneficiaries paid 1.5 billion dollars more for E&M and echocardiograms alone than they would have if payments had been equal across sites of care[29]
	Expansion of bundled payments to include more conditions and involve more care settings	Bundles will likely drive down unit costs of care (cost per bundle), however it is unclear if it will have a significant shift on the volume of overall care
Post Acute Care	Expansion of payment bundles for post-acute care • Expand the number of post-acute care organizations participating • Expand the episodes of care that are covered and length of episode	Potential for an estimated 8.2 billion dollars in savings from 2014-2023[30] with reforms in the post acute sector
	Payment reforms within hospice • Encourage ACA authorized reform to replace per diem payment with a value-based payment to match intensity of services	MEDPAC estimates that such reforms would be budget neutral the first year

[26] Congressional Budget Office. The Budget and Economic Outlook: Fiscal Years 2013 to 2023. February 2013. Page 31.
[27] Lieberman SM.2013. Reforming Medicare through 'Version 2.0' of Accountable Care. *Health Affairs*: 32(7): 1258-1264.
[28] Ibid.
[29] MedPAC. Report to the Congress: Medicare Payment Policy. March 2013. Page 48-49
[30] Office of Management and Budget. The White House. Fiscal Year 2014 Budget of the U.S. Government. April 2013. Page 38, 197.

Sector	Savings Opportunity	Potential Economic Impact
Supplies	Refine and expand competitive bidding to other types of equipment beyond durable medical equipment (DME)[31]	Pilot program in DME competitive bidding saved Medicare 202 million dollars in year one[32] • July 2013 expansion expected to save Medicare Part B Trust Fund 25.7 billion dollars[33] and Medicare beneficiaries 17.1 billion dollars in lower coinsurance and premiums payments[34]
Administrative	Administrative simplification[35] • Shift to electronic transactions • Implement common terms and approaches for insurance billing • Standardize claims forms and review processes	Institute of Medicine estimates savings of 181 billion dollars[36]
Prescription Drugs	Modify payment for physician-administered medications[37] • Reduce payment from ASP+6 to ASP+3	Savings of approximately 20 billion dollars from 2014-2023[38]
	Encourage therapeutic substitution where clinically appropriate	Savings in 2008 alone would have been 1.4 billion dollars[39]

Looking Ahead

Just as there are significant opportunities to deal with the challenging cost conundrum in healthcare, there are additional areas which *could* hold great promise. Notwithstanding, it is not entirely clear how best to enact these policies at the federal level and what effect they might have on the federal budget. One such area is transparency.

As noted in previous hearings hosted by this Committee, there is a great deal of interest in

[31] Bipartisan Policy Center. A Bipartisan Rx for Patient-Centered Care and System-Wide Cost Containment. April 2013. Pages 60-61.
[32] Centers for Medicare & Medicaid Services. Press Release: Contract suppliers selected under Medicare competitive bidding program. April 9, 2013.
[33] Ibid.
[34] Ibid.
[35] Institute of Medicine, *The Healthcare Imperative: Lowering Costs and Improving Outcomes: Workshop Series Summary*. http://www.iom.edu/Reports/2011/~/media/Files/widget/VSRT/healthcare-waste.swf. Accessed July 24, 2013.
[36] Ibid.
[37] Office of Management and Budget. The White House. Fiscal Year 2014 Budget of the U.S. Government. April 2013. Page 41.
[38] Ibid.
[39] Gellad W.F., Donohue J.M., Zhao X., Mor M.K., Thorpe C.T., Smith J., Good C.B., Fine M.J., Morden N.E. Brand-Name Prescription Drug Use Among Veterans Affairs and Medicare Part D Patients With Diabetes: A National Cohort Comparison. Annals of Internal Medicine. 2013. http://annals.org/article.aspx?articleid=1696030

transparency initiatives and efforts to ensure that beneficiaries have the best ability to be a consumer of health care services. A basic psychological premise of consumerism is centered on the notion that information is power. The converse of this premise has been poignantly illustrated by recent analyses and commentary[40,41] that have revealed that most patients and their physicians have little to no understanding of the true cost of care or pricing, often resulting in poorly informed decision-making. It is clear that as consumers face increased out of pocket spending and continue to bear more financial responsibility, there is a need for a systematic approach to increase transparency and then deal with the consequences of such transparency. Several solutions have been proposed for improving the transparency of pricing:

- Anti-trust litigation to reduce the market power of certain insurance companies and providers to drive up prices and obscure them from consumers[42]
- Incentivizing price transparency through legislation and regulatory action[43]
- Market solutions such as making transparent and releasing data on quality and prices of providers to employers would enable them to demand lower-cost and higher quality health plans, hospitals and providers[44]

These solutions are important to consider, but it is unclear what impact these reforms might have on the overall cost of care. Nevertheless, action is warranted—an initial important step would be to continue to expand ongoing efforts around transparency such as the CMS Hospital and Physician Compare Initiative. Additionally, as federally supported and facilitated health insurance marketplaces are implemented nationwide, we should have a better understanding of how transparency affects choice, price, and utilization and what lessons those hold for the Medicare and Medicaid programs. If information is power, we must make sure that patients have as much of it as possible, but simply making the information publicly available will likely not be enough.

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[40] Brill S. Bitter Pill: Why Medical Bills are Killing Us. *Time*. March 4, 2013.
[41] Reinhardt, U. The Culprit Behind High U.S. Health Care Prices. Economix Blog, New York Times. http://economix.blogs.nytimes.com/2013/06/07/the-culprit-behind-high-u-s-health-care-prices/?_r=0 Published June 7, 2013. Accessed July 26, 2013.
[42] Price Transparency in the Health Care Market. UCSF/UC Hastings Consortium on Law, Science, and Health Policy. March 18, 2013. http://ucsfconsortium.uchastings.edu/research/pricetransparency/pricetransparency_whitepaper
[43] Ibid.
[44] Ibid.

In conclusion, as Congress recesses for the month of August, you will each hear directly from the most important witnesses to the ongoing cost challenges—patients. You will likely hear stories that highlight concerns over growing out of pocket costs, information asymmetry, and the sheer complexity of American healthcare. You will also hear stories of dedicated doctors, nurses, and health professionals who work to make sure that every patient receives the best care possible. You have the unique ability to translate these stories into policies that can build upon what is working and modify or eliminate anything that is not adding value to our care. By doing so, we will continue to slow cost growth and encourage greater economic security for our nation.

Thank you for this opportunity and I look forward to your questions.

Chairman MURRAY. Thank you very much.
Dr. ANTOS.

STATEMENT OF JOSEPH ANTOS, PH.D., WILSON H. TAYLOR SCHOLAR IN HEALTH CARE AND RETIREMENT POLICY, AMERICAN ENTERPRISE INSTITUTE

Mr. ANTOS. Thank you, Chairman Murray, Ranking Member Sessions, and other members of the committee, for this opportunity. I am the Wilson Taylor Scholar in Health Care and Retirement Policy at the American Enterprise Institute, but previously, I was an Assistant Director of the Congressional Budget Office and I am currently on the CBO's Panel of Health Advisors.

For the past 50 years, spending for health care has grown faster than the economy. In 1965, health was six percent of GDP. Today, it is 18 percent and it is still rising. This year, Federal spending for Medicare and Medicaid will be $860 billion. Over the next decade, Federal spending for those two programs plus the new subsidies offered on the insurance exchanges will exceed $13.3 trillion.

Any sign that the growth in health spending is slowing would seem to be good news, but that depends on why the slowdown occurred. I will make three points.

First, the recent slowdown in health spending is not likely to last. Most of the decline is due to deteriorating economic conditions, not structural changes in the health system. Private health plans have, indeed, made their own reforms in the way they pay providers and the way they deliver health care, but the poor economy dominates the past decade.

Second, the Affordable Care Act, the ACA, did not materially help slow health spending over the past decade and its expansion of health insurance coverage will drive up spending in the future.

Third, a responsible budget plan that begins to resolve the structural defects in Federal health programs is needed. If we do not take action, health spending will crowd out other policy priorities funded through the Federal budget.

So, the health spending slowdown has, indeed, been remarkable. In 2002, national health spending was growing at 9.7 percent a year. By 2009, the rate had dropped to 3.9 percent and stayed at that level for three years. Does this mark a permanent structural change that will ease the burden of rising health care costs into the future? Probably not, unfortunately. When we finally return to a full-employment economy, health spending will bounce back.

Now, poor economic performance at the beginning of the decade contributed to the initial slowdown. This is something that a lot of analysts tend to overlook. The deep recession that ended in 2009 drove spending growth even lower. The slow economic recovery since then has prolonged this dampening of health spending. So, we have a decade of economic trouble and it shows up in health spending. Obviously, when people lose their jobs, they lose their health insurance and their ability to pay for health services out of their own pockets also declines. This is not how any of us want to get health spending under control.

The ACA did not contribute to the slowdown in the past. The President's health reform was enacted after most of the slowdown had occurred. Moreover, the ACA focused on expanding health insurance coverage, not reducing health spending. Giving 25 million people heavily subsidized insurance may indeed be a good thing, but it will unquestionably increase health spending.

The ACA includes provisions to reduce spending. I will highlight two. The largest savings were from substantial cuts in Medicare payment rates to providers. However, within a few years, hospitals and nursing homes will be paid less than Medicaid rates, which threatens seniors' access to services. That cannot be sustained and Congress will eventually override these formula-driven reductions.

Accountable Care Organizations attempt to replicate the success of integrated health systems like Geisinger Clinic in Pennsylvania and Intermountain Health Care in Utah. Decades of work and investment made those plans what they are today. Such capacity cannot be built overnight, and the departure of nine of the original 32 pioneer ACOs from the program is evidence of that.

On balance, the ACA will add about $500 billion to national health spending over the next decade. The impact on Federal health spending is even higher than that. This further strains our ability to finance existing health programs and have the resources available for other critical domestic and international policy priorities.

Clearly, we need to rebalance our spending priorities. I would recommend that we start with Medicare. Obviously, we need to permanently resolve the SGR problem, but we also need to find $139 billion to cover the cost. We cannot stop there. Traditional Medicare should be modernized and simplified. Replace the complicated benefit structure with a single deductible and uniform copayment. Add catastrophic coverage, something that modern insurance offers to everyone. Medicare does not. Add catastrophic coverage to the benefit.

Limit first dollar Medigap coverage that promotes excessive use of services that often are of little value to the patient. Develop new payment methods that reward better care, not more care. Many other changes are necessary, including proposals mentioned by Dr. Patel, in order to make traditional Medicare a more functional and less costly program.

However, the key to putting Federal health spending on a sustainable path is market-based Medicare reform. We must change the financial incentives of fee-for-service payment if we are to bend Medicare's cost curve. By promoting effective competition and informed consumer engagement, we can fulfill our obligation to ensure that Medicare will be there for future retirees without imposing a prohibitive tax burden on future workers.

Thank you for this opportunity, and I look forward to your questions.

[The prepared statement of Mr. Antos follows:]

American Enterprise Institute
for Public Policy Research

Statement before the Senate Committee on the Budget

Containing Health Care Costs: Recent Progress and Remaining Challenges

Joseph R. Antos, Ph.D.
Wilson H. Taylor Scholar in Health Care and Retirement Policy
American Enterprise Institute

July 30, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Murray, Senator Sessions, and other members of the committee, thank you for the opportunity to testify today before the Senate Committee on the Budget.

The recent slowdown in the growth of health spending has raised hopes that the health system may have shifted to a "new normal," with costs that are more affordable and sustainable for the future. Although private health plans and providers have adopted promising reforms over the past decade, the evidence strongly indicates that health spending growth will rebound as we return to a full-employment economy. Growth rates for health spending might not return to the high levels that we have seen in past decades, but they will rise substantially.

Rising health care costs will have serious consequences for the federal budget. The Congressional Budget Office (CBO) projects that entitlement spending will crowd out other budget priorities over the next decade and beyond, with growth in health programs outstripping other major categories of federal spending.[1] Health spending—Medicare, Medicaid, CHIP, and exchange subsidies—is projected to grow by 33 percent between 2012 and 2022 under current law.[2] Other programs (excluding Social Security) will see their budgets decline by 37 percent. Only interest on the federal debt will grow faster than health spending, increasing by about 80 percent over the decade.

The Affordable Care Act (ACA) will substantially increase national health spending through new subsidies for Medicaid and insurance purchased on the exchanges. The law includes provisions to reduce Medicare payment rates to providers and Medicare Advantage plans, expand bundled payments in traditional Medicare, and introduce accountable care organizations (ACOs). It is too early to know how effective those measures will be in slowing program spending, but the ACO initiative has already suffered a setback with the departure of 9 Pioneer ACOs from the program.

It is imperative that Congress develop a responsible budget plan that can begin to resolve the structural defects in federal health programs and subsidies for health insurance. The key to putting federal health spending on a sustainable path is market-based Medicare reform. By promoting effective competition and informed consumer engagement, we can fulfill our obligation to ensure that Medicare will be there for future retirees without imposing a prohibitive tax burden on future workers.

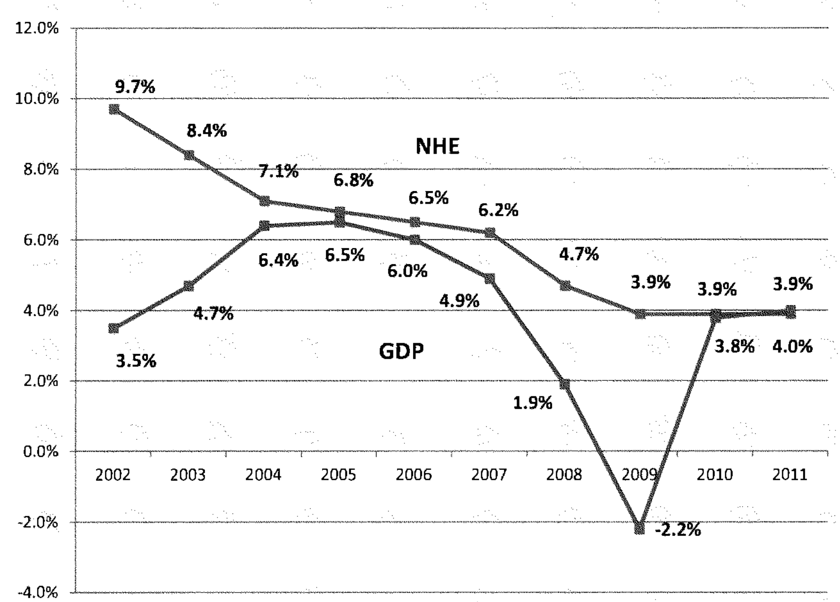
Will the Health Spending Slowdown Last?

With little fanfare until recently, the growth in national health spending has declined sharply over the past decade. Data from the Centers for Medicare and Medicaid Services (CMS) shows that growth in national health expenditures peaked in 2002, growing 9.7 percent in a year

[1] CBO, *The 2012 Long-Term Budget Outlook*, June 2012, http://www.cbo.gov/publication/43288.

[2] Author's calculation of the increase or decrease in the share of each year's GDP accounted for by each major program, based on Table 1-2 of CBO's 2012 long-term budget outlook report, Extended Baseline Scenario.

Figure 1. Annual Growth Rates for National Health Spending and GDP



Source: CMS National Expenditure Accounts, Table 1, http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf.

that saw the economy grow by only 3.5 percent (Figure 1).[3] Health spending growth dropped to 8.4 percent in 2003 and continued to decline until 2009 when the rate fell to 3.9 percent—and has remained at that rate for three consecutive years.

The biggest single factor driving the recent slowdown is the economy. The severe recession that began in December 2007 and ended in June 2009 had an immediate impact on health spending as workers lost their jobs and their health coverage. According to the CMS analysis, the decline in health insurance enrollment in 2009 was the largest one-year drop recorded in the National Health Accounts. The failure of the economy to bounce back as quickly as it has after past recessions has prolonged this dampening effect on health spending.

How much of the slowdown in health spending can be attributed to a weakened economy is uncertain. A study by the Kaiser Family Foundation and the Altarum Institute concludes that 77 percent of the recent decline in health spending growth can be explained by changes in the

[3] Micah Hartman, Anne B. Martin, Joseph Benson, Aaron Catlin, and the National Health Expenditure Accounts Team, "National Health Spending In 2011: Overall Growth Remains Low, But Some Payers And Services Show Signs Of Acceleration," *Health Affairs*, January 2013 32:87-99, http://content.healthaffairs.org/content/32/1/87.full.

broader economy, taking into account both changes in GDP growth and general price inflation.[4] Cutler and Sahni find that the 2007-09 recession accounted for 37 percent of the slowdown between 2003 and 2012.[5]

Holahan and McMorrow point out that narrowly focusing on the recession ignores the impact of the economy on the declining growth rates for health spending that occurred before 2007.[6] The early 2000s were a period of relatively slow economic growth compared to the 1990s (illustrated in Figure 1), and declines in family incomes and insurance coverage probably contributed to slowing health expenditures that occurred in the years after 2002. This evidence supports the Kaiser-Altarum finding that economic declines rather than structural changes in the health sector are primarily responsible for the slowdown in health spending over the past decade.

Slowing the growth of health spending because the economy is failing is obviously not desirable. Other factors also contributed to the decline, but they are clearly less significant and are not necessarily structural changes in the health system.

Fuchs observes that "some of the reasons for the slow growth in the past 2 years...are one-time gains, not alterations in such determinants of long-term growth as new medical technology and the aging of the population."[7] For example, over the past two years, major drug companies have lost exclusive rights to many billion-dollar selling drugs.[8] The availability of lower-cost generic formulations reduces health spending, but does not change the fundamental drivers of health spending.

Changes in the health sector may have more persistent impacts on spending. Ryu and colleagues found that health plans offered by large firms became less generous over the last five years, resulting in increasing out-of-pocket costs for beneficiaries.[9] Not surprisingly, when employees are responsible for more of the cost of cost of health services, spending declines. Consumer-directed health insurance plans, which combine a high deductible with a health savings account and offer lower premiums than more traditional coverage, have gained a

[4] Kaiser Family Foundation, "Assessing the Effects of the Economy on the Recent Slowdown in Health Spending," April 22, 2013, http://kff.org/health-costs/issue-brief/assessing-the-effects-of-the-economy-on-the-recent-slowdown-in-health-spending-2/.

[5] David M. Cutler and Nikhil R. Sahni, "If Slow Rate Of Health Care Spending Growth Persists, Projections May Be Off By $770 Billion," *Health Affairs,* May 2013 32:841-850, http://content.healthaffairs.org/content/32/5/841.full.

[6] John Holahan and Stacey McMorrow, "What Drove the Recent Slowdown in Health Spending Growth and Can It Continue?" Urban Institute, May 6, 2013, http://www.urban.org/url.cfm?renderforprint=1&ID=412814

[7] Victor R. Fuchs, "The Gross Domestic Product and Health Care Spending," *New England Journal of Medicine,* 369:107-109, July 11, 2013, http://www.nejm.org/doi/full/10.1056/NEJMp1305298.

[8] Rick Mullin, "Beyond The Patent Cliff," *Chemical & Engineering News,* December 10, 2012, http://cen.acs.org/articles/90/i50/Beyond-Patent-Cliff.html; Katie Moisse, "10 Top-Selling Drugs Coming Off Patent," ABC News, July 25, 2011, http://abcnews.go.com/Health/Drugs/prescription-drug-prices-plummet/story?id=14152014.

[9] Alexander J. Ryu, Teresa B. Gibson, M. Richard McKellar, and Michael E. Chernew, "The Slowdown In Health Care Spending In 2009–11 Reflected Factors Other Than The Weak Economy And Thus May Persist," *Health Affairs,* May 2013 32:835-840, http://content.healthaffairs.org/content/32/5/835.full.

growing share of the market in recent years. If this trend continues, that will help reduce the growth of health spending.[10]

Additional health system developments could also contribute to lower health spending growth into the future. The health care work force is changing, with more women becoming physicians and younger physicians seeking more stable work hours as employees of hospitals. The adoption of health information technology promises to reduce waste and improve care coordination, although that will only happen if payment and delivery systems change to take advantage of that potential. Care is beginning to move away from the doctor's office and into pharmacies, supermarkets, and shopping malls. Stronger competition among health plans, including those operating on the health insurance exchanges, will exert downward pressure on premiums.

These changes are promising, but there is no evidence that our health spending crisis has been resolved. Moreover, what has slowed in the past decade is the *growth* in health care spending, not the *level* of spending. Adjusting for inflation, health spending has increased an average of $1,385 per person between 2002 and 2011.[11] National health spending has continued its upward climb, although at a slower rate than in the past.

How Much Did the ACA Contribute to the Slowdown?

The primary goal of the ACA was to increase health insurance coverage, not reduce health spending. Since the law was enacted years after the major decline in health spending growth, ACA provisions that could help to slow growth in the future had little impact on the reductions thus far. According to the CBO, the largest source of savings from reduced health spending is reductions in Medicare provider payment rates. Other proposals, including bundled payment and ACOs, intend to change the structure of the program in a more permanent way.

Reductions in Medicare payment rates for hospitals and other providers generate impressive budget savings as scored by the CBO. Cuts in payment rates alone do not change the financial incentives that promote greater use of services and cannot be considered a structural reform. If implemented, this policy generates a series of one-time savings that increase every year.

Congress is unlikely to allow the full amount of payment reductions for hospitals and other Part A providers required by the ACA to be implemented as scheduled. Medicare's Office of the Actuary reported that by 2019 those payment reductions would result in operating losses for 15 percent of hospitals, skilled nursing facilities, and home health agencies. By 2030, 25 percent of Part A providers would sustain losses, and by 2050 that number rises to 40 percent.[12]

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[10] Amelia M. Haviland, M. Susan Marquis, Roland D. McDevitt, and Neeraj Sood, "Growth Of Consumer-Directed Health Plans To One-Half Of All Employer-Sponsored Insurance Could Save $57 Billion Annually," *Health Affairs*, May 2012 31:1009-10152, http://content.healthaffairs.org/content/31/5/1009.full.

[11] Author's calculation using data from the National Health Accounts and the chained CPI to estimate the change in spending deflated to 2002 dollars.

[12] John D. Shatto and M. Kent Clemens, "Projected Medicare Expenditures under Illustrative Scenarios with Alternative Payment Updates to Medicare Providers," CMS Office of the Actuary, May 31, 2013,

The severity of these cuts was emphasized by Medicare's chief actuary in the 2013 Trustees report.[13] He stated:

> Medicare prices would be considerably below the current relative level of Medicaid prices, which have already led to access problems for Medicaid enrollees, and far below the levels paid by private health insurance. Well before that point, Congress would have to intervene to prevent the withdrawal of providers from the Medicare market and the severe problems with beneficiary access to care that would result. Overriding the productivity adjustments, as Congress has done repeatedly in the case of physician payment rates, would lead to substantially higher costs for Medicare in the long range than those projected under current law.

Other Medicare provisions can properly be considered structural reforms that could yield continuing savings, but they are partial measures at best. Bundled payments would expand the boundaries of inpatient payment to include hospital and associated physician and pre- and post-acute services. Bundling provides incentives for providers to economize in treating patients requiring inpatient stays, perhaps by eliminating unnecessary tests or doing a better job coordinating the delivery of services.

Bundling changes the unit of payment but it does not change fee-for-service incentives to expand volume. Any efficiencies that are gained are *micro* efficiencies, focused on the specific episode of care rather than on the entire spectrum of the patient's health care needs. The alternative is capitation, which pays a health plan a fixed amount for all the services provided to the patient. Under bundling Medicare would continue to pay on a piece rate basis, but with larger pieces.

ACOs attempt to create integrated networks of hospitals, physicians, and other providers in the context of traditional fee-for-service Medicare. ACO providers would continue to be paid fee-for-service, but would keep half of any savings compared with what the patient's care would have cost otherwise. High-performing ACOs would also be eligible for a bonus from CMS. Medicare beneficiaries would not formally enroll in an ACO, but their costs would be attributed to their primary physician if that doctor participates in an ACO. In that sense, an ACO is a virtual HMO that is intended to be invisible to the patient.

Supporters of the ACO concept point to earlier integrated systems, such as Geisinger Health Care in Pennsylvania and Intermountain Health Care in Utah, as evidence that ACOs can provide effective lower-cost care.[14] That ignores the decades of development and innovation that made those health plans what they are today. Such capacity cannot be built overnight.

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http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/2013TRAlternativeScenario.pdf.

[13] Paul Spitalnic, "Statement of Actuarial Opinion," Appendix J in The Boards of Trustees, *The 2013 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, June 11, 2013, http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2013.pdf.

[14] James Capretta, "The Predictable Failure of Medicare ACOs and a New Model That Would Actually Work," American Enterprise Institute, forthcoming.

To jumpstart the program, CMS created Pioneer ACOs for health care organizations and providers that were already operating as integrated systems.[15] The program began operation in 2012 with 32 well-regarded organizations—including Partners Healthcare in Boston, Dartmouth Hitchcock in New Hampshire, and others—selected from a large applicant pool.[16]

On February 25, 2013, 30 of the Pioneer ACOs sent a letter to CMS complaining that 19 of the 31 quality standards required by the Administration had insufficient data to support their use, raising questions about the plans further participation in the program.[17] In an unusual move, the plans threatened to leave the program if this problem was not resolved. CMS agreed to a compromise, averting the crisis.[18]

More bad news followed. On July 16, 2013, CMS announced results of the first year of Pioneer ACO operation.[19] Only 13 of the Pioneers saved enough money to share those savings with Medicare, despite their experience as integrated health systems and additional investment in programs and staff to make the program work. Two Pioneer ACOs lost money, and owe the Medicare program $4 million. To avoid possible future losses, 9 of the 32 Pioneer ACOs will leave the program.

The core problem was identified by Chas Roades, chief research officer at the Advisory Board Company, in a Kaiser Health News article.[20] He commented that "we should temper our expectations about how much money we're actually going to save through ACOs." From the viewpoint of the hospital, ACOs are an attempt to preserve the Medicare fee-for-service system and the ACO model only applies to a portion of their Medicare patients. Roades added that it is "really hard to run two disparate sets of books at the same time" with two different sets of financial incentives.

Other elements of the ACA might slow health spending. Beginning in 2018, high-cost insurance plans offered by employers would pay a 40 percent tax on the value of the plan that exceeds a threshold amount—initially $10,200 for individuals and $27,500 for family coverage. Although this policy is inferior to capping the tax exclusion on employer-sponsored coverage, it is likely to be effective in discouraging employers from offering "Cadillac" plans with very generous benefits. The shift to leaner plans with higher cost-sharing requirements would reduce

[15] CMS, "Pioneer ACO Model," undated (accessed July 28, 2013), http://innovation.cms.gov/initiatives/Pioneer-ACO-Model/.

[16] CMS, "Pioneer Accountable Care Organization Model: General Fact Sheet," September 12, 2012, http://innovation.cms.gov/Files/fact-sheet/Pioneer-ACO-General-Fact-Sheet.pdf.

[17] Pioneer ACO plans, Letter to Rick Gilfillan on quality standards for Pioneer ACOs, February 25, 2013, http://www.washingtonpost.com/blogs/wonkblog/files/2013/03/2013-Quality-Benchmarks.pdf; Jenny Gold, "A Bump In The Road To Accountable Care?" Kaiser Health News, March 8, 2013, http://capsules.kaiserhealthnews.org/?p=17632.

[18] Nathaniel Weixel, "No Delay in Quality Accountability for Pioneer ACOs, but Metrics Will Change," *BNA's Health Care Policy Report*, April 29, 2013.

[19] CMS, "Pioneer Accountable Care Organizations succeed in improving care, lowering costs," July 16, 2013, http://www.cms.gov/Newsroom/MediaReleaseDatabase/Press-Releases/2013-Press-Releases-Items/2013-07-16.html.

[20] Jenny Gold, "9 Pioneer ACOs Jump Ship After First Year," Kaiser Health News, July 16, 2013, http://capsules.kaiserhealthnews.org/?p=20879.

health care utilization, but the four-year delay in implementation suggests that the provision may never be implemented.

These and other provisions intended to reduce federal health spending are secondary to expanding access to health insurance, the main objective of the ACA. Expanding Medicaid coverage and creating an insurance subsidy for those with incomes up to 400 percent of the federal poverty level could reduce the number of uninsured by 14 million next year, and by 2016 that number could rise to 25 million.[21] About 10 percent of the under-65 population could become newly-insured as a result of the ACA—substantially adding to the demand for health services and driving up cost.

Some analysts argue that enhanced competition among health plans in the exchanges will reduce health spending.[22] Enrollees are required to pay the full difference between the benchmark plan (which sets the individual's subsidy amount) and higher cost plans. That should lead to competition among the plans focused on price—the one element of health insurance that everyone can understand.

That is certainly the incentive of fixed-subsidy systems, including the premium support model advanced by Rep. Paul Ryan. The problem with the ACA model is that it sets the bar too high for health plans, requiring that they provide far richer benefits than consumers would purchase on their own. Low-income consumers would probably buy lower cost plans than available on the exchange if they were given the federal subsidy to spend as they please, keeping any extra payment to cover other essential expenses. Competition on the exchanges would lower insurance costs, but only after ACA requirements raised the cost level by 25 percent or more—and perhaps as much as two to three times more expensive than plans available on the market today.[23]

The Medicare chief actuary estimated that the ACA would increase national health spending by $311 billion between 2010 and 2019.[24] The estimate takes into account both the expansion of health coverage and the cost-reducing components of the ACA.

The longer-term impact on health spending depends on state decisions to expand Medicaid and Congress's willingness to enforce cost-reducing provisions in the ACA. Accounting for those factors, we estimate that national health spending will increase by about $500 billion between 2014 and 2023 as a consequence of the law. Additional Federal health

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[21] CBO, "Effects on Health Insurance and the Federal Budget for the Insurance Coverage Provisions in the Affordable Care Act—May 2013 Baseline," May 14, 2013, http://www.cbo.gov/publication/44190.
[22] Stephen Zuckerman and John Holahan, "Despite Criticism, The Affordable Care Act Does Much to Contain Health Care Costs," Urban Institute, October 2012, http://www.urban.org/UploadedPDF/412665-Despite-Criticism-The-Affordable-Care-Act-Does-Much-to-Contain-Health-Care-Cost.pdf.
[23] Louise Radnofsky, "Health-Insurance Costs Set for a Jolt," *Wall Street Journal*, June 30, 2013, http://online.wsj.com/article/SB10001424127887324251504578577760224985382.html; Joseph Antos, "Would You Buy Insurance From This Man?" *Daily Caller*, July 18, 2013, http://dailycaller.com/2013/07/18/would-you-buy-insurance-from-this-man/.
[24] Richard S. Foster, "The Estimated Effect of the Affordable Care Act on Medicare and Medicaid Outlays and Total National Health Care Expenditures," Testimony before the House Committee on the Budget, January 26, 2011, http://budget.house.gov/uploadedfiles/fostertestimony1262011.pdf.

spending will exceed that amount, which nets out lower spending for health care by individual consumers and employers. This higher level of federal spending caused by the ACA further strains government's ability to finance existing health programs and still have the resources to advance other domestic and international policy priorities.

A Sustainable Budget

The rising cost of entitlement programs will put increasing pressure on the budget unless action is taken. According to CBO long-term projections, federal spending for Medicare, Medicaid, CHIP, and exchange subsidies will increase 33 percent between 2012 and 2022 under current law.[25] Social Security is projected to grow about 8 percent over that period. Other federal programs will shrink by about 38 percent.

We clearly need to rebalance our spending priorities. Medicare is the place to start.

Medicare spending will nearly double over the next decade, increasing from $586 billion this year to more than $1 trillion in 2023.[26] The oldest members of the baby boom generation have reached age 65 and are enrolled in Medicare. Over the next two decades, some 76 million people will move out of the workforce, into retirement, and into Medicare. That will place an increasing burden on the budget and on younger generations whose taxes support the program.

The uncapped entitlement and distorted fee-for- service structure of traditional Medicare are major causes of the rapid rise in program spending. Poorly targeted fee-for-service payments promote the use of more—and more expensive—services, delivered in a fragmented and uncoordinated environment. The result has been higher spending and poorer patient outcomes.

Converting Medicare to a defined contribution model, with beneficiaries given a choice of competing health plans including traditional Medicare, would change the incentives that drive program spending. In general terms, this is the principle behind the ACA's subsidies in the health insurance exchanges. Seniors choosing a more expensive plan would pay any extra premium out of their own money. Informed consumer choice will create competition among the plans that will help to lower costs.

For this competitive model to work, traditional Medicare must be modernized. The program's benefit structure is needlessly complicated and should be simplified. The separate deductibles for inpatient services under Part A and for physician and outpatient services under Part B should be combined. The confusing array of copayments, coinsurance, and limitations on payments for services should be replaced with an easily-understood schedule of cost-sharing requirements. Coverage for catastrophic expenses should be added as a core benefit.

Medicare's physician payment system should be reformed. After a decade of overriding the reductions required by the Sustainable Growth Rate (SGR) formula, it is time for Congress to

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[25] Author's calculation of the increase or decrease in the share of each year's GDP accounted for by each major program, based on Table 1-2 of CBO's 2012 long-term budget outlook report, Extended Baseline Scenario. See CBO, *The 2012 Long-Term Budget Outlook*.

[26] Congressional Budget Office, *Medicare—May 2013 Baseline*, http://www.cbo.gov/publication/44205.

permanently resolve this ongoing problem. Bipartisan legislation in the House would replace the 25 percent payment rate reduction that would otherwise be imposed in January with annual payment increases of 0.5% until 2019. A new Physician Quality Reporting Program would reward high-performing physicians with bonuses.

The CBO estimates that the cost of a permanent SGR fix is $138 billion over the next decade. The House bill does not specify how the government would cover that cost, but payment offsets will be part of any legislation that is agreed to by Congress. The Medicare Payment Advisory Commission (MedPAC) has suggested a framework that strikes a balance between the total cost of repealing the SGR and the need to ensure beneficiary access to care.[27] That could be the starting point for reaching agreement on a long-overdue reform.

Congress will be tempted to stop its work on Medicare after it finds the savings to pay for the SGR fix. That would be a mistake.

There is broad agreement that Medicare spending is on an unsustainable trajectory that threatens to crowd out other priorities elsewhere in the budget. There is broad agreement that Medicare's performance in delivering services to older Americans can and should be improved. There is great controversy over how to ensure that seniors continue to receive high-value health care at a price that is affordable to them and to taxpayers.

Small-bore policies, such as those recommended by MedPAC to pay for the SGR fix, yield scoreable budget savings. Those types of policies are the bread and butter of this Committee and its counterpart in the House. They are necessary, but they are not enough.

If we want to bend Medicare's cost curve, we must change the financial incentives that drive program spending to increasingly unaffordable levels. A well-designed premium support program can take full advantage of market competition to drive out unnecessary spending and increase Medicare's value to beneficiaries. This is a safe and reasonable approach to lowering program costs over the long term without imposing undue sacrifice on seniors or taxpayers. It is also our best hope for real Medicare reform.

Joseph Antos is the Wilson H. Taylor Scholar in Health Care and Retirement Policy at the American Enterprise Institute. He previously served as the Assistant Director for Health and Human Resources at the Congressional Budget Office, and he is currently a member of CBO's panel of health advisers.

[27] MedPAC, "Moving forward from the Sustainable Growth Rate (SGR) System," Appendix B in *Report to the Congress: Medicare Payment Policy*, March 2013, http://www.medpac.gov/chapters/Mar13_AppB.pdf.

Chairman MURRAY. Thank you very much to all of our witnesses.

I will begin, Dr. Nichols, asking you a question. In order to achieve scorable savings, there are a number of proposals that impose caps on how much the Federal Government's expenditure on health care, Federal programs, can grow. Proponents of that argue that other changes in their plans will increase the efficiency of the market and lead to lower health care costs.

I am concerned that if health care costs are not lowered and Federal spending reaches that specific cap, the savings will come at the expense of our States or seniors or most vulnerable Americans, and those are the people who are going to be left to pay more for health care because the Federal Government would be spending less. So, although our Budget Committee does not have direct control over Federal expenditures, we cannot lose sight—we do have direct control over Federal expenditures, we cannot lose sight of what happens to our families and communities with health care costs.

So, I wanted to ask you to talk about the impact of caps on Federal health care programs and what would be the possible consequences for seniors and families and—

Mr. NICHOLS. Well, Chairman Murray, I think you laid it out pretty well there, and the way I think about the impact of these kinds of proposals, I think every, I will just say, Medicare reform proposal has three elements we should focus on. One is, what is the level of benefit that is implicit in it? What is the rate of growth that you are assuming you are going to achieve or target? And what is your enforcement mechanism?

Those three elements help you analyze, I think, every proposal on the table, and what you are describing is a set of proposals that typically have the level okay for a while but reduce the level significantly over time, impose a cap to achieve what Dr. Antos talked about, guaranteeing the Federal Government's expenditure will not grow beyond X percent. But then the enforcement mechanism is, in Dr. Antos' case and some of these proposals' cases, the health plan basically saying that is all there is, so we will have to figure out what to do.

To me, those proposals shift all the risk of failure to achieve the targets onto beneficiaries and providers, who, after all, are out there trying to basically serve patients they typically have been serving a very long time, and they do a lot of uncompensated care. So you are putting all the risk on those two.

An alternative approach would be to say, look, we do not think health plans can be the enforcer here because they do not have enough market power in a world in which a lot of hospitals actually have more market power than plans do. That is why plans complain about hospital market power. I am sure you get to have those conversations.

So, what other people think is what Dr. Patel was talking about. Let us get at the actual incentives underneath the system. Let us use Medicare buying power as one—in fact, the largest insurer in the country. And let us improve the incentives. And what is exciting is what I talked about in my written testimony. What is exciting to me is that the private sector payers have basically piggybacked onto that and now they are working in tandem to create the very incentives that enable the cost growth to be lowered over time, which reduces the risk.

But the main thing, I would submit, to think about the alternative approach, the ACA approach, if you will, versus the fixed voucher approach, is that the risk is borne by the society as a whole, by the taxpayer. You would have to decide if we do not hit the growth targets. And, by the way, ever since the ACA has passed, Medicare has grown less than the targets that were put into the law.

So if we do not hit those targets, then you have got to make a serious decision, and on the spot, your decision might be in some years, you know what, we are just going to shift those costs to beneficiaries because we cannot do anything else. Other years, you might say, we are going to raise taxes. Other years, you might say, you know what? What we are going to do is change the way we implement the incentive effects that are being developed around the country.

I believe the fact that the private sector is doing so much like what the ACA has engendered suggests, just give it a little more time. Make the targets clear. Make it clear you intend to enforce that in the long run and the market will react.

Chairman MURRAY. Okay. I just have a few seconds left, but Dr. Patel, I wanted to ask you, we do know there are some positive trends in the cost of health care. I mentioned them. Several of you did. But we have some efforts underway right now to change the way we deliver and finance health care. I mentioned several examples of initiatives from my State. You mentioned several. Is it more important to lock in some substantial budget savings from health care programs today or do we have some time to evaluate those efforts that are underway and expand those that the evidence shows are working?

Dr. PATEL. I think it is very important to actually not only allow for time to evaluate so that we can actually, as Dr. Nichols mentioned, we can reiterate and improve, since all these programs are still kind of in flux and in practice. But it is appropriate right now to take what we know from the savings that we have seen thus far and actually apply those and reinvest those into the very reforms that we still need to try to think through and use the Centers on Medicare Innovation to work through. So it is a little bit of both, and that is what we have seen thus far.

Chairman MURRAY. Okay. Thank you very much.

Senator SESSIONS.

Senator SESSIONS. Thank you. I would yield to Senator Johnson.

Senator JOHNSON. Thank you, Madam Chair and Senator Sessions.

I will quickly throw in my two cents' worth in terms of what has caused the slowdown, because I bought health care for 31 years in my manufacturing plant. And certainly as I watched us go from zero deductibles to $100 deductibles to $250, $500, institution of HSAs, a higher deductible plan, which is what really insurance should be, we reconnected the consumer of the product with the payment of the product. We began that process. We brought free market competitive discipline back into the health care market.

That has constrained the cost explosion as well as a poor economy. So, let me first get that on the table.

But I want to take a little bit different tack on this discussion. Dr. Patel, there are about 16 million people working in the health care industry. You work in the health care industry. That is a pretty good employer, right, I mean, from the highest skill level to some of the lowest. The health care industry creates jobs, correct?

Dr. PATEL. Yes, Senator, that is correct.

Senator JOHNSON. Dr. Nichols, I know we are all saying it is a huge problem that we spend 18 percent of our economy on health care. If we want to bring that down, what would be a better product or service that American consumers should consume versus the products and services that extend their life and create better health for them? So, I mean, would a snowmobile be better, or more beer? I mean, what would be a better share of our economy if you could control it all, which is what you want to do?

Mr. NICHOLS. You know, it is a great question and I would answer it this way. The problem is not that, in fact, what we buy extends our lives. The problem is that we are paying too much for the value we are getting in health care—

Senator JOHNSON. And my explanation for that is because government got involved in it.

Let me go back to the root cause. I am a manufacturer. It is in my DNA.

Mr. NICHOLS. Okay.

Senator JOHNSON. In the 1940s, government instituted price controls on health care, and so unions rationally said, well, you know what? We cannot give increased wages. Let us give something else. They started providing health care. That began the separation of the consumer product from the payment of the product. Back in the 1940s, in 1949, consumers paid 68 cents of every dollar spent on health care. Today, they spend 12 cents.

So is that not really—if you really want to find a root cause in terms of why health care spending has dramatically increased, it is we have removed the free market out of it and in its place, unfortunately—public opinion ratings of Congress, which I say is of Washington, is about ten percent. It is probably too high. But that is

because the public understands that Washington, D.C., the Federal Government, is not efficient, is not effective, and is not capable of controlling 50 percent of our health care spending. Is that not really the root cause? The reason this is a problem for the Federal Government is because the Federal Government has taken over 50 percent of our health care industry and they are totally incapable of doing it.

Mr. NICHOLS. Well, sir, I would point to the fact that, in essence, if you go back to 1960, when GDP—we took about six percent of GDP for health care, we did not cover over half of the elderly in our country and they basically depended upon the kindness of strangers, and some hospitals and doctors took care of them and a lot of them could not afford to. So, when you shifted resources to the Federal umbrella, what you did was you made it available to more people.

You are unambiguously correct that the incentives we imparted through third-party payment and some of our initial government programs were not the best. In fact, they led to cost growth. No question about that, sir. The question is, how do we get from where we are now to a better place, and—

Senator JOHNSON. According to your testimony—let me just make a couple—quote you.

Mr. NICHOLS. Okay.

Senator JOHNSON. You said one of the reasons health care spending has decreased is because of the increase in private sector cost sharing. You said—

Mr. NICHOLS. That is what you said, I believe.

Senator JOHNSON. No, that is what you said.

Mr. NICHOLS. Well, but I—

Senator JOHNSON. You said—

Mr. NICHOLS. We agree—

Senator JOHNSON. —we need to tell the American people the truth. You said, we have to focus on communities, not on States. I would add, not the Federal Government. The solution lies in our communities. You said, HHS needs to have creative thinking. Do you think that is possible? And secondly, you said, people are the experts.

So what you are arguing for in your statements is what I would argue for, what conservatives would argue for, is we need to reintroduce free market competitive principles. Reconnect the consumer of the product with the payment of the product. The Affordable Care Act does not reconnect that. The Affordable Care Act is going to have a total government takeover of the health care system to disastrous results, is that not true?

Mr. NICHOLS. No. It is not true. It is not about taking over the health care system. It is about freeing the health care system to pursue the incentive realignments you are actually in favor of. We are not that far apart here. The question is, what is the impact of the law? What the law does is incentivize delivering better value care for patients and for payers, and what the law does is give us a bunch of tools, including transparency.

Senator JOHNSON. Dictate—

Mr. NICHOLS. You know as well as—

Senator JOHNSON. Dictate—

Mr. NICHOLS. You know better than I do—

Senator JOHNSON. Dictated by the Secretary of Health and Human Services in a top-down approach, the Federal Government is going to tell people exactly what medical treatment they can qualify for through the IPAB Board. I mean, is that going to really work? Do you really believe that?

Mr. NICHOLS. Look at how the exchanges are actually working. Look at the benefit package that the insurers are actually offering. They are precisely what was offered in the private market for—

Senator JOHNSON. You think this implementation is working? James Hoffa, the National Treasury Employees Union, they are not quite agreeing with you on that.

Mr. NICHOLS. Well, I would say that implementation takes time, and I would submit to you that, in fact, incentives are being improved. That is why health care cost growth has come down. That is why so many private sector practitioners are actually excited about these payment reforms, because they would like to do the right thing—

Senator JOHNSON. You know, when they enacted Medicare back in 1965, they projected it out 25 years, said it would cost $12 billion in 1990. In fact, it cost about $109 billion. I do not think the Federal Government is particularly good at predicting what this is going to be.

Thank you, Madam Chair.

Chairman MURRAY. Senator Wyden.

Senator WYDEN. Thank you very much, Madam Chair. Madam Chair, I am especially appreciative of the fact that you cited those numbers at the beginning of your opening comments because they are certainly encouraging and I think you cannot fudge those numbers. They are indisputable. I am glad you cited them.

I also want to thank all our witnesses. I have had a chance to work with all three of them and it has been an excellent panel.

Let me start with you, if I might, Mr. Nichols, because of your comments on transparency, and you noted the fact that Senator Grassley and I have introduced this legislation to, for the first time, open up the Medicare database so that all over this country, we could see, in effect, what Medicare was paying for various kinds of services and we could also learn a lot about claims, utilization rates, for example. Why does one area, in effect, bill more for MRIs or hip replacements than another?

And my sense is that the day you publish the Medicare database in this country, you would have, in effect, a new baseline for health care in America. All over the country, if somebody held an employer health plan, for example, or had an HSA—Mr. Antos referenced that—people would look at what Medicare was paying in their area for those particular services and they would look at utilization and they would start making that comparison and saying, why is what I am getting out of sync in terms of costs or utilization? Is that pretty much your take of where you would like to go in terms of transparency?

Mr. NICHOLS. You know, what is fascinating to me, Senator Wyden, is how similar, actually, your vision is from what Senator Johnson just described, and that is how do you make a market work, and I do not know how you make a market work without better transparency, and the Medicare data facts would be huge improvements over where we are today.

I would also just add, what you really want to do is to bring the Medicare data together with the private sector data, and that is what some of these States are doing in these all payer claims databases, because then precisely you can compare what Medicare is paying. You can also look and see, what are we in this community spending more on? Are we out of whack with other places? No one knows that now, and you cannot know it without access to the data. So I am totally in favor of using data to add transparency.

Senator WYDEN. Well, thank you, and I want to note apropos of the kind of coalition that is out there. Some of the most progressive voices in American health care want to do this, as do some of the most market-oriented individuals. I appreciate your making that point.

Dr. Patel, a question for you on chronic care, because you have really been one of the authorities on this with respect to primary care. I think the debate really starts, and it is a point that Senator Whitehouse has touched on with respect to the delivery system, is that Medicare in 2013 is very different than Medicare when it began in 1965. We have got a lot more cancer. We have got many more strokes. And we have a much higher rate of diabetes. This is essentially more than 80 percent of the Medicare spending in the country.

So my question to you is—and Senator Isakson has been particularly helpful in this area, but there are a number of Democrats and Republicans who want to work on this—is it your view, apropos of care coordination, if the incentives were changed so that nurses, PAs, those who specialize in geriatric medicine, were paid to specialize in, in effect, coordinating chronic care, that that could help give us a downward push in terms of holding down Medicare costs while, as Senator Isakson says, beefing up the quality of care for those who are the most vulnerable, while reducing costs? Do you think that is plausible?

Dr. PATEL. Thank you for that question, Senator. It is definitely plausible. It is even less complicated than that. You may not have to ask nurses or physicians assistants to specialize in this. This is actually what most of us are trained to do, but in our current fee-for-service system, we actually cannot do this. If I want to coordinate care outside of seeing someone in my clinic, it is increasingly cumbersome, and, quite honestly, the incentives are not there to actually allow for that.

So you are correct in that some way to coordinate care better for patients with chronic conditions and actually engaging—getting back to the point that both you and Senator Johnson made of allowing consumers to be true consumers in health care, it certainly applies to Medicare beneficiaries with chronic conditions.

Most of my patients have four or more conditions and are on six or more prescriptions, but it should not be that I have to wait until they come into my office in order to start dealing with those problems. From the time of enrollment at Medicare, we should be engaging. And we started that in the Affordable Care Act with the "Welcome to Medicare" visit, but we can certainly specialize that for patients with chronic conditions.

Senator WYDEN. My time is up, but I am glad you made that point, and again, I think this is a unifying point. We just did a chart, an analysis to look at how much of the country, particularly rural areas, and Senator Sessions and I have talked about it, really has few, if any, doctors. So if we were to do what you are talking about with respect to chronic care, is build in that bigger role for the nurses and PAs, again, I think this would produce support across the political spectrum.

Thank you, Chair Murray.

Chairman MURRAY. Thank you.

Senator SESSIONS.

Senator SESSIONS. Thank you.

Dr. Antos, Dr. Patel mentioned the citation of lower premiums than CBO projected, but it appears that the White House has been using numbers of high-cost States. Other States would likely have an increase under the ACA. Is that correct, and why would that be so?

Mr. ANTOS. Well, yes, it is correct, Senator. The notable example, of course, is New York State. I am originally from New York State. It is the most regulated health insurance market in the country. It is also the most dysfunctional health insurance market in the country. When they implemented Guaranteed Issue and Full Community Rating, that went even further than the ACA in terms of community rating, what happened within a year was that most of the insurers who are offering plans on the individual market left. So that left, essentially, Blue Cross, and rates skyrocketed. In fact, for New York, there may well be a reduction in rates to the extent that the regulations from the Federal Government take precedence over the State regulations. But it will not be much, and I am suspicious of that.

Other States, lower cost States, States that have less regulation, appropriate regulation but less regulation of that sort, will, of course, do worse. The common view in the health industry is that premiums will rise at least 25 percent, and there was a story in the Wall Street Journal that said possibly rates would go up two to three times what is now available in the market in some places.

Senator SESSIONS. Well, Dr. Nichols, today is the 48th anniversary of Medicare.

Mr. NICHOLS. How about that.

Senator SESSIONS. And it is the seventh consecutive year, unfortunately, that the Medicare Trustees were forced to issue a funding warning in their annual report. My predecessor, Judd Gregg, on this committee got language in that said if that happens, they have to issue that warning, the administration should lay out a legislative proposal to deal with it. Do you think that warning would provide a good opportunity for the Congress to participate with the President in confronting Medicare difficulties if he submitted that proposal to Congress?

Mr. NICHOLS. Senator, I definitely believe that that warning was put there, as you said, by well intentioned—

Senator SESSIONS. Well, both parties—

Mr. NICHOLS. Exactly, both parties, precisely to provoke that conversation. I do not know anything about what they are doing there in the White House, but I will just say I am pretty sure he would welcome a bipartisan group to come talk about serious Medicare reform. I do believe it has got to be done on a bipartisan basis. I do believe the time to do that is yesterday. And I do believe that that warning was put there for that precise purpose, to engender that. Yes sir.

Senator SESSIONS. Dr. Antos, with regard to this decline in the increase in health care costs, is what we are talking about, from 9.7 percent, according to the numbers I have, in 2002 to 3.9 percent today, is certainly good news in terms of the pocketbook. And the President indicated in his State of the Union Address earlier this year, already, the Affordable Care Act is helping to slow the health care costs.

Well, first, they have not slowed much since he has been in office for four years. Most of the decline began before that. But others have questioned that, including the National Journal. Do you think it is unfair to claim that the Affordable Care Act is in any way responsible for the decline in the rate of rise of the health care costs?

Mr. ANTOS. Well, Senator, of course, it has something to do with politics. I think the American people are not paying attention to much that is said on either side of this issue right now. The fact is that the exchanges do not begin operation until October 1, and so the theory that people are paying—that the public is really paying attention to this, I think, is wrong.

Certainly, looking at the past is going to be pretty irrelevant. For the average person looking in October to buy insurance, somebody who is on the individual market, somebody who does not have insurance today, they are going to see, even with the subsidies, a premium that they do not expect to see. And for a lot of people, that is going to be very difficult to pay for.

Senator SESSIONS. Thank you, Madam Chair. My time is up. I appreciate all the panel for all the valuable comments you have made.

Chairman MURRAY. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Madam Chair.

Let me—I am going to ask about transparency and pricing and all of that, but before I do, let me make the point that I do think that although the consumer market is a concept of some utility in health care, it is a long way from being a complete answer. If you have had a stroke and you do not even know where you are, you are not a good consumer. If you are elderly and have seven conditions going on, you are not a good consumer.

This is not like buying a bicycle, where you say, I like that. I know how it works. Here is how much it costs. I challenge anybody in this room to explain to me what is in their health insurance right now. If you want to have a market, you have got to have a product and you have got to have a price. I do not think anybody really understands what the product is. They kind of buy what other people go. They go by what has a good reputation and stuff like that, and nothing has a better reputation than Medicare. And then they go by price, and here is where I get to my question.

Two members of my family recently had minor health episodes. One of them spent a night in the hospital for observation. The other one just had to have a bunch of tests. I do not have the billing sheet in front of me right now, but my recollection is that each billing sheet basically said, here are the charges. Here is what we paid. Here is what you owe. And for one, rough numbers, it was, like, $10,800. That was for the overnight in the hospital. What we paid was about $1,800, and what I owed was about $40. The other one was about a little under $4,000. What we paid was about $468. And what I owed was $20. So—

Senator SESSIONS. Senator, what do you mean by what you owed and what you paid? I did not quite understand.

Senator WHITEHOUSE. Well, here is my point.

Senator SESSIONS. Yes.

Senator WHITEHOUSE. The first number, the $10,000-plus or the $4,000 was what the bill was. The insurance company paid 15 percent of it, and I had an extra little one or two percent that I was supposed to pay for myself. Where did the rest of it go? What is the price? We run a health care system in which nothing has a price, as best I can tell. You bring your price with you depending on who you are. If you are broke and have no insurance, they will hunt you down for that $10,800. If you have insurance, they will take the $1,800 from your insurance company and say, super deal. You owe me $49. We are all done. And depending on what kind of insurance you have, that number moves around.

But how do you get real market pricing into this system? Would it make sense to pick out a few things, one or two durable medical equipment pieces, one or two tests, one or two pharmaceuticals, and say, look, let us just see how it works if you put a real price on it, where one person does not have to pay ten times as much for the same thing as another person does and try to narrow that. What is your— how do you make this—how do you try to put a price into this cloud of nonsense that is now the pricing system in health care?

Mr. NICHOLS. Well, you have articulated the problem very well, but I think I would start with what some States, some hospital associations, and some insurers are doing, and that is basically allowing you to test ahead of time, I am going to have a baby, I am going to have knee surgery, I am going to have whatever, what is this going to cost me given my condition and how might it vary across the different providers that I have access to? That is how you make a market work. Those tools do exist, sir. You know. You invented some in Rhode Island. But the truth is, they are not everywhere.

Senator WHITEHOUSE. And you have to—

Mr. NICHOLS. And the truth is, they are doing—

Senator WHITEHOUSE. You have to be able to bundle costs together in order to do that—

Mr. NICHOLS. Exactly. Exactly.

Senator WHITEHOUSE. and that is a developing strategy—

Mr. NICHOLS. And so some insurers, some plans. What ought to happen as we roll out these exchanges is that kind of cost calculator should be available on a broader basis. Again, some States are doing it and that would be a really smart thing. The—

Senator WHITEHOUSE. So bundling is a key step.

Mr. NICHOLS. Bundling is a good thing, and letting consumers know ahead of time what different packages are going to enable you to do. And you can do that at the point of purchasing insurance, as well. In particular, when you sign up for a Medicare program, you know what drugs you are on. You know what drugs Dr. Patel has prescribed. You look and see which of these packages are better for me. We could do that. It does require information systems that are essentially connected and well developed and it is not in any way—

Senator WHITEHOUSE. That is a whole another saga and my time has just expired. But let me thank you, Chairman, for holding this hearing. When we are burning 18 percent of our GDP on health care and the least efficient country in the world that is competitive with us is only burning 12, we have a health care cost problem—

Chairman MURRAY. Certainly.

Senator WHITEHOUSE. —and to masquerade it as a Medicare problem, I think, disserves the problem that we face and disserves the American public.

Chairman MURRAY. Thank you.

Senator KAINE.

Senator KAINE. Thank you, Madam Chair.

Thanks for the witnesses. Good testimony. And I am going to have a follow-up question for the record that I will get to at the end, but first, for my colleagues, we have a limited bandwidth, and in some more limited than others—I will talk about myself—and we are going to spend time on a lot of different issues. And so there is a finite chunk of our time that we are going to spend on this very important issue. It is my sincere hope that we do not use that finite chunk of our time for an endless battle for the 45th vote to repeal the Affordable Care Act because it is not going to happen. So let us be open to reforms and embrace reforms.

During the votorama on the budget, I cast a vote for reform, which is to look for an alternative for the way to assess the medical device. I thought the medical device tax on gross receipts probably was not a good idea.

And I am open to reforming the Affordable Care Act and I would hope everybody around the table would be open to reforming the ACA or Medicare or Medicaid or anything else. But if instead of talking about reforms we are going to be talking about repealing the Affordable Care Act, you know, we are wasting our time, because we are not going to repeal the Affordable Care Act and we should not repeal the Affordable Care Act.

The Affordable Care Act has done a number of things very positive, and I know politically, everybody wants to say, if they did not like the ACA, it has had no effect. They are just wrong. We cannot over-claim its effects, but the 70,000 fewer hospital readmissions in 2012 than 2011, the Affordable Care Act has played a major role in that. Millions of Americans getting rebate checks back because of that medical loss ratio, that is because of the Affordable Care Act and that is important.

And I have told this story to my committee members before, but when I was a Senate candidate and for the first time in my life did not have a full-time job, I did not have insurance and we had to go out and buy insurance on the open market. And my wife tried to buy insurance and she was told by an insurance company that they would insure my wife and me and they would insure two of our three children, but they would not insure our third child because of a preexisting medical condition. Safety note: Do not tell my wife that they will only insure two of our three children.

[Laughter.]

Senator KAINE. Do not do that. My wife called the HHS hotline. She has a different last name than me. Nobody knew who she was. She calls in and says, “I think this is against the law.” “Who did you talk to?” “Here is the name and number at the insurance company.” That person at the HHS 800 line called, and within half an hour, the insurance company called back and said, “You are right. We are wrong. We have to offer you an insurance policy on your entire family.”

We are not going to repeal the Affordable Care Act, because if we did, we would be saying to all of those kids, hey, you are back at the mercy of this heartless preexisting insurance company practice that we are putting in the rearview mirror. So I hope that we will embrace reforms, and I think we need to embrace reforms for all the reasons that have been said around the table.

The question I want to ask—actually, what I would really like to do is ask it for the record, and we will put it on the record and I would love your responses back. The issue that troubles me the most in the broad scale on the cost is the cost growth rate of Medicare. Now, to pick up on Senator Johnson, some of the cost increase is for good news. It is not all bad news that we spend on health care. Health care is important.

And the cost growth rate in Medicare is partly a good news thing. We are living longer. That is fantastic. The last I saw, Medicare costs go up by three percent a year, even if there is no inflation, and even if there is no increase in medical utilization, just because of increases in the eligibility. So that is a good thing, and yet it creates a serious cost problem, and it is the Medicare cost growth and the size of the budget that causes me the most concern.

So, the question that I am going to submit by record to you is if you had to tackle giving us advice right now on smart ways, consistent with your own approaches to this, to start to deal more seriously with the cost growth on Medicare, what would you do, how soon you would do it. I think Dr. Patel said you may not want to do something right away. You want to see if what we are doing now in the ACA is having some effect and figure that out before you make suggestions. But I will direct that question to each of you on the record and I appreciate your testimony today.

Thank you, Madam Chair.

Chairman MURRAY. Thank you very much.

Senator BALDWIN.

Senator BALDWIN. Thank you, Madam Chair and Ranking Member, for holding this hearing. I really appreciate the opportunity to delve a little deeper in this topic.

I also just wanted to add some commentary to, you know, the intangible costs of the political debate around implementation of all of this. They are not tangible, but I cannot but help but think that there is a real cost with the obstructionism we have seen, and I have to recall serving over in the other House, in the other body, during the debate on the Medicaid Modernization Act, and that was politically contentious and somewhat—I think that is an understatement—partisan. I did not end up supporting that for a wide range of reasons. But following the passage of that measure, I felt like the most important duty we all had was to work together across the party aisle and try to make this work for our constituents. And it involved building State-based insurance exchanges and, you know, trying to help our constituents understand some pretty complicated choices. But, in any event, we are here now.

I want to also address this issue of transparency, data availability on cost and price and quality. There was some discussion of where the States are at in collecting and sharing this data. In Wisconsin, we have our attempt at an all payer claims database called the Wisconsin Health Information Organization, and so providers, payers, and State agencies subscribe to this database to help them assess and improve their performance.

Right now, the organization holds about two-thirds of the claim data Statewide for Medicaid and private payers. However, current law, very specific details in the ACA, did not allow this database access to the Medicare fee-for-service claims.

Now, I know that our fellow committee members, Senator Grassley and Senator Wyden, have a rather large fix to this. I have been working with Senator Bennet on a very specific bill to make this more available by sort of amending the provisions of the Affordable Care Act. But this, I think, would get our State close to—we would be getting pretty close to full claims.

And I guess I would ask why this is so important to the foundation, to provide a foundation for larger delivery system reforms, why you believe that the wider access to Medicare data is essential, and then I have a follow-on question, and Dr. Nichols, I would start with you.

Mr. NICHOLS. Well, thank you, Senator, and I appreciate you mentioning Wisconsin's experience there because they are, as you know, a leader in a lot of these areas.

Senator BALDWIN. Right. Yes.

Mr. NICHOLS. First, I would say that the fundamental reason you need Medicare in the picture is so that any given practice and any given hospital system, any given health care provider system, can look at the totality of what they are doing. You cannot analyze total cost of care unless you have total cost of care. And you need to see the difference between Medicare, private, Medicaid. You need to be able to say, okay, what if we incentivize the kinds of things Dr. Patel talked about? What if we incentivized paying for care coordination, which is not now paid for in most circumstances? We took a stream from here. You would have to have all the data to figure out how to make that business model work.

What transparency is about is making models work, actually add up, and you cannot do it unless you have got everybody at the table, so that is why it is so important.

Senator BALDWIN. Yes. Dr. Patel, do you have anything to add?

Dr. PATEL. I will just briefly say, I can get more information about how many megabytes of data I used on my cell phone than I can about how much it cost my patients to get care under me in the last month. So I think having access to the claims data is just the first step. It is a huge and a very important step. These databases are hard. It is not easy to get these data claims together, and then on top of that, we just need to make sure that we add to these important all-payer claims databases a way to get the data back out to the very people, patients, providers, and payers, who are making decisions.

And there seems to be a lot of concern about doing that, like, oh, if people can see how much it costs to see me versus him, then there is going to be a big problem. But that is actually exactly what we do need in our country.

Senator BALDWIN. I think on that point, especially as data becomes accessible to providers on a larger scale, it is not just about price, obviously. This drives quality and this drives—it is decision maker support. You know, that is essential. It seems like we have come further, at least in my State, in figuring out how to drive quality with providers than we have what are useful ways to share this information with potential consumers.

And I am wondering, as we—and I realize I am running out of time—as we develop the marketplace that becomes available online October 1, what sort of complementary steps forward we can see for consumers that make this metadata really useful to them in purchasing quality as well as looking at cost.

Mr. NICHOLS. Well, so we talked about setting up these cost calculators, where you can look at, fundamentally, what would it cost me. You can also put right there with the price the quality ranking for that institution, and there are lots of ways to do that and lots of, you know, methods. But those things are being done in the best places in the country. We just need to do in all the country what has been going on in the best places in our country. It can be done, absolutely.

Chairman MURRAY. Thank you very much.

Senator KING.

Senator KING. Thank you, Madam Chair, and thanks for having this hearing.

I want to start with a chart, and to me—I think I am going to have this chart tattooed on my forehead.

[Laughter.]

Senator KING. I mean, this is the whole deal. I was watching a debate on the floor, and this chart actually belongs to Senator Hatch. He was talking about it. I saw it on the monitor and I said, I have got to have that chart. And my friend, Lauren—my colleague, Lauren, got it.

But, basically, what it shows is the whole Federal debt and deficit problem is health care and we have just got to focus on that. And it is not the Federal expenditures on health care, it is health care generally, and that is what is important about this hearing. If we try to solve the Federal debt problem simply by saying, Medicare is going to pay less, Medicaid is going to pay less, all we are doing is shifting these costs to somebody else.

Basically, what this shows is discretionary spending, Social Security, other mandatory, projected out, essentially flat. Health care is where all the expenditures are. So shifting costs is not the answer. We need to talk about, fundamentally, how to lower health care costs, and to say it cannot be done is ridiculous because we pay almost twice as much as anybody else in the world for results that are not that good. So that is where we have got to go.

Now, that is my ridiculously big picture. The small picture is, Dr. Nichols, I believe in ACOs. We have got three of them in Maine. I like the idea of getting away from fee-for-service and I think that you change the incentives. I think that is a good deal. Here is what worries me, particularly in a rural State. You create an ACO. You have basically created a regional monopoly. Monopolies are not, historically, beneficent. How do we deal with the problem of an ACO inherently being a local monopoly?

Mr. NICHOLS. You know, it is a great question. It is a problem not just in Maine, friend. It is a problem in California and lots of other places, as well. So, essentially, what I would observe is those hospitals that are the center of the ACOs you are talking about, they were kind of monopolies before. This is not really a change. What we have lost is an opportunity.

Two things I can think of in the short run. One is what I call domestic medical tourism. I know a surgeon, retired, Denver, worked for a long time in that area, knew a mining executive. After he retired, he called up the mining executive. He said, "You are paying too much for health care. I am bored. Let me help you." He took the 15 most expensive conditions, found the best place for those things to be treated, all over the Upper Midwest, lowered PMPM—

Senator KING. This is like Lowe's sending all their heart patients—

Mr. NICHOLS. Bingo.

Senator KING. —to Cleveland.

Mr. NICHOLS. The Cleveland Clinic. You can do that on a regional basis, and that—

Senator KING. Because I think, in response to Senator Johnson, competition between insurers is not really the deal. To me, it is competition between providers. That is—there are only two ways to regulate price in our society. One is competition. The other is regulation. I think competition is better.

Mr. NICHOLS. It certainly is, and it can work if you have good transparency. That is correct.

Senator KING. Well, you know, we are the biggest health care purchaser, Medicare. I do not understand, Madam Chairman, why Medicare does not say, any hospital or provider that does not publish their data by July 1, 2014, we do not pay anymore. I mean, we have enormous market power as a customer, and I do not think we use it very effectively.

The same thing with Electronic Medical Records. You know, we have been talking about Electronic Medical Records since the 1990s, and we have got all these systems and they are incompatible. I mean, Medicare ought to say, if you do not have Electronic Medical Records that are interoperable by, you know, July 1, 2014, we do not pay you anymore. I mean, all of a sudden, it would concentrate the mind.

The other thing, Mr. Antos—Dr. Antos—are you a doctor?

Mr. ANTOS. I do not see patients. I see numbers.

[Laughter.]

Mr. ANTOS. I do not want to—well, never mind.

[Laughter.]

Senator KING. You are a free enterprise kind of guy. Is there any straightface argument for Medicare not bargaining for drugs? Does anybody in our society who buys things in bulk not get a deal?

Mr. ANTOS. I spent eight years regulating hospital prices in Maryland. Maryland is the only State that does this. And over my eight years, we did not save anybody a dime.

Senator KING. No, but I am talking about bulk purchases. Medicare buys all drugs by the gazillions.

Mr. ANTOS. Well—

Senator KING. You could not get a deal—

Mr. ANTOS. So—

Senator KING. —from a pharmaceutical company if you can bargain? Be serious.

Mr. ANTOS. Well, here is the problem. Look at—

Senator KING. You ever go to Sam's Club?

[Laughter.]

Mr. ANTOS. Sure. Look at what happened with Part D. Part D was set up pretty well except that there were certain drugs that people up here felt were very important, and those were the drugs whose prices have gone up the most. It is not too surprising. So if you have—if you—it is a question of competition. It is not a question of centralizing the purchasing. If it were simply centralizing the purchasing—

Senator KING. Well, but—

Mr. ANTOS. —then why do we not just eliminate all the drug companies—

Senator KING. But it is already central. I mean, the VA gets a deal. They buy in bulk. Medicaid gets a deal. They buy in bulk. We have got this, to me, amazing law that says the biggest purchaser in the society cannot bargain, and I do not—

Mr. ANTOS. Well, so—

Senator KING. —understand why we do that.

Mr. ANTOS. So if the Federal Government were capable of bargaining rather than mandating, I would begin, maybe, to agree with you. But we have seen what bargaining means with the Medicare program. It does not bargain. It dictates. And for that matter, you know, a lot of good ideas that we are now citing—you cited, is it Lowe's or somebody—

Senator KING. Right.

Mr. ANTOS. —sending heart patients to the Cleveland Clinic. You know, the Medicare program had that. I ran that program and it was killed because it was too effective. So I am not confident—

Senator KING. Well, I am not for—

Mr. ANTOS. —I am not confident that the Federal Government is actually capable of following through on good ideas. I am much more confident that private plans with information, with appropriate regulation, can do the job.

Senator KING. Well, I just—I think if you buy something in bulk, you can usually get a better deal, and it just strikes me as it does not pass the straightface test that we could not get a better deal on drugs that we are buying by the billions of dollars.

Mr. ANTOS. So, Senator, why do we not start by allowing mail order pharmacy in Part D. That saves a lot of money. You do not have to walk into the drug store. It is convenient for a lot of people. Virtually everybody under the age of 65 gets their drugs through the mail. Medicare patients are not allowed to because Congress would not allow it. So there are lots of things we could do to improve what is going on here—

Senator KING. And we should. I agree.

I see I am out of time, Madam Chair. Huge set of issues here, but I think the government could be a lot better consumer and could help with a lot of these delivery processes. But I also agree with Senator Johnson that the public has to have a stake in the game, and if, for example, they want to go to a different hospital than the one that their insurance company has bargained—if a customer—if an insurance company has a deal with the Cleveland Clinic and it gets a good price and a consumer wants to go somewhere else, they should be allowed to, but they should pay the differential. And I think that would be a reform—in my State, for example, you have to offer every hospital, which means that insurance companies cannot effectively bargain with the hospitals. So there are all kinds of warping of the market here that I think we need to deal with, information, a lot of the things we have talked about.

Great topic, Madam Chairman. Thank you for doing it. I hope we can talk about this more.

Chairman MURRAY. Thank you. Thank you very much.

I think this was a really good discussion and I want to thank all of our colleagues who participated today, and I want to especially thank our witnesses for coming, for your testimony today.

As a reminder to all of my colleagues, additional statements or questions for any of the witnesses are due in by 6:00 p.m. today.

With that, again, thank you all for coming and this hearing is closed.

[Whereupon, at 12:17 p.m., the committee was adjourned.]

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ANSWERS TO QUESTIONS FOR THE RECORD FROM SENATORS SESSIONS, KAINE, AND KING, FOLLOWING HEARING ON JULY 30, 2013

Len Nichols' Answer to the Question from Senator Sessions:

The 1st year results of the Pioneer ACO program reported accurately in your good question illustrate both the promise and the challenges of incentive realignment in our health care system. The 32 integrated health systems or large multi-specialty physician groups that chose to become Pioneer ACOs are some of the best health care organizations in our country, and they showed it as a group by reducing total Medicare spending on net after all shared saving payouts by $33 million last year while improving quality uniformly on 15 core measures, exactly what smart payment reform engendered by the ACA is supposed to achieve. Overall, costs for Medicare patients treated by the Pioneers as a whole grew 0.5% slower than costs for Medicare beneficiaries outside the Pioneer program. Lowering cost growth while improving quality is the sine qua non of successful payment reform, and this performance is a success to celebrate and build on.

Two provider organizations have dropped out altogether and seven more are switching to the less demanding (and less risky) Medicare Share Savings ACO program. The fact that 14 of the 32 did not meet target growth reductions but only two dropped out altogether shows the commitment of the organizations involved to the concepts of accountable care and incentive realignment. The fact that seven are switching to the MSSP version of an ACO also shows commitment to the general concept of an ACO.

Of course the model is not perfect, and should be tweaked (not jettisoned) over time, in my view. The quality metric targets and future baseline targets should be constantly negotiated between buyers and sellers as more information and experience becomes available to all. Perhaps most importantly, the patient attribution rules should be changed to allow Pioneers (and other) ACOs to

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incentivize beneficiaries to use ACO-affiliated clinicians. As I stated in my testimony on July 30, the administration missed a golden opportunity in the ACO regulations to make clear that patients have key roles to play in incentive realignment. They should not be treated as if their behavior is irrelevant to achieving better outcomes in their or our taxpayers' names. Patient engagement strategies are key to long run success, and financial incentives can powerfully complement what the best provider groups are doing with other educational and motivational tools.

The larger point is that incentive realignment is a complex and hard business, and no one model is likely to be sufficient for our entire large country. Different versions of ACOs are likely be part of our successful future, but so are patient centered medical homes and medical neighborhoods (which incentivize willing specialists and hospitals along with primary care physicians without making them employees or formally aligned as in ACOs). The general direction we need to move is toward where provider self-interest is linked to the social interest in lower cost growth, better health, and more consistently high quality performance, and ACOs can be part of that direction if adapted wisely and widely.

Len Nichols' Answer to the Question from Senator Kaine:

In addition to the ideas highlighted in my testimony, my favorite strategies to reduce Medicare and system-wide cost growth could all be implemented quickly, though some might take a while to play out, and they include:

(1) Make crystal clear statutory and regulatory statements that there will be no reversion to the status quo ante-ACA. Many private healthcare stakeholders have invested considerably in the capacity to be rewarded based on outcomes and to internally manage and externally report information consistent with new incentive alignments. The single most important thing the Congress and CMS could do would be to validate these investments (and elicit them in the heretofore reluctant) and make even more clear that these directional changes in Medicare payment policy will continue until health care cost growth is truly under control. There should be no going back to out of control cost growth just because some sub-specialists prefer it to the social gains from incentive realignment.

(2) Require all insurers, including Medicare, to use a common claims adjudication algorithm within 18 months. Give private plans 6 months to decide on a standard, force Medicare and Medicaid to use it as well, and then 12 months to implement. Today, physician practices and hospitals combined spend as much as 6-14% of the revenue dollar getting paid. Insurers compete on this for 1-2% advantage over each other. So today we allow insurers to tax providers 6-7 times as much as they collect on net from variation in claims adjudication rules.

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There's a term for this in economics, it's called, "stupid." All of the savings from this can be poured into incentive payments to providers for better performance. The only thing holding us back is the mistaken belief that insurers cannot agree on change. They can, if you make clear that the alternative standard that WILL be adopted by a date certain is Medicare's own. Congress has the power to unleash the disciplined creativity of the private sector in this way. Please do so.

(3) Allow and then require Medicare and Medicaid data to be joined with private sector data within All Payer Claims Databases (APCDs), and give states incentives to create and maintain them according to standards that could be set by the public-private All Payer Claims Database Council, if empowered by you to do so. Every community, at least as local as the county level (preferable smaller, e..g, zipcode) should be able to compare it's cost and quality performance on specific and frequent health conditions to that of other similar and dissimilar communities. Only then can communities identify and target areas of potential improvement that reflect their priorities and values.

(4) Create an Office of Collaboration within HHS, and make the nation's Chief Health Collaborator equal to the Administrator of CMS, confirmed by the Senate and report directly to the Secretary. The Mission of the Office of Collaboration would be two-fold: (i) to create multi-payer payment reforms across the country; and (ii) to make Medicare, Medicaid, and the whole of HHS better partners with the private sector in incentive realignment opportunities in general. Too often, federal law and policy is the impediment to incentives being made better in real time, despite the fact providers and consumers on the ground can see what needs to be changed very clearly. More local autonomy for representatives of federal programs, like purchasing managers for multi-state and multi-national corporations have, within broad guidelines and reporting requirements and accountability rules, would do wonders for stakeholder acceptance and engagement of the incentive realignment paradigm.

Len Nichols' Answer to the Question from Senator King:

The most promising payment model in development at the moment is what I call the "medical neighborhood," which builds on the very good concept of a patient centered medical home (PCMH) and extends the incentives to reduce costs while improving health to willing specialists and hospitals. The ACO is one version of this, but that requires a degree of organization and financial control that some providers find a bridge too far. Medical neighborhoods are really seamless and tight provider networks that are committed to the patient centered triple aim and can be incentivized to help each other achieve it, if we but unleash our multi-payer imaginations and relax enough anti-trust fears (through state action immunity) to do so. Smart health plans are

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already thinking of ways to expand their PCMHs in this direction, and smart specialists and hospitals are looking for PCMH and plan partners to make it a reality. Some hospitals are even creating their own plans where willing plan partners do not exist. Incentivizing the entire neighborhood to improve patient health and outcomes and lower total cost of care is the way to go, in my view, and avoids the zero sum games that some PCMHs with highly focused plan partners have become.

Center for Health Policy Research & Ethics

Questions for the Record

Kavita K. Patel MD, MS

Senate Budget Committee

Senator Jeff Sessions

Question:

In light of the disappointing results of the Pioneer program, please provide comments on the lessons that can be learned from the early experience of this program. Given the news that nearly a third of the health systems chosen for the Pioneer program are leaving after the first year of the three-year program, what—if anything—does this say about the concept of ACOs , in general, or the Pioneer program specifically? With the early challenges faced by the Pioneer program, is it fair to doubt whether substantial savings for federal taxpayers will ever materialize from the provisions aimed at cost control in the new law?

Response from Dr. Kavita Patel:

Thank you for these important questions. Lowering costs and improving quality of health care does not come easily. It requires hard work, significant investment, and professional buy-in from an array of providers, beneficiaries, and health system administrators. As with any major program, there are kinks that need adjustment. Notwithstanding, I do believe that Accountable Care Organizations (ACOs) show promise in improving quality and lowering costs, and with a tune-up, will be an integral tool for health system reform.

After the inaugural year of the Pioneer ACO program, 30 of the 32 organizations have decided to continue as Medicare ACOs. As of March 2013, physician groups, hospitals, and other organizations have formed 449 ACOs or ACO-like entities in order to improve quality and shift to coordinated value-based care over fragmented volume-based care. Furthermore, as I mentioned in my written testimony, private-sector ACOs appear to show promise. This indicates that the ACO model remains an attractive option for diverse providers and systems across the nation.

As you mentioned, of the 32 inaugural Pioneer ACOs, seven elected to shift to the Medicare Shared Savings Program (MSSP), and two decided to leave the ACO program all together. There is substantial heterogeneity in the needs and operations of health systems across the United States. Even when ACOs become more ubiquitous, some systems may never fit the mold for programs like the Pioneer ACO program, and thus would be more effective operating in a framework like the MSSP. The hope is that as care coordination infrastructure builds and providers are more comfortable operating in the ACO framework over time, more systems will be able to handle increased financial risk, continue to improve quality, and see further reductions in spending. Additional time to allow these programs to build is essential.

Accordingly, it is both too early to doubt and too early to promise that substantial savings will materialize from this program. The early results, though, suggest that significant savings may be achievable through ACOs. CMS reports Pioneer ACOs achieved lower cost growth (0.3 percent) for their 669,000 beneficiaries than the growth observed (0.8 percent)for similar beneficiaries in fee-for-service during the same period. Of the 32 Pioneers, 18 achieved below budget spending, but 5 of the 18 saved less than the threshold used to exclude normal statistical variation. As a result, these 5 Pioneers did not qualify for shared savings despite having below-target spending. In contrast, the 13 Pioneers with *significant* savings generated gross savings of $87.6 million in 2012. Medicare netted nearly $33 million as the Trust Fund share of the ACO savings. Reduced hospital admissions and readmissions were reportedly principal drivers of overall cost savings.

In contrast to the 18 Pioneers that achieved below budget spending, the remaining 14 Pioneer ACOs experienced above budget spending. Of the 14 Pioneer ACOs, 12 of them were within the threshold established to exclude normal statistical variation. As a result, only two Pioneers had statistically significant losses, totaling $4.5 million.

Apart from the finances, as a practicing physician, one of the most promising aspects of this program to me is the robust evidence of quality improvement with ACOs. All 32 Pioneer ACOs outperformed industry benchmarks on 15 quality measures such as blood pressure control and lipid management in adult diabetics. These first year results should help alleviate concerns that the shared savings methodology would cause providers to "stint" on necessary care and undermine quality.

In moving forward, all ACOs need to improve on actively engaging beneficiaries so they are not seeking care outside of the ACO network. Moving forward, it will also be important to continue providing ACOs with more tools to coordinate care and influence beneficiary behavior. Quality measures should continue to be honed to ensure evidence-based quality practices that are better coordinated across payers and are appropriately anchored. Finally, an alternative method for setting appropriate budgets needs to be developed. Over time, continuously requiring new savings (as previously achieved savings are incorporated into the rebased targets) will undermine ACOs, with the most successful ACOs "hitting the wall" fastest.

To conclude, both financial and quality data point to the substantial benefits that ACOs can offer our health care system in improving health care quality and reducing spending. As with any program, changes take time. That time should be given to this program for the benefit of the health care system, and most importantly, the patients who these changes are ultimately designed to serve.

Questions for the Record

Kavita K. Patel MD, MS

Senate Budget Committee

Senator Angus King

Question:

You have previously stated that you believe the RUC structure of determining Medicare costs should be maintained but become more transparent. The Independent Payment Advisory Board (IPAB) implemented by the ACA is designed to be a transparent committee that makes price recommendations to CMS. Do you believe a RUC-IPAB hybrid would be an effective and transparent system for making price appropriate recommendations to CMS?

Response from Dr. Patel:

Senator King, thank you for this question. In my roles as a Commissioner on the National Commission on Physician Payment Reform[i] and as a practicing internal medicine physician, I have previously stated that the RUC structure for determining Medicare reimbursement is flawed because of the composition of the RUC and its lack of transparency. The RUC is overseen by the American Medical Association and composed of 31 members theoretically representing the entirety of the medical profession. But currently, only nine seats represent specialties that consist of examination and patient management services such as family medicine, neurology, and pediatrics.[ii] Since the RUC is structurally skewed toward procedure-based specialties, there is expert concern that it undervalues cognitive specialties, overvalues technology-intensive specialties, and thus reimburses less for the health maintenance services that are shown to improve health and lower costs. Furthermore, most of the RUC meetings are closed to the public, individual voting records are not released, and transcripts of the meetings are never published. A body such as the RUC should make an effort to be transparent since CMS has historically adopted more than 90% of its recommendations.[iii] Nevertheless, the RUC has made positive strides in recent years. In 2012, the AMA added new primary care and geriatrics seats to the RUC and now requires that all vote totals be made publically available. Further work does need to continue in this direction.

The Independent Payment Advisory Board (IPAB) will certainly aid in reducing some of the problems that currently exist in this system especially if (as designated in statute) there is a broad diversity of input on the IPAB and if there is important feedback and communication between the RUC and other expert advisory bodies on payment. Particularly useful is the trigger of the IPAB after a certain point of Medicare cost growth. One concern for your consideration Senator, is the fact that under current and even projected Medicare growth, it is unlikely that the IPAB would be "triggered" into formation but it is worthwhile to consider how the IPAB might be modified in statute or in practice to do the work that is necessary to deal with the valuation of physician services. The purpose of the IPAB was never really to work in concert or in addition the RUC so there might need to be some modifications in order to derive the greatest benefit from the Board.

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[i] The National Commission on Physician Payment Reform. http://physicianpaymentcommission.org/

[ii] RUC Members Effective April 28, 2013. American Medical Association. http://www.ama-assn.org/resources/doc/rbrvs/ruc-members-current.pdf. Accessed 16 July 2013.

[iii] Laugesen MJ, Wada R, Chen EM. In setting doctors' Medicare fees, CMS almost always accepts the Relative Value Update Panel's advice on work values. *Health Affairs*. 2012; 31(5):965-972.

Questions for the Record

Kavita K. Patel MD, MS

Senate Budget Committee

Senator Tim Kaine

Question:

What reforms would each of you like to implement right now, in the short-term (1-10 years) and over the long-run (10+ years) to stabilize and reduce both Medicare and overall health care cost growth?

Response from Dr. Patel:

There are a number of reforms across the care continuum that show promise in curbing cost growth in both the Medicare program and overall health care expenditures. I will highlight several of them here, and for greater detail, I refer you to Table three in my written testimony (also included here). In the ambulatory and outpatient care setting, transitioning to new payment models that minimize fee-for-service reimbursement is essential. These innovative models would include paying doctors a *case management* fee for a set of services rendered in an episode of care—such as after-hours phone care for a breast cancer patient—and also a fixed *care coordination* payment that is built on concepts such as quality improvement and could qualify physicians to meet requirements for the Physician Quality Reporting System. This enables clinicians to focus less on volume and more on tighter coordination among providers and settings for patients. The Accountable Care Organization (ACO) model should also be modified and extended to allow ACOs to better manage patients with multiple chronic conditions, accept increased accountability and financial risk, and improve patient engagement.

In the inpatient setting, similar opportunities exist: extending hospital readmissions penalties to include broader number of conditions; eliminating of site of service differential payments in Medicare so the same service provided in a physician's office and an ambulatory setting are reimbursed equally; and expanding bundled payments to include more conditions and more care settings. For post-acute care settings, there needs to be an expansion of payment bundles that include post-acute care services and payment reforms to the hospice system that include a value-based payment to match the intensity of the services provided. For medical suppliers, refining and expanding competitive bidding for products beyond durable medical equipment also holds potential savings. Finally, administrative simplification would substantially reduce expenditures the health care system. This includes a shift to electronic transactions, implementing common terms and approaches for insurance billing, and standardizing claims forms and review processes.

To achieve longer-term reductions in spending growth, true reform in the physician payment system, away from fee-for-service compensation, must occur. In line with reports from the National Commission on Physician Payment Reform[i], MEDPAC[ii], The Brookings Institution[iii], Simpson-Bowles[iv], and the Bipartisan Policy Center[v], my primary recommendation is to repeal Medicare's sustainable growth rate (SGR) and transition to payment models that reward high quality and high value care, and not high volume care. Though the cost of SGR repeal is not insignificant, this year is the best opportunity for Congress to make this transition. Elimination of the SGR and fee-for-service cannot happen overnight, and a five year transition period would allow CMS and private payers to transition to the care management fees, care coordination fees, and bundled payments that I previously mentioned. The care coordination fee being linked to quality outcomes would ensure continuous quality improvement over time.

Another longer-term reduction opportunity is around the redesign of the Medicare benefit program to better care for chronic diseases and encourage the healthcare system to integrate services such as behavioral/mental health and end of life care as well as establishing a care plan at the onset of entry into Medicare. We know that if patients have information even from lay caregivers, that their ability to navigate the system as well as find providers who are high quality and also act as good financial stewards is absolutely possible, but there are aspects of the current Medicare program which make this model less achievable:

- No direct benefit around conversations geared towards end of life preferences
- Attribution model in accountable care organizations are limited
- Care received outside clinic/hospital settings are not integrated into the fee schedule or most electronic records
- Poor to little coordination with home health, spectrum of nursing homes, etc
- The extent of behavioral health is largely relegated to carve-outs and care outside of primary care despite mental health parity and a great deal of behavioral health being treated or diagnosed in a primary care setting.

I appreciate your question and the opportunity to speak with the Senate Budget Committee on curbing cost growth in our health care system.

TABLE 3: Summary of Savings Opportunities by Sector

Sector	Savings Opportunity	Potential Economic Impact
Ambulatory Care	Payment models that minimize fee-for-service care: • Episodic payments for chronic conditions/case management fees • Care coordination fees that replace portions of FFS	Repeal of the Sustainable Growth Rate (SGR) will cost approximately 139.1 billion dollars[1]
	Extending the ACO Model[2] • Financial benchmark calculation • Enhance ACO ability to manage care for chronic conditions • Allow ACOs to accept increased accountability and financial risk • Improved patient engagement to avoid "leakage"	Experts have projected possible savings of up to 192 billion dollars from 2014-2023[3] through replacement of physician fee cuts with an inflation-based adjustment and increased financial risk/accountability.
Inpatient Care	Extension of hospital readmissions penalties for a broader number of conditions	While it is not clear exactly how much money would be saved, it is clear that the current program has generated significant savings (280 million dollars in 2013 alone), thus expansion would have a strong budgetary impact
	Elimination of site of service differential payments in Medicare for same services performed in hospital-based settings vs office-based settings.	In 2011, Medicare and beneficiaries paid 1.5 billion dollars more for E&M and echocardiograms alone than they would have if payments had been equal across sites of care[4]
	Expansion of bundled payments to include more conditions and involve more care settings	Bundles will likely drive down unit costs of care (cost per bundle), however it is unclear if it will have a significant shift on the volume of overall care
Post Acute Care	Expansion of payment bundles for post-acute care • Expand the number of post-acute care organizations participating • Expand the episodes of care that are covered and length of episode	Potential for an estimated 8.2 billion dollars in savings from 2014-2023[5] with reforms in the post acute sector
	Payment reforms within hospice	MEDPAC estimates that such reforms

[1] Congressional Budget Office. The Budget and Economic Outlook: Fiscal Years 2013 to 2023. February 2013. Page 31.
[2] Lieberman SM.2013. Reforming Medicare through 'Version 2.0' of Accountable Care. *Health Affairs*: 32(7): 1258-1264.
[3] Ibid.
[4] MedPAC. Report to the Congress: Medicare Payment Policy. March 2013. Page 48-49
[5] Office of Management and Budget. The White House. Fiscal Year 2014 Budget of the U.S. Government. April 2013. Page 38, 197.

	• Encourage ACA authorized reform to replace per diem payment with a value-based payment to match intensity of services	would be budget neutral the first year
Supplies	Refine and expand competitive bidding to other types of equipment beyond durable medical equipment (DME)[6]	Pilot program in DME competitive bidding saved Medicare 202 million dollars in year one[7] • July 2013 expansion expected to save Medicare Part B Trust Fund 25.7 billion dollars[8] and Medicare beneficiaries 17.1 billion dollars in lower coinsurance and premiums payments[9]
Administrative	Administrative simplification[10] • Shift to electronic transactions • Implement common terms and approaches for insurance billing • Standardize claims forms and review processes	Institute of Medicine estimates savings of 181 billion dollars[11]
Prescription Drugs	Modify payment for physician-administered medications[12] • Reduce payment from ASP+6 to ASP+3	Savings of approximately 20 billion dollars from 2014-2023[13]
	Encourage therapeutic substitution where clinically appropriate	Savings in 2008 alone would have been 1.4 billion dollars[14]

[i] Frist W, Schroeder S,et al. Report of The National Commission on Physician Payment Reform. The National Commission on Physician Payment Reform. http://physicianpaymentcommission.org/wp-content/uploads/2013/03/physician_payment_report.pdf

[ii] Report to the Congress: Medicare Payment Policy. Medicare Payment Advisory Commission. http://www.medpac.gov/documents/Mar12_EntireReport.pdf

[iii] Antos J, Baicker K, McClellan M, et al. Bending the Curve: Person-Centered Health Care Reform. April 2013. http://www.brookings.edu/research/reports/2013/04/person-centered-health-care-reform

[6] Bipartisan Policy Center. A Bipartisan Rx for Patient-Centered Care and System-Wide Cost Containment. April 2013. Pages 60-61.

[7] Centers for Medicare & Medicaid Services. Press Release: Contract suppliers selected under Medicare competitive bidding program. April 9, 2013.

[8] Ibid.

[9] Ibid.

[10] Institute of Medicine, *The Healthcare Imperative: Lowering Costs and Improving Outcomes: Workshop Series Summary*. http://www.iom.edu/Reports/2011/~/media/Files/widget/VSRT/healthcare-waste.swf. Accessed July 24, 2013.

[11] Ibid.

[12] Office of Management and Budget. The White House. Fiscal Year 2014 Budget of the U.S. Government. April 2013. Page 41.

[13] Ibid.

[14] Gellad W.F., Donohue J.M., Zhao X., Mor M.K., Thorpe C.T., Smith J., Good C.B., Fine M.J., Morden N.E. Brand-Name Prescription Drug Use Among Veterans Affairs and Medicare Part D Patients With Diabetes: A National Cohort Comparison. Annals of Internal Medicine. 2013. http://annals.org/article.aspx?articleid=1696030

[iv] Bowles E, Simpson A, et al. A Bipartisan Path Forward to Securing America's Future. Moment of Truth Project. April 2013.
http://www.momentoftruthproject.org/sites/default/files/Full%20Plan%20of%20Securing%20America's%20Future.pdf

[v] Daschle T, Domenici P, Frist W, Rivlin A, et al. A Bipartisan Rx for Patient-Centered Care and System-Wide Cost Containment. Bipartisan Policy Center. April 2013
http://bipartisanpolicy.org/sites/default/files/BPC%20Cost%20Containment%20Report.PDF

Responses to Questions for the Record
Joseph Antos, Ph.D.
Wilson H. Taylor Scholar in Health Care and Retirement Policy
American Enterprise Institute

Senator King:

You raise several important issues with regard to Medicare, premium support, and seniors' ability to obtain affordable coverage. The premium support program discussed here is similar to proposals offered by Rep. Paul Ryan and others, but policy specifications may vary.

First, how can we make it easier for seniors to choose from among their health plan choices? Under premium support, all beneficiaries would have a choice of traditional Medicare or private plans, and all plans would provide at least the standard Medicare benefits. Seniors have those options today, and 25 percent of seniors choose a private plan under Medicare Advantage. We can and should do a better job of giving full information to seniors about their plan choices. The Centers for Medicare and Medicaid Services (CMS) has a cumbersome website (medicare.gov) which helps seniors find available plans, but that site does not provide information about the cost of Medigap plans that many seniors purchase to fill in gaps in the standard benefit. Since the realistic choices for many seniors are either traditional Medicare plus Medigap or a Medicare Advantage plan, it is important to make them aware of the full cost of those alternatives as well as other features of the plans (such as extra benefits and the providers who participate in the plan's network). The CMS site also provides only limited information about access to low-income subsidies, including Medicaid. Making better information available on the web site, combined with providing access to personal assistance (such as that planned for the health insurance exchanges) would provide the assistance many seniors need.

With better information, seniors are able to make good choices of plans. A recent study published in the American Economic Review (see http://www.aeaweb.org/articles.php?doi=10.1257/aer.102.6.2639) shows that enrollees in Part D were able to save an average of nearly $300 in Part D by switching plans between their first and second years in the program. This demonstrates that seniors can be smart shoppers if they have the information they need on their health plan alternaitves.

Second, is there a safety net available to Medicare beneficiaries facing high health care costs? Currently, Medicare offers several levels of subsidies to low-income beneficiaries that can help pay for Medicare premiums and cost-sharing amounts (see http://www.medicare.gov/your-medicare-costs/help-paying-costs/medicare-savings-program/medicare-savings-programs.html). Traditional Medicare does not provide coverage for catastrophic costs. However, a beneficiary enrolled in traditional Medicare may also be eligible for full Medicaid benefits or may be enrolled in a Medigap plan that provides catastrophic protection. Under premium support, the subsidy provided each beneficiary would be based on bids from the plans, with higher subsidies to individuals with lower incomes. As part of the reform, all plans (including traditional Medicare) would be required to provide catastrophic coverage. For beneficiaries who cannot pay for their share of the cost of services, a streamlined low-income subsidy program that better targets those in need would be available.

Third, is premium support plus a safety net low-income subsidy program double dipping? No. Properly designed, Medicare reform would target help to those most in need. The current program crudely redistributes the subsidy to favor the poor through the low-income subsidy and income-related premiums. A market-based reform would accomplish this goal more systematically.

Fourth, how would premium support lower overall health spending without shifting costs to individuals? A well-designed Medicare reform centered on the principle of premium support would change the incentives driving up cost, not value. Traditional Medicare pays on a fee-for-service basis, which promotes greater use of services even when there is little or no need for them. Moreover, care delivered under traditional Medicare is uncoordinated, which wastes money and harms patients. By fixing the subsidy in a market to the second lowest bid (or some combination of low bids), plans will have an incentive to reduce unnecessary costs and improve care delivery. For example, under premium support, a plan might invest in non-traditional services that are not now covered by Medicare but that could save money and improve patient outcomes. It is true that beneficiaries choosing more expensive plans would pay the additional premium above the subsidy amount. Those plans will lose market share unless they are offering exceptional value that beneficiaries feel is worth the cost. Hence the competition is on the basis of both price and value. Moreover, there is an obvious limit to the ability of plans to "shift cost." Most Medicare beneficiaries live on fixed or slowly rising incomes, and many do not have the ability to substantially increase their incomes by taking a job. Health plans that raise their premiums excessively will quickly lose market share. Faced with a fixed per-person subsidy and a limited ability to increase premiums, the best strategy for health plans is to cut unnecessary costs and improve the patient's experience.

Senator Kaine:

You asked for reforms that can be implemented now, over the next decade, and over the longer term to stabilize and reduce the growth of Medicare and overall health spending. Sustainable reductions in health spending growth—including Medicare spending—require structural changes in our health financing and delivery systems to promote greater efficiency and smarter decision-making on the part of consumers, providers, and insurers.

Changes should be made to the Affordable Care Act (ACA) to make better use of taxpayer dollars and to avoid imposing permanent new requirements that drive up cost. Those changes include:

- Delay implementation of the exchanges until systems are available to properly determine individual eligibility for a subsidy (either through the exchanges or Medicaid). The recent one-year delay in the employer mandate and associated reporting requirements combined with the announcement that the data "hub" will not be functional demonstrates the need for more time to implement the law.
- Delay the individual mandate one year. This treats businesses and consumers equally and allows consumers more time to understand their insurance options without being rushed into a decision.

- Revise the insurance regulations and mandate requirements to allow consumers more realistic choices and to ensure a stable insurance market. The essential benefits package coupled with the individual mandate is overly prescriptive and forces consumers to buy more coverage than they want. The medical loss ratio rule impedes the adoption of care management and coordination services that can save money and improve care. The employer mandate requires a level of information reporting that is unprecedented, requiring firms to spend money on administrative costs rather than on expanding employment or increasing compensation for workers.
- Better target exchange subsidies to those who need the help. The current schedule provides subsidies to the middle class as well as the poor. A more modest upper income limit, such as 250 percent of the federal poverty level, would be appropriate.

Reforms of the Medicare program would slow federal spending and have sizeable spillover effects on private insurers, who often adopt policies that conform to Medicare rules. Reforms include:

- Restructure Medicare cost-sharing requirements to be more understandable and to foster greater cost awareness among beneficiaries. A single deductible and a simple copayment or coinsurance schedule should replace the current complex set of requirements.
- Restrict Medigap coverage as part of the cost-sharing reform. Limit both Medigap and retiree health plan coverage so that the beneficiary must pay the first several hundred dollars out of their own pockets.
- Develop new provider payment methods in traditional Medicare. The perverse incentives of fee-for-service payment can be reduced (but not eliminated) through bundled payment, pay for performance, competitive bidding for specific services, and partial capitation.
- Promote competition among plans in Medicare, including traditional Medicare, based on premium support or a defined contribution model. Full competitive bidding among health plans would give plans incentives to reduce unnecessary costs. Payment reforms that focus on specific services rather than all the care needed by a patient fail to recognize and promote synergy among health care providers that can reduce cost and improve quality.
- Make Medicare data on provider performance available to consumers and providers.
- Adopt the payment update recommendations made by the Medicare Payment Advisory Commission (MedPAC) in their March 2013 report, as well as their offset recommendations for a permanent physician payment fix. Proposals such as eliminating updates for one year produce short-term budget savings but do not address the underlying structural flaws of traditional Medicare.
- Promote greater coordination of services for dual eligibles, as recommended in MedPAC's March 2013 report. Special Needs Plans should be required to integrate Medicare and Medicaid benefits to meet the clinical needs of complex patients.
- Reduce payment differentials between the outpatient department and the physician's office. In addition to budget savings, this policy reduces beneficiary out-of-pocket spending and promotes the use of lower-cost delivery settings.

Reform the financing of Medicaid, principally by shifting from an uncapped matching grant to a defined contribution approach. Specific reforms include:

- Convert Medicaid to a block grant to the states with fixed per capita subsidies. This largely eliminates the use of tax and other schemes to increase federal payments with little or no cost to the state.
- Create an all-inclusive waiver for states wishing to more fully control their own Medicaid programs, in exchange for a long-term block grant to control federal spending.
- Require states to develop premium assistance programs for Medicaid patients. Such programs give patients and their families greater involvement in care and care decisions.

Other critical reforms address flaws in our tax subsidies for insurance and other system-wide problems. They include:

- Reform the tax treatment of employer-sponsored insurance. Replace the "Cadillac tax" on high-cost health plans with a phased-in cap on the amount of employer and employee premium contributions that can be made on a tax-free basis.
- Raise the maximum amount that may be contributed to a health savings account. Greater use of high-deductible insurance coupled with an HSA increase consumer awareness of cost.
- Malpractice reform that goes beyond caps on awards. Creating an administrative system to hear patient complaints and adjudicate most cases before going to trial would reduce administrative costs, provide more equitable treatment for injured patients, and reduce the incentive of the current system to over-test, over-prescribe, and over-treat.

Although there is much that federal policy can do to promote an efficient, effective, and affordable health care system, the private sector is the source of the changes that bring that result about. Health plans, providers, and other private sector innovators respond to market competition, consumer demand, and federal regulation to craft workable solutions. Federal policy should promote that innovation, not tie it up in bureaucratic red tape.

I did not attempt to classify these proposals as immediate, near term, or long-term. Some of these reforms (such as reducing Medicare payment rates without making other changes) could be implemented immediately but do not change the forces driving health spending growth. Structural reforms would yield results over the long term, but they also require more time for development and implementation. Given the seriousness of our long-term fiscal problem, the country cannot afford lengthy delays before Congress takes up more ambitious proposals.

Senator Sessions:

You asked about the outlook for savings from the accountable care organization (ACO) program in light of the disappointing results in its first year. The program faced serious challenges from the outset, a consequence of a flawed model, excessive top-down controls, and a failure to appreciate how difficult it is to change the culture of medicine.

The Centers for Medicare and Medicaid Services (CMS) issued a controversial proposed rule on April 7, 2011, which set out the parameters of the ACO program. Provider groups were critical of the rule, many of whose requirements remain today (http://www.americanbar.org/newsletter/publications/aba_health_esource_home/aba_health_law_esource_1108_aco_rawlings.html). The lack of an enrollment process means that ACOs are unable to identify and effectively manage the care of patients, who could continue to use any provider accepting Medicare whether or not they were part of the ACO. CMS would micromanage ACOs by requiring that they satisfy 65 quality measures. CMS also proposed to take their share of any savings off the top, rather than allowing savings to be shared on a "first dollar" basis. (That provision was later reversed.) As the CEO of Scripps Health observed, "Frankly, I was surprised. I thought there would be more carrots, not so much stick" (http://www.healthleadersmedia.com/impact-analysis/265335).

CMS had written the rules to start up new business ventures without accepting its fair share of the risk. Even though some of those requirements were later modified, the fundamental problems of ACOs remain. They are stealth health plans that do not give patients the right to opt in or out. Neither the patient nor the provider is allowed to know in advance who they are dealing with, making it difficult for providers to be truly accountable.

Problems have continued for the ACO program. CMS jumpstarted the program by naming 32 provider groups Pioneer ACOs, which began operation in 2012. On February 25, 2013, 30 of the Pioneer ACOs sent a letter to CMS complaining that 19 of the 31 quality standards required by the Administration had insufficient data to support their use, raising questions about the plans further participation in the program (http://www.washingtonpost.com/blogs/wonkblog/files/2013/03/2013-Quality-Benchmarks.pdf). In an unusual move, the plans threatened to leave the program if this problem was not resolved. CMS agreed to a compromise, averting the crisis.

More bad news followed. On July 16, 2013, CMS announced results of the first year of Pioneer ACO operation (http://www.cms.gov/Newsroom/MediaReleaseDatabase/Press-Releases/2013-Press-Releases-Items/2013-07-16.htm). Only 13 of the Pioneers saved enough money to share those savings with Medicare, despite their experience as integrated health systems and additional investment in programs and staff to make the program work. Two Pioneer ACOs lost money, and owe the Medicare program $4 million. To avoid possible future losses, 9 of the 32 Pioneer ACOs will leave the program.

Chas Roades, chief research officer at the Advisory Board Company, commented that savings are likely to be modest under ACOs (http://capsules.kaiserhealthnews.org/?p=20879). From the viewpoint of the hospital, ACOs are an attempt to preserve the Medicare fee-for-service system and the ACO model only applies to a portion of their Medicare patients. Roades noted that it is "really hard to run two disparate sets of books at the same time" with two different sets of financial incentives.

Supporters of the ACO concept point to earlier integrated systems, such as Geisinger Health Care in Pennsylvania and Intermountain Health Care in Utah, as evidence that ACOs can provide effective lower-cost care. Unlike ACOs, those systems enroll their patients and are able to manage all of their care from day 1. Unlike ACOs, those systems are fully integrated with a shared culture of economy and excellence.

Unlike ACOs, those systems have had many years to develop their models and implement delivery system innovations that make those health plans what they are today. Such capacity cannot be built overnight, but that is what ACOs need to do to succeed. The odds are very much against that happening.

THE IMPACT OF POLITICAL UNCERTAINTY ON JOBS AND THE ECONOMY

TUESDAY, SEPTEMBER 24, 2013

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 2:36 p.m., in Room SD–608, Dirksen Senate Office Building, Hon. Patty Murray, chairman of the committee, presiding.

Present: Senators Murray, Nelson, Whitehouse, Merkley, Baldwin, Kaine, Sessions, and Portman.

Staff Present: Evan T. Schatz, Majority Staff Director; and Eric M. Ueland, Minority Staff Director.

OPENING STATEMENT OF CHAIRMAN MURRAY

Chairman MURRAY. Good afternoon. This hearing will now come to order, and I want to start by thanking my Ranking Member, Senator Sessions, and all of our colleagues who will be joining us here today.

I also want to welcome and thank our witnesses, Dr. Mark Zandi, who is the Chief Economist at Moody's Analytics; Dr. Chad Stone, he is the Chief Economist at the Center on Budget and Policy Priorities; and Dr. Allan Meltzer, Professor of Political Economy at Carnegie Mellon University. We are all very glad to have you here today to talk about the ways that uncertainty in Federal policy making, especially when it comes to our budget, has impacted job creation and economic growth.

Five years ago this month, our country was in the middle of a growing financial crisis. Lehman Brothers had just filed for bankruptcy protection. Our economy was spiraling downwards, taking along hundreds of thousands of American jobs and financial security. In September 2008 alone, we lost 459,000 jobs across the country and, as we all remember, the losses grew from there.

Over the last few years, thankfully, our economy has begun to rebuild. Many people are getting back to work. Crucial sectors of our economy are regaining some strength. And even though the long-term fiscal challenges remain, the short-term deficit picture has improved significantly and we are now on stronger footing.

But, as we will discuss here today, the recovery is still fragile and not nearly as widely felt as it should be. Although hiring has picked up, far too many Americans are still looking or stuck in low-paying jobs that offer little short-term or long-term economic security and even less opportunity to get ahead. New Census data shows that the middle 60 percent of American income earners actually have lost ground since the recession ended. Real income for this group declined 1.2 percent over the recovery, while the top five percent of earners gained five percent. So, even though we have come a long way, there is still a lot we need to do to ensure American families recover from the impact of the Great Recession and to ensure strong middle class growth and economic security in the future.

Families across the country are very focused on these issues. Here in Congress, we should be focusing on them, too. That is why what we have seen recently from a minority of extreme Republicans is really deeply disappointing and harmful. Again and again, some of the Tea Party Republicans have chosen gridlock over compromise, brinkmanship over solving problems, and partisan games over economic recovery.

They held the economy hostage over the debt ceiling in 2011 in an effort to, as Speaker Boehner admitted, create enough chaos to force their ideological agenda through Congress. During that debate, job growth and consumer confidence tanked. The Dow dropped more than 2,000 points, and the debacle ultimately led to sequestration, which, while doing relatively little to improve our long-term fiscal condition, has imposed brutal cuts that slowed growth. It has weakened our national defense and it has slashed crucial programs that families and seniors and our future economic competitiveness depend on.

The Congressional Budget Office estimated that ending sequestrating through the end of next fiscal year could add up to 1.6 million jobs. This is one of the many reasons that Democrats have been trying to start a bipartisan budget conference for the past six months now, since the Senate and the House passed their budgets. A bipartisan budget conference would have offered an opportunity for us to work together to replace the harmful automatic cuts with more responsible deficit reduction. But, rather than coming to the table, as we now know, some of the Tea Party Republicans have stood up and blocked these bipartisan negotiations between the House and the Senate each of the 18 times we have now asked to get them started, even though I know that many other Republicans agreed with us that we should at least sit down together and try to get a deal.

Many of us on both sides of the aisle wanted to get to work before we were up against a deadline. We wanted to avoid the uncertainty and governing by crisis that Americans are rightly sick of. But just like in 2011, Tea Party Republicans thought they would have more leverage in a crisis, and so now, here we are today, days away from a possible government shutdown which could affect hundreds of thousands of workers' jobs and disrupt basic services, from Social Security payments to small business loans, all because some Tea Party Republicans have decided once again to try to defend the Affordable Care Act, a law, by the way, that has already helped millions of Americans and is on track to help many more.

If that is not enough, those same Republicans are, to quote Speaker Boehner, "trying to pick a whale of a fight over the debt ceiling," even though economists warn that an unprecedented default on U.S. obligations could throw us back into a recession and devastate the global economy. The bottom line is that when we should be thinking about how to create jobs and how we can encourage growth, some Republicans are letting the Tea Party minority push us from one crisis to the next and their brinkmanship has very serious consequences for our country.

Uncertainty about government policies has increased in the last two years. In fact, the 2011 debate over raising the debt ceiling created even more uncertainty in the economy than the 2008 collapse of Lehman Brothers. Economists and experts have been very clear that we cannot afford more of this. Federal Reserve Chairman Ben Bernanke said last week that current Federal fiscal policy is, quote, "an important restraint on growth." The U.S. Chamber of Commerce, which, by the way, does not often side with Democrats on fiscal issues, even sent a letter to the House urging them to end their campaign to defund health care reform, pass a continuing resolution to keep our government running, and raise the debt ceiling in a timely manner.

Many Republicans are sending the same message to their party. Senator Burr has said repeatedly that trying to defund the Affordable Care Act in the continuing resolution is the dumbest idea he has ever heard. Senator McCain called Republican debt ceiling threats, quote, "shenanigans," and we agree.

We want to pass a continuing resolution to keep the government running and then let us get to work on a long- term budget deal that puts jobs and the economy first, that replaces sequestration fairly and responsibly, that does make smart reductions in Federal spending and asks the wealthiest Americans and biggest corporations to do their fair share, as well.

We on our side continue to be ready to work with anyone who will come to the table, willing to make some tough choices. But as the President has made clear, we are not going to negotiate over the debt ceiling and we are not going to accept bizarre demands like defunding or delaying the Affordable Care Act. All that would do is create more uncertainty for families across the country, and believe me, they have had enough.

Americans have been fighting hard the last several years to get back on their feet, to rebuild their retirement savings, to find new jobs and restore their own financial security. The last thing they need right now is Republicans putting our economic growth, and with it Americans' jobs and retirement and security, at risk.

You know, it really should go without saying that instead of making it harder for families to find work or pay off their debts or send their kids to school, to do the kinds of things that we know strengthen our economy now and over the longer term, we should be doing everything here in Congress to encourage continued and stronger growth.

So, I really hope that Speaker Boehner and the rest of his Republican leadership will stand up to the extremists on the Tea Party minority that just seem to be committed to crisis and stop the hostage taking, stop the political games that are really threatening our fragile economic recovery. And again, we extend the olive branch to sit down and work with us to find a bipartisan balanced budget deal and move this economy forward. And once we can do that, I am confident we can work towards that bipartisan deal that the American people expect.

So, I am really looking forward to this discussion today. It is an important topic. We want to hear from our witnesses about what our priorities should be as we look at the needs of the economy and middle class families, and again, I want to thank all of our witnesses and our colleagues who are here today for this important discussion.

With that, Senator Sessions, I will turn it over to you for an opening remark.

OPENING STATEMENT OF SENATOR SESSIONS

Senator SESSIONS. Well, thank you. We do have a good panel, Madam Chair. I would note that getting along and trying to have a good positive agreement in the face of your opening remarks, which are capable of being written by David Axelrod during the height of a political campaign.

We have got a lot of problems in this country and we need to be dealing with the fundamental problems in this country, and this recovery is not a recovery at all. It is a very, very weak recovery. Things are not going well with the American people. The growth every year falls below what CBO and what the Fed has projected that it would be. Why is this happening?

I suggest it is too many taxes, too much regulation, too much Obamacare, and too much government. We need to have growth in the private sector, and debt itself is pulling down growth. I would just note, of the jobs that have been so touted this year, since January, 77 percent of those jobs were less than full-time, were not full-time jobs. That is clearly a direct result of the Obamacare. And until we deal with these massive government programs and regulations, we are not going to get this economy growing in the right way.

Well, we are here because we have not resolved the large, nagging policy differences that stand in the way of fiscal improvements. The state of middle- and lower-income Americans is worsening on every front. The slow growth of the economy, the slowest economic recovery since World War II, is restraining the normal upward movement and income that previous generations have experienced, even after recessions. If you do not have a job, you are twice as likely to only find part-time as full-time work, if you can find any work at all. Middle-class incomes have stagnated— actually, fallen—and that means that savings for college and retirement are at all-time lows. Even after the recession, in this recovery period, these numbers are still out there.

Young people are not marrying as early as they want due to bad economic prospects. That means families are launching later in life, which gives couples fewer years to pay down their mortgage, create savings, and raise their children. Too many of our public schools waste taxpayers' dollars while consistently failing the children of hard- working parents.

Indeed, we are quietly downsizing the American dream. The new normal really refers to the increasingly modest dreams hard-working families allow themselves. It may be education after high school, it may be retirement, it may be a paid-up home and car when you stop working, but increasingly, not certain and perhaps even likely.

The rapid growth of government debt has slowed the economy— is slowing it now—as has the mounting concern that Washington will ever bring its fiscal house in order. There is a concern we are never going to get it into order. The real uncertainty in the financial markets deal with our capacity to address our short- and long-term fiscal and economic policy problems—solving them, not just passing a CR as if that is going to fix anything.

Businesses have been slow to expand their operations, thus further weakening middle- and lower-income families. Fewer people are working than in 2007. Get this. Just before the recession hit in December of 2007, about 62.7 percent of the population age 16 and above who were looking for a job were working. If that same percentage were working today, we would have 154 million jobs, but we do not. We have only 144 million jobs and only 58 percent of the population is working. I think that is the lowest since 1975. In short, we are missing 9.9 million jobs when we compare this economy to the one in 2007, so we need to ask some questions here.

Here is another way to look at the problems in our job market. In 2007, we had 363,000 discouraged workers, people who had given up looking for work but had not yet disappeared from view by the Employment Security offices. Today, we have 866,000. That is an increase of 140 percent.

Here is another barometer of the middle-class anxiety. We have 1,988,000 fewer full-time jobs today than in 2007. We have 3,627,000 more in the total job population on part- time work than we had in 2007—3.6 million. Our economy appears to be much better at producing part-time jobs than full-time, which is definitely worrisome.

Resolving this jobs crisis for working families will take more than just passing a so-called continuing resolution or a new process for adjusting the debt ceiling— just borrow more, as some have suggested. We need a comprehensive review of our economic policies, and, I might add, even our welfare policies. Obviously, our economic policies are not working very well. Perhaps our welfare policies are exacerbating the trend, also. Tax more, borrow more, spend more, regulate more, more health care from the Federal Government side is not improving our situation. QE3 at the Fed—has it really produced growth that we normally see after the recession? It has not. Their projections have been continually off.

So, let us take this period, this three-month period, to debate the spending priorities and set some much-needed reforms in motion that will actually deal with the problems of growth in America and job creation. What will work to create jobs? Tax more? Spend more? Borrow more? Regulate more? Is that going to create jobs? I suggest to you it will never create jobs. It is a guaranteed plan for failure.

If we can come out of these debates with evidence that we have actually been fixing broken programs, confronting our rising debt, investors will thank us by infusing the private sector with new capital, and that is when working families might begin to see some economic light at the end of a very long tunnel.

I was United States Attorney when President Reagan was President. The government was shut down in the early 1980s. It is still here today, I understand. They shut it down in the 1990s. I think there were two or three shutdowns when Reagan was President, some a little longer than others, some short, and we are still here.

So, we do not need to be panicked about the difficulties that are facing us, the need to reach an accord between our parties that will actually create policies that create growth and jobs, and we are not doing that now and the trends are not good.

So, this is a good panel. I know we will have some disagreements—we already have—but we have got to work on these things. We have a difference of a view about, I think, how to make this country better, and maybe we can learn something today.

Thank you, Madam Chairman.

Chairman MURRAY. Thank you very much.

With that, we are going to turn to our witnesses, and Dr. Zandi, we will begin with you. And again, thank you to all of you for being here today.

STATEMENT OF MARK ZANDI, PH.D., CHIEF ECONOMIST, MOODY'S ANALYTICS

Mr. ZANDI. Thank you, Chairman Murray, Ranking Member Sessions, and other members of the committee, for the opportunity to be here today. I am an employee of the Moody's Corporation, but the views I express today are my own, my own views.

I would like to make three points in my oral remarks. The first one is that political uncertainty has been a significant weight on the economic recovery. Political uncertainty is generated by brinkmanship here in Washington over the budget, over the debt ceiling, over policy and regulation. All those things combined have weighed heavily on economic activity.

I think that is most evident in terms of the decision making of businesses, most clearly in terms of hiring. I have a chart, see chart 1 of my written testimony.

insert zandi chart 1 here.This shows the number of hires month by month back to 2001, when the data begins. This is data from the Bureau of Labor Statistics. And you will note that hiring collapsed during the recession, has made something of a comeback during the recovery, but remains very, very low by historical standards. Current hiring rates on a monthly basis are somewhere between four and four-and-a-half million. In a reasonably well functioning economy, it should be five to five-and-a-half million. You can see that if you go back to the previous recovery or the one before that. So, the political uncertainty, I think, is key to the lack of hiring, the unwillingness of businesses to take a risk.

It is also evident in entrepreneurship, which is also critical to economic growth, short- and long-term, and you can see that in the next slide, which shows job gains at new establishments. And here, too, you can see the shortfall. It is quite significant. Of all the things that I worry about with regard to the economy—and I agree, the recovery has been very subpar—this is it. Entrepreneurship is key to our long-term economic growth. It is what makes our economy tick and why it is such a dynamic economy, the most dynamic economy on the planet. So, this picture has to change, and I think the reason it is so depressed is, in large part, due to the political uncertainty.

Just to give you further context, based on some work I have done, since the uncertainty, political uncertainty rose significantly with the Stimulus Act in early 2009, it has shaved about $150 billion from real GDP, which translates into a little over a million jobs and has increased unemployment by seven-tenths of a percentage point. So if political uncertainty had not risen to the degree that it has, the unemployment rate today would still be high, uncomfortably high, but at 6.6 percent—we are currently at 7.3, it would be at 6.6—that would make a meaningful difference to our economy's performance.

So, point number one is political uncertainty has been a very significant weight on economic activity during the recovery.

The second point is that, at minimum, I think it is key during the current budget battle that policy makers come to terms in a timely way on funding the government—funding runs out at the end of this week—and raising the debt ceiling. Just to give you a sense of the impact here, if the government shuts down for several days, four or five days, no big deal. If it is a month, it will shave about a point and a half off of GDP growth in Q4, which means growth will come to a standstill in the fourth quarter.

If it goes on for six or eight weeks, that means that debt limit is in play. We will probably breach it. In my view, breaching the debt limit would be cataclysmic. It would mean higher mortgage rates, higher borrowing costs for businesses, lower stock prices, lower house prices, a full- blown recession, and there would be no reasonable policy response to it. The Federal Reserve would not know how to respond, and, of course, by definition, fiscal policy makers would not be responding. It would be a very, very dark scenario. So, it is critical that you come to terms on this in a timely way.

Finally, my third point is while I think it is entirely appropriate and desirable for you to address our long-term fiscal challenges, and they are quite significant and there is a lot of hard work to do on entitlement reform and tax reform, I would not add to the near-term fiscal austerity. Under current law, if policy makers do nothing, that is quite significant. We do not need to add to it. The economy is still quite fragile.

Thank you for the opportunity, again. I appreciate it.

[The prepared statement of Mr. Zandi follows:]

Written Testimony of Mark Zandi
Chief Economist and Co-Founder Moody's Analytics

Before the Senate Budget Committee

"The Impact of Political Uncertainty on Jobs and the Economy"

September 24, 2013

The U.S. economy remains frustratingly far from full employment. While there are many reasons for this, political brinkmanship around the federal budget and Treasury debt ceiling has been a significant contributing factor. Much progress has been made since the Great Recession, and the economy's prospects are improving, but this will continue only if policymakers can resolve their differences in a timely way.

Harsh political vitriol, threats of shutting down the government, and the possibility of not fulfilling the government's financial obligations have weighed heavily on the collective psyche. This has significant economic consequences. Businesses are more reluctant to invest and hire, and entrepreneurs are less likely to attempt startups. Financial institutions are more circumspect about lending and households are more cautious about spending. While many factors are at work here, Washington's heated budget battles are a significant contributor.

While the current budget battle will be difficult, it is generally expected that lawmakers will come to terms in time to avoid a government shutdown or a breach of the debt ceiling. They have shown an ability to come together at the last minute in other recent fiscal battles, including the showdowns over the debt ceiling in summer 2011 and the fiscal cliff earlier this year.

As such, the budget battle should have little adverse effect on businesspeople, consumers or investors, provided it is resolved in time. But policymakers should not take solace in this. If they botch it and the government shuts down or fails to meet all its obligations, investor and consumer psychology will be undermined, and the economy will suffer serious harm.

To resolve the current budget impasse, policymakers should not add to the significant fiscal austerity already in place and set to last through mid-decade. Tax increases and government spending cuts over the past three years have put a substantial drag on economic growth. In 2013 the fiscal drag is as large as it has been since the defense drawdown after World War II.

Moreover, because of fiscal austerity and the economic recovery, the federal government's fiscal situation has improved markedly. The budget deficit this year will be less than half its size at the recession's deepest point in 2009. Under current law and using reasonable economic assumptions, the deficit will continue to narrow through mid-decade, causing the debt-to-GDP ratio to stabilize.

As part of any budget deal, lawmakers should reverse the sequester. The second year of budget sequestration will likely have greater consequences than the first, affecting many government programs in ways that nearly all agree are not desirable. A sizable share of the sequestration cuts to date has been one-off adjustments, but future cuts will have to come from lasting reductions in operational budgets.

It would, of course, also be desirable for lawmakers to address the nation's daunting long-term fiscal challenges. While the fiscal situation should be stable through the end of this decade, the long-term fiscal outlook remains disconcerting. If Congress does not make significant changes to the entitlement programs and tax code, rising healthcare costs and an aging population will swamp the budget in the 2020s and 2030s. Both cuts in government spending and increases in tax revenues will be necessary to reasonably solve these long-term fiscal problems.

A grand bargain with comprehensive entitlement and tax reform is likely too much to hope for, but lawmakers can do some things now to address our long-term fiscal issues and help resolve the current impasse.

Revenue-neutral corporate tax reform that scales back tax expenditures in exchange for a lower top marginal corporate tax rate would also be a significant policy achievement. This would significantly improve the competitiveness of U.S. businesses and the economy's long-term growth. Much of the hard intellectual work necessary to accomplish this has been done, and there is general agreement among economists that this would provide a meaningful boost. As part of corporate tax reform, multinationals could be encouraged to repatriate their overseas profits with a temporarily lower tax rate. The resulting onetime boost to tax revenues could be used to finance infrastructure development here at home, also improving U.S. competitiveness and long-term growth.

New budget rules that recognize the magnitude of our long-term problems and encourage solutions would be especially helpful. These could include incorporating fiscal-gap and generational accounting in the budget process, and significantly extending the current 10-year budget horizon to facilitate entitlement and tax reform.

Congress should also use this opportunity to eliminate the statutory debt ceiling. It is an idiosyncratic, anachronistic and, as has been demonstrated, potentially destructive rule that is detrimental to sound economic policy. Absent repeal, an alternative would be to require debt-ceiling increases when spending, taxation and appropriations bills are passed. Doing so would restore the fundamental economic relationship between budgeting and borrowing, and reduce the risk that political brinkmanship could damage the full faith and credit of the United States or the stability of world financial markets.

Political uncertainty

The U.S. economy has made significant strides since the Great Recession, but the recovery has been lackluster and the economy remains far from full employment. Since the recovery began four years ago, real GDP growth has been stuck near a tepid 2% and unemployment is a still-high 7.3%, despite falling labor force participation.

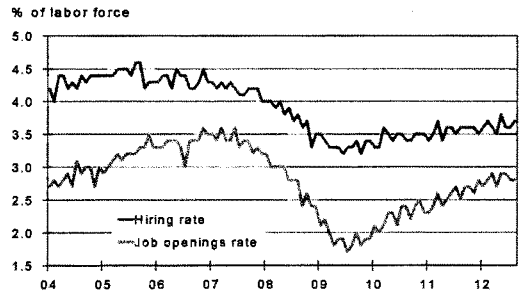
Behind the disappointing recovery is the reluctance of businesses to hire and invest. They have yet to experience the entrepreneurial "Field of Dreams" moment—"build it and they will come"—that sparks stronger economic growth in every recovery. In past recoveries, managers eventually realized they could not continue to increase profits by cutting costs; they needed to invest even in uncertain revenue opportunities. That has yet to happen in the current recovery.

Businesses are not laying off workers—the layoff rate is at a record low and initial unemployment insurance claims are trending down—but they are not hiring many, either. Nationwide, about 4.4 million workers are being hired per month, about 1 million fewer than at the peak of the economic expansion a decade ago.

Hiring is tepid in nearly every industry. In construction and manufacturing, hiring has picked up little since the Great Recession. The only substantive acceleration has occurred in energy, and to a lesser degree, healthcare.

Firms have increased the number of posted job openings, almost back to prerecession levels. Yet companies are not filling these jobs (see Chart 1). The ratio of job openings to hiring is about as high as it has been in the available data back to 2000. In some cases, open jobs go begging because businesses cannot find qualified workers. Yet firms also appear to have grown more picky, refusing to make an offer unless they believe they have a perfect candidate.

Chart 1: Businesss Are Reluctant to Hire



Sources: BLS JOLTS, Moody's Analytics

Businesses are also shy about investing in physical capital. Spending on everything from computer equipment to R&D to warehouses has essentially not risen at all over the past year, and remains not much above its prerecession peak; excluding the energy sector, such spending has actually fallen. Real investment is up only because of declines in equipment prices, which largely reflect the impact of technological improvements.

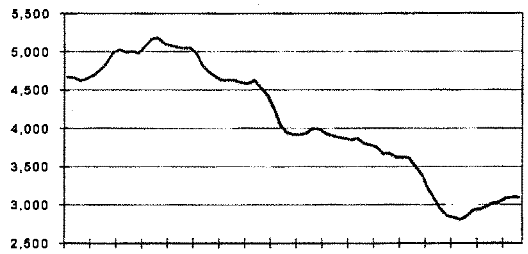
The tepid pace of investment is surprising because businesses are as profitable as they have ever been. Corporate profit margins, measured as the ratio of after-tax profits to output, is at double the average level since World War II. Balance sheets are also sturdy, as businesses are flush with cash and debt loads are light. Credit for new investment is ample and cheap, with banks anxious to make commercial and industrial loans and bond investors lustily buying corporate debt.

Excess capacity in some manufacturing industries and too much vacant office space is probably crimping investment a bit. But manufacturing capacity is lower today than before the recession and commercial construction as a share of GDP is about as low as it has ever been.

The shortfall in hiring and investment appears to stem partly from a drop in entrepreneurial activity. New establishments created close to 3 million jobs in 2012 (the latest data), not much more than during the recession. This compares with 3.6 million jobs in 2007, the year before the recession, and 5 million jobs in 1999 at the height of the technology boom (see Chart 2).

Chart 2: Where Are the Startups?

Job gains at new establishments, ths, 4-qtr moving sum



Sources: BLS, Moody's Analytics

Startups that can expand quickly—once dubbed "gazelles"—such as Facebook and Twitter, are especially important to economic growth, sparking lots of job creation and investment. Indeed, while many analysts have called attention to the plight of small businesses in recent years, it is more precisely the scarcity of gazelles that has constrained growth.

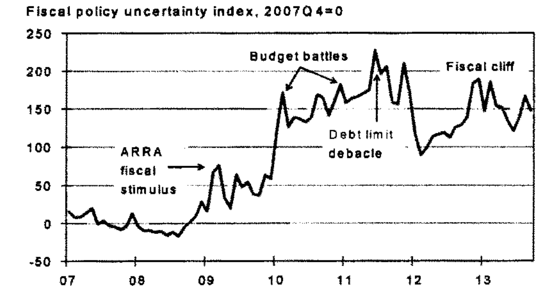
The falloff in entrepreneurship is difficult to explain. Theories abound: The pace of technological change has moderated since the burst of internet-powered innovation around the turn of the century. Fewer Americans are in their 30s, an age when people are most likely to start firms, and high student loan debt holds many of these people back. The high cost of health insurance encourages workers to stick with employers who provide coverage. The flow of foreign immigrants, who are by definition risk-takers, is down.

All these factors likely have some impact. But also important is the nightmare of the Great Recession, which has been difficult to shake, particularly given a seemingly never-ending series of uncertainties and unfortunate events. From the European debt crisis to financial regulation and healthcare reform to Washington's budget battles, there has been much to be nervous about. And the uncertainty continues: One-half of CEOs in the Business Roundtable's 3Q13 CEO outlook survey "indicated that the ongoing disagreement in Washington over the 2014 budget and debt ceiling is having a negative impact on their plans for hiring additional employees over the next six months." Shaky nerves stifle the risk-taking and entrepreneurism that is key to stronger growth.

What goes on in Washington is often a source of uncertainty, but according to the Moody's Analytics index, political uncertainty is currently very high.[1] It rose significantly during the heated debate over the American Recovery and Reinvestment

Act—the $830 billion fiscal stimulus legislation—in early 2009, surged during the budget debate in early 2010, and rose to a record high during the Treasury debt-ceiling showdown in the summer of 2011 (see Chart 3). Uncertainty also increased as the fiscal cliff approached in late 2012, and it has been rising in recent weeks as angst over the current fiscal impasse mounts.

Chart 3: Political Uncertainty Remains High



Source: Moody's Analytics

Political uncertainty constrains business investment, especially on R&D, and reduces hiring and slows GDP growth. Based on a statistical analysis, the increase in political uncertainty since the recession hit in 2008 has reduced real GDP by close to $150 billion, lowered employment by 1.1 million jobs, and increased unemployment by 0.7 percentage point.[2] If political uncertainty had simply remained unchanged from its 2007 level, the unemployment rate today would be 6.6% instead of its actual 7.3%.[3] This is still uncomfortably high, but if not for the logjam in Washington the economy would now be much closer to full employment.[4]

No government shutdown

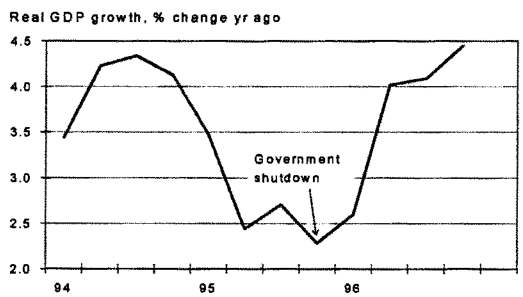
Congress' first order of business is appropriating funds for the fast-approaching 2014 fiscal year. If lawmakers fail to act by October 1, the federal government will partially shut down. At a minimum, lawmakers must pass a continuing resolution to extend current spending authority, which expires at the end of this month.

A shutdown that lasts only three or four days would have modest economic consequences, costing the economy approximately 0.2 percentage point of annualized real GDP growth in the fourth quarter.[5] A brief shutdown would have limited economic impact because it would affect only discretionary spending, the one-third of the budget funded through congressional appropriations. Mandatory spending would not be affected. Some appropriated spending would also likely be considered essential and not cut, in such areas as national security, air traffic control, law enforcement, and the processing of benefit payments. Using the 1995 government shutdown as a guide, approximately half of all government employees would not be able to go to work. Moreover, most government spending would be delayed and not canceled in a brief shutdown. Federal employees would lose pay, but most other activity would be made up later.

However, shutting the government down for three or four weeks would do significant economic damage, reducing real GDP by 1.4 percentage points in the fourth quarter. And this likely understates the economic fallout, as it does not fully account for the impact of such a lengthy shutdown on consumer, business and investor psychology. Any interruption much longer than a month would cause GDP to fall over the quarter, and one longer than two months would likely precipitate another recession.

For context, the longest government shutdown on record, in late 1995 and early 1996, lasted about three weeks. The economy's growth slowed sharply as a result (see Chart 4).

Chart 4: 1995-'96 Government Shutdown Hurt Growth



Sources: BEA, Moody's Analytics

Raise the Treasury debt ceiling

Lawmakers must increase the $16.7 trillion Treasury debt ceiling before mid-October. According to Treasury Secretary Jack Lew, that is when the "extraordinary measures" the Treasury has been using since May to stay under the limit will no longer work.[6] At that point, the government would be able to pay bills with only the cash it has on hand, about $50 billion on any given day.

It is impossible to know precisely when the Treasury will run out of ways to avoid the ceiling. The key uncertainty is revenues: Quarterly corporate income taxes were due September 16, giving the Treasury some leeway, but the Treasury must issue a large amount of nonmarketable debt to the entitlement-related trust funds on October 1, reducing its flexibility. Timing will become clearer after that, but the Treasury will likely be out of options by the end of October, when a large interest payment on Treasury securities is due.

Operationally, the Treasury might be able to prioritize interest payments on U.S. government securities, as those payments are handled by a different computer system than other government obligations. But practically that would be difficult; it would entail paying bond investors before Social Security recipients, for example. Prioritizing other payments would likely not be possible, as the Treasury might not be able to sort through the blizzard of payments due each month to decide which to pay.

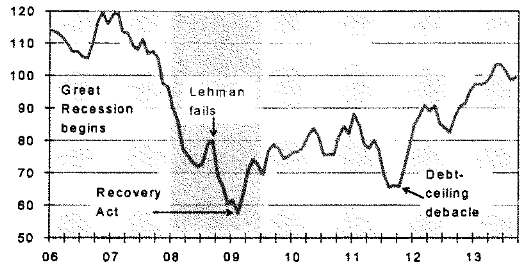
More likely, the Treasury would delay payments as officials suggested in a 2012 inspector general's report. The Treasury could also wait until it received enough cash to pay a specific day's bills. Initially, the resulting delays would be short, but they would increase over time. For example, if the Treasury hit its borrowing authority on October 18, payments to Medicare and Medicaid providers due that day would be delayed one business day, to October 21. But checks to be issued on November 1 for Social Security, veterans benefits, and active-duty military pay would not go out until November 13.

It has become typical for Congress to run down the clock, but in the end it has never failed to come through. The motivation is clear: Any delay in raising the debt ceiling would have dire economic consequences. Consumer, business and investor confidence would be hit hard, putting stock, bond and other financial markets into turmoil.

This was clearly evident in the near-debacle that occurred in summer 2011, when lawmakers raised the debt ceiling at the very last minute. Brinkmanship nevertheless undermined consumer confidence, sent stock prices reeling, and caused credit default swap spreads on U.S. Treasury debt to widen sharply (see Chart 5). The bitter showdown led Standard & Poor's to cut its rating on Treasury debt from AAA to AA+. Although policymakers acted before the debt ceiling was reached, the fallout nearly caused the fragile economic recovery to stall.

Chart 5: Debt-Ceiling Debate Undermined Confidence

Consumer confidence index, Oct 2001=100



Sources: Rasmussen Public Opinion Research, Moody's Analytics

Another such confrontation would also effectively shut the government, which would have authority to spend but would not have the cash to pay for it. The Treasury would have no choice but to eliminate its cash deficit, which will run as high as $130 billion in November. This is about 9% of GDP (annualized). The economy would quickly fall into another severe recession.

Given the serious consequences of not raising the debt ceiling in a timely way, it is widely expected that Congress will do so. After several rounds of fiscal brinkmanship over the last few years, financial markets have become increasingly desensitized to the headlines coming out of Washington. However, lawmakers should not become complacent, thinking that breaching the debt limit is somehow all right. It is not. There will be a violent reaction in financial markets if policymakers fail to act in time.

No additional near-term fiscal austerity

In any agreement to increase the debt ceiling or extend funding for the federal government, lawmakers should avoid adding to the fiscal austerity in place through mid-decade. Congress has been appropriately focused on reducing the government's large budget deficits, but recent tax increases and government spending cuts have put a significant constraint on growth. Under current law, fiscal headwinds will continue to blow hard in 2014 and 2015. It would be wise not to add to those headwinds, and allow the private economy to gather momentum.

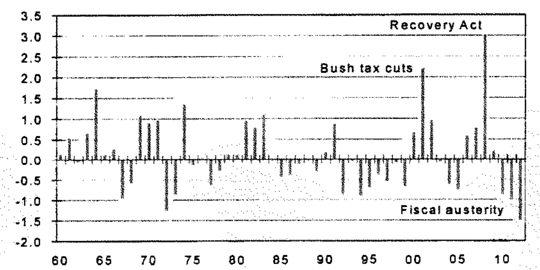
While the U.S. economy has begun its fifth year of recovery from the debilitating Great Recession, it remains fragile. Growth has been modest, with real GDP expanding close to 2% per year since the recovery began, and payrolls are still nearly 2 million jobs shy of their prerecession peak. The nation's 7.3% unemployment rate remains well above most estimates of full employment, which is closer to 5.5%. And this understates the stress in the job market given the large number of potential workers who have left the labor force because of a lack of perceived job opportunities.

The private economy has made significant strides since the recession. American companies have strong balance sheets with low debt and lots of cash, and they have done an excellent job reducing their costs. By most measures, they are highly competitive. The financial system is much better capitalized and liquid, and increasingly willing and able to extend credit. Households have also significantly reduced their debt loads, which are now about as low as they have ever been. Higher house prices and stock values are also supporting households' better financial condition.

But the strengthening private economy is not evident in the nation's overall performance because of fiscal austerity. In calendar year 2013, the drag on the economy from federal tax increases and spending cuts will amount to 1.5 percentage points of real GDP growth. That is, if fiscal policy were simply neutral with respect to the economy, real GDP growth this year would be closer to a strong 3.5% (2 percentage points in actual real GDP growth plus 1.5 percentage points from the elimination of the fiscal drag). The fiscal drag will reach its apex in the current quarter, and over the year is greater than in any other year since the defense drawdown that followed World War II (see Chart 6).[7]

Chart 6: Fiscal Headwinds Are Blowing Hard

Real GDP growth impact of federal fiscal policy, fiscal yr, ppt



Source: Moody's Analytics

The federal government's improved fiscal situation also provides lawmakers with some leeway. Tax revenues are rising at a double-digit pace and government spending is falling. The budget deficit for fiscal 2013 is set to come in well below $700 billion.

This is still large, but it is half of what it was at its peak in fiscal 2009. Under current law and assuming the economic recovery stays intact, the deficit will continue to narrow through mid-decade. The nation's debt-to-GDP ratio, while uncomfortably high at more than 70%, will stabilize.

Given the still-fragile economic recovery, the austerity already in place, and a better near-term federal budget situation, policymakers should not add to the fiscal burden on the economy through mid-decade. This will help the private economy kick into higher gear, hasten a self-sustaining economic expansion, and promote a quicker return to full employment.

Replace the sequester

Policymakers should replace the cuts scheduled for the coming year as part of the sequester with other budget savings.

The impact of the current year's sequester, which began in March, is becoming more visible in the economic data. Hiring freezes announced early this year appear to have accelerated the decline in federal government employment. There has been an even larger impact on hours worked and personal income. Federal furloughs caused government wages and salaries to decline by half a percent in August alone. Cuts in procurement spending are also reducing support for private sector jobs, particularly among defense contractors, although the impact of the sequester on private employment is occurring gradually, with a significant lag.

A second year of sequestration will have greater consequences for the economy. The cuts will be larger and will start immediately, rather than beginning six months into the fiscal year as occurred this year. Because of lags between budgeting and actual spending, and between federal spending and its impact on the job market, the fallout from this year's cuts will carry over into 2014. A sizable share of the fiscal 2013 sequestration cuts was also made through one-off adjustments such as temporary furloughs or zeroing-out unobligated funds that were authorized but not spent. With this low-hanging fruit now gone, future cuts will have to come more from reductions in operational budgets. Given the indiscriminate nature of sequestration, this will be especially disruptive to government programs.

Continuing the sequester would have particular implications for the Pentagon. While in fiscal 2013 sequestration cuts were divided evenly between security spending—on defense, homeland security and international affairs—and non-security spending, in 2014 and beyond the split will be between defense and nondefense, requiring that a greater share of cuts comes from the Pentagon's budget. The Defense Department also paid for a substantial portion of its 2013 cuts by eliminating unobligated balances and, without that cushion this year, will be forced to make deeper cuts from payrolls and operations. The potential for an escalation in military operations in Syria could increase the overseas contingency operations budget, which is not exempt.

Enact budget reforms

The statutory debt ceiling is an anachronistic law that if not repealed should be reformed so that it can no longer lead to a voluntary default on U.S. government obligations. Fiscal-gap and intergenerational accounting should also be adopted in the budget process.

Using the threat of a default on U.S. government obligations as a tool in fiscal policy negotiations has meaningful economic costs. Short of a repeal of the debt ceiling, policymakers should consider strengthening the link between borrowing, tax and spending policy, by requiring "ability to pay" language in any legislation that adds to future deficits. Ability to pay is defined as sufficient projected tax revenue and borrowing authority to cover the current Congressional Budget Office deficit forecast. This requirement would be applied to all direct spending, taxation and annual appropriations bills. Any discrepancies that result from changes in the CBO forecast could be reconciled in the annual budget process.

The debt ceiling would still force lawmakers to think about the long-term fiscal impact of any legislation, but it would do so in the context of the spending and taxation bills that create the need for that debt. This proposal makes use of current CBO budget projections and scoring practices, and thus should cause no new compliance costs.

Policymakers should also adopt the INFORM Act, which would require the CBO and General Accounting Office to adopt fiscal-gap and generational accounting.[8] This provides a more accurate calculation of the nation's long-term fiscal obligations and thus would create the basis for sounder budgeting and fiscal decision-making.

The fiscal gap describes the difference between the present value of projected government expenditures, including interest and principal payments on outstanding federal debt, and taxes and other receipts, including income accruing from the government's ownership of financial assets. Generational accounting measures the burden of closing the fiscal gap on today's and tomorrow's children, assuming they must do so on their own and that the burden on each generation is proportional to its labor earnings.

Fiscal-gap and generational accounting are comprehensive and forward-looking, and determine the sustainability of fiscal policy and the burden of that policy on future generations. Fiscal-gap accounting has already been adopted by the Social Security Trustees and Medicare Trustees and is becoming more widely used in other countries.

Pass corporate tax reform

To break the budget impasse, policymakers should consider adopting revenue-neutral corporate tax reform. Reform that resulted in a lower marginal corporate tax rate would also help the competitiveness of U.S. companies and thus support stronger long-term economic growth.

Corporate tax reform, which involves reducing or eliminating tax expenditures in the corporate tax code and using the resulting additional revenues to reduce marginal rates for businesses, would also be a positive economic step. U.S. marginal corporate tax rates are high by international standards, even after accounting for exemptions, deductions and credits that result in lower effective tax rates. All the loopholes also make the tax code complex and inefficient. Permanently lowering marginal corporate tax rates would improve the competitiveness of U.S. companies and thus long-term economic growth.

As part of corporate tax reform, multinational corporations would be encouraged to repatriate their sizable overseas profits through a temporarily lower tax rate. This would give a onetime boost to tax revenues that could be used to finance needed infrastructure development in the U.S. This too would help the competitiveness of U.S. companies and thus long-term economic growth.

Conclusions

Washington's recent budget battles have been painful to watch and harmful to the economy. Political brinkmanship creates significant uncertainty and anxiety among consumers, businesses and investors, weighing on their willingness to spend, hire and invest.

Despite this, the economic recovery is four years old and counting, and the private economy has made enormous strides in righting the wrongs that triggered the Great Recession. Business balance sheets are about as strong as they have ever been, the banking system is well-capitalized, and households have significantly reduced their debt loads. The private economy is on the verge of stronger growth, more jobs and lower unemployment.

The key missing ingredient is Congress' willingness to fund the government after the end of this fiscal year and to raise the Treasury debt ceiling. If policymakers can find a way to do these things in a timely way, almost regardless of how ungainly the process is, then the still-fragile recovery will quickly evolve into a sturdy self-sustaining economic expansion.

We are close to finally breaking free from the black hole of the Great Recession. All it will take is for Washington to come together over the next few weeks.

[1] The Moody's Analytics political uncertainty index is based on the credit default swap-implied expected default frequency for five-year Treasury bonds, the present value of future expiring tax provisions, and the share of businesses that cite legal and regulatory issues as their biggest problem in the Moody's Analytics weekly business survey. The index is set equal to 0 in 2007, the year before the recession. The higher the index, the greater the uncertainty. Other measures of uncertainty, such as the Baker-Bloom policy uncertainty index, have a similar historical pattern. This index is available at http://www.policyuncertainty.com/

[2] These results are based on a structural vector autoregressive model of the U.S. economy. The model is used to estimate the extent to which surprise changes in political uncertainty produce changes in GDP, unemployment, the hiring rate, investment, jobs, and several other economic variables.

[3] The impact on unemployment is smaller than that found by Leduc and Liu. They concluded that without increased policy uncertainty, the unemployment rate would be 1.3 percentage points lower today. See Leduc, S. and Liu, Z., "Uncertainty and the Slow Labor Market." *Federal Reserve Board of San Francisco Economic Letter*, July 22, 2013. http://www.frbsf.org/economic-research/publications/economic-letter/2013/july/us-labor-market-uncertainty-slow-recovery/

[4] It is difficult to statistically distinguish between political uncertainty and policy uncertainty. Political uncertainty pertains to the uncertainty created by the political brinkmanship and dysfunction in government. Policy uncertainty pertains to the uncertainty created by potential changes in government spending, tax and regulatory policy. The 2011 showdown over the Treasury debt limit was especially hard on the economy as it created a great deal of political uncertainty, but also involved large changes to spending and tax policy. The current government funding and debt limit debates may have less of an economic impact, as it appears to involve more political than policy uncertainty. Despite current legislative efforts to defund Obamacare, such a defunding seems very unlikely to happen, and no other major policy changes are being debated, at least so far. Also mitigating the economic impact of the current debate is that businesspeople, consumers and investors appear to be increasingly desensitized to the political vitriol with each budget battle.

[5] A thorough analysis of the causes, processes and effects of federal government shutdowns, including potential issues for Congress, can be found in "Shutdown of the Federal Government: Causes, Processes and Effect." *Congressional Research Service Report for Congress*. August 6, 2013. http://www.fas.org/sgp/crs/misc/RL34680.pdf

[6] Secretary Lew's letter to Congress can be found at http://www.treasury.gov/initiatives/documents/082613%20debt%20limit%20letter%20to%20congress.pdf)

[7] If fiscal austerity measures had not been implemented since early 2011, making federal fiscal policy neutral with respect to the economy, then real GDP would be nearly $300 billion greater, there would be almost 2 million more jobs, and the unemployment rate would be more than a percentage point lower. This is based on a simulation of the Moody's Analytics structural model of the U.S. economy. The simulation assumes that monetary policy would not have changed; that is, the Federal Reserve would have engaged in the same amount of quantitative easing despite the stronger economy.

[8] The INFORM Act is described in detail at http://www.theinformact.org/content/text-bill

Chairman MURRAY. Thank you very much.
Dr. STONE.

STATEMENT OF CHAD STONE, PH.D., CHIEF ECONOMIST, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. STONE. Chairman Murray, Ranking Member Sessions, and other members of the committee, thank you for the opportunity to testify today on the effect of political uncertainty on jobs and the economy.

Businesses and households, of course, deal with uncertainty of all kinds all the time in a dynamic market economy, and politics ain't beanbag, so we should not be surprised that people fight hard for their preferred policies. But political gridlock over economic and budget policy, combined with brinkmanship over must-pass legislation, has hurt economic performance and job creation. Unfortunately, things seem to be getting worse rather than better as we face yet another threat to the economic recovery generated purely by politics and not by economic events, per se.

I make two overarching points in my written testimony. First, make no mistake, while a government shutdown would be disruptive to the economy, a debt ceiling crisis that ends up with a failure of the Federal Government to honor financial obligations that it has already incurred, whether to bond holders, government contractors, veterans, or a host of other businesses and households, could be disastrous. Evidence from the 2011 debt ceiling crisis suggests that debt ceiling brinkmanship is costly, even if a last-minute deal is struck.

Second, resolving budget issues to avoid a government shutdown or debt default is only half the battle. The specific measures taken matter just as much. In particular, a budget deal that hurts economic growth and job creation in the short run, increases poverty or hardship, or savagely cuts important government programs should not be acceptable.

Moreover, a stop-gap deal, or one that both sides are not committed to seeing enforced, merely postpones the next showdown. In 2011, hard decisions to address the challenge of achieving longer-term fiscal stabilization were assigned to a special committee. Sequestration was supposedly so unpalatable to both sides that it would guarantee an agreement. But, here we are, with sequestration, a possible government shutdown, and a debt ceiling crisis.

There is a broader lesson here. Commissions or super committees and budget rules cannot force unwilling policy makers to make choices they see as unpalatable or to bridge fundamental policy differences that leave little room for compromise. We are a long way from the 1990s, when a strong economy and policy makers' willingness to stick to realistic discretionary caps and pay-go produced a balanced budget and a declining debt.

In my written testimony, I discuss the broad recognition among economists—broad, not universal but broad—that the main factor holding back the economic recovery is weak aggregate demand. If businesses were more confident of future sales and households were more confident that they could expect to see their incomes growing along with the economy and that finding or changing jobs would be easier, we would see faster economic growth and job creation. But we are stuck in a low-demand trap where economic growth is too slow and unemployment remains too high.

The economy has generated plenty of uncertainty on its own in recent years, but policy squabbles over how fast to implement needed long-term deficit reduction without harming the economic recovery and over the appropriate mix between spending restraint and revenue increases has exacerbated the situation. Businesses, households, and financial markets had to deal with uncertainty over policy decisions in the run-up to critical fiscal decisions in each of the past several years—2010, 2011, the big one, the 2012 fiscal cliff—but the greatest uncertainty surrounded the showdown over raising the debt limit in 2011 and how that would be resolved.

Evidence suggests that businesses, households, and financial markets experience heightened uncertainty during such times and that greater uncertainty acts as anti- stimulus, weakening aggregate demand. Failure to resolve the underlying issues or implementing policies that themselves restrain aggregate demand continues the uncertainty and the drag on the recovery.

But resolving the budget crisis with policies that have the same impact or worse is no solution. Sequestration is the poster child of misguided fiscal restraint. But, overall, the pursuit of fiscal austerity policies at the expense of policies aimed at stimulating immediate increases in economic activity and job creation in a weak economy has held back the recovery.

The International Monetary Fund gets it right when they say, ″deficit reduction in 2013 has been excessively rapid and ill designed. Sequestration exerts a heavy toll on growth. And indiscriminate reductions in education, science, and infrastructure spending could also reduce medium-term potential growth. These cuts should be replaced with a back-loaded mix of entitlement savings and new revenues along the lines of the administration's budget proposal. A slower pace of deficit reduction would help the recovery at a time when monetary policy has limited room to support it further.″ That is the IMF in its latest reassessment of fiscal policy in advanced economies and its mission to the United States, its consultation with United States policy makers.

My final words, raise, r-a-I-s-e, the debt ceiling, and do it soon and cleanly. As I say in my testimony, do it like the Danes and raise it so high that it is no longer a bone of political contention. They are the only other country that has anything like our debt ceiling, and they make sure politics does not get involved.

Better yet, raze, r-a-z-e, the debt ceiling by getting rid of it entirely. It has nothing to do with the normal budget process, and the ratio of cost to benefits associated with having a debt ceiling is almost infinite.

Thank you.

[The prepared statement of Mr. Stone follows:]

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Testimony of Chad Stone

Chief Economist, Center on Budget and Policy Priorities
Before the Senate Committee on Finance
September 24, 2013

Chairman Murray, Ranking Member Sessions, and other members of the Committee. Thank you for the opportunity to testify today on the effect of political uncertainty on jobs and the economy.

Businesses and households of course deal with uncertainty of all kinds all the time. That's the nature of a dynamic market economy. And politics ain't beanbag. So we shouldn't be surprised that people fight hard for their preferred policies. But political gridlock over economic and budget policy combined with brinksmanship over must-pass legislation has hurt economic performance and job creation as the economic recovery continues to struggle to gain traction more than four years after the formal end of the recession in June 2009.

Unfortunately, things seem to be getting worse rather than better as we face yet another threat to the economic recovery generated purely by politics and not by economic events *per se*. I want to make two overarching points in my testimony.

- First, make no mistake: while a government shutdown would be disruptive to the economy, a failure of the federal government to honor financial obligations that it has already incurred—whether to bondholders, government contractors, or veterans—would be disastrous. Evidence from the 2011 debt-ceiling crisis suggests that debt-ceiling brinksmanship is costly even if a last-minute deal is struck.

- Second, resolving budget issues to avoid a government shutdown or debt default is only half the battle. The specific measures taken matter just as much. Moreover, a stopgap deal or one that both sides are not committed to seeing enforced merely postpones the next showdown. That's what happened in 2011. Hard decisions to address the challenge of achieving longer-term fiscal stabilization were assigned to a special committee and a budget enforcement mechanism was put in place that was supposedly so unpalatable to both sides that it would guarantee an agreement. But here we are with sequestration, a possible government shutdown, and a debt-ceiling crisis.

There's a broader lesson here. Commissions (or super committees) and budget rules don't work without policymakers who are committed to the goal of fiscal stabilization and willing to make compromises in the interest of avoiding serious harm to the economy and in the interest of sound budgeting. Discretionary caps and PAYGO rules helped policymakers adhere to the 1990 and 1993 budget agreements, which together with a strong economy led to budget surpluses and declining debt by the end of the 1990s. But budget rules and deficit-control measures cannot force unwilling policymakers to make choices they see as unpalatable or bridge fundamental policy differences that leave little room for compromise.

The problem is even more difficult in a weak economy where larger deficits are appropriate in the short-term to support an economic recovery, but policymakers must also demonstrate a commitment to longer-term deficit reduction.

The Effect of Uncertainty and Budget Restraint in a Weak Economy

The legacy of the gut-wrenching financial crisis of 2008 and the confidence-sapping descent into the Great Recession is an economy that is still operating well-below its full potential to supply goods and services. Employment is well below what it would be in a normal job market, due to a combination of high official unemployment and low labor force participation.

Besides the 11.3 million people officially counted as unemployed, there are many people who want a job and would likely find one in a stronger job market but remain sidelined until job prospects improve. Many among the employed would like to be working full-time but have only been able to find part-time work. Altogether about 22 million people are unemployed or underemployed.

It is widely, although I'll admit not universally, accepted among economists that the major factor holding back economic growth and job creation is weak overall demand for goods and services. Businesses have the capacity to hire more people and produce more but they are held back from doing so by weak sales. At the same time, high unemployment and slow-to-nonexistent growth in wages and income hold down household spending, especially if households are rebuilding their balance sheets after earlier financial losses. Something needs to happen to get the economy out of this self-reinforcing low-demand trap.

Fiscal stimulus is one way to do that. It is generally, although once again not universally, accepted among economists that changes in taxes and government spending have a larger effect on economic activity and employment when there is substantial economic slack (an "output gap" between what is actually being produced and what could be produced with normal levels of demand and employment). That effect is even stronger when the use of traditional monetary policy is constrained by very low interest rates (the so called "zero lower bound"). That's certainly the conclusion of a recent International Monetary Fund reassessment of fiscal policy after the crisis:

> While debate continues, the evidence seems stronger than before the crisis that fiscal policy can, under today's special circumstances, have powerful effects on the economy in the short run. In particular, there is even stronger evidence than before that fiscal multipliers are larger when monetary policy is constrained by the zero lower bound (ZLB) on nominal interest rates, the financial sector is weak, or the economy is in a slump. A number of studies have also questioned the earlier evidence of negative fiscal multipliers associated with expansionary fiscal contractions.[1]

[1] IMF Policy Paper, "Reassessing the Role and Modalities of Fiscal Policy in Advanced Economies," International Monetary Fund, September 2013. http://www.imf.org/external/np/pp/eng/2013/072113.pdf

In other words, what the IMF is saying in its restrained and technocratic way is that under the conditions prevailing in the United States in recent years, the idea that cutting government spending in hopes of stimulating economic activity—so called "expansionary austerity"—is invalid. Cutting spending in a weak economy reduces output and employment—and the effects are powerful. Conversely, as the Congressional Budget Office has pointed out in its assessments of the effect of the Economic Recovery Act on output and employment, each dollar spent in a weak economy on government purchases of goods and services or transfer payments to low-and moderate-income individuals through programs like unemployment insurance and SNAP — payments they are likely to spend rapidly — can generate well over a dollar of additional economic activity, creating jobs and lowering unemployment.[2]

CBO reports a range of estimates of the impact of the Recovery Act. The IMF analysis suggests the effect was at the high end of those estimates. According to CBO, at its peak impact in 2010, ARRA boosted real (inflation-adjusted) gross domestic product (GDP) by as much as 4.1 percent above what it otherwise would have been and created as many as 4.7 million additional full-time-equivalent jobs.

The economy has generated plenty of uncertainty on its own in recent years, but policy squabbles over how fast to implement needed long-term deficit reduction without harming the economic recovery and the appropriate mix between spending restraint and revenue increases has exacerbated the situation. Businesses, households, and financial markets had to deal with uncertainty over policy decisions in the run-up to critical decisions about expiring tax cuts and stimulus measures like emergency unemployment insurance at the end of 2010, 2011, and the big one, the 2012 "fiscal cliff." The greatest uncertainty surrounded how the showdown over raising the debt limit in 2011 would be resolved.

Evidence suggests that businesses, households, and financial markets experience heightened uncertainty during such times and that that greater uncertainty acts as "anti-stimulus," weakening aggregate demand. Failure to resolve the underlying issues or implementing policies that themselves restrain aggregate demand continues the uncertainty and the drag on the recovery.

A 2012 analysis by the Federal Reserve Bank of San Francisco[3] finds evidence, for example, that

> ...uncertainty harms economic activity, with effects similar to a decline in aggregate demand. The private sector responds to rising uncertainty by cutting back spending, leading to a rise in unemployment and reductions in both output and inflation. We also show that monetary policymakers typically try to mitigate uncertainty's adverse effects the same way they respond to a fall in aggregate demand, by lowering nominal short-term interest rates.

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[2] Congressional Budget Office, "Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from October 2012 Through December 2012," Table 2, CBO, February 2013.

[3] Sylvain Leduc and Zheng Liu, "Uncertainty, Unemployment, and Inflation," Federal Reserve Bank of San Francisco Economic Letter 2012-28, September 17, 2012. http://www.frbsf.org/economic-research/publications/economic-letter/2012/september/uncertainty-unemployment-inflation/

The study concludes, however, that in the recent recession and recovery,

> ...nominal interest rates have been near zero and couldn't be lowered further. Consequently, uncertainty has reduced economic activity more than in previous recessions. Higher uncertainty is estimated to have lifted the U.S. unemployment rate by at least one percentage point since early 2008.

In short, when the economy is weak and interest rates are very low, heightened uncertainty reduces demand for goods and services and the Fed is less able to provide an offsetting boost. The resulting net reduction in private spending leads to less job creation and higher unemployment.

Deficit-reduction policies have a similar effect. With respect to sequestration, for example, the Congressional Budget Office estimated in July that if the automatic spending reductions in effect in 2013 were cancelled in August and none of the reductions scheduled for 2014 were implemented, real (inflation-adjusted) gross domestic product (GDP) would be 0.7 percent higher in the third quarter of 2014 (the end of fiscal year 2014) and there would be about 900,000 more jobs than the levels CBO was projecting with sequestration in place.

Those are CBO's central estimates; CBO provides a range for the estimated impacts. If the evidence that fiscal multipliers are particularly high under current conditions is correct, those gains from eliminating sequestration are toward the high end of CBO's range: 1.2 percent higher GDP and 1.6 million more jobs.

The remainder of my testimony focuses on the importance of removing the debt ceiling as a source of brinksmanship and policy uncertainty, principles for achieving a sound budget deal, and a brief note on why the individual mandate is a critical piece of the Affordable Care Act and not something that can be bargained away in return for an increase in the debt ceiling.

Raze the Debt Ceiling

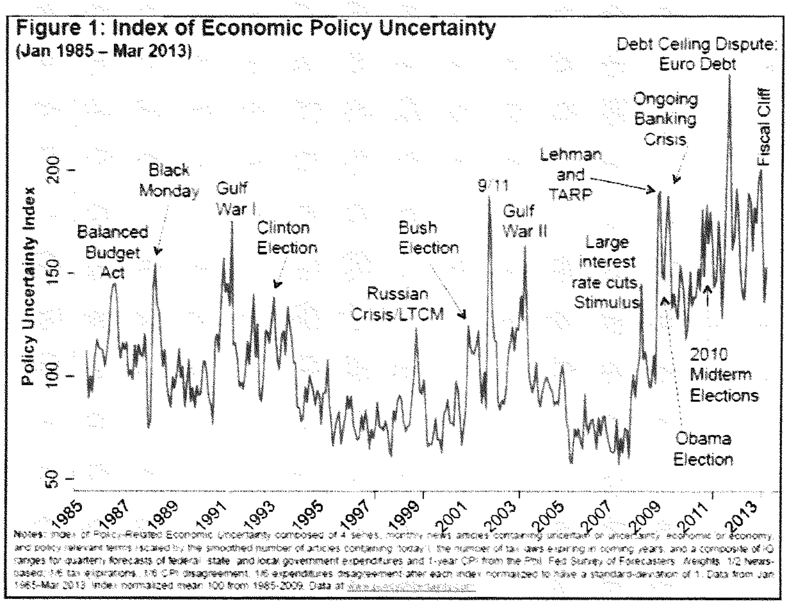
Congress should not be using the debt limit as a political football. In fact, the United States should not even have a debt limit.

The 2011 debt-limit showdown was not pretty, and even though a default was averted, the economy and the budget did not escape unharmed. As Urban Institute Fellow Donald Marron, a former acting CBO director and a member of President George W. Bush's Council of Economic Advisers, testified last week before the Joint Economic Committee, "brinksmanship does not come free."

First, through accident or miscalculation, games of chicken can sometimes end in a crash, and the costs to the United States of actually defaulting on its financial obligations could be very high. Default means the Treasury says to someone, or as Marron says perhaps millions of someones, "Sorry you aren't getting paid." There's no way to decide who gets paid in a way that does not damage the economy. If prolonged, a situation in which the Treasury is required to match payments to available cash would have an economic effect like sequestration plus the fiscal cliff on steroids and would likely plunge the economy back into recession. The difference between default and a government shutdown, sequestration, or the fiscal cliff is that even if the debt limit were subsequently raised, the damage to U.S. credit rating could not be reversed.

Second, the mere risk of default is likely to raise Treasury borrowing costs while a debt-ceiling showdown plays out. Marron cites the 2012 report by the Government Accountability Office (GAO), estimating that delays in raising the debt limit in 2011 raised fiscal year 2011 Treasury borrowing costs by $1.3 billion[4] and the report by the Bipartisan Policy Center estimating that those costs would total $18.9 billion over the full maturity of the securities issued.[5]

Third, the 2011 debt-ceiling showdown produced a marked spike in various measures of uncertainty and a marked decline in consumer confidence. The chart below, for example shows the Index of Economic Policy Uncertainty developed by economists Scott R. Baker, Nicholas Bloom, and Steven J. Davis.[6] The spike associated with the debt ceiling crisis is substantially larger than those associated with the fiscal cliff or the Lehman bankruptcy and the financial stabilization legislation (TARP).



In light of the evidence linking increases in uncertainty to the economy, it is reasonable to infer some economic harm. In a Wall Street Journal op-ed, Bill McNabb, Chairman and CEO of the

[4] GAO, "Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs," Government Accountability Office, July 2012. http://www.gao.gov/assets/600/592832.pdf

[5] Bipartisan Policy Center, "Debt Limit Analysis," September 2013. http://bipartisanpolicy.org/sites/default/files/Debt%20Limit%20Analysis%20Sept%202013.pdf

[6] Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring Economic Policy Uncertainty, May 19, 2013. http://www.policyuncertainty.com/media/BakerBloomDavis.pdf

Vanguard Group, reports that economists there estimate that the spike in policy uncertainty surrounding the debt-ceiling debate cost the economy $112 billion in lost output and likely many hundreds of thousands of jobs in the ensuing two years.[7] Economists Betsey Stevenson and Justin Wolfers also point to evidence that employers probably held back on hiring.[8] While the U.S. and European debt crises are paired in the chart, Stevenson and Wolfers observe that the real trouble in Europe came after consumer confidence and employment in the U.S. were recovering.

Finally, the 2011 crisis damaged the United States' financial reputation. As Marron points out, "Debating intentional default contributes to the perception that the United States does not know how to govern itself." Stevenson and Wolfers point out that "The sense that the U.S. political system could no longer credibly commit to paying its debts led the credit-rating company Standard & Poor's to remove the U.S. government from its list of risk-free borrowers with gold-standard AAA ratings."

We at CBPP think this time looks even worse.[9] Congress on occasion in recent decades has attached both fiscal and non-fiscal items to debt limit legislation. But, on those occasions, the parties in question generally agreed that defaulting on the debt was not the desired outcome if they didn't get their way. They sought to attach their proposals to what they probably regarded as must-pass legislation — sometimes they succeeded, sometimes they failed — and Congress then raised the debt limit to avoid a default.

The same thing could ultimately happen this year. But, increasingly, this year's unfolding drama seems fundamentally different. The tactic of threatening to withhold votes on raising the debt limit unless the legislation includes a delay or repeal of health reform isn't just about trying to attach favored legislative items to a bill that's certain to pass anyway; it's about holding the debt limit bill hostage and actually defaulting unless Congress adds policy changes that otherwise cannot be enacted on their own.

Nor should policymakers fool themselves into thinking that directing the Treasury to pay bondholders and Social Security recipients first if there's a prolonged standoff over raising the debt ceiling is not simply default by another name.[10] This "debt prioritization" is extremely dangerous, and is probably not even be feasible, as Mark Zandi has testified at this hearing. By appearing to make defaulting on the debt legitimate and manageable, it would heighten the risk that a default will actually occur.

In reality, debt prioritization would make things worse for the millions of people and businesses who count on timely federal payments. Protecting bondholders and Social Security beneficiaries

[7] Bill McNabb, "Uncertainty Is the Enemy of Recovery," Wall Street Journal, April 28, 2013. http://online.wsj.com/article/SB10001424127887323789704578443431277889520.html

[8] Betsey Stevenson and Justin Wolfers, "Debt Ceiling Déjà vu Could Sink the Economy, Bloomberg.com, May 28, 2012 http://www.bloomberg.com/news/2012-05-28/debt-ceiling-deja-vu-could-sink-economy.html

[9] Robert Greenstein, "Don't Be Fooled: This Year's Debt Limit Fight Is Frighteningly Different, Center on Budget and Policy Priorities, September 20, 2013. http://www.offthechartsblog.org/dont-be-fooled-this-years-debt-limit-fight-is-frighteningly-different/

[10] PauL N. Van de Water, "'Debt-Prioritization' Is Simply Default By Another Name," Center on Budget and Policy Priorities, September 19, 2013. http://www.offthechartsblog.org/debt-prioritization-is-simply-default-by-another-name/

would leave even less cash on hand to pay veterans, doctors and hospitals who treat Medicare patients, soldiers, state and local governments, private contractors, and recipients of unemployment insurance, SNAP, and Supplemental Security Income.

The Treasury makes roughly 80 million separate payments each month, so deciding which bills to pay would be extremely difficult. And, domestic and foreign lenders would hardly be reassured at the sight of a cash-strapped superpower picking which bills it could afford to pay.

One rating agency explicitly warned in January that honoring interest and principal payments but delaying payment on other obligations would trigger a review and hence a possible downgrade. *The Economist* called failing to raise the debt limit — or attempting to prioritize payments — an "instrument of mass financial destruction."

We should ***never*** get to the point of default — or even ***consider*** getting to it. We should not legitimize the idea of a default. We should consider the possibility beyond the pale. The potential costs to the economy, to U.S. and global markets, and to America's standing in the world are simply too great.

Ideally, policymakers would abolish the debt limit, eliminating all risk that the government won't pay its bills on time. To my knowledge, only one other developed country, Denmark, has a statutory debt limit anything like ours. Both have put a dollar limit on how much debt the government can issue. There's a crucial difference, however, between our debt limit and Denmark's: the Danes do not play politics with theirs, as Jacob Funk Kirkegaard of the Peterson Institute for International Economics explains:[11]

> The Danish fixed nominal debt limit – legislatively outside the annual budget process – was created solely in response to an administrative reorganization among the institutions of government in Denmark and the requirements of the Danish Constitution. It was never intended to play any role in day-to-day politics.

When the financial crisis caused a sharp increase in government debt in 2008-2009, the Danes raised their debt ceiling – a lot. The 2010 increase doubled the existing ceiling, which was already well above the actual debt, to nearly three times the debt at the time. As Kirkegaard reports, "The explicit intent of this move – supported incidentally by all the major parties in the Danish parliament – was to ensure that the Danish debt ceiling remained far in excess of outstanding debt and would never play a role in day-to-day politics."

The Constitution gives Congress power over federal borrowing, which it has exercised for decades through the statutory limit on federal debt. But the government is also legally bound to honor its financial obligations. Holding the debt limit hostage risks provoking a governance crisis in which the President is forced to choose between breaking the law by ignoring the debt ceiling or breaking the law by not paying government obligations in a timely manner. In terms of economic damage, the former is by far the better choice.

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[11] Jacob Funk Kirkegaard, "Can a Debt Ceiling Be Sensible? The Case of Denmark II, Peterson Institute for International Economics, July 28, 2011. http://www.piie.com/blogs/realtime/?p=2292

A Bad Deal to Avoid Default Would Hurt the Economy

The last debt-ceiling crisis produced an outcome nobody was supposed to want—sequestration—because of political gridlock over a long-term solution. CBPP has developed four criteria for evaluating any deal that emerges as we head toward zero hour for authorizing government spending for fiscal year 2014 and raising the debt ceiling, or as part of later negotiations after any temporary stopgap measures:[12]

1) **Does it strengthen or weaken the economic recovery?**

The Federal Reserve's monetary-policy-making committee decided last week that the economic recovery is not solid enough to start phasing down any of the measures it's been using to stimulate economic activity. One factor influencing the Fed's decision was surely a concern with the damage to the recovery that a government shutdown, or worse, a debt default would cause.

That damage would come on top of the drag on economic growth from fiscal tightening at the federal and state and local levels that's been underway since the stimulus from the 2009 Recovery Act peaked in 2010, including sequestration.

An ideal budget plan would replace sequestration with sizeable deficit-reduction measures that take effect gradually as the economy and labor market strengthen as well as temporary, up-front measures to boost job creation now. Such a policy would both strengthen the economy in the short term *and* produce more total deficit reduction and a better long-run debt trajectory than sequestration beyond the first decade.

Such a solution is fully consistent with the IMF analysis cited earlier[13] of what we have learned about fiscal policy in the wake of the financial crisis:

> The design of fiscal adjustment programs, and particularly the merit of frontloading, has returned to the forefront of the policy debate. Given the nonlinear costs of excessive frontloading or delay, countries that are not under market pressure can proceed with fiscal adjustment at a moderate pace and within a medium-term adjustment plan to enhance credibility. Frontloading is more justifiable in countries under market pressure, though even these countries face "speed limits" that govern the desirable pace of adjustment. The proper mix of expenditure and revenue measures is likely to vary, depending on the initial ratio of government spending to GDP, and must take into account equity considerations.

The United States is not under market pressure and hence has no need to pursue short-term deficit reduction aggressively. In fact, given the IMF's assessment of fiscal multipliers in a weak economy with very low interest rates and inflation, such a policy would be counterproductive. Issues of equity and the proper mix of expenditure and revenue measures deserve careful evaluation.

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[12] Sharon Parrott, Richard Kogan, and Robert Greenstein, "Averting a Budget Crisis Is Not Enough: Criteria for Evaluating Budget Proposals," September 10, 2013. http://www.cbpp.org/cms/index.cfm?fa=view&id=4010

[13] IMF, "Reassessing the Role of Fiscal Poli http://www.imf.org/external/np/pp/eng/2013/072113.pdf

The IMF was very pointed about this following its latest annual consultation mission with U.S. policymakers:

> **On the fiscal front, the deficit reduction in 2013 has been excessively rapid and ill-designed.** In particular, the automatic spending cuts ("sequester") not only exert a heavy toll on growth in the short term, but the indiscriminate reductions in education, science, and infrastructure spending could also reduce medium-term potential growth. These cuts should be replaced with a back-loaded mix of entitlement savings and new revenues, along the lines of the Administration's budget proposal. At the same time, the expiration of the payroll tax cut and the increase in high-end marginal tax rates also imply some further drag on economic activity. A slower pace of deficit reduction would help the recovery at a time when monetary policy has limited room to support it further.[14]

2) Does it protect low-income Americans and avoid increasing poverty and hardship?

In deficit-reduction efforts in 1990, 1993 and 1997, leaders of both parties embraced the principle that any deal should not increase poverty or impose additional hardship on low-income Americans. Fiscal commission co-chairs Alan Simpson and Erskine Bowles embraced the same principle in their plan.

Last week's Census Bureau report on income, poverty, and health insurance suggests that any upcoming budget deal should adhere to the same principle. As CBPP President Robert Greenstein noted, "the new Census figures demonstrate that the painfully slow and uneven economic recovery has yet to produce significant gains for Americans in the bottom and middle of the economic scale."

3) Does it adequately fund public services?

Yielding to Republicans' demands for more large immediate spending cuts would not only threaten the recovery but also savage important government services. The House-passed budget resolution of this spring would set overall discretionary (non-entitlement) funding at the post-sequestration level but shift tens of billions of dollars from non-defense programs to defense. That would require programs in the Departments of Labor, Health and Human Services and Education be cut 18.6 percent below their 2013 post-sequestration levels.

Discretionary funding would shrink even without such large cuts. The cuts required under the Budget Control Act that President Obama and Congress enacted after their last debt-ceiling showdown would, by 2017, reduce non-defense discretionary spending — even without sequestration — to its lowest level on record as a percent of GDP, with data going back to 1962.

4) Does it strike a reasonable balance between spending and revenues and between defense and non-defense?

Deficit-reduction efforts since 2010 have tilted heavily toward spending cuts. Excluding sequestration, roughly 70 percent of the policy savings have come from program cuts and 30 percent from revenue increases. If sequestration continues, the ratio will move closer to 80-20. Revenues

[14] International Monetary Fund, "Concluding Statement of the 2013 Article IV Mission to The United States of America," IMF, June 14, 2013. http://www.imf.org/external/np/ms/2013/061413.htm

should account for a larger portion of future policy savings if we are to avoid savage cuts to important government services, anti-poverty programs and key entitlement benefits — and, thus to avoid exacerbating inequality and constraining opportunity.

Policymakers designed sequestration to pressure both parties to reach a budget deal by requiring that cuts come half from defense and half from non-defense programs, thus giving both conservatives and liberals a reason to replace sequestration with a more thoughtful approach. Efforts to shield defense and put all of the burden on non-defense would reduce conservative incentives to compromise.

To repeat, resolving budget issues to avoid a government shutdown or debt default is only half the battle. The specific measures taken matter just as much.

A Note on Why the Individual Mandate Is An Essential Feature of the Affordable Care Act

Opponents of the Affordable Care Act (ACA) health reform legislation want to see it repealed or crippled, and their ardent desire to see it used as a bargaining chip in the debt-ceiling debate introduces a major element of uncertainty. It is important to recognize, however, that the individual mandate requiring everyone to acquire health insurance as long as it's affordable is critically important for enabling health reform to achieve its goals of increasing coverage and controlling costs. It is much more significant than responsibilities placed on businesses to offer health insurance.

As my CBPP colleague Edwin Park explains,[15] starting in 2014 the ACA prohibits insurers from denying coverage to people with pre-existing conditions or charging sick people higher premiums. Without the individual mandate, those reforms would encourage older, sicker people to buy insurance but would give younger, healthier people an incentive not to do so until they became sick. Premiums would rise as the pool of insured people became older, sicker, and smaller. As Park reports:

> Specifically, a one-year delay of the individual mandate would raise the number of uninsured Americans by about *11 million* in 2014, relative to current law, and would reduce the expected coverage gains under the Affordable Care Act (ACA) by nearly 85 percent, according to a new [Congressional Budget Office] estimate. Delaying the individual mandate also would raise premiums for health insurance purchased in the individual market in 2014, CBO finds.

Proponents of delaying the individual mandate draw a false analogy between it and the Obama administration's delay in implementing the law's employer responsibility requirement for a year. As my CBPP colleague Judy Solomon has pointed out,[16] the vast majority of large employers – the only companies that are subject to the requirement to offer coverage and the related penalty if they don't – already offer health coverage and are unlikely to stop. Moreover, as Solomon says:

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[15] Edwin Park, "Delaying the Individual Mandate Would Result in Millions More Uninsured and Higher Premiums," Center on Budget and Policy Priorities, September 12, 2013, http://www.cbpp.org/cms/index.cfm?fa=view&id=4012

[16] Judy Solomon, "Delay Won't Keep People from Obtaining Health Coverage," Center on Budget and Policy Priorities Off the Charts blog, July 3, 2013. http://www.offthechartsblog.org/delay-wont-keep-people-from-obtaining-health-coverage/

What's key is that the delay won't affect a core component of health reform: in 2014, workers who do not get coverage through their jobs will be able to get good coverage in the new marketplaces, with subsidies available to those with low and moderate incomes.

Chairman MURRAY. Thank you very much.

Dr. MELTZER.

STATEMENT OF ALLAN H. MELTZER, PH.D., CARNEGIE MELLON UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, TEPPER SCHOOL OF BUSINESS

Mr. MELTZER. Thank you, Madam Chairman, Mr. Ranking Member, Senators. I am pleased once again to respond to questions from the Senate committee about the reasons for the slow recovery.

The facts about the slow recovery are not in doubt, so I will not dwell on them. We understand them. You both spoke about them. We see unemployment is high. Poverty remains higher. Failed efforts to lower the spread between upper incomes and lower incomes have done the reverse. Policy has really not achieved the nice things that people would like it to achieve. Forecasts have been overly optimistic. Deficit projections become more pessimistic. The debt-to-GDP ratio in the long term, according to CBO, reaches 200 percent. Long before that happens, we will be in crisis.

Why so much stimulus and so little recovery? Well, there are lots of reasons. The Fed pumps out money, but the problems are mainly non-monetary. My colleagues have talked about uncertainty, and I certainly agree with them that uncertainty is a problem. Uncertainty about the deficit and the debt ceiling are problems. They are a problem. They are not, in my opinion, the problem. The problem is the longer-term position of how the United States gets back on the growth path, which has been left since the Reagan and Clinton years to produce growth, jobs, standards of living, incomes, and all that.

There are two overriding problems. One is unsustainable budget deficits, especially underfunded entitlements. You all know about that.

Second are the demands for higher tax rates, and decisions to increase regulation raise current and expected future costs and heighten uncertainty. Uncertainty is the enemy of investment, and that is the main reason, in my opinion, why the long-term growth rate is down.

There is no valid economic theory, no theory of any kind, that advises short-term stimulus to consumer spending. John Maynard Keynes is usually invoked. He always favored investment. He never favored consumption. You could read his work, as I have done, from beginning to end. You will not find him in favor of consumption spending. He favored investment, investment spending. Keynes' idea of stimulus is the Kennedy-Johnson permanent tax cuts or the Reagan tax cuts. While he favored deficit spending to finance investments in recessions, he actively opposed permanent deficits, and I have a quotation in my paper that I will not read.

In summary, there is no valid basis in economics for the policies we have followed and they have not ended the recession in almost five years, not surprisingly, and most forecasts that I have seen call for subpar growth in the next few years. We can do better. We should do better. And if we are going to achieve the America that we want, we have to do better.

In searching through past recessions, there is only one with slow investment and sluggish growth of employment similar to the one.

That is 1938 to 1940. You can see Table 6 in the paper in my testimony. What President Roosevelt did is similar to what President Obama has done. He called the businessmen economic royalists. He tried to pack the Supreme Court. He passed an excess profits tax. He ginned up the Antitrust Division to go after businessmen. He got Congress to establish the Temporary National Economic Commission, which was very anti-business. He did a whole lot of things. He did them until the war. He was a populist until the war. When the war came, the businessmen that he was so despising of, he appointed Knudsen of General Motors to be his economic czar. Populism ended. The war was his triumph.

That is what we need to do now. We need to adopt policies which look at the long-term objective of getting the economy back on a stable growth path.

Let me read to you, not from econometric analysis but from what real businessmen say. Professors Porter and Rivken of the Harvard Business School asked 10,000 Harvard Business School alumni—as you know, they run many of the major corporations—about their decisions to locate plants. The respondents cited a couple as problems—the U.S. tax code, an ineffective political system, a weak public education system, poor macroeconomic policies, convoluted regulation, deteriorating infrastructure, and a lack of skilled labor—as reasons for not investing in the United States. Most of the decisions were to move investment out of the United States. That tells us something, I think, which is critical.

Here is one example, one of many, many examples of regulation which hurts our economy. Before Sarbanes-Oxley, half of the world's new issues for corporations were made in the U.S. market, namely, New York. After Sarbanes-Oxley, one in 12 instead of one in two. Brokers in London have the pictures of Senator Sarbanes and Congressman Oxley in their office. That tells you something about what regulation is doing to us. We are over-regulated. You may think that there are good things or bad things about the regulation. One can differ about that. But regulation at the present time and high tax rates impede growth and recovery.

[The prepared statement of Mr. Meltzer follows:]

Why the Recovery is Slow: What Should Be Done?

By Allan H. Meltzer

The Allan H. Meltzer University Professor,
Carnegie Mellon University and
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Senate Budget Committee

September 24, 2013

Sept. 2013

Mr. Chairman, Mr. Ranking Member, Members: I appreciate the opportunity to respond to the questions, Why Is the Recovery Slow; What Would Speed Recovery?

In the fifth year of recovery from a serious recession, the unemployment rate remains distressingly high at 7.3 percent. Much of the decline from the peak is at least as discouraging as the many discouraged workers who have left the labor force. An unusually large part of the slow job increase is for part-time work, not permanent employment. Despite the administration's expressed concern for the widening spread is the distribution of income, the spread has widened. And the recently released data on poverty shows that 46.5 million people are impoverished, 15 percent of the population. In sum, a miserable set of failed policies.

Private forecasts remain more optimistic than outcomes. Less optimistic, indeed downright pessimistic, are forecasts for government budget deficits and debt. The latest CBO estimate show budget deficits rising from 3.3 percent in 2023 to over 6 percent in 2035 and higher still in later years. Government debt reaches 100 percent of GDP in 2038 and 200 percent in 2075. Long before these numbers are reached, we will be in crisis. Unsustainable policies end that way.

I believe current and recent policies bear most of the blame for slow recovery. The administration and the Federal Reserve rely too heavily on short-term palliatives that have little long-term benefit for the economy. The Fed's major error is refusal to recognize that our problems are not monetary. The Fed's past actions assure that there is no shortage of money or liquidity; banks hold $2 trillion of excess reserves, so they can make loans to any qualified borrower at the lowest interest rates in our history, if only more would borrow.

Much of the Fed's stimulus helped banks rebuild their capital and repay the loans that helped many banks survive. Now large banks pay dividends and bonuses from the earnings the Fed's interest rate policies allow them to earn. The effect on unemployment is modest at best.

We need stable, pro-growth policies, not more of the same. Our economic problems are mainly real, not monetary. The Federal Reserve's huge expansion has had only a small effect.

Some console themselves by forecasting improved recovery. Maybe, but users should know that forecasters have been consistently too optimistic. This recovery has remained persistently weaker than forecast.

It is not unusual for forecasts to be wrong. Economics is not the science that gives high quality quarterly forecasts with low errors. There is no such science.

But a string of persistent errors always overestimating the rate of recovery calls for an explanation. I believe the principal explanation is the mistaken, often perverse government policies that discourage investment and employment. We saw this outcome once before. The administration is repeating the error last seen in 1938-1940.

Good policy is based on the best validated theory representing the accumulated professional knowledge. At the start of the Obama presidency, his chief adviser said that policy actions should be "timely, targeted, and temporary." That is a strange mixture that lacks any analytic foundation. Modern economic theory teaches us to make permanent, not temporary, changes and to encourage not discourage investment incentives. What analytic basis do we have for the administration's targeted actions? None. Do we know how to manipulate relative responses to increase the size of the response? I believe not.

We have two overriding problems. First, unsustainable structural budget deficits, especially unfunded spending for entitlements creates uncertainty that clouds the future. Second, greatly increased regulation of business also heightens uncertainty and raises current and future costs.

Uncertainty is the enemy of investment. Uncertainty about future tax rates, spending, and regulation is the main reason that investment is low and that much investment goes to robotics, programs and other labor-saving investments.

John Maynard Keynes is frequently cited as the intellectual father of short-term policies to restore growth by increasing government spending to stimulate private consumption. The 2009 stimulus implemented that policy by offering sizeable temporary tax reduction to middle income taxpayers and temporary payments to state and local governments. (As recipients of social security, my wife and I received checks.)

To write my book on Keynes's work, I read most of his books and papers. Keynes believed that the 19th century problem of raising living standards was too little saving. The 20th century problem, he said, was too little investment, in part a result of uncertainty. In his *General Theory*, he gave an economist's explanation.

No one who has read Keynes's work carefully can find him favoring policies to boost consumer spending. He opposed them throughout his life. As late as 1943, he wrote to his Cambridge colleague, James Meade, disagreeing with Meade's proposals to encourage consumer spending by giving temporary tax relief. A return of taxes on which people could only rely for an indefinitely short period, he said, would have very limited effects in stimulating consumption. Milton Friedman and Franco Modigliani later earned Nobel prizes in part for independently developing this theme.

In his 1921 *Treatise on Probability*, Keynes highlighted uncertainty, the "unknown unknowns" long before Secretary Rumsfeld used the term. He never changed his mind about uncertainty as a reason for changes in investment spending and economic activity. As early as the 1928 election in Britain, Keynes argued that in periods of recession and slow growth, policy should encourage capital spending. In his words, "Generally speaking, the indirect employment which schemes of capital expenditure would entail is far larger than the direct employment...the greater part of the employment they provide would be spread far and wide over the industries of the country...[T]he greater trade activity would make for further trade activity; for the forces of prosperity like those of trade depression work with a cumulative effect...In the economic world, 'coming events case their shadow before'." He never said the same about consumer spending.

Keynes would have eagerly endorsed the Kennedy-Johnson tax cuts or the Reagan tax cuts that permanently reduced corporate and high marginal personal rates. They changed incentives and reduced uncertainty about future tax rates and thereby increased business investment. And he warned the proponents of large, persistent budget deficits not to favor persistent deficits. His student, protégé and later colleague, Richard Kahn, wrote that Keynes's *General Theory* advocates deficit finance in only one place and only if other means fail. Keynes favored temporary deficits to replace private investment, but he opposed permanent deficits.

Uncertainty is always with us, but Obama administration policies and statements heighten the problems that businesses see. The president used anti-business rhetoric in his election campaign, campaigns for higher tax rates usually without mentioning specific rates, and raised health care, energy and other costs without limiting the increases. Generations of managers learned to choose investments by estimating the value of future costs and revenues have no idea what the costs will be. They wait, holding on to cash. Uncertainty reduces investment, as Keynes believed. And much of the U.S. private sector investment in this recovery adds labor-saving equipment and computer programs to increase output by increasing worker productivity without much new hiring. High unemployment continues.

I do not claim that the stimulus policies were useless. But it must be obvious that they are inadequate. My main criticism is that we have long-term problems that require implementing the kind of consistently stable, expansive policies that reduce uncertainty about spending, taxes and regulations. I am sure from what they say that some see benefits in higher tax rates and increased regulation. They should not ignore the heavy costs of prolonged high unemployment and growing despair that uncertainty about taxes and regulation engender.

An Earlier Sluggish Recovery

Historical comparisons are never precisely accurate descriptions. Yet the current recovery has several similarities to the very sluggish recovery from the deep pre-war 1937-38 recession. Like President Obama, President Roosevelt chastised businessmen, in his case, he called them "economic royalists." He tried to pack the Supreme Court. He began anti-trust proceedings against several industries and companies and introduced an unpopular excess profits tax and a minimum wage among other programs that many businesses regarded as hostile or counter-productive. Reported unemployment rates rose. By 1940, at 14.6 percent, they were still slightly above the rate in 1937, when the recession began. Now as in 1938-40 investments and unemployment lagged and recovery was slow.

See Table 1

President Roosevelt's anti-business rhetoric and action ended with the war. War brought an overriding goal and an end to political infighting that united the country.

Business men are not always right, of course, but we have learned that attitudes and expectations matter greatly. Short-term policy actions that heighten uncertainty will not restore output to its long-term growth path. It is past time for a bi-partisan policy to increase business investment spending and a long-term program to reduce future deficits. The slow recovery and inept policies reinforce rampant pessimism and prolong high unemployment. A better future depends on leadership on both sides that looks well beyond the election. To service our large foreign debt, we must export more of our output and import less. To increase exports, future consumer spending must grow more slowly than in the past.

Table 1

Investment and Employment in Two Slow Recoveries

Year	1937-41		Year	2008-12	
	Gross Private Domestic Investment[a]	Total Wage and Salary Workers[b]		Private Fixed Investment[c]	Total Private Employment[d]
1937	11.8	31,026	2008	2128.7	114,342
1938	6.5	29,209	2009	1703.5	108,321
1939	9.3	30,618	2010	1679.0	107,427
1940	13.1	32,376	2011	1818.3	109,411
1941	17.9	36,554	2012	2000.9	111,826

a/in billions. Economic Report, Jan. 1967, p. 225
b/in thousands. Economic Report, Jan. 1967, p. 242
c/in billions. Economic Report, March 2013, p. 346
d/in thousands. Economic Report, March 2013, p. 378

Almost every current CEO, CFO, or business manager learned as part of his or her MBA to base investment decisions on discounted future cash flows. Current uncertainty about tax rates, healthcare costs, labor regulations, energy costs and finance preclude correct calculation of future costs and cash flows. Most firms hold extraordinary amounts of cash waiting for reduced uncertainty. We cannot eliminate all uncertainty about the future, but we can and should reduce the additional uncertainty created by tax and regulatory policies.

Conclusion

The United States has long-standing real problems that require policy procedures very different from the policies we have. Current policies aim at near-term change. Little if any thought is given to the longer-term consequences. The accumulation of neglect of those consequences and uncertainty about current and future policies is the main reason the recovery is slow.

Economic analysis shows us how to work out of our problems over time. I argue that there is no analytic basis for the policies we have. It is a misreading or probably non-reading of Keynes to claim his work as the model for short-run problems.

Our policies are driven by hope and political pressures, not economic analysis. Some claim that economics has failed. A more correct statement is that policy has been politicized so much that it has lost sight of the economic principles that made America great. Those policies would work well again if applied as part of a constant long-term plan for growth.

Chairman MURRAY. Thank you very much to all three of you.

Dr. Zandi, let me start with you. You stated that you expect lawmakers to come together at the last minute because the failure to do so would, and I quote, have dire economic consequences, and I think that is a very sensible and rational position for anybody to assume that those of us who are in elected office and sent here to do everything we can to avoid inflicting harm on our economy and on our constituents would do everything we could to do that. But I just—I worry because there seems to be a lot of dysfunction and unwillingness to compromise here today, and I think many people need to really understand what the impacts of that is.

And I wanted to ask you, really, the question that was posed by this hearing, to talk about the uncertainty that we create here, how it impacts people. So let us start with the debt limit and what it would mean for the United States to default, and for all of our viewers who are watching at home here today, maybe if you could describe for them what a default on our debt would mean to them and their families and what they would see at home.

Mr. ZANDI. Sure. If we breach the debt limit, and that looks like, under reasonable assumptions, it will be in the second half of October, in all likelihood, the Treasury would continue to pay on the debt. They have the mechanism for doing that and I would be surprised if they did not.

However, that would mean that the Treasury could not meet all its other bills, and they are quite substantive. I will give you an example. On November 1, there is a very large Social Security payment that is due. The government would not have enough cash on hand to make that payment. So, in all likelihood, the Treasury would wait for a day, two, three, five, six, seven days, whatever it took to raise the cash sufficient to make the full payment to Social Security recipients. And over time, if this would continue, the lag between the bills that are coming in and the checks that are being cut would increase.

Well, I think if we got into that kind of situation, I think, immediately, there would be panic and bedlam. If Social Security recipients are not going to get their checks, I just think it would be cataclysmic. And, moreover, even global investors who the Treasury said they are going to pay would rightfully question whether that will continue. I mean, are we going to pay global investors, half of whom are foreign investors, before we pay Social Security recipients? Legitimate questions that an investor would ask themselves. So financial markets would be sent into turmoil.

What does this mean for the average American? Well, it means it would be very difficult to get a mortgage. Mortgage rates would rise. It would mean businesses, small businesses, big businesses, would have trouble raising money to fund their activities. The cost of funding would increase and become much less available. It would mean house prices would decline. It would mean stock prices would decline. And it would very quickly mean layoffs and unemployment would surge.

And as I said in my oral remarks, there is no policy response to that, none, as we all realize the Federal Reserve is at the end of its rope. How would it respond? And, by definition, you all would not be responding, by definition. So it would be an incredibly dark situation and on par with the Great Recession, maybe even worse, depending on how things played out.

So, we just cannot go down that path. It is opening an economic Pandora's box, literally.

Chairman MURRAY. Okay. Thank you very much for helping us understand that.

The debt limit crisis is the most recent and perhaps the most obvious example of uncertainty, but it is not the only one. Over the last few years, Congress has repeatedly taken the nation from one crisis to the next with brinkmanship. I mean, the best example I have is the budget we passed out of here in the Senate and the House passed their budget and we have been waiting for almost six months now to be able to go to conference to let the country know where our investments are going to be made and what our priorities are and how we are going to manage our budget.

I have to say that some of our Republican colleagues here in the Senate have been pretty clear about why they are blocking that. They oppose any compromise. They have said it on the floor. They say they do not want to compromise even with the House Republicans and they wanted this brinkmanship that we have today on the budget and raising the debt limit. They seem to believe that solving some problem by pulling the government and the economy from one crisis to another is the way to go.

But I wanted to ask any one of you—Dr. Stone, let me start with you—is not the problem Congress and sort of the one-two punch of brinkmanship and austerity that threatens our economy and economic recovery and jobs and global position?

Mr. STONE. Well, Congress has the power of the purse. They have responsibility over the debt, over government borrowing, and over spending and taxes, and so they are the ones who have to make the decisions. And if the process is not working, it is Congress that needs to make the decisions initially. The President obviously has to go along, but it starts with Congress.

Chairman MURRAY. Does anybody else want to comment?

Mr. MELTZER. Yes. You may be happy to hear, I do not blame the Congress. You are elected by your constituents. What we see—the division that we see in the country is a division in the country. You are sent here, perhaps, to represent the voters in Washington who want one thing. The others, the Tea Party people are sent to represent people who want something very different. And you know that your fate as an elector, as a legislator, depends upon major issues, doing things that your voters—that is where the split is. The split is in the public. Neither side has been able to convince the public that they have the truth.

Chairman MURRAY. Well, Dr. Meltzer, I would not disagree that we come from different constituents. But my constituents tell me consistently that they expect me to come here to sit down with others who disagree with me and find solutions, and that really is why I am so frustrated, is because I cannot do that. I am not allowed to by a few who are holding the budget hostage. So I think that is—

Mr. MELTZER. I certainly—

Chairman MURRAY. That is one of the reasons we are where we are.

Mr. MELTZER. I certainly agree with you that compromise—you know, I have been coming here, testifying before various committees since about 1959, before many of the people in this room were born. So I am familiar with governments which have been governments of compromise and governments which fear compromise. In my opinion, that depends on leadership.

Chairman MURRAY. Right.

Mr. MELTZER. The President is the leader of the country. It is up to him to push for compromise. He does not do that. That leaves the problem where it is.

I would like to say one other thing. I do not agree with Mr. Zandi about the dire consequences of a default. The consequences will depend on the size of—there will be consequences, but the consequences will depend upon how long the default goes on. It is not going to go on forever, and it probably will arouse enough reaction from the public that we will, if we do not get the agreement before, we will get it after. And if you look at the previous examples—

Chairman MURRAY. My time is running short and I do want to give Dr. Zandi a quick second to respond. Even the discussion around, we may default, will that have an impact on our economy?

Mr. ZANDI. Sure. It already is. You know, just to be a little bit esoteric here, looking at credit default swap spreads on U.S. Treasuries, they jumped yesterday to 32 basis points. For context, a week ago, they were at five basis points. At the height of the July—August 12 shutdown, they were at 80 basis points. So we are already on our way.

And I disagree incredibly strongly with the notion that breaching the debt ceiling would not have major catastrophic consequences. We had one technical default on Treasury debt back in 1979. It was a mistake. It centered around a budget debate, but it was a mistake. Some individual investors did not get their money on time. The academic research clearly shows that that has cost us tens of billions of dollars, that one little mistake, and they got paid right back with interest and were made whole. But because of that, it raised the interest costs. So we are playing with real fire and it would not only do damage to the economy, it would be very counterproductive for the budget long-run, not just next year, but for decades to come.

Chairman MURRAY. I have gone way over my time limit. I need to turn it over to Senator Sessions.

Senator SESSIONS. Well, thank you.

Well, we have had these crises before and we bounced back rather rapidly, Dr. Zandi. And I would note with regard to debates, maybe Dr. Meltzer would recall, but it seems to me that a showdown over the debt ceiling resulted in Gramm-Rudman being passed. It resulted in the Balanced Budget Act of 1997. It resulted in the Budget Control Act of 2011, all of which, I think, had, over the long term, positive results for the American economy.

And there are a lot of reasons out there that we have uncertainty in our economy, and it is not because we refuse to change—some of us want to change the debt course we are on. That is not the only thing that is hurting the economy.

Dr. Meltzer, is it not true that the uncertainty over the Obamacare health care thing is impacting employment and businesses in a rather significant way in America today?

Mr. MELTZER. Yes. I mean, even the labor unions have indicated that Obamacare is hurting the 40-hour week as it is. I mean, as you pointed out in your opening remarks, a great part of the jobs that are created are temporary jobs. One of my children, a chef, was fired. Her employer said to her, "We like your work, we think you are great, but you are going to put us over the ceiling, so we have to get rid of you so that we will be below the ceiling." That is just one example. It is happening every day to people in the real world.

Senator SESSIONS. Last week, the Environmental Protection Agency announced dramatic new CO2 regulations that have been interpreted to be the death of coal. Does that create uncertainty, Dr. Meltzer?

Mr. MELTZER. And cost. It creates cost. The administration does things that they believe are probably good things to do, but that they increase the power of labor unions. That is a no-no for businessmen. They may be right or wrong, but it has an effect on the attitudes that they have.

I read you the list of things that the Harvard Business School graduates who are in positions to make these decisions, what they listed. They listed regulation as one of the main things, uncertainty about tax rates. I mean, all those things are—and the poor education system in the United States. Those are things which we really need to do something about and we do not do it.

Senator SESSIONS. Dr. Meltzer, in your long and very distinguished career, do you think that the $1 trillion extraordinary deficits we have been running for the last four, five years are creating economic uncertainty?

Mr. MELTZER. Oh, of course. I mean, there may have been a time in the past when people thought that deficits would be self-financing in the longer term, but that time is long past. So now, people see $1 trillion deficits, higher tax rates, higher tax rates that fall on those people who have to invest. And that is what was lacking in 1938 to 1940. That is what is lacking now. It is the investment part of the economy that is the slowest part of the economy. And to add to that, when they invest, they invest in robotics, labor-saving technologies like computing.

Senator SESSIONS. Well, thank you.

Dr. Zandi, the uncertainty out there, I know, has some basis in fact and we need to work our way through the difficulties that we have without breaching the debt ceiling and without having to extend the CR, if it is at all possible. But sometimes these events provide the only opportunity to get a discussion going and to make changes of a significant nature.

We thought we had a real opportunity to fix long-term entitlements in the 2011 Budget Control Act process. It did not occur. But we did get, over ten years, a reduction in the growth of spending from growing $10 trillion to growing $8 trillion, approximately, and I think that was long-term positive for the country.

This chart up there is Stanford University's daily news-based economic policy uncertainty moving average, and if you look to the far right, where we are today, it is right at the normal level, at 100 on that chart. We have had spikes repeatedly, but it seems to come back down. So we have had some spike and down and spike and down. It is preferable that we reach an agreement and that we make some compromises.

And, Chairman Murray, I would just note that the President has said he will not even discuss changing one tittle in his health care law, and you can do anything—we can cut the—Congress can fail to fund it and he will veto it. He will not accept it. He will not talk about anything to avoid the debt ceiling when, in the past, we made historic reforms leading up to the debt ceiling. It seems to me that the President ought to be leading, as Dr. Meltzer said, and helping us to reach an accord on some of these issues where we can make some improvements.

And everybody knows the health care bill is a train wreck. It is not working. It is not going to work. We cannot even discuss, have votes in the Senate, have our colleagues vote on how to make it better to deal with at least some of the problems? Slam the door. Harry Reid, the Majority Leader, none. And so if there is a problem, I suggest it is on both sides.

Chairman MURRAY. Well, thank you, Senator Sessions. I would disagree. The President has made it clear that he will work with us on the law to make it better, but he is not going to repeal it or not fund it.

Senator KAINE.

Senator SESSIONS. Well, he has not—

Senator KAINE. Thank you, Madam Chair.

Just for the witnesses, I kind of want to start with a couple of what I think are simple questions. Maybe they will not be quite so simple, but if I could just get each of you to answer them quickly.

Regardless of the magnitude of the harm, would a government shutdown, under current circumstances, be harmful to the economy?

Mr. ZANDI. Yes. Obviously, the longer the shutdown ensues, the greater the damage.

Senator KAINE. Dr. Stone?

Mr. STONE. Yes.

Senator KAINE. Dr. Meltzer?

Mr. MELTZER. Yes, but if you look at the chart that was up there a moment ago, you see the uncertainty goes up and it comes down again very quickly. So if it is a short period, the damage will be slight. If it is a long period, the damage will be serious.

Senator KAINE. You have all indicated that—again, you can argue about the magnitude of the harm, but that a shutdown under current circumstances would be harmful.

Mr. MELTZER. Of course.

Senator KAINE. Is threatening a shutdown also harmful?

Mr. MELTZER. Not very.

Senator KAINE. Dr. Zandi?

Mr. ZANDI. Yes. I think it adds to the uncertain economic environment and it impedes hiring, investment decisions, and it is a weight, a corrosive—I call it a corrosive on economic growth, yes.

Senator KAINE. And Dr. Stone?

Mr. STONE. It is not as—it is harmful. It is not as harmful as uncertainty leading up to a debt default. The biggest spike in the chart is the debt discussions in 2011. And just as a shutdown only going on for a little while, most of the damage can be undone, a debt default, you cannot undo the damage to the credit rating of the United States.

Senator KAINE. I want to get to debt default in a minute, but just on government shutdown, you all agree that it would be harmful under current circumstances, to some degree, and two of the three of you agree that even threatening a shutdown has some potential for harm.

So, let me go to default. Would a default on the Federal debt under current circumstances, regardless of the magnitude, be harmful to the economy? Dr. Zandi?

Mr. ZANDI. That would be cataclysmic to the economy and to our fiscal situation.

Senator KAINE. Dr. Stone?

Mr. STONE. Absolutely.

Senator KAINE. And Dr. Meltzer?

Mr. MELTZER. Of course, but, you know, you and I both know that major negotiations, people never reveal their favored or willing position until the very end.

Senator KAINE. Well, let me get to that, actually, as the second part of the question. So, if a default would be harmful, how about threatening default, threatening default on our debts? Does that have some harm to the economy? Dr. Zandi?

Mr. ZANDI. Significant negative consequences. I think it already is having an impact. It has had an impact.

Senator KAINE. And Dr. Stone?

Mr. STONE. Yes. Estimates of the economic damage from the 2011 episode show a magnitude of possible damage equivalent to estimates for what sequester is doing.

Senator KAINE. And Dr. Meltzer?

Mr. MELTZER. As you know better than I, the public does not have a high opinion of the Congress—

Senator KAINE. I do know that.

Mr. MELTZER. —so this would just be one other example of the malfunctioning of the legislative process.

Senator KAINE. And would you agree that lack of confidence in an institution like Congress is going to have a negative economic effect?

Mr. MELTZER. Long-term, yes. But if you looked at the chart, you see it has not appeared yet.

Senator KAINE. Finally—

Mr. ZANDI. Could I just make a quick point?

Senator KAINE. Yes.

Mr. ZANDI. Look, I think it is reasonable to have debates about lots of things, but the one thing we cannot debate, that is sacrosanct, is we pay our debt on time. I mean, this was established by Alexander Hamilton on day one of the country and it has reaped enormous benefits for us. If that becomes questioned in any way, that will cost us dearly for generations to come. That has got to be rock solid.

Senator KAINE. So, all three of you agree that the default would have harm on the economy—

Mr. MELTZER. Absolutely.

Senator KAINE. —magnitude depending upon the time, and that two of the three of you agree that even threatening default has a negative economic consequence.

The last thing I will ask you is, is the absence of a budget deal in Congress between the two houses something that has a negative economic effect? Dr. Zandi?

Mr. ZANDI. Yes. Anything that adds to the uncertain economic environment, and this would qualify, is a weight. It is not something that matters in any given day, week, or month, but over a period of time, certainly over the four years of this economic recovery, it has added up to real dollars and cents and real jobs and unemployment.

Senator KAINE. And Dr. Stone?

Mr. STONE. It is certainly a symptom. It is not showing up in interest rates right at the moment, but it is a symptom. It is a longer-run problem. It is not an immediate crisis.

Senator KAINE. And, Dr. Meltzer, absence of a budget deal hurting the economy?

Mr. MELTZER. Absence of a long-term return to a stable budget path. The current crisis is one thing. The longer- term problem is the major problem facing the United States.

Senator KAINE. Okay.

Mr. MELTZER. That is what we should be dealing with.

Senator KAINE. Well, Madam Chair, then, just to conclude, I want to be mindful of the Ranking Member's opening comments and try not to be finger pointing in my conclusion, so let me say it this way.

I do not know of a single Democratic member of the Senate or House who either wants to shut down government or is advocating or threatening a shutdown of government. I do not know of a single Democratic member of the Senate or House who either wants to default on America's debt or is advocating or threatening a default on America's debt. And I do not know of a single Democratic member of the Senate or House who has blocked us from going to a budget conference, which we have been trying to go to for six months ago yesterday.

And I will yield back.

Chairman MURRAY. Senator Portman.

Senator PORTMAN. Thank you, Madam Chair, and appreciate the witnesses today.

We have talked a lot about uncertainty and I concur totally. In fact, I have been all over the State of Ohio in the last couple months because of the August work period, talking to people about uncertainty, and they talk about Obamacare a lot, as you can imagine. They also talk about the national debt and whether we are going to get this thing under control. I think it is a wet blanket on the economy. They talk about the proposals the President has for tax increases, and they do not know if it will happen or not, but they are concerned about additional tax increases, particularly on pass-through entities.

And, of course, they talk about—in Ohio, particularly- -about what is going on with the EPA because of the substantial new costs we are going to have in terms of energy in our State. We are a State that depends on coal for our electricity.

And, of course, uncertainty about the Fed. You know, is QE3 going to continue or not, and what are interest rates going to be, and we have seen that with the market gyrations.

But I have another question for you and it is about something maybe worse than uncertainty, which is the certainty of something bad, and that can also have a negative impact on the economy. And, again, I go back to the debt. We are asking once again for Congress to vote on this debt limit, and I know a bunch of my colleagues on the other side of the aisle think we should not have that vote, that there just should be an automatic increase in the debt limit.

And I would just make the observation that if we look back over the past few decades, the only time Congress has ever made any substantial progress on the debt or deficit—I found one exception, it was for about $30 billion—but has come in the context of a debt limit. And it is interesting. I mean, and the Ranking Member talked about the—Senator Sessions talked about Gramm-Rudman. Dr. Meltzer, it sounds like you were probably there as a senior member of the economic team. But, I mean, this is all that has worked, really. I think about the 1990 deal. I was at the Bush White House then. That was a debt limit discussion, the Andrews Air Force Base discussion.

So, this notion that the President has that he refuses to negotiate on the debt limit, I mean, it is not about negotiating, it is about getting the votes for something that is unpopular. Our constituents do not like the idea that we keep raising the debt limit because they get it. It is like a credit card to them and we have overspent on the credit card and what are you going to do about it? We have to do something on the underlying problem. And so I just think it is irresponsible for the administration to take this position that we are not even going to talk to Congress about dealing with raising the debt limit to historic levels.

Anyway, it seems to me the certainty is as much a problem as the uncertainty, and the certainty is, if we do not do something about it, that we will find ourselves, as Erskine Bowles said at that very table, in the most predictable financial crisis that we have ever faced.

Let me ask you this. If Congress were to raise the debt limit without—without—addressing the underlying problem of spending, doing nothing on it, which is what a lot of folks are recommending, including the President, would that make businesses more or less confident about hiring and investing?

Mr. MELTZER. Less.

Senator PORTMAN. Doctor?

Mr. MELTZER. What people want, what businessmen want, what intelligent consumers want, is a long-term return to the growth path, the stable growth path that we had, say, very nicely from 1985 to about 2003 and 2004. We met, by the way, at the Hoover Institution. It is nice to see you.

Senator PORTMAN. Oh, yes. Nice to see you again. You asked me a tough question there, so I get to ask you a tough one.

[Laughter.]

Mr. MELTZER. That is fair enough.

Senator PORTMAN. Well, look, I think—and I want to hear Dr. Stone and Mr. Zandi on this, too, but I think that is the question that we are kind of facing here on the debt limit. Are we going to do anything? You know, it is not whether we are going to do Simpson-Bowles. Unfortunately, we are beyond that now. We are not looking at a grand bargain, but at least a bargain or an agreement or something on the spending side—

Mr. MELTZER. That moves you in the right direction.

Senator PORTMAN. Moves us in the right direction, and we are living through the weakest economic recovery, really since the 1920s, if you look at it in terms of GDP or jobs. I know there are lots of reasons for that that have to do with the global economy, but one of the reasons, in my view, is we are not addressing this problem.

But, Dr. Zandi and Dr. Stone, do you want to address that question? If we did nothing on spending but simply extended the debt limit again for a year or two years, would that make businesses more or less interested in investing and creating jobs?

Mr. STONE. I do not think raising the debt ceiling with no conditions attached would be more disruptive than continuing to squabble over it. Congress has enacted—

Senator PORTMAN. That is not the choice I gave you, though. It is, do you do something on spending or not when you raise the debt limit? Which would be better for the business environment?

Mr. STONE. Raising the debt limit.

Senator PORTMAN. And not doing anything on spending?

Mr. STONE. If that is the choice, yes.

Senator PORTMAN. So you would not see any reductions in spending as appropriate in the context of a $17 trillion- -

Mr. STONE. Well, I thought the choice was raising—

Senator PORTMAN. CBO has sat at that very table and told us that the health care entitlements alone are going to go up 100 percent in the next ten years, a hundred percent. Is that sustainable?

Mr. STONE. I agree completely that we need to address our long-term fiscal challenges, but they are not the issue right now. The uncertainty around the debt ceiling—

Senator PORTMAN. So does S&P, by the way, and when we had the downgrade, what did they say? They said, you guys have to deal with this. They said mid-term, but they also are concerned about the long-term, obviously. But we have got to do something about the underlying problem. And they indicated most recently, and Fitch indicated, in the absence of an agreed and credible mid-term deficit reduction plan that would be consistent with economic growth, the current negative outlook is likely to be resolved with a downgrade later this year, even if the debt ceiling—

Mr. STONE. A deficit reduction—

Senator PORTMAN. —even if the debt ceiling is averted. That is Fitch.

Mr. STONE. A deficit reduction plan. But you did not give me any deficit reduction plan. You gave me an "only cut spending" deficit reduction plan—

Senator PORTMAN. Yes. I said—

Mr. STONE. —and that is what you have to do, and—

Senator PORTMAN. I said, reducing spending.

Mr. STONE. Well, that is—the deficit reduction could also include increasing revenues judiciously, and that is what the IMF was—

Senator PORTMAN. Let me quote Mark Zandi on that in his testimony today. Tax increases and government spending cuts over the past three years have put a substantial drag on economic growth. So, look, we have just raised taxes over $600 billion. We also have another trillion in Obamacare. And if we do not deal with the spending problem, look, it is not ideology, it is math, and CBO, again, has sat at this very table and talked to us about this. We know that spending as a percent of GDP continues to go up dramatically. We also know that taxes as a percent of GDP levels off just above the historic average, 19 percent.

So, anyway, thank you, gentlemen. I am over my time.

Chairman MURRAY. Senator Whitehouse.

Senator WHITEHOUSE. Thank you. This is a lively hearing with very different views being expressed.

I have to, I think, push back at the Ranking Member's suggestion that everybody knows the health care bill is a train wreck. I can assure you that if you are a parent of a child who is coming up on 26 and is able to stay on your health care and not be out there uncovered, that is no train wreck for you. If you are a parent of a child who has got a preexisting condition and you either could not get insurance for them or you could never move your job, because as soon as you move, they would become uninsurable and you would have to make them a ward of the State or spend down to Medicaid in order to do that, for a family like that, this is no train wreck at all. For a senior who has saved, on average, over $1,000 by closing up the doughnut hole, that is no train wreck for the seniors.

And, frankly, I think that when we get the insurance exchanges up and going, that is just stuff that we usually agree on, unless you put the name Obamacare on it. Then, suddenly, it is controversial. But if you took the name off, we agree on real markets. We agree on real prices in real markets. We agree that the product should be transparent. We agree that you should not get special deals. You should be able to sign up for what is there. That is what this does. It creates an open, transparent market in which you have to post your real price, in which a small business can get the same deal as a big business and it is not all done in the back room at the insurance company. If you did not call that Obamacare, everybody in this country would think that was a good idea.

So, I have to dispute the proposition that at least everybody knows the health care bill is a train wreck. I think—

Senator SESSIONS. Well, you responded. That was the statement of the Democratic Chairman of the Finance Committee, who worked with the bill. He is calling it a train wreck. And I would just note that with regard to your view that it is moderate reform, Harry Reid just recently said, the Majority Leader, that this is the beginning of a single payer for health care in America, and it is a big deal and the American people do not favor it.

Senator WHITEHOUSE. Well, I am a fellow who would like to go to single payer, so that comes as no threat. But this is not that. The single payer that we have now is the Veterans Administration. We take the people we care the most about in this country, we take the people who have put their lives at risk for us, who have worn this country's uniform, who have gone under arms under its flag and we give them the best we have to offer, and guess what it is. It is single-payer government-run health care. That is the best—

Senator SESSIONS. Well, I think it is good that you have acknowledged that. The President, of course, has yet to acknowledge that.

Senator WHITEHOUSE. So, I do not think there is any shame in a government-run health care program. I think we give it to our best.

I also think it is a little bit unfair to say that we do not want to do anything about the debt when we have put $2 trillion of spending reductions into law—$2 trillion of spending reductions into law—and on the other side of the aisle, people are still defending, on the revenue side, letting hedge fund billionaires pay lower tax rates than brick masons, letting oil companies get away with huge multi-billion dollar subsidies that they visibly do not need because they are the most profitable companies in the history of the planet, letting companies still get tax benefits for offshoring jobs outside of our country, and letting people at high incomes not contribute into Social Security and Medicare the way regular families do.

So, you know, I think you have got to be a little bit cautious about saying that we do not want to do anything about it. I think we have given and given and given and given again and find it hard to understand some of the things that the Republicans will not put on the table.

Dr. Stone, you said that—in your testimony, and I think we have sort of addressed this—experience from the 2011 debt ceiling crisis suggests that debt ceiling brinkmanship is costly, even if a last-minute deal is struck. By that, you mean that once you take the debt ceiling hostage, there is harm in just doing that. You do not actually have to shoot the hostage. It is obviously worse if you shoot the hostage, but just taking the debt ceiling hostage is bad, correct?

Mr. STONE. Yes. A hostage crisis creates the problem.

Senator WHITEHOUSE. And you say, also, the idea that cutting government spending in hopes of stimulating economic activity, according to the IMF, so-called, what you called "expansionary austerity," is invalid. Cutting spending in a weak economy reduces output employment and the effects are powerful. Could you—that is your own testimony, but could you put it in the light of what we are seeing in Europe, where austerity was applied, and in the light of the fiscal multipliers that we have seen recently that show substantial economic expansion beyond just the amount of the immediate spending.

Mr. STONE. Right. The statement that you quoted is from the International Monetary Fund and it was talking about how, looking at what has actually happened—we had a debate a few years ago about whether cutting the budget deficit in the short-run was going to be good for the economic recovery because of claims that uncertainty over the debt was the most important thing rather than weak demand in the economy. And the IMF's reassessment, based on the European experience, which is even worse than ours, and on our experience, is that the expansionary austerity argument in the context of countries like the United States and the major European countries is—I think the technical term would be "bunk." I said "invalid" to be polite in the testimony.

And so in both cases, you have a problem with the monetary authority not being able to do very much because interest rates are so low, and, therefore, the multipliers are larger in a positive and a negative direction. When you cut government spending, the ripple effect through the economy is bigger than in an economy with fuller employment or an economy in which the Fed could cut interest rates to offset the effect. It is worse in Europe, but it was bad here.

Senator WHITEHOUSE. Thank you.

Chairman MURRAY. Thank you. Thank you very much.

Senator BALDWIN.

Senator BALDWIN. Thank you, Madam Chair.

I am very pleased that you are having this hearing and apologize for my tardiness. One of the responsibilities of a first-year Senator is to preside from time to time on the floor and that is what kept me from hearing your opening remarks. But a very similar debate, at least among the Senators, was beginning to unfold on the floor of the Senate earlier today as I was presiding and the debate on the continuing funding resolution was beginning.

And, as I mentioned, I am a first-year Senator, so I just got off a campaign trail in the last year, and I remarked over and over again during that time in the State of Wisconsin about just how hard the people in my State are working to recover from the devastating recession, deep recession, and how much harder they have to work because of these manufactured fiscal crises, you know, so many working two jobs, so many happy to have gainful employment at all, but it is not what they were making before the recession hit. I mean, it is incredible grit that I am seeing, and I wanted to come here and see us in the Congress match that grit with a commitment to get out of these situations like the one that is unfolding right now.

You know, I think certainty and predictability and responsibility are also American values that we have got to return to, and so against that backdrop and against the commitment that I made to fight to strengthen the middle class, regrow the middle class who has taken such a battering in recent years, I wonder if you can talk a little bit—if you feel expert enough to talk about how this impacts—this uncertainty, the prospect of a shutdown, the prospect of a default, the continuing weight of the sequester—impacts the middle class, perhaps as distinct from the top one percent and the working poor. Especially, I just ask that in light of seeing how hard my constituents are working to recover from such a difficult economic situation.

Why do we not go from right to left and start with you.

Mr. MELTZER. Thank you, Senator. You know, it is not hard to see how a compromise could be reached. The President would have to give up tax increase. The Tea Party would have to give up the end of Obamacare. That would be the beginning of a compromise. That is not so hard to realize.

Senator BALDWIN. I guess I want to know, in terms of the impact of a shutdown or a default, how it affects especially our struggling middle class.

Mr. MELTZER. Not terribly, if it is short.

Senator BALDWIN. Mr. Stone.

Mr. STONE. It weakens an economic recovery that has already been weak and is not delivering for the people you are asking about.

Mr. ZANDI. Just to be specific, if the government shuts down, you cannot get an FHA loan. Many middle-income households are very reliant on the FHA in the current context to get a loan. You cannot do it if the government is shut down. You cannot get a student loan. Many middle-income households are desperately reliant on student loans to send their kids to college. You cannot do that. You cannot get an SBA loan, a small business loan, and many middle Americans own small businesses, right? In Wisconsin, many small businesses are key to the middle class. Courts would be disrupted. Travel and tourism destinations would be disrupted.

You know, in the grand scheme of things, it is no big deal. But in the context of the hardship that these folks have been struggling with, it adds up, right. I think the uncertainty hurts so much in the current context because we have been through the wringer, right? I mean, the recession has been debilitating psychologically on everybody and we are nervous and we are scared and we get spooked by even the little things.

And so if we start talking about defaulting on the debt, if we start contemplating the possibility of not making Social Security payments, Medicare, Medicaid payments, even if it is not going to happen—and I cannot imagine you would allow that to happen, I just cannot see that—that hurts. That scares people. And, again, you know, because they have been put through so much. So why go down that path when, at the end of the day, we know what you are going to have to do? You are going to have to raise the debt limit and fund the government. There is no other option.

Senator BALDWIN. Thank you.

Chairman MURRAY. Well, thank you very much.

I want to thank all of our colleagues who participated today, but I especially want to thank our witnesses for your testimony and your responses. I cannot think of a more important topic, and as I said at the outset, we have to end this constant uncertainty and governing by crisis. It really is putting our economy at risk and our families and our businesses and our communities, as you have outlined. So, thank you to all of you for your testimony today, and—

Senator SESSIONS. Madam Chair, could I ask one question of Dr. Meltzer on a slightly different subject?

Chairman MURRAY. If you can do it fairly quickly.

Senator SESSIONS. Dr. Meltzer, I believe we have a chart on the Federal Reserve. You have written about the Federal Reserve. You have been a student of it for longer than—

Mr. MELTZER. Forever.

Senator SESSIONS. —any other person. I notice that their projections—this was in the Wall Street Journal. It is something I have looked at with regard to the Congressional Budget Office. They have overestimated growth. Here, this chart shows that for every single report from the Fed beginning in April of 2011, and then they projected an average of 3.9 percent growth for 2013, each year, they had to reduce downward their projection for 2013 growth, and just September 18, they came in at 2.15, almost half what they have projected.

I guess I will ask you two things. We in the Congress are a bit intimidated by the Fed. We tend to accept everything. People tell us we have to accept what they say is—

Mr. MELTZER. Do not do it.

[Laughter.]

Senator SESSIONS. Do not accept everything they say.

Mr. MELTZER. The Constitution gives Congress, that is, the right—the concern for monetary policy. Article I, Section 8 makes you. They are your agent. You are the principal.

Senator SESSIONS. Well, and this chart, in 2011, April, I mean, they studied the consequences. They knew what their policies would be. They knew we were passing a stimulus bill and so forth. But they missed it dramatically. They missed—they were inaccurate. What—

Mr. MELTZER. Yes—

Senator SESSIONS. That causes me to wonder if they are as smart as they pretend to be sometimes.

Mr. MELTZER. Yes. Briefly, I have written for many years, and my presidential address to one of the associations, economic associations, is all about the fact that economics is not the science that gives you good and quarterly forecasts. There is no such science. We do not know how to do that. Just as weather forecasters do not know how to tell you what the weather will be with great accuracy, doctors do not know how to tell you who is going to get the flu, economists cannot tell you what the next quarter is going to be with any great accuracy. The Fed is about as good as anybody else, but nobody is very good. The average error over time is about equal to the average growth rate.

Chairman MURRAY. Dr. Zandi, do you want to respond?

Mr. ZANDI. No. He is a legend. I am not going to respond.

Chairman MURRAY. All right. We will let it end with that. All right.

Mr. MELTZER. Thank you.

Chairman MURRAY. Well, as a reminder to all of our colleagues, additional statements and/or questions for any of the witnesses from today's hearing are due in by 6:00 p.m. tomorrow, to be submitted to the Chief Clerk.

And again, thank you to our witnesses for participating.

Mr. MELTZER. Thank you.

Chairman MURRAY. The hearing is adjourned. [Whereupon, at 3:53 p.m., the committee was adjourned.]

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