# THE PRESIDENT'S BUDGET: FISCAL YEAR 2005

## HEARING

BEFORE THE

## COMMITTEE ON THE BUDGET
## HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

HEARING HELD IN WASHINGTON, DC, FEBRUARY 3, 2004

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# THE PRESIDENT'S BUDGET: FISCAL YEAR 2005

**TUESDAY, FEBRUARY 3, 2004**

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

The committee met, pursuant to call, at 2:14 p.m., in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Shays, Gutknecht, Thornberry, Toomey, Hastings, Schrock, Brown, Putnam, Wicker, Franks, Garrett, Barrett, Hensarling, Diaz-Balart, Crenshaw, Tancredo, Portman, Spratt, Moran, Baldwin, Moore, Capps, Thompson, Baird, Emanuel, DeLauro, Ford, Scott, Cooper, Edwards, Majette, and Davis.

Chairman NUSSLE. The Budget Committee will come to order. This is a hearing on the President's budget for fiscal year 2005.

We are very pleased again today to have before us the Director of the Office of Management and Budget, Josh Bolten, and the Honorable Gregory Mankiw, who is the Chairman of the Council of Economic Advisers; and I understand it is your birthday today, so "happy birthday." Do you need a CBO score to determine your age or anything like that before we start?

Mr. MANKIW. I will ask Josh about that. He is in charge of all the numbers.

Chairman NUSSLE. Up here on the Hill we believe CBO is in charge of all the numbers, just so you are clear about that.

We also have another announcement that I am pleased to make and this is, right, there is obviously somebody for everybody in the world because the staff director for the minority side, Tom Kahn, is engaged to be married. So congratulations. There is somebody for everyone, as they say, knowing Tom as well as we all do.

No, we are very pleased for you and we wish you the best of luck as you move forward. Congratulations.

Now we have got all of the fun out of the way, we can get down to some of the things we came to talk about. And I know we are meeting today in an air of concern, as we should be, about the Federal budget deficit. We are all concerned, as we move forward from this point, with exactly how we are going to deal with it.

But I do not want to get off on the subject of deficits just yet because, while we are all concerned about the Federal budget deficit today, we are not going to shy away from some of the other deficits that we have out there in the country.

When President Bush took office, we believe he had a security deficit in this country—a homeland security, national security deficit. We also believe that there was an economic growth deficit. In fact, he inherited a recession we had to do something about. Certainly it manifested itself very dramatically in the years after President Bush took office.

But before we talk about only the financial situation of the budget, we do, I believe, have to hearken back to how we got to this situation and the fact that there were deliberate choices made by this committee on both sides with votes that we are glad to advertise to reduce taxes, to increase defense spending, and to protect the homeland and to deal with national emergencies that have gotten us to this situation.

So before we start talking about where we are today, we do need to remember that part of how we got to this situation was because of other deficits that needed to be taken care of first in order to protect this country and make sure that people were working again.

The budget that the President has proposed is not going to meet everybody's likes or dislikes. There is always something in it for everybody and there is always something in it that people can disagree with. The choice of this committee, as we move forward, is to come together and to come up with a fiscal blueprint that addresses the needs of our economy, that addresses the needs of our national security and can do it in a fiscally responsible way to get us back on track.

The President has laid out an agenda of strength, of growth and of opportunity for the future—strength of our Nation because we have to be strong if we are going to be free. We can't be free unless America is strong, so we have got to be free, and we want to be strong in order to preserve that.

Secondly, America cannot provide the opportunities for our future if America's economy is not growing, creating jobs, providing opportunities for our kids in the future; and we knew that whether it was the Federal budget or the budget that families have to balance around their kitchen table every night in Iowa or across the country that you need a job in order to get that done. And while every economic indicator is pointing in the correct direction right now for economic growth, there are still too many people out there who, tonight, around their kitchen table with their spouse and their kids, are trying to figure out how to pay their bills, because they do not have a job.

So we have to maintain a continued vigilance in making sure the economy grows. And we want to make sure that we do not raise taxes in the budget that we put forward, and so that will also be a hallmark.

Finally, with regard to the budget, we need to, I believe, control spending. It is the one port in the storm that we can hold on to. It is the one thing we can control.

Numbers will go up, numbers will come down. All sorts of things are outside the control of this committee, but there is one thing that we know for sure; and that is, we can, if we determine that it is important enough, control spending, not only in the 17 percent that the appropriators like to remind me is the portion that seems to always get the attention, but across the board in defense, in homeland.

We shouldn't be wasting one penny; one dollar should not be wasted in those programs. And we know that there are opportunities out there to make sure that those dollars are being spent wisely.

So we are going to look in every nook and cranny of the budget in order to make sure that we can find savings, ways that we can root out waste, fraud, and abuse; and we are going to continue to be vigilant in controlling spending because, for us, cutting deficit in half is an important goal. In fact, I am unaware of anybody who has got a better goal to meet right now.

But we know that this long journey toward cutting deficit in half in 5 years—while a 5-year journey can start with the first step today, and that is by controlling spending in this budget. It doesn't matter what we are projecting for next year if we can't cannot get our job done this year.

So this year's budget, as we look to the future, has got some work cut out for it. The President has proposed, as Director Bolten has identified in his budget, 65 programs that can be eliminated, another 63 that can be reduced. There are a number of suggestions that are good, that we should pay heed to on the discretionary as well as the mandatory side.

But as we move forward, we have to also look at ourselves in the mirror. We have a transportation bill coming to the floor here. In fact, as I understand it, the Senate, the other body, just passed a bill the other day that has already gotten a veto warning from the President. If we cannot control the spending this year, 5 years is somewhat of an irrelevant goal. We have got to do what we can right now.

So I think the proof will be in what we are able to do now, not just what this budget looks like 5 years from now.

One other thing I wanted to mention, because it has come up and I want to put it into the record, there has been some discrepancy over numbers already on Medicare and a few other instances, and I just want to get this out. I have had an opportunity to communicate with the Congressional Budget Office. They have sent me back a letter indicating that while there might be all sorts of different predictions, prognostications, and projections for what the budget may look like in the future, the Congressional Budget Office has done its research, has done its work on the Medicare bill. It did it back when it passed.

It has taken another fresh look at it, and in its operative sentence here—I will read it for you—it says, "To date, we have not received any additional data or studies that would lead us to reconsider our conclusions. Therefore, CBO believes its estimate is sound and has no reason at present to revise it." Medicare is going to be scored by CBO and CBO numbers are going to be the ones that control determining the size of the Medicare bill.

Does that mean that we are not going to have to provide oversight to Medicare? Absolutely not. We have got to provide oversight to Medicare just like we should for food stamps and other mandatory programs that are out there. We should push in our other committees that we serve an effort to ensure that are we, as authorizers or appropriators, provide the oversight on a regular basis. But at least, to start with, CBO is firm on the fact that we have good numbers to use.

While it is interesting that there are other people making predictions, those numbers are probably wrong almost the date that they are put out. And we are going to have to provide constant vigilance to make sure that that program stays within its means and meets the needs of seniors the way we did this last year when we provided a voluntary drug benefit under Medicare for the first time ever.

We have got a lot of work to do, and I know that this is going to be a lively discussion, as it almost always is. We have some important work to do that begins today. But again I believe that the most important thing we can do this year to set us on the right course is to make sure this budget provides that America is strong, that our economy continues to grow, and that we have very detailed provisions to control spending now—not just 5 years from now, but today in this budget.

With that, I would be happy to yield to my friend, Mr. Spratt, for any opening comments he would like to make.

[The prepared statement of Mr. Nussle follows:]

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

Good afternoon, and welcome to this Budget Committee hearing concerning the President's budget request for fiscal year 2005 certainly one of the most important we'll have all year.

Today I am pleased to welcome Josh Bolten, director of the administration's Office of Management and Budget, and Greg Mankiw, chairman of the President's Council of Economic Advisors.

Yesterday, President Bush submitted his fiscal year 2005 budget to Congress. And in the usual flurry of quick judgements and half-information, some of the basic points of the administration's request got lost. So let's review the priorities set by this request priorities I believe are supported by the vast majority of Americans, and the vast majority of this Congress.

They are: One, protect our homeland; two, ensure that the United States has the world's most superior defense; three, keep our economy growing and creating jobs; and four, do all of this while at the same time ensuring that we're getting ourselves back on the path to fiscal restraint and reduced deficits.

These without question are the most urgent priorities of this nation, and they will certainly be the top priorities of our congressional budget.

But there is one thing I can pin down for you now, and that is that we're going to do whatever we can to ensure the continued growth of our economy and of jobs for Americans. And that means that raising taxes is not even an option. It's off the table. Period.

The President has proposed making permanent the tax relief, and I can guarantee you that we will support that in our budget.

Now to deficits.

We all know how we got here, but let's review now so that we don't have to do yet another run through later in this hearing:

We have large deficits because we deliberately responded to the extraordinary set of challenges of the past few years, including 9/11 and its aftermath, the conflicts in Iraq and Afghanistan, and the economic recession. We did what we had to do, and that meant borrowing money in order to protect the country and strengthen the economy.

How do we get ourselves back on track?

We've already acted on and will continue to support the first piece of this puzzle, and that is promoting a robust economy and job creation.

However, while growth is important, it is not the only answer. We must also get a hold of our out-of-control spending. As I just said, we simply cannot continue to spend like we have been without facing major consequences down the road.

The President's budget sets a plan to cut our current deficit in half in 5 years. Is this doable? I'd say, with a little restraint, absolutely.

I'm encouraged that the President's request continues the effort begun in the House of Representatives last year, when we came up with a list of about $110 billion in wasteful spending that could be reformed, cut or eliminated.

Some of those savings initiatives were included in the President's budget, and I think that's certainly a step in the right direction to get our spending, and thus the deficits, under control.

Now, would I like, and will I look at possibilities to reduce the deficits further, faster? Absolutely. But again, this is a pretty good start.

So today, we'll begin this process of planning our budget by reviewing the President's request, and we'll continue by meeting with several of the President's cabinet secretaries over the next month to get a better idea of what is included in their budget requests.

Again, my first impression of this budget is that it's going to be a good foundation for Congress as we plan our own budget. I am certainly interested, and eager to hear more.

Now, before I wrap this up, I'd like to make a prediction one that I actually hope does not come true.

Just last week, I sat here and once again listened to some of my colleagues over and again claim their grave concern about the deficits. And I truly hope that their concerns are sincere.

But my prediction today is that their concern about the deficits might have a lot more to do with rhetoric than it does with their actual willingness to do anything about them.

I can just about guarantee you that you will not hear these same critics telling us their plans for controlling spending, but for increasing spending. You will also hear, though likely in slightly masked terms calls not for us to spend less, but for the American taxpayers to spend more via tax increases to finance this continued overspending by the Federal Government.

So again, that's my prediction, and I can only hope that it will be proven 1wrong.

With that, I'll turn it over to Mr. Spratt for his opening statement, and then we'll hear from OMB Director Bolten.

Mr. SPRATT. Thank you, Mr. Chairman.

Dr. Mankiw and Mr. Bolten, welcome, both of you. We look forward to both of your presentations today on this critically important matter.

This is the last budget that President Bush will send us during this term of office, and it isn't exactly playing to rave reviews. The lead editorial in the Washington Post today, "The Bush administration's 2005 budget is a masterpiece of disingenuous blame-shifting, dishonest budgeting and irresponsible governing." If I had said that myself, the chairman would have gaveled me down. It is the lead editorial in the Washington Post today.

The New York Times says, "The President's budget is an exercise in election year cynicism." So let us take a look at the last 4 years that this particular budget completes.

When the President came to office in January of 2001, he found a budget in surplus, in surplus by $236 billion in the year 2000 and by $127 billion in 2001, the year he took office. In 3 years, from 2001–04, this administration has moved this surplus to a deficit by almost $650 billion. Back out the surplus in Social Security and the on-budget deficit for this year is $675 billion.

Now the numbers are getting so big it is hard to keep them in relation to something that we can call "reality."

Let me put it in perspective in one way. In 1980–81, when President Reagan took office, the national debt was $711 billion. The sum total of all the debt that the government owed to the public was $711.9 billion. You will incur in your budget this year almost that much debt, this year alone.

Since 2001, you have added about $533 billion to the national debt. Over the next 5 years, you will stack another $2 trillion on top of that.

Let me offer another perspective just to show that balancing the budget is tough, but it is feasible. It has been done. Our claims might otherwise be empty, but in the 1990s we did it. From 1993 to the year 2000, every year for 8 straight years during the Clinton administration, the bottom line of the budget got better, as this chart clearly shows. It went from $290 billion the last year of the first President Bush's office to a surplus of $236 billion in the year 2000.

Every year of this administration, the Bush administration, the bottom line of the budget has gotten worse and worse and worse to the point where this year we will have another record deficit, $521 billion. It is hard to put a pretty face on these figures.

You say that you are reversing course in this budget for 2005. But in effect what you are telling us is that we are going to let the deficit go up by almost 50 percent this year and then over the next 5 years that will leave us—we are going to bring it down by 50 percent.

Now, this budget purports to do that, purports to cut the deficit in half over 5 years, but there are a lot of problems with that particular claim. For starters, this budget doesn't capture all the spending that is likely to occur by your own acknowledgment in fiscal year 2005. For example, it leaves out the cost of deploying 125,000 troops to Iraq and 12,000 troops to Afghanistan. We know what the cost is. We have done it before. We have got cost experience, but there is no estimate of what that cost will be here.

Last year's budget, by the way, left out the same cost, and then after the budget was passed, you sent us two bills. You sent us the cost of the war in two installments, $80 billion in April, $87 billion in October, $167 billion in supplemental spending.

The President told the country just 2 weeks ago in the State of the Union that he would send us a budget in 2 weeks, a budget that, quote, "pays for the war." Those were his words. But this budget doesn't pay for the war.

You acknowledged, Mr. Bolten, yesterday that the cost of the deployments to Afghanistan and Iraq could come to as much as $50 billion. You said that was a ceiling, but that they could rise to as much as $50 billion.

I think both of you would agree that is a major omission, that is a big sum of money even for government work. And I have to tell you, it casts doubt on the claim that you can cut the deficit in half over the next 5 years.

It makes us wary of other sleight-of-hand techniques in this budget: revenues that you claim for ANWR when you know that that idea has gone around the track many times and never crossed the finish line; co-pays and deductibles that veterans must pay for prescription drugs and for enrollment in a veterans hospital—been around before, never made it across the finish line. I could go down, again and again and list things which have been tried before and failed because the policy did not meet with our approval, and yet you are relying upon these revenues with the purported expectation that this year they will pass.

In the absence of any surplus—it is gone; surplus that we thought was there in 2001 was overestimated to the tune of about $3.5 trillion. In any event, what is left of it has been written off to tax cuts and spending increases, but in the face of these deficits, now there is no surplus anymore.

You venture to include $1.2 trillion in additional tax cuts over the next 10 years, but you include almost nothing for fixing the Alternative Minimum Tax, even though the Treasury Department itself has told us that unless we fix the Alternative Minimum Tax, which affects about 2 to 3 million tax filers today, by 2010 it will affect 20 to 30 million tax filers. We know politically it has to be done and yet you request $1.2 trillion in additional tax cuts and include nothing for fixing the Alternative Minimum Tax other than indexing the exempt amount.

Easily, the additional costs there could be $600 billion; and when you adjust the $1.2 billion by that $600 billion, if you fix the AMT and you add interest to it, because if you have more deficits you have got more debt service to pay, it is clearly a $2 trillion item on top of the budget you are proposing. And what you offer as an antidote for that is spending restraints on one-seventh of the budget, nondefense, discretionary domestic spending.

Oddly enough, when you do a budget, ordinarily you look for the spikes in the budget—what has been going up the fastest, what is costing the most—and you try to bear down on them. If you look at these accounts, the domestic discretionary spending accounts, and if you back out international affairs, which is included, and you back out homeland security, they have barely grown, maybe 2 percent over the last 2 fiscal years. So what you are proposing is that we now reduce the rate of growth to 0 percent or maybe a half of 1 percent and that will solve the problem.

You can understand, I hope, why we are skeptical.

We will give you a fair hearing today, but we have to tell you we are deeply concerned about this deficit. We are deeply concerned about where your budget takes us, and we are very, very doubtful, very, very skeptical that it puts us on the track toward cutting the budget in half even if that were an acceptable goal. I would want a more ambitious goal.

So we will have lots of questions to ask you today. What are the programs that you propose to eliminate? What are the tax cuts? Because we share with you the object—we believe that these budgets are simply intolerable and cannot last over time. I don't think the course that you are plotting is sustainable.

And so today there will be lots of questions. We are concerned that this is not a feasible goal that you have laid out because of the conditions you have prescribed for it. I have more questions about it, and that is why I am just cutting my statement short to get to it.

But thank you for coming. We look forward to putting these questions to you. We look forward to working with you, if possible to work out this very, very grave problem for our country.

Chairman NUSSLE. Thank you, Mr. Spratt.

Mr. Bolten welcome back to the committee, and we are pleased your entire statement will be in the record and we are pleased to receive your testimony.

**STATEMENT OF JOSHUA B. BOLTEN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET**

Mr. BOLTEN. Thank you, Mr. Chairman and Mr. Spratt. It is a pleasure to be back before the committee.

Mr. Chairman, I particularly commend you for your statement reminding us if we don't adequately protect the national security, the homeland security, nothing else matters. And I also appreciate your reminding us that we can begin the restraint of spending immediately. That is where the President's budget is headed, and that is why we have presented the budget we have.

The President's budget continues to support and advance his three top priorities: winning the war on terror, protecting the homeland, and strengthening the economy. The President is committed to spending what is necessary to provide for our security and restraining spending elsewhere.

Since September 11, 2001, more than three-quarters of the increase in the Federal Government's discretionary spending has been directly related to our response to the attacks, enhancing homeland security, and the war on terror. The President's 2005 budget continues this spending trend: significant increases in essential funding for our security programs, combined with a dramatic reduction in the growth of discretionary spending unrelated to security. With your support in enacting this budget into law, we will be well on the path to cutting the deficit in half within 5 years.

Mr. Chairman, we find it useful to divide spending in the budget in the discretionary portion of the budget in the way that Mr. Spratt just described, which is to distinguish between defense, the boxes on the left, homeland security in the middle—which, by the way, is not congruent with the Department of Homeland Security. About two-thirds of the Department of Homeland Security is in that middle box, but they do a fair amount of spending that is not homeland security related; and there are also a number of departments that do have important homeland security accounts, like Health and Human Services, Agriculture, the Justice Department have important accounts in that middle group. And then finally the category of nondefense, nonhomeland spending, which you see on the right.

The President's 2005 budget, as you will see in the yellow bars, increases spending by 7 percent to support our men and women in uniform and transform our military. It increases homeland security spending by nearly 10 percent—that is the yellow bar in the middle—to strengthen our capabilities created to prevent future attacks. And it holds the rest of discretionary spending to half of 1 percent—that is the yellow bar on the right that you can barely see—less than half the rate of inflation, while continuing to increase funding for key priorities such as the President's No Child Left Behind initiative.

The President's budget is built on the sensible premise that government spending should grow no faster than the average increase in American family incomes of approximately 4 percent. This budget proposes to hold the growth in total discretionary spending to 3.9 percent and again to reduce the growth in nondefense, nonhomeland spending to half of 1 percent, below the rate of inflation.

In the last budget year of the previous administration, that is, 2001—those are the green bars on the chart—discretionary spending unrelated to homeland security soared by 15 percent. With the adoption of the President's first budget in 2002, that growth rate was reduced to 6 percent and 5 percent the following year, then 4 percent and below 1 percent for the President's 2005 budget presentation. The President's budget builds on the pro-growth economic policies that have laid the foundation for the economic recovery now under way and for sustained economic growth and job creation in the years ahead.

The tax cuts that you and the Congress enacted have been critical to strengthening the economy and creating jobs. Perhaps the best time in American history, these tax cuts deserve much credit for today's brightening economic picture, which includes nine consecutive quarters of positive growth, the highest quarterly growth in 20 years, an 8.2 percent annual rate in the third quarter of this past year, extraordinary productivity growth, continued strength in housing starts and retail sales and encouraging signs of renewed business investment. These indicators suggest that job growth, which is critical, but also typically lags in recovery, should continue to strengthen in the months ahead.

The President will not be satisfied, however, until every American who wants a job can find a job. So this budget supports the President's six-point plan for economic and jobs growth including making permanent the tax relief that has fueled our economic recovery.

The sustained growth that this budget supports will be good news for our budget picture as well. As the economy improves, Treasury revenues will as well.

Mr. Chairman, like America itself, the Federal budget has faced extraordinary challenges in recent years. A stock market collapse that began in early 2000, a recession that was fully under way in early 2001, revelation of corporate scandals years in the making, and of course, the September 11 attacks and the ensuing war on terror. With Treasury receipts only beginning to reflect a recovering economy and major ongoing expenditures in Iraq, Afghanistan, and elsewhere in the war on terror, we still face a projected deficit of $521 billion in the 2004 fiscal year. That size deficit, at 4.5 percent of GDP, is not historically out of range. Deficits have been this large or larger in 6 of the last 25 years, including a peak of 6 percent in 1983.

Under the circumstances that created it, today's deficit is certainly understandable. But that deficit is also undesirable and unwelcomed, and with the enactment of this budget, we will bring it down. With continuation of the President's economic growth policies and sound spending restraint reflected in the budget that we released yesterday, our projections show the deficit will be cut more than half over the next 5 years. You can see that on the chart—our projections on the chart that is on the screen now.

The dramatic reduction begins in the fiscal year of this budget which, Mr. Chairman, you emphasized, 2005, for which we are projecting a deficit of $364 billion, roughly 3 percent of GDP, the rapid deficit reductions continue in subsequent years with our projections, showing the deficit falling to 1.6 percent of GDP by 2009.

This is not only well below half its current 4.5 percent level, it is also well below the 2.2 percent average deficit during the last 40 years; and the black line that you see going across the middle of that chart is that 2.2 percent average deficit over the last 40 years. It is, in our judgment, a reasonable and desirable goal over the next 5 years to bring ourselves well below that 40-year average Federal deficit.

This deficit reduction is the combined effect of economic growth and spending restraint. As the economy recovers, tax receipts as a percent of GDP rise to historical levels by the end of the budget window, while spending restraint keeps outlays flat or slightly declining as a share of GDP. The spending restraint reflected in this budget is not automatic, so we are also proposing new statutory budget enforcement mechanisms, establishing in law limits on both discretionary and mandatory spending and requiring that any increases in spending be paid for by spending offsets.

We plan to transmit legislation to the Congress that has three elements:

First, to reinstate caps on discretionary spending for 5 years, through 2009; Second, a pay-as-you-go requirement limited to new mandatory spending. Any proposed increase in mandatory spending under our proposal would have to be offset by a reduction in mandatory spending; tax increases could not be used as an offset, and pay-go would not apply to tax legislation. Third, measure the long-term unfunded obligations of major entitlement programs and propose a 60-vote hurdle in the Senate for legislation that would expand these obligations.

I know that many members of this committee on both sides of the aisle have expressed interest in these sorts of budget enforcement mechanisms, and I look forward to working with you to gain enactment of these proposals to restrain spending.

Finally, the President is keeping his administration focused on what the American people care most about, results. The measurement of government's success is not how much we spend but rather how much we accomplish. This budget includes a scorecard that measures the progress agencies are making in achieving results so that the government continues to be more and more accountable to the taxpayers.

Since President Bush took office, our Nation has confronted a cascading set of challenges. The President and Congress responded on all fronts—with tax relief to get the economy going, the largest reorganization of the Federal Government in 50 years to create a new Department of Homeland Security, and the largest increase in the defense budget since the Reagan administration—to wage and win the war on terror. The President's 2005 budget builds on this record of accomplishment. With renewed economic growth and the Congress' cooperation in restraining spending and focusing it on our most critical priorities, we can accomplish the great goals the President has set for the country while dramatically improving our budget situation.

I look forward to taking your questions.

Chairman NUSSLE. Thank you, Director.

[The prepared statement of Mr. Bolten follows:]

PREPARED STATEMENT OF JOSHUA B. BOLTEN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Chairman Nussle, Ranking Member Spratt, and distinguished members of the committee, the President's 2005 budget, which was transmitted to the Congress yesterday, continues to support and advance three overriding national priorities: winning the war on terror, protecting the homeland, and strengthening the economy.

The President is committed to spending what is necessary to provide for our security—and restraining spending elsewhere. Since September 11, 2001, more than three-quarters of the increase in the Federal Government's discretionary spending has been directly related to our response to the attacks, enhanced homeland security, and the war on terror. The President's 2005 budget continues this spending trend: significant increases in essential funding for our security programs, combined with a dramatic reduction in the growth of discretionary spending unrelated to security. With Congress' help in enacting the budget we transmit today, we will be well on the path to cutting the deficit in half within 5 years.

The President's budget:

- Increases defense spending by 7 percent to support our men and women in uniform and transform our military to ensure America has the best trained and best equipped armed forces in the world;
- Increases homeland security spending by nearly 10 percent to strengthen capabilities created to prevent future attacks; and
- Holds the rest of discretionary spending to half of 1 percent growth—less than half the rate of inflation—while continuing to increase funding for key priorities such as the President's No Child Left Behind education reforms.

The President's budget is built on the sensible premise that Government spending should grow no faster than the average increase in American family incomes of approximately 4 percent. This budget proposes to hold the growth in total discretionary spending to 3.9 percent and, again, to reduce the growth in non-defense, non-homeland security spending to half of 1 percent, below the rate of inflation. In the last budget year of the previous administration (2001), discretionary spending unrelated to defense or homeland security soared by 15 percent. With the adoption of President Bush's first budget (2002), that growth rate was reduced to 6 percent; then 5 percent the following year; and 4 percent for the current fiscal year.

The President's budget builds on the pro-growth economic policies that have laid the foundation for the economic recovery now underway, and for sustained economic growth and job creation in the years ahead.

The tax cuts Congress passed and were signed into law have been critical to achieving the President's priority of strengthening the economy and creating jobs. Perhaps the best timed in American history, these tax cuts deserve much credit for today's brightening economic picture, which includes:

- Nine consecutive quarters of positive growth through the end of 2003;
- The highest quarterly growth in 20 years—an 8.2 percent annual rate in the third quarter of 2003; and the highest growth for any 6-month period in 20 years as well;
- Extraordinary productivity growth;
- Continued strength in housing starts and retail sales; and
- Encouraging signs of renewed business investment.

These indicators suggest that job growth, which typically lags recovery, should continue to strengthen in the months ahead.

The President will not be satisfied however until every American who wants a job can find a job. So this budget supports the President's six-point plan for economic and jobs growth, including making permanent the tax relief that has fueled our economic recovery.

The sustained growth that this budget supports will be good news for our budget picture as well: As the economy improves, Treasury revenues will as well.

Like America itself, the Federal budget has faced extraordinary challenges in recent years: a stock market collapse that began in early 2000; a recession that was fully underway in early 2001; revelation of corporate scandals years in the making; and of course, the September 11 attacks and ensuing war on terror.

With Treasury receipts only beginning to reflect a recovering economy—and major ongoing expenditures in Iraq, Afghanistan, and elsewhere in the war on terror—we still face a projected $521 billion dollar deficit for the 2004 fiscal year. That size deficit, at 4.5 percent of GDP, is not historically out of range. Deficits have been this large or larger in six of the last 25 years, including a peak of 6 percent in 1983.

Under the circumstances that created it, today's deficit is certainly understandable. But that deficit is also undesirable and unwelcome, and with Congress' help, we will bring it down. With continuation of the President's economic growth policies and sound spending restraint as reflected in the budget we are releasing today, our projections show the deficit will be cut by more than half over the next 5 years.

This dramatic reduction begins in the fiscal year of this budget, 2005, for which we are projecting a deficit of $364 billion, roughly 3.0 percent of GDP. The rapid deficit reductions continue in subsequent years, with our projections showing the deficit falling to 1.6 percent of GDP by 2009. This is not only well below half its current 4.5 percent level, it is also well below the 2.2 percent average deficit during the last 40 years.

This deficit reduction is the combined effect of economic growth and spending restraint. As the economy recovers, tax receipts as a percentage of GDP rise to historical levels by the end of the budget window, while spending restraint keeps outlays flat or slightly declining as a share of GDP.

The spending restraint reflected in this budget is not automatic. So we are also proposing new statutory budget enforcement mechanisms, establishing in law limits on both discretionary and mandatory spending, and requiring that any increases in spending be paid for by spending offsets. We plan to transmit legislation to the Congress that has three elements:

- Reinstate caps on discretionary spending for 5 years through 2009.
- A pay-as-you-go requirement limited to new mandatory spending. Any proposed increase in mandatory spending would have to be offset by a reduction in mandatory spending. Tax increases could not be used as an offset and pay-go would not apply to tax legislation.
- Measure the long-term unfunded obligations of major entitlement programs and propose a 60 vote hurdle in the Senate for legislation that would expand these obligations.

I look forward to working with this committee to gain enactment of these proposals to restrain spending.

Finally, the President is keeping his administration focused on what the American people care about—results. The measure of government's success is not how much we spend, but rather how much we accomplish. This budget includes a scorecard that measures the progress agencies are making in achieving results, so that the government continues to be accountable to the taxpayers.

Since President Bush took office, our Nation has confronted a cascading set of challenges. The President and Congress responded on all fronts, with tax relief to get the economy going, the largest reorganization of the Federal Government in 50 years to create a new Department of Homeland Security, and the largest increases in the defense budget since the Reagan administration, to wage and win the war on terror. The President's 2005 budget builds on this record of accomplishment. With renewed economic growth and the Congress' cooperation in restraining spending and focusing it on our most critical priorities, we can accomplish the great goals the President has set for the country, while dramatically improving our budget situation.

Chairman NUSSLE. Welcome too, Chairman Mankiw. We are pleased to receive your testimony at this time. If you have a prepared statement, it will be made part of the record. You may summarize.

**STATEMENT OF N. GREGORY MANKIW, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS**

Mr. MANKIW. Thank you very much, Chairman Nussle, Ranking Member Spratt, and members of the committee. I appreciate the opportunity to testify on the administration's economic forecast as it relates to the budget for fiscal year 2005.

The administration's economic forecast is a joint product of the Council of Economic Advisers, the Office of Management and Budget, and the Treasury. In developing it, the administration consciously adopts conservative economic assumptions that are close to the consensus of private-sector forecasters.

The U.S. economy made notable progress in 2003. The recovery was still tenuous going into the year. On the one hand, powerful contractionary forces still lingered, the capital overhang, corporate scandals, and uncertainty about future economic and geopolitical conditions. On the other hand, economic stimulus was provided by expansionary monetary policy in the administration's 2001 tax cut and 2002 stimulus package.

Over the course of 2003, the contractionary forces dissipated and the expansionary forces were augmented by the tax relief that the Congress passed and the President signed into law in May.

The economy has gained considerable momentum over the past year. Real GDP increased at an annual rate of 6.1 percent in the second half of 2003, the strongest reading for any half-year period in nearly 20 years. Growth in exports and in business equipment and software investment picked up sharply in the middle of 2003, and the labor market began to rebound. Core consumer inflation declined to its lowest level in decades.

The administration forecasts continued economic recovery with real GDP growth well above its historical average and a further decline in the unemployment rate. Real GDP is projected to increase 4 percent during the four quarters of 2004. On a calendar-year-over-year basis, GDP is projected to increase 4.4 percent this year. Much stimulus remains in the pipeline in the form of low marginal tax rates and refunds on 2003 tax liabilities. Tax refunds are expected to be higher than usual because although last year's tax cuts were retroactive to January, withholding changes generally were not. In addition, businesses can expense 50 percent of their equipment investment through the end of 2004. The lower tax rates, higher tax refunds, and investment expensing included in the Jobs and Growth Act are expected to reduce tax collections by $146 billion in 2004, compared to $49 billion in 2003.

The U.S. economy continues to display supply side characteristics favorable to long-term growth. Advances in productivity have been remarkable. We estimate the growth of the economy's long-run potential to be about 3.1 percent per year. During each of the next 4 years, real GDP is expected to grow faster than its long-run potential rate as the economy continues to recover. In particular, real GDP growth is projected to average 3.7 percent during the 4 years from 2003–07. The administration projects in 2008 and 2009 real GDP will expand at its potential rate of 3.1 percent and the unemployment rate will stabilize at 5.1 percent.

Let me conclude with a few remarks on the relationship between the budget deficit and the economy. It is true that large persistent deficits act as a drag on the economy. It is also true that higher tax rates alter incentives in a way that acts as a drag on the economy. In my view, concerns about the deficit should not be resolved with higher tax rates. Doing so would merely replace one drag on growth with another. Rather, the solution to long-run deficits is continued progrowth tax policy and spending restraint.

The President's tax cuts were designed to encourage work, saving, and investment, the building blocks of economic growth. He has presented a budget with significant spending restraint. These proposals will position the U.S. economy for further strong growth in the years ahead.

I thank you for the opportunity to testify. I look forward to your questions.

Chairman NUSSLE. I thank you for your testimony.

[The prepared statement of N. Gregory Mankiw follows:]

PREPARED STATEMENT OF N. GREGORY MANKIW, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Chairman Nussle, Ranking Member Spratt, and members of the Committee, thank you for the opportunity to testify on the administration's economic forecast as it relates to the President's budget for fiscal year 2005.

As you know, the forecast is a key input into the budget process. The Council of Economic Advisers initiates a macroeconomic forecast twice a year, in the fall for the budget and the spring for the Mid-Session Review. The forecast itself is a joint product of the Council, the Office of Management and Budget, and the Treasury-the administration's economic "troika." The chief economists and staffs from the three agencies work closely together, and then I review the forecast carefully, together with the secretary of the Treasury and the Director of the Office of Management and Budget.

In developing the forecast, the administration consciously adopts conservative economic assumptions that are close to the consensus of private-sector forecasters. This approach provides a prudent and cautious basis for the budget projections.

The outlook for 2004 and beyond reflects the key role of the administration's policies in supporting the recovery and boosting job creation. The administration's policies are designed to enhance U.S. economic growth, not just maintain it.

## 2003: AN ECONOMIC TURNING POINT

The U.S. economy made notable progress in 2003. The recovery was still tenuous going into the year. On the one hand, it was still struggling against powerful contractionary forces-the capital overhang, revelations about corporate scandals, and uncertainty about future economic and geopolitical conditions. On the other hand, it had the benefits of the stimulus from expansionary monetary policy and the administration's 2001 tax cut and 2002 stimulus package. Over the course of 2003, the contractionary forces dissipated and the expansionary forces were augmented by the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), which the President signed into law in May.

The economy now appears to have moved into a full-fledged recovery. The economy has gained momentum over the past year, with annualized real GDP growth increasing from 2½ percent during the first half of 2003 to 6.1 percent during the second half-the strongest GDP growth for any half-year period in nearly 20 years. GDP growth in 2003 was supported by robust gains in consumption, residential investment, and defense spending. Inventory investment declined over the first three quarters of last year but turned positive in the fourth quarter. Growth in business equipment and software investment and in exports picked up noticeably in the second half of the year. The labor market began to rebound in the final 5 months of 2003. Core consumer inflation declined to its lowest level in decades.

## GDP GROWTH, PRODUCTIVITY, AND UNEMPLOYMENT

The administration forecasts that the economic recovery will strengthen further this year, with real GDP growth running well above its historical average of 3.3 percent since 1960 and the unemployment rate continuing to decline. The administration expects real GDP to increase 4.0 percent during the four quarters of 2004. This projection is close to that in the latest Blue Chip consensus economic forecast (as of January 10, 2004). This compares with GDP growth of 4.3 percent during the four quarters of 2003 and 2.8 percent during the four quarters of 2002. Measured on a calendar year-over-year basis, the administration projects GDP growth of 4.4 percent in 2004, compared with 3.1 percent in 2003 and 2.2 percent in 2002.

In 2004, the composition of GDP growth is expected to shift away from household and government spending and toward business fixed investment and net exports. Evidence of emerging momentum in investment accumulated over the course of 2003: businesses began to hire, build inventories, and increase shipments of nondefense capital goods. In addition, expected faster growth among U.S. trading partners and the decline in the exchange value of the dollar make U.S. exporters well-positioned for expansion.

Much stimulus remains in the pipeline in the form of refunds on 2003 tax liabilities this spring and the ongoing effects of the current low interest rates. The reduction in the tax withholding schedule included in the 2003 fiscal package (JGTRRA) only began in July 2003, and households are still adjusting to these lower tax rates. Moreover, tax refunds in the first half of 2004 are expected to be higher than usual: the tax cuts were retroactive to January 2003, but last year's withholding changes generally did not capture tax savings on income earned in the first half of the year. In addition, because of the 2002 and 2003 tax cuts, businesses will be able to cut their tax liabilities by expensing 50 percent of their equipment investment (rather than depreciating the new capital) through the end of 2004. The lower tax rates, higher tax refunds, and investment expensing included in the Jobs and Growth Tax Relief Reconciliation Act are expected to reduce tax collections by $146 billion in 2004, up from $49 billion in 2003.

The U.S. economy continues to display supply-side characteristics favorable to long-term growth. Advances in productivity have been remarkable, and inflation remains low and stable. We estimate the growth of the economy's potential GDP to be 3.1 percent per year.

During each of the next 4 years, real GDP is expected to grow faster than its potential rate as the economy continues to recover. The administration forecasts that real GDP growth will average 3.7 percent at an annual rate during the 4 years from 2003 to 2007-again in line with the consensus of private-sector forecasters. Because this pace is somewhat above the assumed rate of increase in productive capacity, the unemployment rate is projected to decline over this period. In 2008 and 2009, real GDP growth is projected to continue at its long-run potential rate of 3.1 percent, and the unemployment rate is projected to stabilize at 5.1 percent.

The growth rate of the economy over longer time horizons is determined by its supply-side components, which include population, labor force participation, productivity, and the workweek. The administration expects nonfarm labor productivity to grow at a 2.1 percent average annual pace over the forecast period, virtually the same as that recorded during the 43 years since the business-cycle peak in 1960. The projection is notably more conservative than the 4.4 percent average annual rate of productivity growth since the output peak in the fourth quarter of 2000. After such an extraordinary surge, a period of more typical productivity growth is likely as firms shed their hesitancy to hire. In addition, the slower pace of productivity assumed in the forecast reflects the administration's view that in the absence of a good explanation for the recent acceleration, it is prudent to base the productivity forecast on longer-term averages.

In addition to productivity, growth of the labor force is projected to contribute 1.0 percentage point per year to growth of potential output on average through 2009. Labor force growth results from growth in the working-age population and changes in the labor force participation rate. The Bureau of the Census projects that the working-age population will grow at an average annual rate of 1.1 percent through 2009-roughly the same pace as during the years between 1990–2003. The last year in which the labor force participation rate increased was 1997, so the long-term trend of rising participation appears to have come to an end. Since then, the participation rate has fallen at an average 0.2 percent annual pace-although some of the decline in 2001 and 2002 probably resulted from the recession-induced decline in job prospects. In 2003, the baby boom cohort was 39–57 years old, and over the next several years the boomers will be moving into older age brackets with lower participation rates. As a result, the labor force participation rate is projected to edge down an average of 0.1 percent per year through 2009. The decline may be greater, however, after 2008, which is the year that the first baby boomers (those born in 1946) reach the Social Security early-retirement age of 62.

In sum, potential real GDP is projected to grow at a 3.1 percent annual pace, slightly above the average 3.0 percent rate of real GDP growth since 1973 and slightly below the 3.3 percent average since 1960. Actual real GDP growth during the 6-year forecast period is projected to be slightly higher, at 3.4 percent, because the civilian employment rate makes a transitory and small (0.2 percentage point) contribution to growth through 2007 as the unemployment rate falls. This contribution then ends as the unemployment rate stabilizes at 5.1 percent.

### CONSUMER SPENDING

Consumer spending is expected to moderate this year after rising briskly in the second half of 2003. Real personal consumption expenditures increased at an average annual pace of 3.0 percent during the first half of 2003 and then accelerated to an annual rate of 4.7 percent in the second half of the year.

Wages and salaries increased moderately in the second half of 2003, bolstered by the emerging recovery in the labor market. Moreover, the personal tax cuts included in the 2003 fiscal package (JGTRRA) meant that U.S. households were able to keep substantially more of their earnings. The reduction in withholding and the advance rebates of the child tax credit added $37 billion to disposable income (not at an annual rate) in the second half of the year.

Other factors also likely contributed to the strengthening of consumer spending over the course of 2003. The robust performance of equity markets and solid gains in home prices bolstered wealth. Household wealth (net financial resources plus the value of nonfinancial assets such as cars and homes) increased $2¼ trillion during the first three quarters of 2003, and it probably rose substantially further in the fourth quarter given the solid increase in broad indexes of stock prices in the last few months of the year. Consumer sentiment was depressed early in the year by the prospect of war with Iraq. Sentiment jumped in April and May following the successful resolution of major combat operations and then was little changed until November, when it picked up noticeably. By the end of the year, household sentiment was somewhat higher than it had been at the end of 2002 and much higher than it was just prior to the war with Iraq.

During 2003 as a whole, consumption grew somewhat faster than household after-tax income. Personal saving as a fraction of disposable personal income averaged 2.3 percent in 2002 and was slightly lower, at 2.0 percent, in 2003.

The likely behavior of personal saving in coming years is a key factor in the consumption outlook. In particular, the relative flatness of the personal saving rate over the past couple of years appears to be the result of offsetting forces. On the one hand, capital losses associated with the decline in the stock market from March 2000 to March 2003 probably tempered consumption (with some lag) and, in turn, caused the personal saving rate to increase. On the other hand, personal saving was likely depressed by the boost to consumption from low interest rates (both directly through the availability of low-interest-rate loans on durable goods and indirectly through the funds made available by cash-out mortgage refinancings). As interest rates and incomes rise over the course of the next several years, the transitory forces boosting consumption growth should dissipate, and as a result, real consumption is expected to grow more slowly than real GDP.

An increase in corporate contributions for defined-benefit pension plans may boost the saving rate in the near term from what it might be otherwise. The Pension Benefit Guarantee Corporation (PBGC) has estimated that corporate contributions to defined-benefit plans will increase sharply above 2003 levels. Indeed, rapid increases have already begun, according to separate data included in the Employment Cost Index. The contributions raise personal income (as it is measured in the National Income and Product Accounts), but because these funds are not placed in the hands of employees until retirement, they may have smaller effects on current-year consumption. As a result, they may increase the personal saving rate.

### RESIDENTIAL INVESTMENT

Real residential investment is expected to slow somewhat in 2004 after a remarkably robust performance in 2003. During the four quarters of 2003, real residential investment grew at an average annual rate of more than 10 percent. Housing starts moved above the already high 2002 level to an average of 1.8 million units in 2003, the largest number of starts since 1978. In addition, sales of both new and existing single-family homes rose to record levels.

Some of the strength in housing demand reflected the same gains in after-tax income and wealth that bolstered real consumer spending. The low levels of mortgage interest rates were another important driving force. The interest rate on new fixed-rate 30-year mortgages slipped from an average of 6½ percent in 2002 to an average of 53/4 percent in 2003. This level is the lowest in the 32 years for which comparable data are available. Indeed, according to data from the Michigan Survey Research Center, consumers' assessments of home-buying conditions remained very positive in 2003, largely because of low mortgage interest rates. As a result of the very favorable conditions in the housing sector, the U.S. home-ownership rate climbed to 68.2 percent in the third quarter of 2003-equal to its highest level on record.

### BUSINESS FIXED INVESTMENT

Business investment in equipment and software picked up sharply in the second half of 2003 and the strength is expected to persist in 2004. However, business investment in structures is forecast to gain only slightly over the year.

Real business fixed investment-firms' outlays on equipment, software, and structures-posted a gain of 6.4 percent during the four quarters of 2003 after declines of 10.2 percent during the four quarters of 2001 and 2.8 percent during the four quarters of 2002. The acceleration during the year was noteworthy, with real investment rising at an annual rate of 9.8 percent in the second half compared with 3.1 percent in the first half of the year. The improvement from 2002 to 2003, as well as the pickup over the course of 2003, largely reflected a strengthening in real purchases of equipment and software.

Within the equipment and software category, the largest increases occurred for certain high-tech items. Real outlays for computers increased nearly 40 percent during the year, and real investment in software continued its solid upward trend, rising 12½ percent. Outlays for transportation equipment were held down by further large declines in purchases of aircraft during the year. Finally, real spending on equipment outside of the high-tech and transportation categories posted a solid gain over the course of 2003.

The increased momentum in business purchases of capital goods in 2003 likely reflects the impact of several factors. First, with capital overhangs probably behind them, firms were poised to take advantage of further declines in prices of high-tech goods stemming from continued technological advances. Second, striking gains in productivity and falling unit labor costs bolstered corporate profits. Third, the cost of capital was held down by a number of factors, including falling prices for high-tech capital goods, but also by low interest rates, rising stock prices, and the investment incentives introduced in the Job Creation and Worker Assistance Act of 2002 (JCWAA) and expanded in the 2003 fiscal package (JGTRRA).

The administration expects the recovery in real business investment in equipment to strengthen further this year, reflecting the acceleration in output, continued low interest rates, and the investment incentives provided by the 2002 and 2003 tax cuts. Fixed investment in equipment tends to be related to the pace of growth in output (along with the cost of capital), and so the pickup in real GDP growth from 2.8 percent during the four quarters of 2002 to 4.3 percent during the four quarters of 2003 is projected to lead to an increase in investment during 2004.

Growth in equipment investment in 2004 should be further boosted as firms pull forward spending in anticipation of the expiration of the period when businesses are able to expense (rather than depreciate) 50 percent of the value of their equipment investment. The flip side of some investment being pulled forward into 2004 is that investment may grow more slowly in 2005. Even so, the pace of equipment investment in 2005 is projected to be strong.

Despite the emerging recovery in spending on equipment and software, business demand for structures remained soft in 2003. High overcapacity seems to have offset the impetus imparted by low interest rates and higher cash flow. In the office sector, vacancy rates rose substantially for the third consecutive year. Vacancy rates moved still higher in the industrial sector and now stand at extremely elevated levels. The good news is that the substantial declines in total spending on structures seem to have abated. Indeed, real investment in nonresidential structures dipped only about 1.3 percent over the four quarters of 2003, in contrast with a plunge of more than 25 percent during the preceding 2 years. Strength in oil and gas drilling and an increase in construction of general merchandise stores during the year have offset continued softness in some other sectors.

The forces that shape the outlook for business structures-the growth of output and the cost of capital-are much the same as for business equipment. However, they operate with a longer lag because of the time it takes to plan and build these structures. Investment in business structures is projected to post a small gain during 2004.

### BUSINESS INVENTORIES

Inventory investment is projected to make a noticeable positive contribution to GDP growth through the first half of 2004 and then stay at a level that keeps stocks in line with rising sales throughout 2004 and 2005. This would continue a turnaround in stockbuilding that appears to have begun in September 2003 and was evidenced by the positive contribution of 0.6 percent by inventory investment to fourth-quarter GDP growth. Businesses began 2003 with lean inventories following a massive liquidation in 2001 and little restocking during 2002. Inventory investment was substantially negative over the first three quarters of 2003, as increases in production lagged those in final demand. The reasons for this slow response of production are unclear. Firms may have been surprised by the strength of final demand, or they may simply have been waiting for compelling evidence that a sustainable recovery was under way. The net decline in inventories during the first three quarters of 2003 left stocks in their leanest position relative to final sales of goods and structures in at least 50 years. This lean position resulted, at least in part, from efficiencies generated by just-in-time inventory-management techniques.

### GOVERNMENT PURCHASES

Real Federal Government spending is expected to fall in the 2005 and 2006 fiscal years, and remain fairly flat thereafter. The defense supplemental appropriations for fiscal year 2004, signed in November 2003, allows for some further near-term growth in Federal Government purchases. Real Federal spending (consumption expenditures and gross investment) climbed 53/4 percent during the four quarters of

2003. The gain was led by a rise of 73/4 percent in real defense spending largely related to military operations in Iraq. Real nondefense spending rose about 2½ percent. This increase was less than one-third as large as the gain during the four quarters of 2002, when outlays were stepped up considerably for homeland security.

Tax receipts of states and localities decelerated during the economic slowdown, while fiscal positions deteriorated as well from rising health care costs and increased demand for security-related spending. With many of these governments subject to balanced-budget rules, they have taken a variety of measures to address their fiscal imbalances, including drawing on accumulated reserves (so-called "rainy day funds"), raising taxes, and restraining spending. Real expenditures of state and local governments were little changed during the four quarters of 2003, in contrast with an average annual gain of around 3 percent over the preceding 5 years. With state and local governments still under pressure, their real expenditures are projected to increase slowly during the coming year. Eventually, their fiscal situations should be improved by increases in tax revenue resulting from the strengthening of the economy.

### EXPORTS AND IMPORTS

Prospects for exports over the next 2 years look promising for the first time since the global slowdown began in 2000. Growth among the non-U.S. OECD countries is projected by the OECD Secretariat to rise to 2.6 percent during the four quarters of 2004, up from a pace of 1.6 percent during 2003. Growth is expected to rise further to 2.8 percent in 2005. The expected growth in foreign markets should support growth in U.S. exports. In addition, the effect will likely be augmented by a rise in the U.S. market share of world exports owing to the effects of the 23 percent decline in the value of the dollar against major currencies from its peak in early 2002 through the end of 2003. The effect of the recent dollar decline on exports will likely take a couple of years to be fully felt.

Real imports are projected to increase along with domestic output, but the growth of real imports is likely to be slowed by the recent decline in the dollar's value relative to other currencies. On balance, real imports are projected to grow at about the same pace as GDP, on average, during the next 2 years. Nominal imports will increase faster than real imports because import prices will rise in reaction to the recent dollar decline. The current account deficit, which rose to about 5 percent of GDP in the first three quarters of 2003, is projected to edge up in 2004 and decline thereafter.

Overall, real net exports are expected to make a small positive contribution to real GDP growth during the next year and are likely to make a larger contribution thereafter. Over the next 6 years, the returns to foreign owners of U.S. capital are likely to grow faster than the returns to U.S. owners of foreign capital, a legacy of a long period of strong foreign investment in the United States during the past decade. As a result, real gross national product (GNP), which includes these net foreign returns to capital, is expected to grow slower than real gross domestic product (GDP).

### THE LABOR MARKET

Boosted by strong demand and income growth, the labor market in 2004 and beyond is expected to build upon the favorable developments in the last 5 months of 2003. Nonfarm payroll employment fell an average of 50,000 workers per month in the first 7 months of 2003, before increasing 35,000 in August, 99,000 in September, and an average of 48,000 per month in the fourth quarter. The strengthening was experienced in most sectors. Job gains in professional and business services stepped up appreciably from the modest upward pace seen earlier in the year. Construction employment began to expand in the second quarter after 2 years of modest job losses, and the quarterly averages of employment in the wholesale trade, transportation, and utilities industries turned up at the end of the year. The manufacturing sector continued to shed jobs through year-end, though the pace of decline slowed, and the factory workweek climbed more than 0.5 hour, on balance, in the final 5 months of 2003.

The unemployment rate increased in the first half of 2003, reaching a peak of 6.3 percent in June, before falling during the second half of the year. In the fourth quarter, the unemployment rate averaged 5.9 percent, the same as it had been a year earlier. Because the labor force is constantly expanding, employment must be growing moderately just to keep the unemployment rate steady. For example, if the labor force is growing at the same rate as the population (about 1 percent per year), employment would have to rise 110,000 a month just to keep the unemployment rate stable, and larger job gains would be necessary (and are expected) to induce a downward trend in the unemployment rate.

Looking ahead, temporary-help services employment-a leading indicator for the labor market-suggests substantial further employment growth in the future. Average growth in temporary-help services employment over a 6-month period has a striking positive correlation with growth in overall employment over the subsequent 6 months. Statistical analysis suggests that an increase of one job in temporary-help services corresponds to a subsequent rise of seven jobs in overall employment. Employment in temporary-help services has expanded 194,000 since last April, suggesting robust growth in overall employment this year. The unemployment rate is projected to fall to 5.5 percent by the fourth quarter of 2004-well below its average of 6.3 percent since 1970.

## INFLATION

Core CPI inflation is expected to continue at a low level in 2004, and overall inflation is expected to be even lower as energy prices retreat further. Overall CPI inflation is projected to fall to 1.4 percent during the four quarters of 2004-close to the past year's pace of core inflation. With the unemployment rate expected to average 5.6 percent for the year as a whole (above the estimated 5.1 percent midpoint of the range of unemployment rates consistent with stable inflation) the level of slack-although less than in 2003-is still projected to hold down inflation during 2004. Also keeping inflation in check is the recent rapid pace of-and solid near-term prospects for-productivity growth. Offsetting this effect is the somewhat higher pace of import-price inflation (resulting from the recent dollar decline) and the quicker pace of GDP growth. Over the next 5 years, CPI inflation is expected to edge up, eventually flattening out at 2.5 percent, a level that is identical to the consensus private-sector forecast.

The path of inflation as measured by the GDP price index is similar, but a bit lower throughout the projection period. Inflation as measured by the GDP price index is projected to fall to 1.2 percent during the four quarters of 2004, the same as the 1.2 percent pace of the core GDP price index during the four quarters of 2003. GDP price inflation is projected to increase slowly thereafter-roughly parallel to the rise in CPI inflation.

The wedge between the CPI and the GDP measures of inflation has important implications for the Federal budget and budget projections. A larger wedge reduces the Federal budget surplus because cost-of-living adjustments for Social Security and other indexed programs rise with the CPI, whereas Federal revenue tends to increase with the GDP price index. For a given level of nominal income, increases in the CPI also cut Federal revenue because they raise income tax brackets and affect other inflation-indexed features of the tax code. Of the two indexes, the CPI tends to increase faster in part because it measures the price of a fixed market basket. In contrast, the GDP price index increases less rapidly than the CPI because it reflects the choices of households and businesses to shift their purchases away from items with increasing relative prices and toward items with decreasing relative prices. In addition, the GDP price index includes investment goods, such as computers, whose relative prices have been falling rapidly. Computers, in particular, receive a much larger weight in the GDP price index (0.8 percent) than in the CPI (0.2 percent).

During the 8 years ended in 2002, the wedge between inflation in the CPI-U-RS (a version of the CPI designed to be consistent with current methods) and the rate of change in the GDP price index averaged 0.5 percentage point per year. With the core CPI and the core GDP price index both increasing at about a 1¼ percent pace during the past year, inertia suggests that the near-term wedge will be only about 0.2 percentage point in 2004. The wedge is expected to widen eventually to its recent mean of 0.5 percent by 2009.

## FINANCIAL MARKETS

Stock prices skidded early in the year, but rallied in March and have been on a solid uptrend since then. During the 12 months of 2003, the Wilshire 5000 index-a broad measure of stock prices-rose 29 percent. An increase of this magnitude has not been seen in any year since 1997. High-tech stocks did even better; for example, the Nasdaq index, which is heavily weighted toward high-tech industry, rose 50 percent during 2003. Nearly two-thirds of the rise in broad measures of stock prices occurred after the President signed the 2003 tax cut (JGTRRA) in late May; the Act reduced marginal tax rates on dividends and capital gains and thus likely contributed to the robust performance of stock prices.

Following a large decline in 2001, and a smaller one in 2002, the interest rate on 91-day Treasury bills fell an additional 29 basis points in 2003 and ended the year at 0.9 percent. These reductions reflected the Federal Reserve's efforts to stimulate the economy, leaving real short-term rates (that is, nominal rates less expected inflation) slightly negative. Following market-based expectations of interest rates (derived from rates on Euro dollar futures), the administration does not expect real rates this low to persist once the recovery becomes firmly established, and nominal Treasury bill rates are projected to increase gradually. Long-term interest rates fell sharply last spring and then rebounded in the summer. For the year as a whole, long-term Treasury rates were about unchanged, but corporate interest rates dropped a bit as the spread over Treasury rates narrowed. The administration projects that the yield on 10-year Treasury notes, which averaged 4.3 percent in December 2003, will edge up gradually next year, consistent with the path of short-term Treasury rates.

The gradual increase in the interest rate on 91-day Treasury bills is projected to continue through 2009. The rate is expected to reach 4.4 percent by 2009, at which date the real interest rate on 91-day Treasury bills will be close to its historical average. The projected path of the interest rate on 10-year Treasury notes is consistent with that on short-term Treasury rates. By 2008, this yield is projected to be 5.8 percent, 3.3 percentage points above expected CPI inflation-a typical real rate by historical standards. By 2009, the projected term premium (the difference between the 10-year interest rate and the 91-day rate) of 1.4 percentage points is in line with its historical average.

## THE COMPOSITION OF INCOME

A primary purpose of the administration's economic forecast is to estimate future government revenue, which requires a projection of the components of taxable income. The administration's income-side projection is based on the historical stability of the long-run labor and capital shares of gross domestic income (equal to GDP less a statistical discrepancy). During the first three quarters of 2003, the labor share of gross domestic income (GDI) was on the low side of its historical average. From this jump-off point, it is projected to rise to its long-run average and then remain at this level over the forecast period. (The income share projections are consistent with data available through December 2, 2003. They exclude any effects of the later comprehensive revision to the National Income and Product Accounts.) The labor share consists of wages and salaries, which are taxable, employer contributions for employee pension and insurance funds (that is, fringe benefits), which are not taxable, and employer contributions for government social insurance. The administration forecasts that the wage and salary share of compensation will decline while employer contributions for employee pension and insurance funds grow faster than wages. This pattern has generally been in evidence since 1960 except for a few years in the late 1990s. During the next 5 years, the fastest growing components of employer contributions for employee pension and insurance funds are expected to be employer-paid health insurance and contributions for defined-benefit pension plans.

The capital share (the complement of the labor share) of GDI is expected to fall before leveling off at its historical average. Within the capital share, a near-term decline in depreciation (an echo of the decline in short-lived investment during 2001 and 2002) helps boost corporate economic profits, which in the third quarter of 2003 were noticeably above their post-1973 average of about 8 percent of GDI. The share of corporate economic profits in GDI is projected to be bolstered in 2004 by the strong recent productivity growth together with stable gains in hourly compensation, and an expected decline in depreciation.

From 2005 forward, the profit share is expected to slowly decline back to its historical average of about 8 percent. The projected pattern of book profits (known in the national income accounts as "profits before tax") reflects the 30 percent expensing provisions of the Job Creation and Worker Assistance Act of 2002 and the 50 percent expensing provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003. These expensing provisions reduce taxable profits from the third quarter of 2001 through the fourth quarter of 2004. The expiration of the expensing provisions increases book profits thereafter, however, because those investment goods expensed during the 3-year expensing window will have less remaining value to depreciate thereafter. The share of other taxable income (the sum of rent, dividends, proprietors' income, and personal interest income) is projected to fall, mainly because of the delayed effects of past declines in long-term interest rates, which reduce personal interest income during the projection period.

CONCLUSION: THE IMPORTANCE OF SPENDING RESTRAINT

Let me conclude with a few remarks on the relationship between the budget deficit and the economy. It is true that, according to most economic models, large, persistent deficits act as a drag on the economy. It is true as well that, according to most models, higher tax rates alter incentives in a way that also acts as a drag on the economy. In my view, concerns about the deficit should not be resolved with higher tax rates. Doing so would merely replace one drag on growth with another. Rather, the solution to long-run deficits is continued pro-growth tax policy and spending restraint. The President's tax cuts were designed to encourage work, saving, and investment-the building blocks of growth-and he has presented a budget with significant spending restraint. These proposals will ensure that the current economic recovery continues and position the U.S. economy for further strong growth in the years ahead.

Thank you for the opportunity to testify. I look forward to your questions.

Chairman NUSSLE. We have a number of members who are here today and others that are coming back. I am going to try to limit my questions to the time limit, and I am going to ask other members to do the same to respect other members' questions. So let me get into this quickly.

As I understand it, from my years on the Budget Committee in service in Congress, there are three ways that we can tackle the problem we have got. We can raise taxes, we can cut spending, or we can grow the economy. And unless I am missing something here, the President is not picking No. 1. He is basically saying, we are not going to raise taxes at this time in our economic situation, and we don't believe that that is the right recipe in order to fix the deficit.

Is that your understanding, there are no tax increases in this budget?

Mr. BOLTEN. Mr. Chairman, that is correct. We have some loophole closers in there, but in general there are no tax increases contemplated in this budget. And, in fact, what we are proposing is to extend the tax cuts that you have enacted precisely because the most important thing we can do to restore our budget picture to health is to keep strong economic growth going, and the most important element in doing that is sustaining the tax cuts that you have enacted.

Chairman NUSSLE. Let me get into the second one, and that is spending restraint. It is a fairly austere budget. It is interesting to me that we will hear complaints that we don't get to balance soon enough, or we don't cut the deficit soon enough, or it isn't realistic because Congress won't get it done. What do we expect the President to do? He has got to propose something.

He has given us a blueprint to work from. It is austere. Can we do better? We might be able to do better than that. But the way I see it right now—and this is what I would like to ask—is, where do you see the potholes—no pun intended, maybe pun intended—spending concerns that the administration, looking at the congressional playing field, the way it sets up right now? And I guess, maybe more specifically, what are your concerns about the transportation bill and about the energy bill and about the appropriations process that you see laid before you?

Mr. BOLTEN. Mr. Chairman, you have just highlighted our principal short-term anxieties about what might happen to our budget picture over the course of this early legislative season. They are first and foremost with the appropriations process, but we are just beginning that now with our budget presentation. We look forward to working with you, with the leadership, and with the Appropriations leadership in making sure that we keep that appropriations process well contained within proper limits, as I believe we did this past year.

But the immediate challenges include, notably, the highway bill which you just mentioned. We are carrying in our budget a proposal for a 6-year highway bill that contemplates spending $256 billion over 6 years. That is a 21 percent increase over the last 6-year highway bill. So there is a substantial increase built in there. There are proposals now in gestation on both sides of the Capitol which go substantially above that. Either this morning or late yesterday, a letter came forward from Secretary Mineta and Secretary Snow indicating the principles within which the administration proposes to live and the principles that led us to our number of $256 billion, and added that if legislation were presented to the President that departed from those principles, his senior advisors would recommend that he veto the bill.

Chairman NUSSLE. What were those principles?

Mr. BOLTEN. Mr. Chairman, the principles were three:

First, that transportation infrastructure spending should not rely on an increase in the gas tax or other Federal taxes;

Second, that transportation infrastructure spending should not be funded through bonding or other mechanisms that conceal the true cost to Federal taxpayers; and

Third, that highway spending should be financed from the Highway Trust Fund, not the General Fund of the Treasury.

Chairman NUSSLE. If those are the three principles, is the word "veto" tucked into that letter somewhere?

Mr. BOLTEN. The penultimate paragraph of the two Secretaries' letter says that if a surface transportation reauthorization bill that breached any of these three principles were presented to the President, his senior advisors would recommend that he veto the bill.

Chairman NUSSLE. Well, we have got a test then, and it is probably going to come up before the budget, and we will just have to see how it all shakes out.

But this is what we are talking about. There is a lot of chest-beating right now about spending, mostly from Members of Congress on both sides. And the President has been very clear; he said no tax increase has to come out of the trust fund, and no bond proposal to try to figure out a way to get around the first two principles. And we will just have to see how Congress reacts, because it is interesting to me, I have always thought this—it has always been interesting to me that the President gets blamed or given credit for the budget situation. The Democrats love to give President Clinton the credit for balancing the budget. It isn't any more true than it is now.

Congress, says Article I of the Constitution, we are responsible for the purse strings, and if we put a bill on the President's desk that violates those principles, we are asking for a veto. And it is more spending than in the budget, so if you are concerned about the deficit, you have got an opportunity right now. And I have got just as many projects as everybody else does that we think are vitally important to my district and State. We all do and we will all advocate for them.

But we have an opportunity to put our chest-beating where our mouth has been and our budgets have been and our proposals have been with the first bill out of the blocks, even probably before a budget gets passed. I would suggest to you that that will be a very good test to determine not only who is responsible, but whether or not we are going to get our arms around this deficit and whether or not we are going to be able to get on a glide path to cut it in half in 5 years.

I have tons of other questions, but I wanted to get that on the record and find out where you were coming from, and I appreciate your testimony in that regard.

Mr. Spratt.

Mr. SPRATT. Mr. Chairman, you mentioned the fact that there are no tax increases in the budget. There is something called the Alternative Minimum Tax, which the Treasury Department has said will increase taxes to a higher rate for up to 30 million tax filers by 2010. I said earlier there is no mention of that problem here.

As you propose $1.2 trillion in additional tax cuts, you offer nothing except for indexing the exempt amount of the AMT as a correction. We all know it is coming, and it is in fact a tax increase for middle-income American, the AMT, if you leave it on the books in its present form.

I said earlier that the President had included in his State of the Union message a statement that he would send us a budget in 2 weeks and that budget would pay for the war. This budget doesn't pay for the war.

Would you tell us why it doesn't pay for the war and why the President made that statement if the budget was to be sent to us in this form?

Mr. BOLTEN. Mr. Spratt, I believe the President's statement in the State of the Union was referring generally to the war on terror, and at the time that we presented this budget, we acknowledged that in addition to the proposals that you see on the table enclosed in this budget, we have expressly said—and it is contained in the document that you have received—we have expressly said that we will need supplemental funding in——

Mr. SPRATT How much? Can you give us an approximation?

Mr. BOLTEN. Well, one of the reasons why there is not a specific number in here is that it is impossible to know how much we will need for the war in Iraq and Afghanistan.

Mr. SPRATT. But that happened last year, you know, and within months we had an $80 billion supplemental on our desk, in a few months we had an $87 billion supplemental on our desk. We now have 3 years of cost experience in those theaters. Surely we can extrapolate what the likely cost is going to be in 2005.

Mr. BOLTEN. Well, Mr. Spratt perhaps you are able to extrapolate exactly what the security situation is going to be in Iraq and Afghanistan, but I think most of our defense experts are unable to say that.

Here is what I did say yesterday if I may——

Mr. SPRATT. I think as the Budget Director you should at least have some approximation because it is a big number and it determines whether or not you can fulfill the pledge that you have solemnly made to cut the budget deficit in half in 5 years. $50 billion is a big number.

Mr. BOLTEN. I agree completely, and that is why I used a number in my remarks at a press conference yesterday that you cited.

If I could lay out what I actually did say, the number—the amount that we will need to spend for the war in Iraq and Afghanistan is not knowable at this time, first. Second, it is common practice, and in fact, it is far preferable practice that we handle emergencies, war spending, through supplementals so they don't end up folded into the base, which means that it is very hard to get that funding out once the war ends.

What I did say, as well, is that our current spending path suggests that we will be spending in 2004 outlays less than $50 billion to keep our troops on the ground supplied in Iraq and Afghanistan. If you want to assume that the level of our commitment in 2005 is going to be as robust as it has been in 2004, then you will have to add into our deficit number for 2005 something below that $50 billion figure. My own expectation is that our need will be less, but we do not know.

The reason why I used that particular figure was for those who want to assume our commitment is going to need to remain as large, my hope and expectation is that it will be lower, but we want to be sure that we are forthright in indicating that we are going to need that spending in 2005, and you need to add that into your deficit calculation.

Mr. SPRATT. I understand. I have got one minute under the rules.

OK, I will take a few minutes.

When you mentioned the deficit, you did say it is undesirable and you did say it is unwelcome. I don't find a lot of moral fervor in those words, and it seems to me that in the budget here you are making a choice. You know that there is no more surplus, and therefore, $1.2 trillion in additional tax cuts has to go straight to the bottom line and has to increase the deficit, pro tanto, by that amount, $1.2 trillion. So in effect you are saying that tax cuts trump the deficit, tax cuts in my estimation—this administration's estimation—are more important than the deficit itself.

Mr. BOLTEN. What we are saying, Mr. Spratt, is that economic growth is a priority here because it is flagging economic growth that brought us into the deficit situation we now face. It is recovering economic growth that will bring us out.

Mr. SPRATT. And you are not worried that $521 billion deficits and $2 trillion in additional debt over the next 5 years could indeed run up interest rates, could cause, you know, foreigners not to want to hold all of the denominated assets? There are all kinds of economic perils that deficits can impose upon the economy.

Mr. BOLTEN. No question about it, and Dr. Mankiw—I will let him say a word in just a second—specifically mentioned that in his testimony.

We do need to be concerned about that. So far, we have not seen those effects in the economy. We continue to have historically low interest rates right now in the economy, but it does need to be a matter of concern, which is why we have proposed a budget that we believe credibly puts us on a path toward bringing that deficit well below its 40-year average over the next 5-year period.

Mr. SPRATT. Dr. Mankiw, if you don't attain that goal and we have deficits of this magnitude indefinitely into the future, aren't you worried about the impact on the economy, interest rates, growth?

Mr. MANKIW. I think the reason that deficits are undesirable, as Mr. Bolten said, is that they do tend to raise—put pressure on interest rates. There is a wide range of views among professional economists about how large that effect is. But I think certainly the consensus among professional economists is there is some upward pressure on interest rates there, and that is one reason why we want to get the deficit down, because it is bad for growth to run large persistent deficits; and that is precisely why the President has proposed a budget to reduce the budget deficit in half over the next 5 years.

It is also true that high tax rates put downward pressure on economic growth. So the win-win situation is we have neither the burden of deficits nor the burden of high tax rates through spending restraint.

Mr. SPRATT. It is my understanding that tax revenues this year will be 15.8 percent of our gross domestic product, and that is their lowest level as a percentage of GDP since 1950.

Mr. MANKIW. Tax revenues are down in part because the economy is down, in part for technical reasons involving the stock market and capital gains collections and other sort of economic factors associated with the end of the high-tech bubble.

Mr. SPRATT. Let me ask one other question on a different topic; then I will turn it over to the others.

The President also said in his State of the Union speech that his budget would include and the administration would support health care tax credits, and those would include refundable tax credits because otherwise they wouldn't be of any value to lower-income citizens who don't happen to have health care and don't have incomes that are significantly taxable.

When we look through your budget to see how much was provided for that, we found that there was $65 billion included as an expenditure, which a refundable item would be, an outlay; however, it was footnoted, and the footnote indicated that this proposal for refundable health care tax credits to help Americans who don't have health insurance obtain it through the tax code, this idea would be implemented only if the total cost of it were its offset.

You didn't propose offsets. Instead, you say in the budget documents, we are ready to work with Congress to identify $65 billion in spending offsets, which I think you will agree in this kind of budget would be a Herculean task.

So is this a proposal that you will put this up if we can find $65 billion to make room for it in the budget?

Mr. BOLTEN. Mr. Spratt, that proposal is fully up before you. It has been up before you in the past few years. It has been on the President's agenda for some time.

Mr. SPRATT. But the budget documents say it is contingent on our identifying $65 billion in offset spending cuts.

Mr. BOLTEN. Right. And we do have $35 billion in mandatory spending offsets that could be applied to this purpose, but we want to be sure it is consistent with the proposal that we have made for budget enforcement reform that we fully offset any increase in mandatory spending, as this would be; and what we are indicating is that we are prepared to work with you, once the legislation is taken up, to ensure that we do have adequate offsets for it.

It is not a 1-year proposal, as you know. This is over the full budget——

Mr. SPRATT. Over a 5-year period of time, I guess. Where does the $35 billion come from? That will be my last question. The offsets you have identified, what are they?

Mr. BOLTEN. A large portion of it comes from Medicaid savings, that is, the intergovernmental transfer proposal, and several others that are listed in the budget.

Mr. SPRATT. Aren't you taking from one poor person to help another?

Mr. BOLTEN. I don't think so, Mr. Spratt, if you are talking about the intergovernmental transfers proposal.

Mr. SPRATT. No. I am simply saying you are taking it out of Medicaid, which helps poor people.

Mr. BOLTEN. No. In that proposal what we are doing is taking money away from the Medicaid program that States themselves are taking away from the Medicaid program in a way that we think is not at all supportive of Medicaid. It is basically a mechanism that States have used over time to help their own budgets, that is totally unrelated to Medicaid and not proper for the Federal Government to be paying.

Mr. SPRATT. We will talk about it another time. Thank you.

Chairman NUSSLE. Mr. Gutknecht.

Mr. GUTKNECHT. Thank you, Mr. Chairman.

And thank you for coming up here to visit with us today. I must confess I haven't had enough time to really go through the details of what the President has put before us, but I am struck at how much things have changed. I have been on the Budget Committee long enough that I remember where we were on September 11, 2001. We were preparing to have a Budget Committee meeting to talk about how we could keep from dipping into the Social Security Trust Fund. We don't even talk about that anymore; that is how far we have come.

The other thing, I am struck, in listening to Mr. Spratt, with how both sides seem now to be defending turf that we were formerly completely unfamiliar with. On one hand, they are concerned about the Alternate Minimum Tax, which was put in in previous years to tax the rich, and yet at the same time they want to eliminate the tax cuts which might benefit the rich. There is a certain amount of inconsistency on both sides.

But I do agree that the issue here we really need to concentrate on is economic growth because the one thing that we saw through the last 6 years is that if we could keep the economy growing here in this country, it helps cover a world of sins by this Congress.

And I want to come back to something, Mr. Mankiw, that you said, because I don't think you answered completely, because I think it is important. I have said before—I believe this—we have a lot of theories around here. I tend to subscribe to your theory that if you want stronger economic growth, you have to allow Americans to keep and spend more of their own money; and the reason I believe that is because they can spend that money far more efficiently than we can spend it on their behalf, which is the real argument for reducing the scope and size of the Federal Government. But I want to come back to a point, and we are going to argue about how much the government should spend and how much it should grow and how much of the GDP it should consume.

But one of the other points that I have made before is that government will be paid for. We can argue economic theory, but this is a fact: Government will be paid for. It will either be paid for now by current taxpayers or it will be paid for in the future by taxpayers, with interest. Our children will pay for that government, with interest.

I want to come back to that question because I think it is important. If we continue to borrow upwards of $400 billion a year from our grandchildren, how much impact does that have on economic growth? And if we allow the government to grow, if the Federal Government continues to grow at two or three times the rate of the private sector, what does that do for economic growth in both the short and the long term?

Mr. MANKIW. Most economists believe that tax cuts of the sort that the Congress passed and the President signed into law are good for economic growth both in the short run and the long run.

In the short run, such tax cuts have important demand side of results, you put more money in people's pockets, they spend them, firms start hiring more workers to produce the goods that people are buying.

In the long run, it has important supply-side effects by encouraging people to work, encouraging people to start businesses, encouraging savings, investment, and capital accumulation, which are the backbones of productivity growth which leads to higher real wages and higher living standards.

But as you pointed out, the government faces a budget restraint. What that means is that tax cuts and spending restraint have to go hand and in hand. You really can't do one without the other. So it makes perfect sense, when the President talks about making the tax cuts permanent, that he also talks about spending restraint, because only through spending restraint is it possible to make the tax cuts permanent, and that is precisely why the President has proposed this progrowth tax policy and progrowth budget.

Mr. GUTKNECHT. So you don't think that there is a consequence, in the next 2 to 3 years, of these big deficits? You think the Federal Reserve is going to keep interest rates low forever?

Mr. MANKIW. I am not going to comment on Fed policy, although we do have an interest rate forecast in part of the administration forecast. That forecast is for rising interest rates as the economy recovers. It is very normal in a cyclical recovery for interest rates to rise as the economy recovers, and that is certainly what we are expecting, as well as most private-sector forecasters.

Most economic textbooks will tell you the appropriate time to run a budget deficit is in times of war and recession, and we have experienced both. And I think the deficits we are seeing now, while not desirable, are a very understandable response to this series of economic and political forces that we have been experiencing.

On the other hand, large persistent deficits are not desirable and do impede economic growth, and that is precisely why this budget includes shrinking budget deficits over time.

Mr. GUTKNECHT. Thank you.

Chairman NUSSLE. Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman.

In his State of the Union address, President Bush told us, and I quote, "In 2 weeks I will send you a budget that funds the war, protects the homeland, and meets important domestic needs by limiting the growth in discretionary spending to less than 4 percent." But yesterday, 2 weeks later, the President sent us a budget that does not fund the war in Iraq or the war on terrorism in Afghanistan or anywhere else.

The DOD press release, the Department of Defense press release on the budget, states that with respect to incremental costs for operations in Iraq, Afghanistan, and the global war on terrorism, we have yet to determine the scope of those operations.

Well, you know, Chairman Nussle said very clearly to the witnesses for the Department of Defense that when you submit your budget for 2005, you have got to include the war on—the war in Iraq and estimates of any other military conflicts. Now, to say, in quotes, "a budget that funds the war," that was clear, could not have been clearer, and yet the Department of Defense and the Office of Management and Budget—you, Mr. Bolten—have decided you are going to ignore the President's statement.

Now, I think it is appropriate for you to explain why you chose to ignore the President's very clear statement, and I know your answer is going to be something about, we don't know when we are going to hand over power in Iraq. The fact is that you said yesterday that we are funding the war in Iraq and Afghanistan at a rate of $50 billion.

Now, if you put $50 billion in there, would that not be more accurate than to put zero? Is there any chance that we will spend zero on the war in Iraq and Afghanistan in the fiscal year 2005, Mr. Bolten?

Mr. BOLTEN. Mr. Moran, the budget document that you have in front of us expressly says that we will need supplemental funding in 2005 for our ongoing operations in Iraq and Afghanistan. That is the actual incremental cost of keeping the troops on the ground. So we have been completely forthright in this document.

Mr. MORAN. Mr. Bolten, I am sorry and I know what is in the budget, but I am not asking you what you have said in the budget. I am asking for an explanation, because we have a budget here that you are telling us is not complete, that you are telling us you are going to make offsets, for example.

We need to have some idea. Where are you going to get those offsets when you decide to actually ask us for the cost of the war in Iraq? The President now says, we are told, he is going to wait until after the election to hit us with that supplemental.

But that means this whole budget resolution process is something of a sham. We know it is not accurate. We know we are going to have to take money from other programs. We know we have to fund the war in Iraq. We knew when we got the budget resolution last year that there was no money for Iraq, and yet there would have to be. We have now spent $166 billion we have allocated for the war in Iraq, and those numbers are above our budget resolution. And it is one of the reasons why when the President said he was going to hold it at 4 percent, total spending went up by about 12½ percent, about 3 times what the President said it was going to be; discretionary spending, about 8 percent.

That takes credibility out of our budget resolution process. It makes us in the Congress look bad, and yet there is nothing we can do about it if you are not going to be straightforward with us. Some of this is a lecture, but it is a lecture I am sure that the chairman would like to make if he wasn't in the position he is in. But I would like to know, get some idea where you expect us to get the money to pay for the war in Iraq, which you know is going to necessarily have to be funded after the election.

Mr. BOLTEN. I have had an opportunity to discuss this with the chairman. It was not quite in the same vein as the conversation that you and I are having right now, but what I did say yesterday, and I repeat today, is that the right way to do this kind of funding is through supplemental funding. We only have two choices in our current system, and maybe we ought to talk about how else we might do it. We could put the additional funding for a war, for which at this time we do not know the costs, and put that into the regular budget, run the risk that it becomes part of the baseline and increases defense funding inappropriately out into the future; or when we know the numbers, when we have a better handle on them, we can handle that incremental funding, and that is all we ask for in the supplementals is incremental funding.

We can ask for that through supplementals. Given those two choices, the correct path is to do the latter. And when we come forward with a budget, we are going to need to do the latter. I also set some limits on what I think the actual request is going to be because I identified for Mr. Spratt and I identified for the press yesterday the amount we believe we are spending now in Iraq and in Afghanistan.

Out over the course of the coming year, we expect that amount, the actual outlays to be less than $50 billion. If you choose to believe that our commitment in Iraq and Afghanistan is going to need to remain as robust in 2005 as it has been in 2004, then that is the number you should expect to add to the deficit. My own hope is it will be less and probably substantially less.

Mr. MORAN. Zero is not an accurate number.

Chairman NUSSLE. If I could, I do share the gentleman's frustration. I think many of us do, for the very reason your last point or question and that is we know it is not going to be zero. The challenge that we have is that we hope it is not going to be 50 either. And trying to come up with a number in between is a challenge, particularly when we don't want to feed it into the base of defense spending that, as a result, grows and compounds every year thereafter.

And I would ask if I could, as a followup to the distinguished gentleman from Virginia, is there a way, or would you be willing to work with us to try and answer this question as we move the budget resolution forward, because we believe that honest budgeting—we know it is not zero and hope it is not 50, but we are afraid to put in 30 if it is really 40. I mean, that is the challenge we have got, or afraid to put in 10 if it is 20. Coming up with a way to answer this question so it is clear within the budget and it is clear within the stated goal of reducing the deficit over time is something we need to work with you in order to accomplish.

Mr. BOLTEN. It is a challenge and you have identified exactly the problem. If we put in too large a number and we end up having that money in the base, then we run the risk of inflating the defense budget entirely inappropriately and expanding our deficit in ways that all the members of this committee would be concerned about. If we put in too low a number, then we would be accused of trying to hide the true costs of the war and underfunding the actual needs of our troops. There is a real challenge to these emergency situations and that is what this is. This is a war. There is a real challenge to budgeting for them. I would be happy to work with the committee.

Right now, our only available option that makes any sense is to notify the committee, as we have done very forthrightly in this budget, that we intend to come forward with a supplemental when the numbers are clear and at a time when the Defense Department needs the money.

Chairman NUSSLE. I thank the gentleman.

Mr. Thornberry.

Mr. THORNBERRY. Thank you, Mr. Chairman. Dr. Mankiw, I want to get back to this point that Mr. Gutknecht asked about and you referred to at the end of your statement, because I do think it is a very fundamental issue when you look at budgets as to the economic effect of taxes or borrowing. I have saved an article from last fall written by Robert Samuelson. This copy happened to be in the WashingtonPost.com, and it is entitled "The Deficit Chicken Hawks." He points out in the beginning that a variety of Republicans and Democrats are talking about deficits and the problems that they create, and then he goes on to say that almost everything you think you know about budget deficits is wrong or misleading and talks about their effect on the economy and the effect on tax rates.

But the key is this paragraph, which I want to read, and I want to see whether you agree with Samuelson's opinion. He says, and I quote, "but the big gest misconception about deficits is that by themselves, they threaten the economy's long-term vitality. Not true. The real threat is rising government spending. The reason is simple. Government spending must be paid for by either taxes or borrowing. If spending rises too high, economic growth may suffer from either steeper taxes or heftier deficits. Spending is the real culprit."

Now is that your view and the administration's view that either taxes or spending create?

Mr. MANKIW. I absolutely do agree with that. One of the things that no economist that I know of disagrees with is the idea that the government faces a budget constraint. What that means is that every time you increase spending, you are increasing taxes, if not immediately, then sometime down the road, and that is the sense as I said earlier the policy of cutting taxes and restraining spending go hand in hand. Permanent tax cut is only feasible if it is with spending restraint. That is why the President has put forward the spending-restrained budget in front of you.

Mr. THORNBERRY. Perhaps we ought to keep our eye on the ball, at least in the opinion of this economist that the real threat is spending levels rather than spending deficits. Mr. Bolten, I want to ask you specifically on the subject of taxes, my understanding is that some of the reductions in taxes which we have passed in previous years are set to expire at the end of this calendar year. I would like to know what those tax cuts that are set to expire, how many people are affected, if you have those numbers, and how they would be affected if they expire in taxes and those areas are allowed to go back up?

Mr. BOLTEN. There are three specific provisions that expire at the end of this year. They are the child credit—these are tax cuts, the child credit that expands the credit to $1,000 per child. There is marriage penalty relief and they are the expansion of the 10 percent bracket. I don't have the exact numbers for you. We would be glad to provide them for the record. Maybe one of my colleagues could help me out with something, but those provisions apply to nearly every taxpayer. Certainly, your average family in America, these are the tax cuts that are important to them. And they make a huge difference in the tax bill that the average American family faces, because child credit, the marriage penalty and the expansion of the 10 percent bracket hits right at the heart of where the tax code hits average American families.

Mr. THORNBERRY. I would appreciate it, if not now, to know how many or what percentage of the taxpayers are affected by each one and how much their tax bill will go up if these tax cuts are allowed to expire.

Mr. BOLTEN. We can break that down, Mr. Thornberry, but I would say that almost every taxpayer in America is affected by at least one of these provisions.

Chairman NUSSLE. Ms. Baldwin.

Ms. BALDWIN. Thank you, Mr. Chairman, Ranking Member Spratt. One of the best ways to appraise this budget is whether it conveys to the American people that this President understands the problems they are facing and attempts to confront those problems head on. Mr. Bolten, today, I would like to take a little opportunity to look at how this budget will affect my constituents. And it seems to me that the President's priorities are more tax cuts, and that those tax cuts continue to benefit the most affluent Americans over middle and lower income Americans, and one of the immediate issues of jobs, health care and education.

And parenthetically, these are the three chief issues that my constituents raised to me when we get a chance to meet and share. This budget makes most of the provisions of Bush's 2001, 2002 and 2003 tax cuts permanent, and at a projected cost of 1.1—sorry, 131.6 billion over 5 years, but at a cost of $936.3 billion over 10 years or $2.2 trillion when one includes interest on the debt.

But it also proposes a series of new tax-favored savings account, the lifetime savings account and a new tax-favored retirement savings account. And in both of these cases, programs appear affordable in the short-term, 5-year picture. But when fully mature, these are projected to cost up to $50 billion per year. These tax initiatives, all of them combined, will certainly drive us deeper and deeper into debt and will disproportionately, as I mentioned earlier, enrich the very most affluent in this country.

In so doing, this will squeeze out our immediate hope in doing some meaningful things to address some our constituents's top challenges, jobs, education and health care. The effect of extending the tax cuts that previously had been passed and due to expire, remains very similar to the original packages before us. The top 1 percent of households will receive on average a $58,000 tax break, but yet the average middle income family will receive a tax break of around $655.

So this commitment of just under $1 trillion over 10 years, only 47 percent or $440 billion will go to the top 5 percent of households. And that is a larger share than the entire 90 percent—bottom 90 percent gets when combined. I think that the new savings plans would similarly benefit the very wealthy. The lifetime savings account, when fully up and running, according to some estimates, would provide the top 5 percent of the population with 50 percent of the tax benefits. The top 10 percent would secure two-thirds of the tax benefits. And believe it or not, the retirement savings accounts are supposed to be even more skewed in terms of who receives the tax benefits. And I don't have time to go into some of the reasons why these appear so skewed in the outyears, but if you look at even current law, the Treasury Department says only 4 percent of those currently eligible to contribute to IRAs are able to actually max out and 5 percent of those participating in 401Ks are able to actually contribute to the minimum. These are the people who are going to receive the real benefit of these new proposals.

But bringing it back home, the average family of 4 in my district will not get a lot of these benefits from these trillion dollar commitments that we are making over the next 10 years, aside from additional interest payment on rapidly-expanding debt. And yet, families in my district are still struggling with recent job losses and significant increase in health insurance costs. And it appears from this budget, reacting to these are simply not a priority. If you will, do you dispute the outyear, 10-year estimates, 2009–14 on the tax-cut extensions that I just mentioned and also the fully implemented savings programs?

Mr. BOLTEN. Ms. Baldwin, I don't actually have the numbers at hand on the LSAs, RSAs. I am going to ask Dr. Mankiw to say something on that. With respect to the extension of the tax programs, I think your numbers sound about in the range that we have estimated, and I think those were roughly the numbers that we were carrying in the budget tables at the back of our proposal. If I may take—Mr. Chairman, if I may go over Ms. Baldwin's time for several minutes because she raised some issues. Can I ask for one chart to be put up on the screen about the tax cuts, because you expressed some concern about the tax cuts being skewed to the rich.

One of the things that happens with our tax code and has happened increasingly over time is that wealthy people have paid a larger and larger percentage of the total income tax. So, therefore, if you cut taxes, wealthy people tend to get more of the tax cut. But the net effect of the tax cuts that this Congress passed, and the previous tax cuts that the previous Congress passed, has been to make the tax code more progressive, and that is demonstrated in this chart.

And let me take one example which is the top 5 percent. Those are the top 5 percent of income earners in this country. Those are people making more than $135,000 a year. And I think most of us would accept that is someone in a pretty high income range. Before the tax cuts, if you took out all of the tax cuts, the income tax cuts that you all adopted, those people were paying 50 percent of the total tax revenue in this country. The top 5 percent would have been paying 50 percent of the total tax revenue. After the tax cuts, that same group is paying 53 percent of the total tax revenue in this country. The result of the tax cuts that you all enacted has been to make the tax code more progressive rather than less.

And I think that is the kind of relief that the tax cuts have made. More importantly than arguing sort of in the rear view mirror about who is benefitting more than who because there is a lot of benefit to go around in these tax cuts, the important part of the tax cuts is that they benefit the economy. Jobs is No. 1, I imagine, in your district. People care most about jobs. And where the jobs are coming from is especially in the small businesses of America.

Those small businesses typically, especially the subchapter S corporations, pay the top income tax rate. They flow through their income and pay the top income tax rate. So when you talk about a tax cut benefitting the rich, a lot of the people getting that tax cut are the businesses. They are getting it through their business to create jobs. It is the small businesses in districts all over America that are really creating jobs. When they get that tax money, they are able to plan, they are able to invest and use that money to create jobs.

If you care about jobs going forward, the worst thing we can do for those folks is threaten them with a tax increase. That will choke off the economic recovery that we are now seeing and cause those people to draw in on their investment and fail to create the jobs that I think are the most important things on your mind and the President's mind as well. Let me ask Dr. Mankiw to say a word about the LSAs and RSAs.

Mr. MANKIW. Let me just say a word about the broader economic impacts of tax provisions aimed at increasing private saving. Private saving is now a low by historical standards, and that is a concern for many economists, and it is concerned both at the micro level that people may not be saving enough, but it is also concerned at the macro level, because one of the things we learn in basic macroeconomic courses is that saving provides the funds available for investment in the economy, new factories, new equipment, new housing. Investment in turn leads to capital accumulation.

Capital accumulation in turn leads to productivity growth. And it is growth in productivity that allows rising incomes, rising real wages and rising living standards for American families. In thinking about the LSA RSA proposal, it is important to think about this not only in terms of its immediate effects, but the fact that this is going to provide incentives to save, which in turn is going to provide the foundation for longer term economic growth.

Chairman NUSSLE. Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman. First thing I wanted to just touch on for Dr. Mankiw, to just follow up on a discussion we had earlier, you described two different aspects or two different ways in which the tax cuts affect the economy for the better. One was the demand side, the sort of immediate impact of people having more cash and they spend it; and the other is the supply side effect of creating greater incentives to work and save and invest. It strikes me that over time, the bigger impact of the two is the supply side effect, the fact that as long as we keep lower marginal tax rates, as long as we maintain lower capital gains rate, as long as we keep the pro-growth policy in effect, we get year after year after year ongoing permanent increased incentives and therefore greater economic impact.

So as you weigh the two, the greater economic value comes from maintaining the lower tax rate regime versus the short-term demand side impact. Do you agree with that or would you characterize it differently?

Mr. MANKIW. I agree with 90 percent of what you said. Most economists would say that the demand side effects would predominate in the short run over the period of 6 months or a year when you have unused capacity, and the idea is to increase demand. People put that capacity back to use. But over time as the economy goes back toward full employment, supply side effects will predominate, and both the supply side effects of lower marginal tax rates, meaning increased incentive to work also means increased incentives for capital accumulation in saving which is—which leads to productivity and growth in the long run.

Mr. TOOMEY. I want to follow up briefly on the comments from my colleague from Texas, which I think were exactly to the point about the real measure of the burden the government imposes on the economy. I have long believed that it is best measured by the total level of spending and the way in which we finance that spending is of secondary importance to the total amount for a variety of reasons. I am very glad we established that once again here today. I think we need to emphasize and keep our eye on the ball. The problem is spending. That is what generates the big deficits and that is what represents the misallocation of capital. In terms of getting that under control, there are several things we have attempted.

In the past, we have had a practice perhaps not always observed, but at least occasionally observed when there was a supplemental appropriation bill introduced, at least the nondefense parts would often be offset or at least there would be an attempt to offset it. I myself offered amendments in recent years to try to offset the nondefense portion of supplemental appropriation bills. Yet we have not been able to do that. And if my recollection is correct, the administration has not requested off sets. Is that the policy of the administration now or in the future, if we do have additional supplemental requests outside of the defense arena to those new spending measures that would above and beyond this budget?

Mr. BOLTEN. Mr. Toomey, we don't have a policy of when we will or not seek offsets. Something as large as a war supplemental, there really isn't a reasonable prospect of doing that. When we see the prospect and see the prospect of actual enactment, we would like to work with you to see to it that any additional spending, for whatever the supplemental may be, that we can offset it because we are concerned about the same things you are: that those supplemental expenditures do tend to undermine the integrity of the whole budget process.

Mr. TOOMEY. When you have a war, it is just not feasible, and I have not advocated that we attempt to offset that kind of magnitude. But as you recall, we did have more modest size and nonwar related supplementals, including about $1 billion for FEMA recently, where I think we could have off set that. And if we can get that situation where it is manageable, I hope you will work with us and establish that discipline in finding those offsets.

Second thing I wanted to observe, I am glad to see that the President is proposing a very, very modest, certainly by recent historical standards, a very modest increase in nondefense, nonhomeland security discretionary spending. I hope we can hold it to even less than that, but certainly that is movement in the right direction. My concern is that only amounts about one-sixth of the total budget here, and two-thirds of the total budget is mandatory spending. We have recently, in recent years, increased that dramatically, a farm bill, this new prescription drug bill which is, of course, an enormous increase. Isn't there something we could be doing now on the mandatory side to try to get this under control, especially since mandatory spending has been growing at a more rapid rate in recent years and it already represents two-thirds of the budget?

Mr. BOLTEN. There is a great deal we can do on the mandatory side. The chairman and you have long both been advocates to control that portion of the spending, which is that much more difficult to control. We have proposals in our budget to reduce some mandatory spending. I alluded to one in my exchange just now with Mr. Spratt on Medicaid, but there are a lot of other areas where I think we can work on holding those expenditures down. And institutionally, I think a very important move we can make is to adopt the kind of budget enforcement legislation that the administration is intending to put forward that would set limits on mandatory spending. If you want to propose to increase mandatory spending under this proposal, you have to propose at the same time to cut mandatory spending.

Chairman NUSSLE. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman. We have a $7.1 trillion debt, national debt in our country right now. We have a $521 billion deficit projected for this year. We are spending almost a billion a day on what I call the debt tax, the interest on the national debt. That is the only tax that can never be repealed. And we are here talking today about what we are going to do this year and how we are going to try and cut that in half over the next 5 years, and I am very, very concerned about the future of our country.

I spoke to a high school class 2 weeks ago. And I said to the senior class why should you be concerned about the national debt. One girl raised her hand and said because we are going to have to pay it off. Good luck to them and good luck to our grandkids, because we are going to saddle them with a debt that I don't think they can ever pay off, especially when it comes to the baby boomers starting to retire and that kicks in as well. So we have some major problems here, and I think this budget submission does not deal with reality of the situation we are facing right now. And I want to be as respectful as I can here, but I am very, very concerned here.

And I think we as Republicans and Democrats need to come together and put aside partisan politics and say we have a problem in this Nation and we have to do something for the future of our kids and our grandkids and our country to make sure that we solve this problem. The chairman talks about how we want to stay strong and free, and I want that and I think both people on both sides of the aisle want that for our country. But a country can't be free, strong, and broke, and that is where we are headed right now if we don't turn things around. When it comes to supporting our national defense, when it comes to supporting our homeland security, I think you are going to have 95 percent of people in this Congress agreeing with that.

And we will support our troops. I voted for the use of force resolution. And I voted for the $87 billion supplemental and I will support our troops, but I don't like it—and with all due respect, when people come in here and say, well, we are not going to tell you how much it is going to cost because we don't know; even businesses make advised and informed judgments and projections and estimates. And you could give us a projection or estimate about a supplemental. If it is wrong, it is wrong but it is better than a zero estimate. And that is what we had last year. I am concerned about where we are going.

Again, I think we need to work together and put aside partisan politics and do what is right for our country. You talk about the worst thing we can do right now to small business—and I want to protect small business and I don't want any tax increases. I voted for the President's tax cuts 2 years ago when we were in surplus mode. I voted against it last year when we were in deficit mode and supported a smaller tax cut that was paid for because I thought it was the fiscally responsible thing to do.

What we need to do now, you talk about the worst thing that could happen is a tax increase for businesses. I think maybe worst than that would be what Alan Greenspan expects to talk about in the next 30, 45 or 60 days, and that is, the danger of interest rates going up when this economy starts chugging again. And you remember the late 1970s. We had interest rates of 14, 16, 17 percent and that would be absolutely devastating for business, real estate, consumer borrowing for everybody in this country as far as I am concerned, except for people who want to get a large return on their investment.

We cannot afford as a Nation and people are not seeing that right now, and I think because we have the lowest interest rates in this country we have had in 40 years. If we don't get a handle on this, I fear we could be in for rough sledding ahead, and we owe it to our country to do much better than that.

The thing that gets me the most about this job is the ungodly partisanship up here. I am not being partisan when I say that because both sides do it, but we need to stop that and start working together for our country. And I guess I would ask you again, I suppose you can't do it today, but please come back to us as soon as possible with some estimate as to what this continuing conflict in Iraq is going to cost, just an estimate so we can plan. I don't expect it to be built in the base.

I understand the reason for that, but you could at least give us an estimate between zero and 50 billion of what it is going to cost. And I would ask you to do that and submit it back in writing as soon as possible. Thank you.

Chairman NUSSLE. Mr. Hastings.

Mr. HASTINGS. Thank you, Mr. Chairman, and I thank the two of you for coming and testifying today. I have to remark with my friend from Kansas, and I know and I understand the compassion he is speaking with in trying to get this resolved and I have been on this Budget Committee—this is my 4th year now, and I remember 9/11 also when we were supposed to meet here and talk about getting into the Social Security trust fund and how difficult that was. But what Mr. Gutknecht didn't say when he referred to that was that times have changed.

September 11 changed a whole lot and that is representative of the need for this country as represented with the increase in homeland security spending of 10 percent, and defense, 7 percent, and trying to keep a cap on other spending because the economy hasn't grown. But the reason I mention to my friend from Kansas' remarks on that, we have the responsibility in this committee to build a budget. I would hope—we are the majority party and we will have a budget. I would hope that we will have an alternative so we can debate the alternative. We didn't have that the last time. And without an alternative this becomes a whole lot of political gamemanship.

So I am with my friend from Kansas. I hope we don't do that. But it seems to me we ought to at least acknowledge there hasn't been a budget that we can debate between the two of us. I want to talk about a couple of issues in my district that hasn't been touched about, but I want to give kudos to OMB, particularly in regard to the commitment that your predecessor made at OMB and you have made at OMB regarding the clean up of the most environmentally contaminated sites in this country, and that is the nuclear sites at Hanford and Savannah River and other places in the country.

The administration made a commitment two years ago to accelerate that clean up that will save billions of dollars in the outyears. I want to congratulate you for keeping that commitment. I just wanted to say you have kind of a proviso in there to have at least some discussion on the reclassification issue. I want to let you know that this member is talking to both the Department and my State to see that that gets done as quickly as possible. And if you want to comment on that, that would be fine.

Mr. BOLTEN. Thank you for your comment, and I thank Mr. Moore for the tenor of his remarks.

Mr. BAIRD. Would my colleague from Washington yield for just one moment?

Mr. HASTINGS. I have a short period of time and I want get my questions——

Mr. BAIRD. We did have a budget last year, an alternative.

Mr. HASTINGS. Again, dealing with the Northwest, and you had some language and some issues there with the power authorities and specifically with BPA and specifically on page 196, you said that the administration might consider proposing legislation regarding Bonneville Power. I understand that this is something that the administration is considering. Now is it true that you are just considering this? Is that an accurate statement?

Mr. BOLTEN. That is correct, Mr. Hastings, and we would be very open to working with you on whatever plans we have.

Mr. HASTINGS. That is something we work with on a bipartisan basis in the northwest, and we look forward to working with you as that consideration comes forward.

Mr. BOLTEN. Mr. Hastings, we are aware of your interest and know what a strong advocate you have been for Bonneville and for all of the folks in that region. And we will certainly be consulting with you closely before we come out with any proposal.

Mr. HASTINGS. I appreciate that, because BPA has tried some innovative things and that was the direction as a matter of fact that this committee and OMB had given them in the past. One last question here in my last minute. To get on the larger scale again, Mr. Toomey talked about the mandatory spending. I am glad you are going after the mandatory spending, because that is two-thirds of the budget. Would you care to comment on the 65 programs that you are seeking to eliminate just briefly. I want to save a minute.

Mr. BOLTEN. Just briefly, Mr. Hastings, we do have a number of terminations proposed in this budget. There are 65 of them. They total $4.9 billion savings over the 2004 enacted levels. In addition to that, we have 63 major programs with major reductions in them. The total savings on that is about $8.0 billion savings over the 2004 level.

So there is quite a bit in this budget—quite a bit of belt tightening. This is not good news all around. There will be plenty of complaints from probably almost every member concerned about something we are proposing to either terminate or ratchet down. We will be ready to work with each of the members as we go through the process going forward. But something we do recognize is that when we have these demands of defense and homeland security, we do need to tighten the belt elsewhere. I think we are doing it in a responsible way, making sure that the real priorities of this country continue to be met.

Mr. HASTINGS. Real quickly, Mr. Chairman, if I may. My remarks regarding a budget was a budget proposal alternative submitted in this committee. That has not happened in 4 years in this committee. That is all I was saying.

Chairman NUSSLE. Mrs. Capps.

Mrs. CAPPS. Thank you, Mr. Chairman and Ranking Member Spratt. I would like to turn our attention—Mr. Bolten, and welcome, Dr. Mankiw as well—to Medicare as a part of our budget. It has been widely reported in the press and it was revealed in the

President's budget that the administration has a much higher cost estimate for the recently passed Medicare legislation, projecting a 10-year cost of $534 billion, a $139 billion increase over CBO's estimate. Now in a letter from the CBO to Chairman Nussle dated yesterday, CBO explained the differences, including a $46 billion higher payment for private plans. Can you confirm that the administration estimates that private plans will receive increases of $46 billion under Medicare legislation?

Mr. BOLTEN. No, I can't, Mrs. Capps. The actuaries have a large number of differences. I don't have any reason to disbelieve the number, but it is a very complicated area.

Mrs. CAPPS. Yesterday, HHS officials briefed staff stating that the administration's estimate for payments to private plans is $46 billion. And in a letter to Chairman Nussle dated yesterday as well, CBO stated, and I quote, "Both estimates assume that many of the participants in Medicare Advantage, which are the private plans as they are called now, are in areas where the payments to MA plans and beneficiaries through premium rebates would exceed what it would cost if those beneficiaries were in the fee-for-service sector. Most of the additional participants in the administration's estimate are in relatively low cost, low density areas where the payments to MA plans and beneficiaries would be substantially higher than the cost of those beneficiaries in the fee-for-service sector."

In other words, it would cost more to make these payments to private plans than it would to keep seniors in traditional Medicare. And my question is why should we pay private plans so much taxpayer money to provide services that would be cheaper in traditional fee-for-service plans—in a traditional Medicare fee for service?

Mr. BOLTEN. I have to leave it to the actuaries who have done the briefing to provide you with the actual numbers. But stepping back to the principle involved, which I think is what you are asking about the Medicare bill that you all enacted last year adopts the very sound principle that that system overall will be better off if there is competition and choice in the system so that seniors who want to—only those seniors who want to, can move into a private plan that has a very strong history of providing both superior service, of providing more innovative service and ultimately doing it at lower cost.

Within the budget window that the actuaries are talking about, there is an anticipation——

Mrs. CAPPS. I would like to state for the record, according to Medicare Payment Advisory Commission, MedPAC, Medicare already pays private plans 19 percent more than what it would cost to serve those same seniors in the Medicare fee for service plan. And based on data from HHS's own actuaries, the average annual growth in Medicare spending from 1999 to 2002 was 6.4 percent as compared to 10 percent for private health insurance. This is the evidence that we have. And even when you scrub the numbers to make sure they only compare benefits covered by both Medicare and private plans, Medicare growth was still lower at 6.2 percent compared to 8.7 percent for private plans.

And you may say that private health plans are better at controlling costs, but all the concrete evidence is against you. MedPAC, the foremost resource on Medicare financing, clearly says that private plans cost taxpayers more than traditional Medicare. And even the data from your HHS supports this conclusion.

On top of that, the fact is that they cost the taxpayer more and private plans are also less reliable than traditional Medicare. Across the country, even when they get increased payments, the private plans keep cutting benefits, raising cost-sharing and getting up and leaving our loved ones in the lunch. I strongly urge that the administration rethink this policy like our seniors are doing as they are receiving this bill and the language that it has been couched in. And I think we should go back and do away with this failed privatization experiment. I have left you a few seconds to comment on these strongly-held convictions and the data that I bring from my constituents in my district.

Mr. BOLTEN. I understand the convictions. There is a philosophical divide here that I think was resolved in the Medicare bill that you all adopted and that is, do you trust the government to be dictating what seniors——

Mrs. CAPPS. How do you respond the statistics that I have given to you from MedPAC?

Mr. BOLTEN. I don't have any basis to dispute the statistics of what is happening now in the short run. In the long run, I have every confidence that the private sector is going to be able to provide——

Mrs. CAPPS. Based on what? Based on what?

Mr. BOLTEN. Based on 200-some years of history in this country with a system in which the most innovation comes not from the government, the most efficiency comes not from the government, the most quality of care comes not from the government but from innovation in the private sector. And I think that was effectively litigated and resolved in the bill that you all adopted.

Mrs. CAPPS. I yield back.

Chairman NUSSLE. Just because you referred to it, I think it is my duty, since the letter was to me, to ask that it be made part of the record. I ask unanimous consent that the letter from CBO be made part of the record and I believe and I hope it has been distributed.

Mrs. CAPPS. Thank you very much.

[The information referred to follows:]

CONGRESSIONAL BUDGET OFFICE,
*Washington, DC 20515,*

February 2, 2004.

DEAR MR. CHAIRMAN: CBO's baseline budgetary projections released in the Budget and Economic Outlook include $395 billion in outlays over 2004–13 for the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108–173). That amount is identical to CBO's scoring of the bill when passed. In contrast, the administration estimates that additional outlays resulting from that act will total $534 billion over the 2004–13 period.

Of course, a complete comparison of the overall budgetary impact of the legislation must also consider the effect on revenues. CBO estimates that the revenue effects of the legislation are largely offsetting. The legislation reduces revenues by providing qualified taxpayers with health savings accounts. At the same time, it increases revenues, CBO estimates, as businesses reduce expenditures on nontaxable health benefits and increase them on taxable wages. The administration has not released its estimated effects of the legislation on revenues. Those estimates could certainly differ from CBO's.

Because the new prescription drug program represents a major departure from what currently exists, there is a great deal of uncertainty about its budgetary impact and a wide range of possible outcomes. CBO's estimate was the result of extensive analyses of the pharmaceutical drug market, the Medicare program, and the likely responses of potential enrollees. To date, we have not received any additional data or studies that would lead us to reconsider our conclusions. Therefore, CBO believes its estimate is sound, and has no reason, at present, to revise it.

CBO has consulted with the administration to identify the major factors that account for the differences between the two estimates. Although such a comparison is complicated and we do not have complete detail on the key attributes, it appears that the difference derives from of differing assumptions or estimates in a number of areas. Attached is a sununary of those major differences. We will continue to work with the administration to understand the differences in more detail.

I hope this information is helpful to you. The CBO staff contact for this analysis is Tom Bradley, who can be reached at 226–9010.

Sincerely,

DOUGLAS HOLTZ-EAKIN,
*Director.*

COMPARISON OF CBO AND ADMINISTRATION ESTIMATES OF THE EFFECT OF H.R. 1 ON DIRECT SPENDING

*Note: CBO estimates that the revenue effects of II.R. 1 total less than $0.5 billion over 10 years. CBO presently has no specific information on the administration's estimate of the revenue e/fects of H. R—1.*

The administration's estimate of $534 billion in outlays through 2013 is $139 billion higher than CBO's $395 billion estimate. Almost all of that difference is attributable to our estimates of the Part D drug benefit and the Medicare Advantage program.

PART D DRUG BENEFIT: THE ADMINISTRATION'S ESTIMATE IS ABOUT $100 BILLION HIGHER (2004–13)

Basic benefits account for about $32 billion (about 7 percent higher than CBO estimate).

The administration assumes a higher participation rate (94 percent of all Medicare enrollees, compared to CBO's assumption of 87 percent participation).

Both agencies exclude about 5 percent who would be subject to secondary payer rules. The administration assumes that 94 percentage points out of the remaining 95 percent will participate.

CBO excludes Medicare enrollees who decline Part B—we assume those beneficiaries generally will not participate because they have already showed that they will turn down a benefit with a 75 percent subsidy. CBO also excludes some beneficiaries who have generous prescription drug coverage through the Federal Employees Health Benefits program and other Federal programs.

The administration estimates per-capita costs that are about 4 percent higher throughout the 2006–13 period than CBO estimates.

The differences in the number of participants and the per-capita costs each account for about half of the $32 billion difference in the cost of the basic benefit.

The administration's low-income subsidy is about S47 billion higher (a 24 percent difference.)

The administration assumes higher participation (13–15 percent higher than CBO after the third year of the program). CBO estimated participation in the low-income subsidy based on experience with participation of Medicare beneficiaries in the Medicaid, QMB, and SLMB programs.

The administration assumes full participation immediately; CBO ramps up over 3 years.

The administration's per-capita cost is higher than CBO's-initially 7 percent to 10 percent higher, with the difference shrinking to 4 percent by 2013.

Savings in the Medicaid program account for about $18 billion of the difference. Medicaid savings will occur because creation of the Medicare drug benefit will end Medicaid's responsibility for providing prescription drugs to individuals who are eligible for both programs. However, those savings will be offset, in part, by additional Medicaid costs for newly enrolled people. CBO estimates that H.R. 1 will reduce

Federal Medicaid spending by $141 billion over the 2004–13 period, compared to administration's estimate of $123 billion.

CBO's estimate of net savings is higher largely because of differences in baseline projections for Medicaid spending on waiver programs to provide limited drug coverage to low-income Medicare beneficiaries who do not otherwise qualify for Medicaid. CBO's baseline projection of Federal Medicaid spending for those waiver programs was $18 billion higher than administration's baseline projection.

MEDICARE ADVANTAGE: THE ADMINISTRATION'S ESTIMATE IS $32 BILLION HIGHER ($46 BILLION VS. $14 BILLION)

The administration assumes much higher participation (32 percent of Medicare beneficiaries enrolled in Medicare Advantage (MA) plans vs. CBO's estimate of 9 percent[1]).

Both estimates assume that many of the participants in MA plans are in areas where the payments to MA plans and beneficiaries (through premium rebates) would exceed what it would cost if those beneficiaries were in the fee-for-service (FFS) sector. Most of the additional participants in administration's estimate are in relatively low cost, low density areas where the payments to MA plans and beneficiaries would be substantially higher than the cost of those beneficiaries in the FFS sector.

Chairman NUSSLE. Mr. Schrock.

Mr. SCHROCK. Thank you, Mr. Chairman, Mr. Bolten, Dr. Mankiw, thank you for enduring us again. I want to ask you a question. According to your testimony, the current deficit is 4.5 percent of the GDP. What is the high est percentage of GDP that the deficit has ever increased? I think for relation purposes, it would be good to know that.

Mr. BOLTEN. In the last 25 years, the highest has been 6 percent of GDP in 1983 during the Reagan administration. In World War II, it probably spiked above 30 percent. So in all-out wartime, it got much higher. But in modern times, the highest was 1983 at 6 percent of GDP.

Mr. SCHROCK. One of the President's goals is to cut the deficit in the next 5 years, and I wish we could do it quicker and do you think it is doable? Do you think we could do it quicker? And if so, what is the path you take to get us there?

Mr. BOLTEN. The chart that I had up on the screen showed that we do get there more quickly than 5 years of cutting the deficit in half as a percentage of GDP. It looks like on the numbers that we have—let me take the one with the green bars, you will see that on the current numbers, it looks like we just barely make it in 2006. The members have been correct in pointing out that especially in 2005, and maybe even in 2006, we will need to add in money for war in Iraq and Afghanistan.

So that may be an unrealistic expectation to say we will make it by 2006. But by 2007, 2008 and 2009, I think we are comfortable in that range if we adopt the President's policies. One important caveat I want to comment on is that we are making conservative economic growth assumptions. We are on the low side of CBO and the Blue Chip economic forecasters. The biggest factor in bringing these deficits down more rapidly is strong economic growth. And that is why we are so convinced that the right thing to do is not impose a tax increase in this economy, but to keep the tax cuts

[1] CBO's estimate of 9 percent participation in MA plans does not include the effect on participation of payments to plans from the stabilization fund. The estimate assumed the stabilization funds would be spent, but CBO did not estimate the number of participants who would enroll in plans as a result of those expenditures.

going, because if we can get better economic growth out of this economy, we will get that deficit down that much more rapidly.

Mr. MANKIW. We do make conservative economic assumptions. We very much try to track the private sector, but our forecast was locked almost 2 months ago, and there has been good news in the economy. So I think right now, the forecast implicit in this budget is on the conservative side of the private sector forecasters. For example, in 2004, year over year, we have 4.4 percent growth rate. The Blue Chip consensus of private sector forecasters is 4.6. And CBO was 4.8. The same thing is true in 2005. We are a little conservative compared to the Blue Chip and CBO. If CBO turns out to be right on economic growth, that will be good news as far as the deficit concerned.

Mr. SCHROCK. Do you think it is possible to grow our way out of this deficit?

Mr. MANKIW. I don't think by itself. It is going to require spending constraint. But the way we are going to get ourselves out of the deficit is a combination of robust economic growth, which we are forecasting and CBO is forecasting even more over the next few years, together with the spending restraint.

Mr. SCHROCK. Mr. Bolten, the President's budget also proposes two significant spending controls, caps on discretionary spending and then a pay as you go mechanism for entitlement programs. How serious do you think the President is this year in enacting the budget controls? And would you say insisting on them is the price for signing the appropriation bills?

Mr. BOLTEN. The President is serious about them, and I have discussed them with him directly, and I have shared with him the keen interest among members of this committee with reinstituting those kinds of controls. So he is quite serious about it. It is probably not up to me from this witness chair to say what the President is likely to insist on or not, but I do know he attaches a priority to it. We at OMB and CEA, and I think I speak for Dr. Mankiw as well, attach a very high priority to it, and we are anxious to work with you on it.

Mr. SCHROCK. He has threatened to veto and never has. He has never not signed a bill. Do you think he would not sign the appropriations bill? Is he that serious?

Mr. BOLTEN. I think the President would certainly not sign an appropriations bill that went outside the limits that he was proposing to keep us to. And I repeat that I think the leadership, your chairman, the rest of the leadership and the Congress was very effective this past year in making sure that the appropriations did not exceed the limits that were agreed to by the President.

Mr. SCHROCK. I hope so.

Chairman NUSSLE. Mr. Thompson.

Mr. THOMPSON. Thank you, Mr. Chairman and Mr. Bolten. I would agree that September 11 and a downturn in the economy created a bunch of challenges that we had to deal with, but I really don't think that they explain what I see is a real credibility gap in the document that we are looking at today. There are admissions. There are—outyear costs are ignored. If you look at the tax cut provisions, the big cost doesn't come until after 2009, and that is at the same time we have a huge spike in the baby boomers that are going to be dependent upon different services. And I think that has to be explained to have any credibility.

There is a PAYGO provision in this document, but it only applies to one side. It doesn't take into effect the revenues. And I don't know how you can spend—do tax expenditures without calculating where those costs are going to come from, because like everything we have discussed here today, that money comes from someplace. And as it is right now, it is merely tacked on to this incredibly large and ever-growing national debt.

There are discrepancies between the two entities that calculate the costs of these programs, most notably is the prescription drug bill. It is $135 billion different cost from one entity vis-a-vis the other. I hate to beat a dead horse, but the whole war-funding issue, it is just not here. We have a budget document that does not have one penny regarding funding for Iraq. And that is just not—you could not take that out to any one of our districts and get one constituent that any one of us represents to see where that is justified. It would be probably laughed at. And there are also cost shifts in this document. Some on this committee are fond of talking about what constitutes a tax cut.

Well, if you are going to charge veterans who leave the military with an understanding that they get health care, a $250 charge and these aren't rich guys, these are 30,000-something a year salary with five dependents, that is a cost shift that these people are having to bear. And then the idea of cutting local law enforcement by the number in your document and then put a slide up that suggests that we are increasing funds for homeland security, these are the first responders, the fire and the police guys.

And if you take it with one hand and then give it back with another, the local guys who are going to have to respond, if there is a problem, are going to have trouble doing that. And I think these issues need to be addressed. And I would like to hear on PAYGO how you can possibly expect us to support half a PAYGO program. Seems to me we should look at both the expenditures and the tax expenditures as well.

Mr. BOLTEN. Mr. Thompson, I am going to ask Dr. Mankiw to talk in more detail about the distinction between mandatory spending increase and a tax increase or a tax cut. But the short version here on that specific question is that it is, as Dr. Mankiw and others have described earlier, it is spending that is the problem. It is overspending in the economy that damages the economy, and it is not undertaxing that damages the economy.

Mr. THOMPSON. But it is a loss of dollars that are available. That would be like saying I want to retire, work part-time, make 30,000 a year and put an addition on my house, and the banker is going to say how are you going to pay for it? That doesn't wash. You have to be able to assess where the money is going and where the money is coming from.

Mr. BOLTEN. I want to take up one of the other things that you mentioned, because several of the things you mentioned, I think we have had a chance to have an exchange on. But one of the things you mentioned last, is the first responders, and I want to come to it because I think it is a very good example of where we in the administration and this Congress need to make some tough choices about priorities. The President is proposing to increase homeland security spending overall by 10 percent. There are large increases in biosurveillance. There are large increases in counterterrorism efforts and so on. And I apologize, Mr. Chairman, if I could go over just a minute here. But we can't spend on everything. And one of the areas where we have been spending in homeland robustly is in getting money out to first responders. And we have put that money out since September 11 as a capacity-building undertaking to bring the first responders all over America more up to the risks that we face.

Mr. THOMPSON. That may be, but the point I am making, you give it up on one program and take it away from local law enforcement and firefighters on the other, and it comes out of the same pocket of the local law enforcement and local firefighters and first responders.

Mr. BOLTEN. This is part of the very difficult exercise that we need to engage in jointly, which is making some choices. In our budget, we have made the choice that more of that first responder money—there is still a good chunk of that money in here, but a lot more of that first responder money needs to go to the high-threat areas, to the urban areas, critical infrastructure and so on and get moved away from your average city and town that probably is not realistically under as much threat. This would be unfortunate news to some, a lot of police chiefs and fire chiefs in all of your districts, but it is the right way to set our priorities if we are going to protect the homeland. Those are the kind of choices that are made in the budget. There is a lot of money in this budget going in to first responders, but we are going to focus it on the high-threat areas and unfortunately disappoint some people who are not in the high-threat areas. Let me ask Dr. Mankiw to respond on the other.

Mr. MANKIW. When thinking about fiscal policy, there is more to think about than just the budget deficit. The budget deficit is obviously an important measure of what fiscal policy is doing, but what it doesn't capture is how fiscal policy is affecting the incentives that the tax code is giving for people to work and save, how the tax code is affecting the cost of capital and the incentives for people to start businesses and hire workers. So that is the sense in which you can't think of tax increases in equivalent ways of reducing much deficit. Taxes have important effects on incentives and typically adverse, and as a result, impede economic growth. Summary measure is an incomplete picture of what fiscal policy is doing to the entire economy.

Chairman NUSSLE. Mr. Putnam.

Mr. PUTNAM. Thank you, Mr. Chairman. I didn't mean for you to skip over Mr. Crenshaw, but I will be happy to move ahead. The agencies that are facing cuts, Agriculture, HHS, Transportation, there is a common thread there that I observed and I wanted to know if it is just a coincidence or it is material, they lost significant portions of their apparatus to homeland security, which has gotten huge increases in the last couple of years. So are we, in a sense realizing savings from some of these agencies? Now grant it, it is a transfer to homeland security and not necessarily a real savings, but are we seeing a net reduction in the size of these departments as a result of shifts of agency and personnel to homeland security? And if so, what kind of a number are we talking about?

Mr. BOLTEN. We are undoubtedly seeing that but we have tried to adjust for it in the budget. We may have missed some things, but by and large as we presented the numbers to you, we have tried to adjust for the transfers that have taken place so that if you look at last year's budget or the year before, more importantly the year before, you would still be looking at apples to apples and not looking at a highly distorted situation because the Treasury Department lost the Customs Service over to the Department of Homeland Security.

Mr. PUTNAM. So the reduction is a net real reduction in spending then?

Mr. BOLTEN. In most cases, yes.

Mr. PUTNAM. One of the things that I have observed in my very short period of time here as it relates to defense, in particular, is how outstanding our men and women in uniform are at doing exactly what they do best and how poor a job in many cases the underpinning logistics personnel, procurement, human resources, database, IT, all of the components of the democracy are. And while it is important while we hold homeland security and defense somewhat harmless, I am wondering if there is an effort to address some of the cost-saving recommendations that have been made by GAO and other congressional oversight agencies.

Consistent double-digit increases, while clearly very important in wartime, they also create instances of waste. And I want to make sure we are not holding them harmless from oversight as well.

Mr. BOLTEN. We are not, Mr. Putnam; and we appreciate the interest that you have and I know the chairman has, a lot of other members have, in holding the government's feet to the fire on this very issue. Because we have seen over the last decade or so enormous increases in productivity and efficiency in the private sector, and it is hard to see that in government, and we are doing the best we can to try to squeeze the same kind of things out of government that has happened in the private sector.

One of the mechanisms we use to do that in this administration is through the President's management agenda. We keep a score card, and you can find it in the budget here. Look for the little red, yellow and green lights that appear next to agencies and to programs. We now are going around assessing all the programs in government and saying, is it delivering value for money, for the taxpayer's dollar?

As we have gone about making our budget decisions for this 2005 budget in the past, and increasingly in the future, we are going to be basing those budget decisions on which programs are delivering real value for the taxpayer's dollar; and, if they are not, we either need to fix it or take the money away from that program.

Mr. PUTNAM. We appreciate that. You and your predecessor have put management back into the Office of Management and Budget, and that is important. I hope you stay on it.

Mr. BOLTEN. I give Mitch Daniels a lot of credit for that. I think he has really set us on a good path; and we have a terrific deputy director at OMB who is not here with me today, Clay Johnson, who is driving that agenda very effectively. We are very grateful for that.

Mr. PUTNAM. Dr. Mankiw, following up on some of the discussion about economic growth and the need to grow our way out in addition to spending restraint, your estimates are fairly conservative in terms of GDP growth. What would each additional point in GDP growth translate into in terms of revenues to the government and its impact on the deficit? Is there a way to calculate that?

Mr. MANKIW. Yes. There are sensitivity assumptions in the budget that will tell you precisely how GDP translates into that. I don't have those numbers in front of me, although Steve is about to find them. So there is no question that higher GDP translates into higher revenues. We might even have that right—we will get that number to you. It is in the budget somewhere.

Mr. PUTNAM. Thank you very much.

Chairman NUSSLE. Mr. Baird.

Mr. BAIRD. I thank the chairman.

First of all, what happened to the lock box and what would be the actual deficit if we didn't actually borrow from Social Security and Medicare to mask the size of the true deficit?

Mr. BOLTEN. I don't have the figure at hand. I think it is reflected in the budget documents. But we look at the budget on a unified basis, which is the way that previous administrations going back for decades and the CBO have always looked at the budget deficit. Because what is important about the deficit is what is it taking—what is it requiring the government to borrow from the private sector to meet its financing needs? So the unified budget deficit is, I think, the relevant measure to use for that purpose.

Mr. BAIRD. So what is the on-budget deficit projected to be for 2005, then?

Mr. BOLTEN. For 2005 we show if you were to take the Social Security surplus out it would come to $543 billion.

Mr. BAIRD. And if you counted the borrowing we are doing from Social Security surplus, what would that deficit then be?

Mr. BOLTEN. I think that is the figure I have just given you.

Mr. BAIRD. So $543 billion.

Mr. BOLTEN. Yes.

Mr. BAIRD. I show, it looks to me—how much are we borrowing from Social Security then, from the trust fund?

Mr. BOLTEN. Well, the Social Security surplus in 2005 is projected to be $179 billion.

Mr. BAIRD. So, in other words, that is effectively what we are rolling into the budget, which I think we promised we wouldn't do when we talked about lock boxes.

Mr. BOLTEN. Well, every dollar is still being set aside.

Mr. BAIRD. I understand the economic theory, but the Congress and President talked a lot about a lock box, and we don't hear that much anymore, and the folks back home ask what happened to it.

Mr. BOLTEN. But it remains true that every dollar that is going into Social Security that is coming in in Social Security taxes is being set aside in the accounts of the U.S. Government to be paid out for Social Security benefits.

Mr. BAIRD. But we borrowed from it and written an IOU.

Mr. BOLTEN. But that money will be there for Social Security beneficiaries. In the long run in Social Security that situation is going to change, and that is why I think we need to pursue fundamental Social Security reform.

Mr. BAIRD. Let me ask a second question. As I look at the transportation bill, there is an enormous difference between the President's numbers and the numbers that the Transportation Committee has looked at. The Transportation Committee numbers came out of several years of hearings with experts from the States and the industries saying this is what we need to fix our infrastructure deficit. How do you propose we make up that difference? Does it fall to the States or the local communities, this more than $100 billion difference?

Mr. BOLTEN. I think some of that burden is going to have to fall to the States and locals if there are actually unmet needs. In the administration's view we can meet the appropriate Federal share of highway spending with the $256 billion that we have proposed, which as I mentioned before is a 21 percent increase over the last 6-year Federal highway——

Mr. BAIRD. It is fascinating, because that is not anywhere close to the indication that we have had from all the hearings we have had in the Transportation Committee; and, interestingly enough, that is one of the provisions of the budget that could actually be funded if we were to look at a pay-as-you-go kind of measure for transportation.

It could be a self-funded measure, but the administration has drawn a line in the sand, which raises another question for me. Has anyone calculated how much the President's budget shifts the cost onto States and local communities in the name of patting ourselves on the back and saying we have lowered your taxes by a trillion dollars or so at the Federal level? If I look at COPS funding and the zeroing out of Byrne grants and the cut for wastewater treatment and inadequacy of funding of transportation, aren't we shifting literally hundreds of billions of dollars on to the States which are already financially strapped?

Mr. BOLTEN. I don't believe that is the case. I don't have a calculation for you, but there is a great deal of Federal money that does go out the door in share money to the States, in grants to the States that are to be passed on, including especially for our education programs which have been dramatically increased under this President. I don't have a calculation for you, but I think what we need to do at the Federal level is to decide what is the proper Federal responsibility, and I think this budget and the administration thinks this budget hits the right target on meeting the Federal responsibilities in terms of what funding we need to be passing on to the States.

Mr. BAIRD. I would be interested over the next few weeks, as all of us have folks coming back from districts asking how can we get some Federal help, to be honest with them and say we are cutting your budget like crazy.

Mr. Mankiw, before I finish, I thought you heard you say something remarkable, all Federal spending, earlier, leads to increased taxes. You can think of no government programs, no Federal spending that have actually lowered taxes over time? The Internet creation, for example.

Mr. MANKIW. What I am saying is that the government faces a budget constraint. Technically, that means that the present value of government spending has to equal the present value of tax revenues. So that if the government decides to change one side of the equation, it is going to have to at some point in time change the other side of the equation, much as a household over the long run its consumption and consumer spending and income have to sort of balance in some present value sense. So if the government is going to sort of spend more money, at some point it is going to have to raise revenue to pay for that spending.

Mr. BAIRD. Thank you, Mr. Chairman.

Chairman NUSSLE. Thank you.

Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Bolten, while I hear a lot from the other side of the aisle about deficits, would you agree that the President has inherited a defense and homeland security deficit he had sought to correct?

Mr. BOLTEN. The President did encounter a situation in which defense spending had been declining for many years. He made a commitment to restore that, and defense spending over the course of the President's four budgets is up over $100 billion from where it was, from about $300 [billion] to $400 billion, to transform the military, restore the strength of the military.

On the homeland security side, in many respects an entirely new subject for this country. Funding as we measure it, and it is a little hard to measure, was at about $10 billion at the time the President came into office. The President has tripled that in his budgets, and we are now up in the $30 billion region.

So these are necessary expenditures for our national security, for our homeland security that have been at the top of the President's priority list.

Mr. BROWN. Thank you very much. This has been my observation, too, as we talked about the supplemental bill, whenever that may come again.

We were over in Iraq, and we actually saw firsthand what is going on over there. It is difficult to predict how long those troops will be there and exactly what their needs will be. I am just pleased we had a chance to meet with them and how high-spirited they were and how much they believed in what action was taken.

So I was pleased that I had a chance to see firsthand, but I think you are right on target. Why try to build in some margin of—a factor that we are not quite sure whether we will need it or not? So I applaud you for taking that initiative.

I am concerned about the highway bill myself, coming from South Carolina where there is a tremendous amount of road needs. We have a tremendous influx of tourists. And I know that basically the highway system has been driven by user fee, I guess, on the fuel. But I notice, too, as part of the 256 I believe you mentioned in this budget here, how much of that is exactly mass transit and how much is being attributed to enhancement funds?

Mr. BOLTEN. Congressman, if I could just provide you that for the record. I don't have that at hand, but my recollection is that it is about a four or five to one ratio, I think, if I have got that about right. But let me get that to you for the record.

Can I make one comment about your earlier remark which is it may come as a surprise to many members but something I hear consistently from our folks over in Iraq, from the coalition provisional authority and from the military there, is that they very much appreciate it when you and other Members go to visit, that it puts a little extra burden on the security situation, but it means a lot to the men and women in uniform over there that people are concerned, people care, and that you go out to visit them. Somewhat surprisingly, the military actually encourages the visits that you all make because they are important for the morale and they are important for you all to see the important mission that is being done there.

Mr. BROWN. And then, on spending the trust fund money for items outside the trust fund like mass transit enhancement, how do you feel about that as you addressed the budget?

Mr. BOLTEN. Well, those are also expenditures that are inherent in the highway program.

Again, I will give you for the record exactly the breakdown that Secretary Mineta and Secretary Snow have in mind within that 256; and, if I may, I may ask them to be in touch with you directly to ask them to give you the full rationale for the numbers that are contained in the President's budget.

Mr. BROWN. OK. Because I think the Senate might have had a different idea about how they would fund some of those items. I noticed part of the three points I think the President introduced in this budget that he would not allow any general fund money to be used for highway money, but I certainly see mass transit enhancements as two different things other than just user-fee-driven items.

Chairman NUSSLE. The gentleman from Illinois, Mr. Emanuel.

Mr. EMANUEL. Thank you, Mr. Chairman.

When you run a record deficit of $521 billion, it goes to prove the theory that you cannot finance three wars with three tax cuts. And that is what we got. We got a historic deficit, and the reason we got it is we are trying to finance three separate wars with three tax cuts: the war on terrorism, the war in Iraq, and the war in Afghanistan.

I have heard the lecture for the last year, for a longer period of time from a lot of other folks from the other side here, including members of the administration, that if you have a growing economy, the deficits will go down. You all are projecting growth in the mid 3 range, somebody has it at 4 percent, and yet we are hitting a historic high deficit. So what we have here in my view is not just a fiscal deficit but a credibility deficit.

You want to increase the war on terrorism, homeland security; yet you cut police and firefighters.

You want to talk about the importance, as Secretary Evans did, about the importance of our manufacturing industry and how we are going to now focus where the manufacturings are; yet we cut the Manufacturing Extension Program which helps small business manufacturers.

We talk about Medicare. We had a number of $400 billion. We all debate it. Yet it is coming in at $540 billion.

You just a second ago, Mr. Bolten, whom I respect greatly, talk about government following how business do things in the private sector and get more efficient. Some of us believe that if Medicare was allowed to negotiate like the private sector we would get efficiencies, but because of the influence of the pharmaceutical industry, the government couldn't act like a business and be more efficient.

Now the White House wants to talk about holding nondiscretionary spending, but if you look at the White House's expenditure and OMB expenditure, your own budgets have gone up 7 and 15 percent respectively over the last 3 years.

I also think, on Iraq, last year you didn't have a number for the war in Iraq and yet 2 months after the budget you presented a number. The chairman of the committee himself said, whom I greatly respect, and we all agreed, don't come back here next year without a number.

Now if you can't predict a year number, how about putting 6 months in? Because I think we can all safely agree around here we are not going to be out of there in 6 months. We are not going to have less than 100,000 troops there.

So what we have here, as a great movie once said, is a failure to communicate. What we have here is a credibility deficit, let alone a fiscal deficit.

I admire your ability of always talking about how the government should start catching up to where the private sector has been. There are members of both parties here who have talked on Medicare of how to get the government to act like the private sector. We permitted private sector insurance industries to do both negotiating. We want Medicare to create a Sam's Club for 41 million members, both negotiate, get reduced prices, get efficiencies. It is prohibited. So I compliment you and I really welcome that you want government to work like a business, but we are not allowed to do that here.

I just find on a series of fronts, whether you look at the war on terror, cutting police and firefighters, whether you look at the Manufacturing Extension Program, which we have cut and not fully funded, Medicare, the White House funding, OMB funding compared to nondiscretionary, and then the war in Iraq, that in every one of those areas we have said one thing and done another.

I think when the budget comes up it represents—as the President once said, your word has to be credible. I agree with that; and, unfortunately, we are woefully short of that goal, not that Congress has been all—ever perfect.

Not all tax cuts are bad. In fact, some tax cuts lead to economic growth. But not all tax cuts lead to the same amount of economic growth, and not all government spending is good. Some is more productive in the areas of education, health care, and the environment; and some is wasteful. We in this budget don't make those choices, and so it is going to be left up to both—Members of both parties to start making those choices, because this budget doesn't give us, in my view, a starting point to make it.

I yield back the rest of my time.

Chairman NUSSLE. Thank you.

Mr. Franks.

Mr. FRANKS. Thank you, Mr. Chairman.

Mr. Chairman, you mentioned when we began this committee that really the only way to deal with the deficit was one of three venues; and that was to raise taxes, to cut spending, or to grow the economy. I guess I just want to point out I think you are correct, but I want to point out that the President has done some pretty significant things toward trying to grow this economy, and if there is anything that is obvious in this process it is that the tax cuts that he implemented have had a dramatic impact on the economy.

I think in terms of the spending aspects we should perhaps even look at the recent Medicare bill where the President had asked for something much smaller and much less costly than what we gave him.

It is also important to keep in mind that the alternative that our friends on the other side of the aisle advocated was much more expensive.

Having said that, the discussion related to the whole Iraq war and the projections that the Office of Management and Budget have to make is underscored by something. As it turns out, Henry Brown here took me with him to Iraq, and one of the things that we discovered over there was that in June there will be an election that will essentially put almost all of the control of that government into the hands of the new Iraqi leadership, which could encourage us to stay or encourage us to leave, and it really underscores the impossibility that you have to project what kind of spending that we will make over there.

Having said that, it has been said that there are no easy or simple answers. I would suggest to you there are simple answers sometimes. There are no easy ones.

When it comes to balancing this budget, Mr. Moore over here mentioned that 95 percent of us will support the President on homeland security and on the defense budget. I guess my question to you—and you probably are not going to be able to give me an answer here, but I really sincerely hope that you would perhaps try to make a collegial effort at trying to give us an answer at some point. What if we said, all right, so we will leave the homeland and defense numbers that you project the same, we will make the tax cuts permanent, and we will freeze everything else until she balances. How long would it take us to balance the budget if we simply froze it at the amounts that we have now?

I know that people say that is outrageous, but it was pointed out recently here by a colleague that in World War II we saw this huge spike in the deficit, 30 percent or more, and yet that was the time when we actually saw a precipitous drop in discretionary spending. Those things show us that when people need to do something badly enough, they do do it.

Is it impossible in this day and age that we could leave defense spending and homeland spending for the increases and freeze everything else until we balance this budget?

Mr. BOLTEN. Mr. Franks, it is not impossible. The budget that we have presented is not all that far off of that particular goal. We are glad to work with you as we go through the budget resolution. We think we have done a lot of belt tightening in this budget. You have heard from some of your colleagues that the belt is pinching a little too tightly in some areas. We will be hearing from probably almost every Member at some point that the belt is tighter in some place than they want it to be. We have gone a long distance in that. I am sure there are other distances to go.

So I would say to you, no, it is not impossible to get to the kind of budget you are talking about.

Mr. FRANKS. I will just leave this last thought here. A lot of times in such a debate there is a lot of rhetoric that is used that the nomenclature becomes pretty confusing after a while. But I think one thing that the American public could understand and perhaps even support us on is if we said, all right, we are going to take care of homeland defense, we are going to take care of defending the Nation, we are going to do what we can to stimulate this economy, and we are simply going to freeze where we are until we balance this budget and deal with this crisis. I think you folks have made a magnificent effort, and I really sincerely would ask you if you might to give me what that projected date would be if we try to freeze it where we were until it balanced. Would you do that?

Mr. BOLTEN. We will do our best, Mr. Franks.

Mr. FRANKS. Thank you, sir.

Chairman NUSSLE. Ms. DeLauro.

Ms. DELAURO. Mr. Mankiw, you published a book in the 1990s, "Principles of Economics." It included a section on President Reagan's economic policies which, like those of President Bush, called for deep tax cuts based in part on the idea that tax cuts could help pay for themselves by producing faster economic growth. You entitled the portion called Charlatans and Cranks, where you ridiculed the Reagan policies as, quote, "fad economics and tantamount to fad diets."

Quote: An example of fad economics occurred in 1980 when a small group of economists advised Presidential candidate Ronald Reagan that an across-the-board cut in income tax cuts would raise revenue.

After reviewing the impact of the Reagan policies, which included a run of high-budget deficits that lasted into the mid 1990s, Dr. Mankiw wrote that the moral of the experience was that, quote, "when politicians rely on the advice of charlatans and cranks, they rarely get the desireable results they anticipate."

I am not going to ask you to answer the question, because I have to move on to say some other things, but do we have charlatans and cranks advising the President of the United States today? Apropos of that, the question is, in fact, can we have a strong economic growth in this country and continue to have deficit financing of tax cuts?

Let me move to another portion. There is also another quote which is directly from a column from you, Dr. Mankiw, that talked about tax cuts and the candidates Al Gore and George Bush, that if this technology boom continues, Gore's smaller tax cut looks stingy; if it fizzles, Bush's large tax cut seems profligate. Whatever tax plan the next President adopts, we may have to rethink it in a few years. I hope we will rethink it.

It would appear to me that we have got a repeat of something that happened last year, and that is really kind of sleight of hand in what comes out in the budget process. Three or four examples I think will tell the story.

The war, we have no numbers, you say it is impossible. That is like my saying, I can't put aside money for my kids for college education because I don't know where he or she is going to get into. So let us do zero, nada, nothing, leave it there and hope for the best when it comes along. Impossible.

That is not your job. You have an obligation in the same way that we have an obligation. If you tell the President—if I were President of the United States and you told me you couldn't tell me how much the war will cost, adios, you wouldn't be in the job today.

Second, $139 billion Medicare costs all of a sudden appeared the very next day. You know, after we get through the passage of the bill, the discussion, et cetera, the cost is suddenly $139 billion. Five-year budget versus a 10-year budget, the $900 billion in tax cuts come after, you know, presumably a second Bush administration, and I say presumably. You have got nothing about AMT, nothing about Social Security in the budget. It doesn't pass the smell test.

Take a look at today's New York Times. This is not coming from Congresswoman DeLauro, Democrat, Third Congressional District of Connecticut. The Concord Coalition: If you look at fiscal policy, it looks like an exploding cigar. You go to the moderates, you go to CATO, you go to the left, you go to anyone, no one believes that this is a credible budget; and, quite frankly, it is not credible. It does not pass the smell test.

Given all that I have said, I think there is a minute and 20 seconds left. Let me ask you this: In terms of your tax cut policy here, was it an oversight to leave out the 12 million kids, 6 million families who didn't make it into the last go-round when they just yanked them out of the bill in the middle of the night, those people who make $10,500 a year to $26,000 a year, who pay payroll taxes, property taxes, and sales taxes? I have to believe it was an oversight.

A question of people in jobs today. Let us take a look at the budget again, cuts, job training, employment services, training job cuts proposed in the last several years, vocational training cut, objection to extending unemployment benefits to workers. How are we going to put this money that our colleagues talk about back into the pockets of working Americans? We are doing nothing in this budget to do that, but we are taking the money out of their pockets to do that.

I have 13 seconds left. You are welcome to answer or not to answer any of the questions.

Chairman NUSSLE. Well, I would be happy to allow the witnesses to answer. The gentlewoman's time has expired, but we will let both witnesses answer if you care to.

Mr. MANKIW. Let us me just answer very briefly some of your comments.

Let me start with what you ended with, jobs. Jobs are very much the President's focus. The aim of the tax cuts was precisely to create economic growth and create jobs, and I think we are starting to see that happening. The unemployment rate has fallen from 6.3 in the summer.

Ms. DELAURO. A thousand jobs in the summer.

Chairman NUSSLE. The gentlelady's time has expired. The witnesses can answer the questions that the gentlelady has posed.

Ms. DELAURO. Thank you very much, Mr. Chairman.

Mr. MANKIW. The unemployment rate has fallen from 6.3 down to 5.7, and I think you will see continued good news in the job market. Obviously, it is not good enough. We want it to be better, but I think we are heading in the right direction.

Regarding your comments on my previous writings, I have been critical in the past of claims that tax cuts are self-financing; they fully pay for themselves with more upward economic growth. If I believed that, I wouldn't be calling for spending restraint. We could finance more spending with more tax cuts. The fact is the President has put forward cutting taxes and spending restraint as a dual program for creating economic growth, and that is perfectly consistent with things I have iterated before.

On the Social Security numbers, as Mr. Bolten said, actuaries differ. This is a very complicated area. This is a bold new program. It is not surprising that people looking at a new program like this is going to have different estimates as to what the costs are going to be. The CBO has reiterated just a few days that ago they believe it will be under $400 billion and some actuaries believe differently. Even for someone like me, who is sort of very much in the weeds, a detail kind of nerd, it is very hard to figure out why these numbers differ and who is right; and I don't think anybody really knows who is right.

Ms. DELAURO. No charlatans and cranks, though, huh?

Thank you, Mr. Chairman.

Chairman NUSSLE. Just a nerd I think is what he was referring to.

Ms. DELAURO. We can all pick up our appellations.

Mr. GARRETT Yes. I don't know if I can get that chart back up. I just want to go back to that 1 percent, 10 percent of taxpayers who are in this country.

While we are waiting for that, on TV a week or so ago, there was a show, 20/20, with John Stossel. I don't know if you saw it. He just wrote a book of—myths, misconceptions and stupidity I think was the name of the program. One of the issues was, who is paying the taxes in this country? He was talking to one of the many people running for President right now, and the question was, what should the top 1 percent in this country should be paying? And the response was maybe 5 percent or maybe 10 percent, maybe even 15 percent.

Finally, Mr. Stossel said, well, would you be surprised to know that they are already paying almost a third of the Federal budget? To which the candidate immediately did, as candidates do, change the subject to something else.

That was a surprise to me a year ago when we find out that this tax package that we passed was a progressive tax cut, and it is actually shifting the burden, which I think is appropriate where we are and we should stick with that plan. Maybe it is no surprise then during the President's State of the Union address when the President spoke and said that certain taxes were going to be lapsing at the end of this year—and you may recall some people on the other side of the aisle actually started to applaud. Maybe they fall into the category. Because there is around 22 percent of the American public right now who believe that they are in the top 1 percent of the income tax range.

All in all, then, what you can say out of this whole 2 hours that we have been here, there is one thing we can agree on, that the deficit continues to be a problem for both sides of the aisle. I think we can probably agree that most people here are not going to be championing eliminating the child tax credit, the marriage penalty tax, nor the expansion of the 10 percent. So if that is off the table, the tax cuts are off the table, increasing them, then it leaves us with the spending issue.

Again, someone from the other side of the aisle in the paper today is reported as saying that the President's budget is crowding out health care, education, and veterans. Yet when I saw the chart, after you look at homeland security and defense and Medicare—of course, we already know what the spending is like on that in health care—education, we are still seeing substantial increases in educational spending; and veterans also is next in line after education. So I don't know how anyone can say that this budget is crowding out any of those areas.

To some of us conservatives, we may actually raise some questions: Are we still spending appropriately in those areas? Because—maybe you can comment on this at the end—one report said that in certain States, not my State of New Jersey, but in certain States when it comes to educational funding so much money has been coming over the last several years from the Federal Government to the States that—so much money is coming into those States that they actually have to put it into reserve because they cannot spend it fast enough.

I see you are nodding your head. I don't know if you heard that as well. If that is true, then why are we still seeing significant increases in spending on the education side of the equation?

The other question I have is, 65 programs to be eliminated sounds like a whole lot of programs. I applaud you and would like to have more information on that. When you gave us the number of $4.9 billion, that that comes out to another $4 [billion], $5 billion after that—I am bad with math—but the percentage of that out of the entire Federal budget of $2.4 trillion is probably a pretty tiny number. So I guess I leave you with the question of can't we do better than that? Aren't there more programs that can be totally eliminated?

You made reference before to one of the questions about the effort going on right now as far as efficiency studies—maybe the wrong term—of programs, and I think I saw on one of those charts someplace that one of the studies showed that around 6 percent of the Federal programs that they looked at are operating efficiently—my words, not the study's report. Around 23 percent said they were moderately efficient, but around 50 percent of them, they really couldn't measure whether they are doing their job or not.

I know you have to do this, but how do you come to us and say, even with all the information that we have, we don't know that half the programs are really doing the job, we know that only around 6 percent are actually doing the job, and yet we still want to spend more in all these areas? Can't we do better than that? Can't we at least do the idea of freezing all those programs until we get back to see how we improve them and make sure they are efficient, fallen at 6 percent, or to increase that number of eliminated programs from 65 to a much more significant percentage of the Federal budget?

Mr. BOLTEN. Mr. Garrett, thank you for those comments. I think we can do better. We have gone a long way in this budget, I believe, to go after that portion of spending that we think is least warranted. But, as you can see from listening to your colleagues and from your own experience here on Capitol Hill, you know that we will have enormous difficulty going after even one of those programs, because every program has some merit, every program has a protector.

You mentioned education spending. Of those 65 programs that are being terminated, almost half of them or somewhere in that range are actually in the Education Department. Because there are just dozens of programs filtered throughout the Education Program that are not showing results. We are trying to bring those programs down.

At the same time, the President has put a very high priority on education in his administration, and we have seen under his administration K–12 funding increased if his 2005 budget is enacted, a change from 2001–05 an increase of $12 billion going into K–12 education, a 49 percent increase.

Just this year in the 2005 budget, the President's budget, we will be proposing another billion dollar increase for Title I funding. That is for the lowest income schools. Overall in this administration that would make a 52 percent increase in Title I funding.

I appreciate your raising it, because it gives me a chance to address the canard that this administration is somehow underfunding education. It has been very robustly funded. In a few cases, and I think it is being dealt with, States have not been able to absorb it quickly enough. I think that is being addressed, and I think we are putting money out in an appropriate fashion at this point. But even with as tight a budget as we have, even with cutting those programs that we think need to be eliminated, there is room in this budget for us to spend on priorities, and that is what this budget does.

Chairman NUSSLE. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Chairman, chart No. 1, we have had a lot of discussion about whose fault and who is doing what. I just wanted to remind people of the history.

When President Clinton came into office, we passed a bill without any Republican votes on the floor of the House or Senate that created that green line going up toward surplus.

In 1995, when Republicans took over, President Clinton actually vetoed several bills, so many that we actually had to close down the government because Congress wouldn't pass a bill that he would sign. He wouldn't sign those irresponsible tax cuts. The budgets passed from then for the rest of his term with a Republican Congress were under the threat of his vetoes.

In 2001, you see that this President came in with a $236 billion surplus and signed the kinds of tax cuts that President Clinton had vetoed and you see that read line falling off the side.

In summary, President Clinton and the Democrats, the green line; President Bush and the Republicans, the red line.

We have heard about people whining about where is the Democratic plan? The Democratic plan is the tough choices represented by the green. The Republican plan is the easy choices, increase spending, cut taxes, and you get the red.

Now we have heard about 9/11 causing all these job losses that are dropping the economy. The fact is that this is the worst job creation record since Herbert Hoover. Jobs were created during the Korean war, during the Vietnam war, hostages in Iran, the cold war. Every President since Harry Truman has had more jobs created during their term than when they left except this one.

Now all tax cuts do not have the same stimulus effect on the economy. There are other things you can do other than cut taxes and $40 billion I think we spent right after 9/11. We could have hired police officers and other domestic security types of jobs. With $40 billion you could have hired over 1 million people. We hear that 3 million jobs lost, and we get the "what, me, where are you" explanation that that is good news about jobs.

In 2005, the budget we know from discussion so far that it is not credible. We have got the $50 billion missing from the war.

Could we get chart No. 3? The blue line in chart No. 3 is what we were told by this administration we would be dealing with now. The red line now is the present story. Offsets are not realistic. We are not going to cut veterans' benefits. We missed Medicare by $100 billion, and the program hadn't even started. That chart would require us to reject the President's suggestion about going to Mars, reject his position on privatizing Social Security. As a colleague of mine said, this might represent the President's faith-based initiative, trying to believe in his budget.

Let me ask you a couple of questions, Mr. Bolten.

On page 384 you have got the individual income tax revenue at $765 billion; is that right, $765 billion? Now, as this chart shows—go back to chart No. 1. As this chart shows, we began this administration with $236 billion. We are now in the hole $521 billion. That is a $757 billion swing; is that right? That is right. OK. Now, we have individual income tax, total revenue $765 billion, and we have had a swing of $757 billion. As the Director of the Office of Management and Budget, are you embarrassed at having to present that budget?

Mr. BOLTEN. No, sir, I am not and——

Mr. SCOTT. And we have got the "what, me, where are you" defense.

Now, the interest on the national debt, when this administration came in, in 2009 isn't it true that the net interest on the national debt was going to be zero, when you came? Now don't you project it at $299 billion and going up at about $25 billion a year? How many people can you hire with that $300 billion at $30,000 a year? How many people can you hire with that $300 billion that we are going to be paying in interest that we did not expect to have to pay? Ten million. How many people are unemployed in America today? Nine million. Does that embarrass you? No.

You said we need to fundamentally change Social Security. Is there any money in here to fundamentally change Social Security? Is there any transition cost in the budget that you presented?

Mr. BOLTEN. Mr. Scott, would you like me to take your questions one at a time or in group now?

Mr. SCOTT. Any kind of way you want.

Mr. BOLTEN. All right.

First—actually, could I have the pie chart up, please?

If we are looking at the sources of the deficit we now face, this is an accurate reflection of what is behind the numbers you just saw. The economy is what brought us into the deficit situation we now face. There was a stock market bubble. There was a recession that started in at least the first quarter of 2001, some economists believe earlier. The stock market collapse started in 2000. If you take a look at the actual numbers of what led us into the deficit situation we now face, what you see is that the economy, the collapsing economy, was the overriding factor in bringing this out.

The tax cuts are not responsible for the deficit situation. The tax cuts deserve the credit for turning that situation around, putting us back into an economic growth situation. Because it is economic growth that is going to make those revenue numbers turn around. If you look at the chart, what you see is the revenue numbers turning back up. That is the situation that is going to actually create jobs and make our deficit situation improve over the long run.

Mr. SCOTT. So you are not embarrassed?

Chairman NUSSLE. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Gentlemen, first let me applaud the administration for interjecting words like “pay-go” and “spending caps” and “spending restraint” into the vocabulary of the United States Congress. It appears that you are attempting to take that first turn of the wheel in the battleship of spending. But it is the United States Congress who are the sailors on this ship, and so the work has to be done here.

Obviously, there has been a lot of talk about tax relief; however on one side of the aisle it appears to be part of the problem and on the other side, it appears to be part of the solution.

As I look back through in the history of tax relief, I see that during the 1920s when we cut marginal rates we increased GDP, and tax revenues. I see that during the 1960s under President Kennedy, when we had tax relief we increased GDP and tax revenues. I see that during the 1980s under President Reagan we cut marginal rates again. We increased GDP and tax revenues because we were not attempting to take a larger portion of the family pie. We were trying to grow that pie.

Most recently, I see a report from Treasury saying that with the Bush tax relief package, we have had the greatest increase in GDP for a 6-month period in 20 years, and tax revenues are up this last quarter over 1 year ago. Have you seen that report? Do you dispute those figures that tax revenues have indeed increased?

Mr. BOLTEN. Tax revenues do seem to be firming, and the projections are for them to firm substantially more in the future as the economy strengthens.

Mr. HENSARLING. Let me ask you a little bit about spending. There is a lot of angst about the Federal budget deficit. I share that angst, but there are two different battles that I believe are taking place. One is between the balanced budget and the unbalanced budget. But there is another battle taking place between the Federal budget and the family budget, and I fear the Federal budget is winning.

We are now spending $21,000 per household for the first time since World War II, the fourth highest in the history of the United States of America. I believe mandatory spending is now up to 11 percent of GDP for the first time ever. From 1998 to 2003 spending increased from $16,000 per household to $21,000 per household, which I am told is the greatest 5-year spending spree, since World War II.

I am concerned about American families and how they finance their education programs. How are they going to find the money to buy a computer for their son or daughter? I am concerned about their housing programs. How are they going to find money to pay the down payment on their first home? I am concerned about their jobs program. How are they going to find the capital to create that first small business? So as I look at it by any measure, it is spending that is out of control here. So I applaud you for taking steps toward budget process reform.

I hear a lot of discussion about cuts, but under your budget, if I am reading it correctly, mandatory spending goes up, defense spending goes up, homeland security spending goes up and discretionary spending goes up. Is that correct? Do I have a correct reading of the budget?

Mr. BOLTEN. You do, Mr. Hensarling. There are cuts in specific sectors and overall discretionary spending is held at a moderate 3.9 percent overall increase, but it is at that number because we need to accommodate larger increases in defense and homeland spending.

Mr. HENSARLING. Are there things that this Congress can do to introduce the concept of actually getting greater services for the American taxpayer at a lesser cost?

For example, when I have looked at the HUD budget over the past few administrations they seem to routinely lose 8 to 10 percent of their budget in the $3 billion range. Apparently, 26 percent of the people who have received Federal student loans have them forgiven for disability while holding down full-time jobs. I have seen reports that say, conservatively, 8 percent of the cost of health care is due to frivolous lawsuits. What programs does the administration have to start rooting out waste, fraud and abuse and duplication so that we can do more for the poor beleaguered taxpayer and do more to protect the family budget from the Federal budget?

Mr. BOLTEN. Mr. Hensarling, we have a number of programs to do that across—especially the entitlement programs in Medicare and Medicaid, the Earned Income Tax Credit, IRS. All of those areas are areas where the government is losing money because of waste, fraud and abuse.

Your chairman has been one of the leaders for some time in trying to ensure that government goes after that money as aggressively as it possibly can. We are doing that, I think, in this budget, but we are anxious to work with you on ideas of how we can do it better.

Chairman NUSSLE. Mr. Edwards.

Mr. EDWARDS. Mr. Chairman, this budget may represent the largest faith-based initiative of this administration. I am a person of faith, but this budget is unbalanced, unfair, and unrealistic. Mr. Bolten, I will predict right now in your presence that the real deficit in fiscal year 2005 will be far closer to $600 billion in borrowing from our children than the $521 billion that you projected in this budget.

Frankly, I think this supply-side, no-pain, all-gain proposal sounds more like voodoo economics than a good-faith effort to project what the real budget will be this year and the decade ahead. The last time an administration promised massive increase in defense spending, massive tax cuts, and balanced budgets was in 1981 in the Reagan administration. The result of that no pain/gain promise to the American people was quadrupling the national debt in a little over a decade; and I must say that at least David Stockman, President Reagan's budget director, had the integrity to later write a book where he admitted to the American people that that no-gain promise of higher defense spending, massive tax cuts and balanced budgets was something he knew simply wasn't true.

It surprises me that some of the very same people that I hear using the principle of personal responsibility in our financial affairs as a basis for passing a crackdown on bankruptcies by middle-income and lower-income working families turn around and say, even though we are facing half a trillion dollar deficits, don't blame me. That is somebody else's responsibility, somebody else's cause.

I believe these record-breaking deficits are a clear and present danger to the American economy and to our children's future. For 3 years in a row, the budget deficit will have been larger than any deficit in American history prior to this administration. Let me repeat that. For 3 years in a row, the Federal budget deficit will be larger than any administration in American history prior to this one.

Let us be specific. In just 2 years, fiscal years 2003 and 2004, we will have added $896 billion to our already massive national debt. Now, let us assume, as the Congressional Budget Office has, approximately a 4 percent borrowing cost for that money. What does that mean to the average American? It means that Americans today and our children tomorrow will pay $36 billion a year in taxes simply to pay the interest on 2 years of irresponsible budget deficits, and they will pay that debt tax until the day they die—ourselves, our children, and our grandchildren.

My colleagues, the debt tax is the one tax you cannot repeal, because we must pay the interest on the national debt, which to those who talk about holding down spending just happens to be one of the fastest-rising and largest single component of the Federal spending budget. This debt tax on average will be a permanent tax, a permanent tax increase, for a family of four of over $400 a year once again until the day they die.

The irresponsible level of deficit spending that we are seeing I believe will harm economic growth and jobs growth by driving up the cost of expanding businesses and buying homes and cars; and, like Mr. Hensarling, I, too, worry about a family's ability to buy a house. Because once the economy gets back on its feet, these kinds of massive borrowings in the marketplace are going to drive up home mortgage rates to the point where Americans will no longer be able to afford to buy homes and to buy cars.

This budget unbelievably and unfairly forces America's veterans to accept $14.9 billion in cuts over the next 5 years in veterans' health care and other services. As someone who represents 17,000 soldiers from Fort Hood, TX, who are now fighting in Iraq, I think it is bitterly unfair to ask those soldiers today who are tomorrow's veterans to pay with reduced health care services for tax cuts that in many cases go to the largest, wealthiest Americans in this land of ours, Americans who will never have to risk their lives in combat.

I just want to suggest that—and I will finish in 30 seconds if that is with your permission, Mr. Chairman—for those who suggest that spending cuts is the honest way to balance this budget, tell me why then the administration is asking for an increase in three of the five largest Federal programs that represent 70 percent of all Federal spending: defense, interest on the debt, and Medicare. The other two are Medicaid and Social Security, and I do not hear any cuts for that.

Let us be honest with the American people, Democrats, frankly, as well as Republicans, and deal with this issue on a bipartisan basis to solve this problem for the good of our children and our grandchildren.

Mr. BOLTEN. Mr. Chairman, if I could just take 60 seconds. I know Mr. Edwards didn't ask a question, but I wanted to correct one item in case there was some misimpression about the spending on veterans' care. There is no cut in veterans' care spending. There are, in fact, increases and have been throughout the Bush budgets.

At the time that the President took office, there were 3.9 million veterans getting health care from the VA. There are at this point 5 million VA patients getting health care. They are getting it more quickly, they are getting better health care, there is less of a backlog in getting claims processed, and the overall budget for veterans' health care has gone up substantially. The overall budget of the Veterans Affairs Department has gone up by 32.5 percent under President Bush, and medical care alone has grown by 34 percent, and we are continuing those kinds of increases in this budget.

I think the veterans are well cared for in this budget, and it seems to me that we are handling this in a very responsible fashion to meet the needs of those who have served our country so honorably.

One general comment, if I may, Mr. Edwards. I think we can disagree on exactly what the solution is. There is no lack of concern about the budget of the United States within the administration. We think we have presented a budget that addresses that situation credibly and effectively, and where we have a disagreement is whether the right answer here is to raise taxes to try to bring the budget back into a favorable situation. That seems to me to be the nub of all of our conversation here.

Mr. Mankiw and I and the rest of the administration say, no, the wrong answer is raising taxes on this economy. The right answer is maintaining a path of responsible fiscal restraint and ensuring that there is sufficient economic growth to bring back both jobs and a reasonable deficit situation.

Mr. EDWARDS. Mr. Chairman, can I ask you a question briefly?

Chairman NUSSLE. The gentleman's time has expired.

Mr. EDWARDS. That is why I would like to ask you a question.

Chairman NUSSLE. I am sitting up here. I don't——

Mr. EDWARDS. If I could ask a brief question——

Chairman NUSSLE. I will try.

Mr. EDWARDS [continuing]. Since Mr. Bolten answered a question I didn't ask, but he had a right to make his comments. But since in my opinion he did not accurately reflect what I said, may I have 30 seconds to reflect what I honestly said regarding veteran spending?

Chairman NUSSLE. Just so we are clear on the record here, the gentleman went well beyond his 5 minutes. I will allow the gentleman to respond. You have 30 seconds and please do so. But members will be allowed to put statements in the record, and I think the gentleman's advocacy for veterans is well-known. I am not sure you have to take 30 seconds to defend that. I think you certainly have——

Mr. EDWARDS. Twenty-five.

Chairman NUSSLE. Twenty-four and we will make it a CBO score. How about that?

Mr. EDWARDS. You have got it. Thank you, Mr. Chairman.

Mr. Bolten, you and I both know that it doesn't tell the honest information to the American veteran if you say you increase veteran spending by 1 or 2 percent, that veterans' health care costs are going up 12 to 14 percent. That is why I said it is a cut in real services by $14.9 billion over the next 5 years and I stand by that. Thank you, Mr. Chairman, for your courtesy.

Chairman NUSSLE. Thank you, Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. And I want to congratulate Mr. Bolten and Mr. Mankiw on their testimony today. I know they haven't gotten to answer a lot of questions because they haven't been given much time on the other side, but they have done a great job in talking about what I think is a very realistic budget. To my friend Mr. Edwards, your complaint was this is a no paying budget and then where we ended up there is not enough money for veterans. I mean, I just—I think that says it all. We have increased veterans' spending by 30 percent over the last 3 years as I look at this. And it is a 9 percent increase in this budget. And they do it in the context of an overall nondefense, nonhomeland security budget of .5 percent. I mean, it is tough. You have to make priorities. Do you disagree with those numbers?

Mr. EDWARDS. I do disagree with those numbers. If you listen to Veterans of Foreign Wars national commander, he calls this budget——

Mr. PORTMAN. That is not the point. The point is you can't call it a no-paying budget and saying we are not spending enough in an area where we are increasing it 9 percent.

Mr. EDWARDS. It is not what I said.

Mr. PORTMAN. I understand what you said about health care costs. All I am saying is this is a budget that prioritizes. That is why it is realistic. It basically says to us look, we all agree, I hope on both sides of the aisle that the tragic events of 9/11, the corporate scandals, inheriting an economy that was beginning to spiral into recession, caused this, and let us put up the pie chart again, or chart 9. It shows very clearly.

The pie chart says half of it was due to the economy getting into the deficit. This chart up here now takes it year to year. It basically says it is half. I will say 45 percent. About 30 percent is new spending. And we can say whether we should have spent that or not. We spent a lot more on veterans. We spent a lot more on defense. We spent a lot more on our homeland security because of the war on terrorism. Maybe we shouldn't have spent so much, but we did. About 18.5 percent, as I read it, 20 percent was due to the tax relief. And the question is, was that a good investment? Was that 20 percent a good investment? 20 percent of the deficit we are facing was due to the tax cuts. And I would ask Mr. Mankiw and Mr. Bolten to respond. What has been the effect of these tax cuts? Have they helped?

Mr. MANKIW. Absolutely. There is a large economics literature that suggests that one of the ways to stimulate an economy that is in recession is to cut taxes and put money in peoples' pockets, to reduce the cost of capital, to stimulate investment spending and that is exactly what these tax cuts were aimed to do.

Mr. PORTMAN. So the economic growth in the second half of this year 2003 was the fastest since 1984. I mean we didn't get all the jobs back we hoped to, but we have real growth and that leads to revenue and that is way we got into a balanced budget in the late 1990s. It wasn't by cutting by spending, although we restrained spending as this budget does and that is admirable. It was because the economy grew. That is how we got into surpluses last time. I think you have to make a decision, was it worth it or not? It looks like it was worth it because the economy is coming back and we have incredible growth.

I would ask you the following question then, which is should we increase taxes at this point? If we don't make the tax cuts permanent—I hate to use the word term "permanent," because it is really keeping taxes from going up and it is going to happen next year starting with the child credit, 10 percent bracket, marriage penalty, what impact would that have on the economy?

Mr. MANKIW. Not making the tax cuts permanent would be contractionary much in the same way that cutting taxes was expansionary.

Mr. PORTMAN. I think what chart 3 shows is that growing the economy and restraining spending is the key. And this shows what the total discretionary spending is out to the year 2009. And if you look at that chart, it talks about discretionary spending having increased by an average of 9.7 percent. Maybe that was good and maybe it wasn't. We did what we thought we had to do to protect this country, take care of our veterans and so on. But in the next 5 years, their total discretionary spending would grow at 1 percent. If the economy grows, as we all hope it will and we keep the spending under control, what will happen, Mr. Mankiw?

Mr. MANKIW. If we keep spending under control and make the tax cuts permanent, we will set the conditions for continued robust economic growth.

Mr. PORTMAN. And we will end up having a lower deficit. And I just got to say, when I was first running in Congress 1992, the deficit, as a percentage of the economy, was 4.7 percent. Is the deficit bigger this year or was it bigger the year I ran for Congress?

Mr. MANKIW. It is 4.5 percent in this budget. Whenever looking at the size of a deficit, the nominal dollar figure is not tremendously meaningful. What is meaningful is to look at it relative to the size of the economy. And we are a much bigger economy today than we were 20 years ago.

Mr. PORTMAN. The relative size of the economy which is the key determinant as any economist will say, this is not the biggest deficit in history. Nobody likes them. We want to get out of them and this is the plan to do that. How about we talked about interest on the debt as a percentage of GDP. When I was first elected, it was a higher percentage of GDP than that. Why? Because interest rates are low. Why? Because people don't think these deficits are going to continue forever. And that is key. Thank you, gentlemen, for your testimony.

Mr. SCOTT. Parliamentary inquiry. Will we be allowed to submit questions in writing?

Chairman NUSSLE. What we usually do—I just needed to check how we have done this in the past. I will ask unanimous consent that not only members be allowed to submit statements for the record, but also to submit questions for the record. Any objection? Without objection, so ordered.

[Prepared statement of Mr. Putnam follows:]

PREPARED STATEMENT OF HON. ADAM H. PUTNAM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman, I am pleased that we have convened today to receive the fiscal year 2005 budget from the President of the United States. I am honored to be here today with you, Ranking Member Spratt, and the rest of the committee, to begin the process of reviewing and passing a budget for our country. I would like to thank the Mr. Bolten, for joining us to discuss in detail the President's budget. This budget, which holds spending growth to less than 1 percent of the rate of inflation and aims to cut the deficit in half over the next 5 years, is a step in the right direction in addressing the growing Federal deficit. I am confident that together the President and Congress can act in a fiscally responsible manner while also providing a budget to make America more secure, more prosperous, and more hopeful.

The President has presented a bold plan to provide substantial increases to improve our nation's security and win the war on terror. It also increases funding for key priorities such as economic growth and job creation, and affordable health care. This budget reflects two realities. First, we have an obligation to protect our homeland from terrorists who want to attack us. Second, we must act in a fiscally responsible manner in order to fight deficits, we need to grow the economy and hold the line on spending.

This budget goes far to strengthen America's domestic opportunity. This budget shows the President's commitment to continue to grow America's economy. The President proposes to continue the strong pro-growth policies that are creating jobs and opportunities for the American people. I am pleased this budget makes permanent the tax relief Congress passed: doubling the child tax credit; reducing the marriage penalty; phasing out the death tax; lowering rates on capital gains, stock dividends, and small businesses to create incentives for job creation; and lowering rates for every American who pays income taxes. I am delighted that the President's tax relief agenda has resulted in significant benefits for the people of Florida including more than 6.1 million taxpayers in Florida seeing their income tax bills reduced, more than 1.7 million married couples in Florida benefiting from marriage penalty relief and over 1.5 million families in Florida benefiting from the increase in the child tax credit from $600 to $1000. The President's budget will secure these positive economic trends for Floridians by making the tax relief permanent.

The budget also stays on the path to creating better quality healthcare in America. Last year, Congress passed the Medicare Prescription Drug and Modernization Act of 2003 to improve healthcare for America's seniors. This year, the President has proposed making healthcare more affordable for all Americans by creating new tax credits for the purchase of health insurance.

The President has also presented a budget that lays out a solid, aggressive plan to bolster our nation's strength and stability abroad. This budget makes a clear commitment to provide our nation with the best trained, best equipped and most efficient military force in the world. The budget provides the newly created Department of Homeland Security and related agencies with the resources necessary to win the war on terror.

While the President has shown a strong commitment to enhancing our domestic and national security, he has also presented a budget that takes into account the mounting deficit that threatens to bankrupt future generations. The President has made a strong commitment to reduce the deficit, cutting it in half in the next 5 years. I am hopeful that Congress can make the tough choices to help restrain spending, so that our budget is brought back to balance, as soon as possible. We have a moral obligation to Americans not yet born o get out fiscal house in order.

I look forward to Director Bolten's testimony as I am sure he will provide all of us with a clear picture of the President's budget and its focus on the most urgent needs of our country: winning the war against terror, ensuring that our citizens are safe, strengthening and stabilizing our economy, and shrinking the Federal deficit.

[The prepared statement of Mrs. Capps follows:]

PREPARED STATEMENT OF HON. LOIS CAPPS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

The President's budget submitted yesterday represents yet another low point for this administration. The President tells us in this document that we will have a record-breaking deficit of $521 billion in fiscal year 2005. But he greatly understates the deficit at hand, advocates policies that will enlarge the problem, and leaves critical national needs unmet. The administration witnesses and the President have tried yet again to downplay the magnitude of the fiscal problems we face today and for the foreseeable future.

But we have heard this song before. Last year, OMB Director Daniels explained how the size of the deficit wasn't that great and that the administration had everything under control. He even produced us charts that showed us how the deficits would decrease in each of the successive years.

Mr. Chairman, one year ago, the predicted deficit for fiscal year 2005 was $208 billion. Now the projected deficit for fiscal year 2005 is $521 billion. And this actually understates the problem.

For example, the President's budget includes no money for the continuing occupation of Iraq and Afghanistan. No one believes that our troops will be out of Iraq by October 1, the start of fiscal year 2005. Right now we are spending several billion dollars a month and that will likely continue for at least the next few years. Yet there is nothing in the budget to pay for these costs.

The President's budget doesn't fix the Alternative Minimum Tax problem in the tax code that will result in a hidden tax hike for tens of millions of middle class taxpayers over the next 10 years. A true fix of this problem will cost over $500 billion over the next 10 years, according to CBO.

In addition, the President has advocated proposals that cost trillions more that he doesn't have any plans to pay for. For example, he has called on Congress to make permanent the tax cuts of the last few years that have mostly benefited the wealthiest in our society. That would add another $1 trillion to the deficit over the next 10 years. The President wants to go to Mars and the moon. Fifteen years ago, another President Bush advocated going to Mars and it was estimated to cost at least $400 billion. And the President wants to privatize Social Security with transition costs that are at least $1 trillion.

To his credit, the chairman of the Budget Committee has repeatedly stated that “deficits do matter.” I completely agree with him. But what matters even more are the steps we take to deal with these deficits and how that affects our citizens. And again, the President's plan fails. His plan is to continue giving big tax cuts to the wealthiest among us and pay for them by ignoring the needs of everyone else.

This is irresponsible, unfair and it won't work. This budget underfunds the President's commitment to fix our failing schools by more than $9 billion. It freezes the maximum Pell Grant award and reduces the average award for the third straight year, even any parent with a child in college knows that college costs have risen dramatically. In addition, the budget offers little help for the more than 43 million uninsured Americans. The President's tax credit proposals will serve mostly to undermine the current insurance market and the Health Savings Accounts will mostly benefit the wealthy and healthy.

The President's budget underfunds by $13.5 billion over 5 years the amount needed just to continue providing current medical care for our nation's veterans. In my district, the VA is scrambling to find a way to continue offering specialty services in Santa Barbara. At a time where the President's policies in Iraq are creating thousands of new disabled vets, this cut is unconscionable.

This budget represents skewed priorities that are hurting American families and it should be rejected.

[Questions submitted for the record follows:]

QUESTIONS FROM HON. JOHN SPRATT, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH CAROLINA

*Question.* In your oral testimony, you claimed that the "total tax burden" paid by the top 5 percent increased as a result of the 2001 and 2003 tax cuts. Yet the chart you showed related only to the Federal income tax burden. Could you please provide the Committee with the share of total Federal taxes paid, with and without the 2001/2003 tax cuts, by the top 1 percent and the top 5 percent of the income distribution? Please provide the figures for 2004 and for 2010.

*Answer.* The data from which this analysis is drawn comes from the Department of Treasury, which has not done a similar analysis for all Federal taxes paid. To our knowledge, neither the Congressional Budget Office nor the Joint Tax Committee have produced such analysis recently.

An analysis of the share of total taxes paid with and without the 2001/2003 tax cuts would undoubtedly show different levels of the tax shares than does the chart showing only Federal income taxes. However, one can also suggest that such an analysis would undoubtedly continue to show that the effect of the tax cuts has been to make the overall tax system more progressive because there were no legislative changes to the non–income tax components of the Federal tax system that would have altered their distribution.

*Question.* In your oral testimony, you intimated that an appropriate benchmark for the growth of discretionary spending is the nominal growth of household income. Could you please provide a comparison, on a year-by-year basis for each year between 2004–09, of the projected nominal growth in household income and the projected growth in discretionary spending under your budget?

*Answer.* I do believe that discretionary spending growth for fiscal year 2005 should not exceed the growth in family income. The President has proposed 3.9 percent discretionary spending growth in fiscal year 2005. The budget shows discretionary spending increasing 3 percent in 2006, and by 2.9 percent in the following years of the budget window.

In looking at the data, we find a multitude of measures of family income which tend to show about 4 percent growth. For example, the Census measure of the average annual rate of increase of median family income for the twenty year period from 1983 to 2002 was just under 4 percent.

Our economic forecast for 2004 and beyond does not attempt to forecast family incomes in any way. Consistent with the practice of previous administrations, our economic forecasts focus on economic parameters that are directly relevant for forecasting future tax receipts and spending levels. Thus, for example, the administration forecasts the levels of income in each forecast year, and how that income is likely to be distributed across categories such as corporate income, wages and salaries, and sole proprietorship income.

It is possible to develop forecasts of family income growth using the administration's existing forecasts of national income growth, but to do so would require making additional assumptions such as how the income distribution is likely to change, and additional demographic assumptions such as how the percentage of individuals in families as defined by the Census Bureau is likely to change. The administration has not heretofore attempted to forecast these additional variables, and thus it is not possible to construct a forecast of family incomes without this additional information.

QUESTIONS FROM HON. DAVID VITTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

*Question.* At least 4 months have passed since the study was originally expected to be released, and apparently the delay is now with an OMB review of the study. Can you explain what is holding up the study and why the original deadline was not met?

*Answer.* OMB completed its review of a draft report in November 2003. As a result of that review, we provided recommendations to the Army Corps of Engineers for improving the report and its strategy for addressing the needs of this ecosystem. At this point, the Corps is working to reach agreement with the State on the revisions that will be needed to (1) focus the restoration effort on the parts of the ecosystem that require the most immediate attention, (2) identify the key long-term scientific uncertainties and engineering challenges facing the effort to restore the ecosystem, and (3) make the best possible use and leveraging of Federal, State, NGO and private sector funds.

*Question.* Bureaucratic hold-ups only mean more of Louisiana's coast will be lost before a restoration plan can be developed and then implemented. What assurances can you give that this study will be released soon? Can you think of anything that I or the state government can do to help you speed up the study's release?

*Answer.* Under the 1990 Breaux Act and numerous other state and local authorities, a strong regional collaboration on restoration is already underway and is providing an important science, technical, and policy foundation for the work that lies ahead in protecting and restoring the ecosystem. The administration is working diligently to release a report that contributes strategically to this effort as soon as possible. The State and the Corps are working together in good faith to come to agreement on the revised plan, particularly regarding the most important near-term actions. Previous experience indicates that moving forward too quickly with a flawed plan eventually makes matters worse rather than better. We want to get this right at each stage of the process.

*Question.* Can you commit to working with me and the rest of the Louisiana delegation to provide additional funding for Louisiana's coastal restoration efforts?

*Answer.* We welcome the opportunity to work with you and the delegation on this important issue. The most recent budget already commits the administration to seeking a major increase in funding for coastal and wetland efforts. For example, we propose to nearly double last year's estimate of funds that the Federal-State task force would obligate for fiscal year 2004—from $49 million to $95 million.

Regarding the Coastal Louisiana draft report, it is premature to make any funding commitments. Once a feasibility report is completed and approved, it can be used to inform future funding decisions.

QUESTION FROM HON. MAC THORNBERRY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

*Question.* My understanding is that some of the reductions in taxes which we have passed in previous years are set to expire at the end of this calendar year. I would like to know what those tax cuts that are set to expire, how many people are affected, if you have those numbers, and how they would be affected if they expire in taxes and those areas are allowed to go back up?

*Answer.* The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased in tax relief over a number of years, the exact timing and amount of relief depending on the specific provision. The Jobs and Growth Tax Relief Act of 2003 (JGTRRA) accelerated much of this relief, including the marriage tax penalty relief, the increase in the child tax credit, and the increase in the income threshold for the 10 percent tax bracket to their fully phased in levels, but only for 2003 and 2004. After 2004 the tax relief reverts to the phase-in schedule described in the 2001 tax bill. The President has called on Congress to make the tax relief permanent at the 2004 levels. Unless Congress acts to extend the relief in effect in 2004, millions of American families are going to face a very large tax increase in 2005.

The exemption amount of the individual Alternative Minimum Tax (AMT) was also increased in EGTRRA for taxable years 2001–04, and increased further by JGTRRA for taxable years 2003–04. For 2004, the exemption level is $40,250 for single filers, $58,000 for married filers filing joint returns, and $29,000 for married filers filing separate returns; under current law the exemption amount would revert to its pre-EGTRRA levels of $33,750, $45,000, and $22,500, respectively. The President has called on Congress to maintain through 2005 the exemption amounts at their 2004 levels. The President has also called on Congress to extend a provision from the 2002 tax bill that allows taxpayers to use nonrefundable tax credits against AMT liability.

The 2002 tax stimulus bill included a provision to allow taxpayers purchasing qualified business assets to deduct 30 percent of the cost in the year of the purchase, with the balance of the amount depreciated under the normal schedules. The provision, commonly, referred to as "bonus depreciation," applies to investments made prior to January 1, 2005. The 2003 tax bill increased the upfront deductible percentage to 50 percent.

The bonus depreciation provision was intended to stimulate business investment by reducing the cost of capital to new investment; it appears to have had its intended effect and should be allowed to expire.

If the Congress fails to extend the four expiring tax provisions—the increased child tax credit, the increased 10 percent bracket amount, the marriage penalty relief, and the AMT relief—then taxpayers will face a $20.9 billion tax increase in 2005, and a $118.6 billion tax increase over the 2005–09 period. Such an enormous tax increase would slow the economy as it continues to return to full employment, and it would be a great burden to impose on family incomes. We do not yet have figures from the Treasury Department as to how many taxpayers would be affected in each year.

QUESTION FROM HON. HENRY E. BROWN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH CAROLINA

*Question.* But I notice, too, as part of the 256 I believe you mentioned in this budget here, how much of that is exactly mass transit and how much is being attributed to enhancement funds?

*Answer.* The funding level requested in the fiscal year 2005 budget would provide $44 billion for transit programs from fiscal year 2004–09. The administration's SAFETEA proposal would retain the 10 percent transportation enhancements set-aside of Surface Transportation Program funds, as was provided under TEA–21, for transportation-related activities that strengthen the cultural, aesthetic, and environmental aspects of the Nation's transportation system.

Mr. NUSSLE. Mr. Cooper.

Mr. SCOTT. Questions to the witness?

Chairman NUSSLE. Yes, sir. Mr. Cooper. You aren't going to ask me any questions or you can try. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman. When you run a deficit, that means you have to borrow money from somebody to fund the deficit. And in absolute dollar terms, we are running the largest deficit in American history. And in percent of GDP terms they are not quite as large, but they are still pretty sizeable. But nothing changes the fact that you have to borrow the money from somebody. And you can sell these bonds either to U.S. folks or you can sell them to foreign folks. So with a $500 billion deficit, doesn't that mean we have to sell $500 billion worth of bonds? Is that about right?

Mr. MANKIW. That is correct.

Mr. COOPER. And there are 365 days a year, so that is over a billion dollars a day that we have to borrow from somebody. Many of our bond borrowers are foreigners?

Mr. MANKIW. That is correct.

Mr. COOPER. Do you have an estimate of how much we depend on foreign bond borrowers everyday?

Mr. MANKIW. The Treasury Department has those numbers, but there are sizeable purchases of U.S. Treasury bonds overseas.

Mr. COOPER. Is it on the order of 30, 40 percent of the total?

Mr. MANKIW. Yes.

Mr. COOPER. And when the value of the dollar fluctuates, that can affect the return of the foreign bond buyer, right?

Mr. MANKIW. That is correct.

Mr. COOPER. And recently, I think we have had a softer dollar than in some years, and that can hurt the return that a foreign bond buyer receives, right?

Mr. MANKIW. That is correct.

Mr. COOPER. That could affect their willingness to lend us more money in the future?

Mr. MANKIW. Well, in principle it could, but so far the U.S. bond market has held up quite well, even with fluctuations in the dollar. The U.S. the dollar is very much to the world standard. And we continue to be able to borrow at quite low rates because of the confidence in the American economy.

Mr. COOPER. So far so good. And we all pray that good news will continue. But in your own deficit or your own budget, you say the current path of deficits unsustainable. My good friend, the Wall Street journal columnist Alan Murray has a little three-part question in today's paper. He says who says deficits are unsustainable, John Kerry, Barbara Streisand or Josh Bolten? And the answer is all three. That is probably one of the few things I probably agree on, but it is on page 191 of your analytical supplement. And it is pretty scary reading for anybody who wants to get on the Web and read that part of it.

Mr. BOLTEN. It is scary for me to be lumped in with Barbara Streisand.

Mr. COOPER. I don't want to ruin your reputation. But every day when you run a deficit, you have to depend on somebody to loan you money, U.S. citizens who are presumably more willing to do that and also foreigners. What guarantees do we have these nice foreign folks are going to be willing to continue to loan us money in historically high amounts, for, as David Stockman used to say, as far as the eye can see? What guarantees do we have that they are going to be interested in loaning us this money in the future?

Mr. MANKIW. The U.S. dollar remains at a standard and a place of safety. Also a place where people put when they want a very safe asset, and that reflects large confidence in the U.S. economy. But it is probably true that over time, the trade deficit will shrink and that will affect our—how we finance the deficits. It is one of the reasons why one would want to get the budget deficit down. I think we share your concern. The issue is not goals. I think we share the goal of reducing the budget deficit and I think a difference of opinion may be over means.

Mr. COOPER. The U.S. dollar is not the only store of value in the world. The euro, in recent years, has appreciated substantially, hasn't it, a relatively new up-start currency. It went from 80 cents to $1.20. So if you had invested in euro bonds, you would have gotten an appreciation that might have exceeded your return on having invested in U.S. paper. So it would have been wiser if you were a savvy world investor to have invested in their debt instead of ours. This is the heart of the capitalist system.

Mr. MANKIW. Despite that appreciation of the euro, the United States has been growing faster than Europe and is expected to continue growing faster than Europe.

Mr. COOPER. In terms of dollar returns.

Mr. MANKIW. Interest rates have been higher in Europe.

Mr. COOPER. I see my time has expired, but the core issue is that if we run a deficit, someone on this earth is going to have to be willing to loan us money, over a billion dollars a day, and you haven't told me any guarantee or reason other than historical path that they are going to be willing to continue to loan us this money in the future.

Mr. MANKIW. I think because they believe correctly that the U.S. Government will honor its debt obligations.

Mr. COOPER. I see that my time has expired, Mr. Chairman.

Chairman NUSSLE. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman. One of the challenges Mr. Bolten and Mr. Mankiw as being at the low end of the totem pole is that there is not a whole lot of new ground to cover with you, but we are not notorious for sacrificing 5 minutes either. It is a general habit we have when we get elected to something. Let me try a little different ground. One of the things that is crystal clear, I think from listening to this entire colloquy over the last 2 hours is that there clearly is a scenario that one could envision in which that these tax cuts might seem enormously successful if your projections are right about rising revenues, if your projections are right about the deficits as a percentage of GDP, if your projections are right about economic growth.

At the same time, it seems fairly clear there is a scenario in which all of those numbers could be very wrong and the whole house of cards could come tumbling down, if you will. Given that, it strikes me that there may be a real opportunity for this Congress to think about the tax cuts in terms of tying them to what our relative percentage of what the deficits' relative percentage to GDP is in 2007, 2008 and 2009. For whatever reason, I think I understand the politics of it, but for whatever reason, the Bush administration is committed to getting this Congress to act now in dealing with the sunset issue.

That is why I think some of us on both sides of the aisle think it is a bit premature. Why not simply tie for the largest portion of these tax cuts, why don't you simply tie whether they sunset or not, to what the deficits' percentage of GDP is at any given time over the next several years instead of making a decision right now to just lock in the tax cut strategy, irrespective of what the economic consequence might be.

Mr. MANKIW. You are absolutely right that economic projections are uncertain and indeed, as many forces that affect an economy well beyond economic policy. We saw that in the 1990s with the high tech bubble, which came collapsing down. Had tremendous positive influences in budget projections in the late 1990s and negative influences as the bubble collapsed. Uncertainty is never good for an economy. Investors thinking about starting a new business will often delay. We can't eliminate uncertainty. Uncertainty is a natural part of the economic environment. But it is good to keep uncertainty to a minimum.

Uncertainty about tax policy is one kind of uncertainty that can be eliminated, or at least reduced. But the less uncertainty there is, the better. Thinking, for example, about the reduction of the tax on dividends. That has had a positive effect on the stock market. To the extent that it is uncertain as to whether that is going to continue, that is going to mitigate the positive effect in the stock market and mitigate the positive effect it will have on the cost of capital, investment and economic growth. So the argument for making the tax cuts permanent is to try to reduce uncertainty. If you are not going to eliminate uncertainty, that is part of economic life. But by leaving the uncertainty on the table is a negative for the economy.

Mr. DAVIS. I understand that at the abstract level, but I guess my concern is that given the incredible number of imponderables that we have from what our international obligations may be to what tax revenues may be and frankly, given the backdrop to all of this, you all have gotten wrong the last 3 years in terms of the job growth and revenue rise and in terms of what the deficit would be. And we can debate until we are blue in the face why that has happened, but make no mistake, we have gotten it dramatically wrong the last 3 years. And it is my guess that we are going to get it dramatically wrong again.

So from an economic standpoint, what is the risk in tolerating a little bit more uncertainty to forego the question for now of whether these tax cuts need to be permanent? What is the rush to deal with this now? We have had the uncertainty for the past year and that didn't prevent 8.2 percent growth in the third quarter of last year and prevent 4.3 percent growth in the last quarter. So what is the rush to deal with this question now other than the fact that it is a good election year issue?

Mr. MANKIW. Because the sooner we resolve uncertainty, the better. It is very hard to quantify the impact of uncertainty.

Mr. DAVIS. I understand that. Obviously the uncertainty has been here all of last year. It didn't prevent 8.2 percent growth in the third quarter. It didn't prevent 4.3 in the last quarter. I would be happy to have the average of those two, 6.6 this year. I would be happy to take that. So again, what is the rush? What is the rush to deal with this now as opposed to dealing with it in future Congresses?

Mr. BOLTEN. If I could say one thing, I think a lot of people out there in the country and the markets are expecting that this Congress will do the right thing and will extend the tax cuts into the future.

Mr. DAVIS. The uncertainty has been there.

Mr. BOLTEN. I actually think the uncertainty is pretty low because the American people are pretty confident that this Congress will do the right thing, as am I.

Mr. DAVIS. Why not wait until 2007 or 2008?

Chairman NUSSLE. The gentleman's time has expired. For the last series of questions for this panel, Mr. Shays.

Mr. SHAYS. Thank you. None of us are in love with this budget. None of us are in love with the fact that the economy has fallen significantly. I think none of us are thrilled about the fact that we had 2001, that we had an industry that fell apart in terms of a confidence in the marketplace and the fact that the stock market went down. None of us are thrilled about it, the question is what do we do about it. And I was with Mr. Edwards for part of this conversation until he mentioned veterans and talked about a 1-percent increase and.

I thought there lies some of the problem. We kind of gained the issue that is most sensitive because any way you look at it, if we look at veterans spending from 2001 to now, we have added 49.4 percent. That is one huge increase. Nearly 50 percent of the budget. Or if we just do the last 3 years, we have added 32 percent. We have added $16 billion. Only in Washington when you have such a significant increase do people call it a cut. I know we have some veterans who want even more benefits. But what I tell them is we are doing a heck of a lot. What I didn't hear, at least in the time I was here was any solutions. I heard no solutions frankly from anyone. I heard that we need to work on a bipartisan basis, and I agree with that. But I don't hear my colleagues on the Democratic side of the aisle say they want tax cuts—I hear they criticize tax cuts but they don't want tax increases.

There is a bill going around that restores—makes—eliminates the tax cuts, and there are only a handful I think that are on the bill; is that correct? Just a handful. So it strikes me also a bit discouraging.

Last year, I want to say this to Mr. Bolten, we cut 1 percent off the President's increase and it would have been great to have the President's support. We got it out of committee, but we didn't get any help from our Democratic colleagues. And we would have reduced the increase by 1 percent. And that would have had significant benefit I think each and every year.

I certainly don't fault this administration for the fact that we have to fight this war on terrorism and it takes more money or that we are engaged in a horrific conflict in Iraq that can have huge benefits, but we are at war and we are going to have deficits. I know that. I congratulate this administration for encouraging tax cuts and growing the economy. I have one difference on the tax increase. I have not, even in my wealthiest community, had anyone tell me they wanted the total elimination of the inheritance tax. They would like a tax rate come from 55, say, down to 25. They would like the threshold to go from 1 million up to something, but nobody has asked for the total elimination of it. And I am kind of hard-pressed why the administration pushes that. And let me ask you this. Wouldn't it be wiser just to extend the tax cuts that are coming due now rather than do all of them; continue to look at it and have the confidence, frankly, that this administration, because of the good job it has done, will get reelected and revisit that in years to come?

Mr. BOLTEN. I will ask Greg to talk about the death tax in detail.

Mr. SHAYS. Not in detail, spare me.

Mr. BOLTEN. In as much detail as is possible in 1 minute and 16 seconds.

Mr. SHAYS. I don't want him to use that much time. You got about 20 seconds to tell me about the death tax. Go for it.

Mr. BOLTEN. Let me take 8 seconds and say about the timing. We absolutely need to extend those tax cuts that are expiring this year. And we also think it is the moment to extend all of the others as well. When Mr. Davis was asking me about why not leave some uncertainty out there, I think there is confidence out there that we will extend those tax cuts. I think we will undermine that confidence if this Congress does not act to extend all of them permanently.

Mr. SHAYS. That is an argument.

Mr. MANKIW. On the death tax I will be very brief. Two issues, growth and fairness. On growth, the death tax is a tax on capital. As a tax on capital, it beats capital accumulation and economic growth. On the fairness issue, the question is why should someone who chooses to leave his money to his children face a higher tax rate than someone who chooses to spend on himself when he is living?

Mr. SHAYS. We have others who decide to give it to charity.

Mr. MANKIW. And they get a charitable deduction for that. The question is why should I stop spending on myself, give me a tax break relative to rather than giving it to my children. It is an issue of fairness. Those are the two arguments.

Mr. SHAYS. All I say we look forward to working with you. We need to do a better job working with our colleagues on the Democratic side of the aisle. But we didn't hear a lot of solutions today from members, which obviously is part of the challenge.

Chairman NUSSLE. I thank our two witnesses for their testimony, and we will certainly look forward to working with you as we craft the budget and put it together this year and particularly we want to be helpful and we hope and we know you join us in the endeavor to control spending. We have a lot of work as I said in the outset. It is not just about the budget, we have an energy bill. We have a transportation bill. We have other mile markers on the road here to deficit reduction that will tell us whether we are on the road or whether or not we are veering off. I hope colleagues and the administration are ready to work together to control spending, not just budgetary spending 2, 3, 4 years in the future.

Mr. BOLTEN. We are indeed, Mr. Chairman, and we thank you for your attention.

Chairman NUSSLE. The second panel for today we will call up and allow for our first panel to depart. The second panel is Peter Orszag—at least that is how I would pronounce it in Iowa—doctor and senior fellow from the Brookings Institute. And we are certainly honored to have you with us today and honored to receive your testimony at this time.

Chairman NUSSLE. And your entire testimony will be made part of the record.

**STATEMENT OF PETER R. ORSZAG, SENIOR FELLOW, THE BROOKINGS INSTITUTION**

Mr. ORSZAG. And I will be brief because I know the late hour is difficult for everyone. Let me make three or four points, and actually follow up on some of the discussion that has occurred earlier this afternoon. First I want to talk about the alternative minimum tax. There has been a lot of discussion about tax increases in the future. In 2010, under the administration's budget, 34 percent of the 2001 tax cut would be taken back by the AMT. There would be 30 million taxpayers or so on AMT, and roughly a third of the total 2001 tax cut would be taken back. In my view, the administration neither needs to admit that and indicate that families will not be receiving these tax cuts that the President is talking about or show the costs of avoiding that outcome, which, by way the way, in 2009, 2010, would amount to $70 billion. That is one of the reasons why the claim that the deficit would be cut in half by 2009 in my opinion is not credible.

Second point that was discussed was the effects of locking in the tax cuts on uncertainty in the future. And I think, in some sense, this misses the boat. Think of a family that has leased a car that it can't afford and then has something bad happen to it. Makes it even less affordable to have the car. The lease comes up for expiration and the family decides to purchase it because it really wants to make sure it knows what kind of car it is driving.

That is similar to locking in these tax cuts. The fundamental source of uncertainty is the fiscal imbalance in this country. What taxes are we going to increase and what spending programs are we going to reduce in order to bring balance back to the Federal budget. Locking in the tax cuts does not resolve that source of uncertainty. It actually makes it worse.

We are kind of having a discussion that really doesn't match up to the underlying source of uncertainty which is the Nation's large fiscal gap.

Third point I want to make is something that has not been remarked upon very much this afternoon, which has to do with the savings accounts, that came up a little bit. What is remarkable about the budget is that among the only tax cuts that are not extended, in other words, that would be eliminated under the administration's budget is the savers' credit for moderate income families who struggled to put away some money in a 401(k) or IRA. And under current law, have some of that matched by a Federal tax credit. That would expire under the administration's budget. And yet there are large new tax subsidies for savings done by high income households. This has to do with national saving. High income households offered a tax break are much more likely to just shift assets from other accounts into the tax-preferred account than low income households.

So if we care about raising national saving, where we should be concentrating incentives are at the bottom end of the income distribution where families don't have other assets to shift. That means that any dollar that actually shows up in the account is much more likely to be new saving rather than just shifting of assets. And finally, I wanted to stay very brief. Let me talk about the budget rules that are proposed in this budget. I think that it is not only on balance to impose restraints just on one side of the budget and not another, but actually unlikely to work. And the reason it is unlikely to work is that you will have stronger incentives to shift programs from the spending side to the tax side as we have seen has already occurred over the past 2 decades or so creating what Chairman Greenspan has called a tax entitlement. It doesn't do any good to potentially inefficiently shift programs from the spending side to the tax side, which is what the incentives would be under the type of budget rules that the administration is proposing. So my written testimony, Mr. Chairman, goes through these issues in much more detail. But given the late hour, I will leave it at that for now.

[The prepared statement of Mr. Orszag follows:]

THE PREPARED STATEMENT OF PETER R. ORSZAG[1], JOSEPH A. PECHMAN SENIOR FELLOW, THE BROOKINGS INSTITUTION, CO-DIRECTOR, TAX POLICY CENTER

Mr. Chairman and members of the committee, thank you for the opportunity to testify on the President's fiscal year 2005 budget and the budget outlook. My testimony makes several key points:

• The Nation is on an unsustainable fiscal path—and the administration's budget makes the long-term fiscal problem substantially worse.

• Assuming that we extend expiring tax provisions, maintain a constant level of real per capita discretionary spending, and reform the alternative minimum tax, the unified budget deficit over the next 10 years amounts to $5 trillion or more, according to a wide variety of independent analysts.

• The unified budget projections include large cash-flow surpluses accruing in trust funds for Social Security, Medicare, and government pensions over the next 10 years. In the longer term, Social Security and Medicare face significant deficits. Outside of the retirement trust funds, the adjusted budget now faces a deficit of more than $8 trillion over the next decade.

• Sustained budget deficits have damaging economic consequences. Ongoing fiscal deficits will reduce future national income, reduce flexibility to respond to unforeseen events in the future, and increase the risk of fiscal and financial disarray, with potential costs far larger than those presented in conventional economic analyses:

• Using conventional economic tools and conservative assumptions that have previously been adopted by the Bush administration's Council of Economic Advisers, the deterioration in the official CBO projections since January 2001 will, by 2012, raise interest rates by 125 basis points, reduce annual national income by more than $300 billion, and increase U.S. indebtedness to foreign investors. The adverse effects would persist and grow over time.

• The conventional analysis may well understate the costs from large, sustained budget deficits such as the ones we now face in the United States. As Robert Rubin, Allen Sinai, and I recently concluded, "The scale of the nation's projected budgetary imbalances is now so large that the risk of severe adverse consequences must be taken very seriously, although it is impossible to predict when such consequences may occur."

• The administration's budget substantially understates the fiscal imbalance likely over the next decade or so, because it ignores many likely costs:

• Among other factors, under the administration's policies, more than 33 million taxpayers would be on the Alternative Minimum Tax (AMT) by 2010—and 34 percent of the 2001 tax cuts would be erased by the AMT. For households with incomes between $100,000 and $200,000, the AMT would take back almost two-thirds of the 2001 tax cuts by 2010.

• The administration's budget does not fully finance the Future Year Defense Plan and other likely defense costs.

• Because it leaves out many likely costs, the administration's claim to cut the budget deficit in half over the next 5 years is not credible.

Even if the administration's claim for the unified budget were credible, furthermore, the deficit outside Social Security under the administration's own projections would remain 3.6 percent of GDP in 2009. And after 2009, according to the administration's own projections of its extended policies, the budget would deteriorate rapidly.

• The tax cuts are a major fiscal issue for the next decade and thereafter. If the 2001 and 2003 tax cuts were extended, they would contribute significantly to the nation's long-term fiscal imbalance:

• Making the 2001 and 2003 tax cuts permanent would increase the deficit by $1.7 trillion over the next decade. The administration's budget shows a lower cost, but that is mostly because it assumes that the AMT "takes back" a growing part of the 2001 and 2003 tax cuts over time.

[1] The views expressed are those of Dr. Orszag alone and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center. Much of this testimony draws directly upon joint work with William Gale of Brookings, Robert Rubin of Citigroup, and Allen Sinai of Decision Economics, Inc. See, in particular, William G. Gale and Peter R. Orszag, "The Budget Outlook: Updates and Implications," Brookings Institution, January 29, 2004, and Robert Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," Paper presented at the AEA–NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, January 2004. My co-authors should not be held responsible for the views expressed in this testimony, however.

• The total budget cost (with interest) from extending the 2001 and 2003 tax cuts, along with other expiring provisions such as the R&E credit, exceeds $2 trillion. If these tax provisions are worth extending, they should be paid for.

• Over the next 75 years, the tax cuts would cost more than three times the actuarial deficit in Social Security.

• Fixing the budget problem at this point will require both spending reductions and revenue increases. Both are necessary to create an atmosphere of fiscal discipline, and abandoning fiscal discipline on one side of the budget likely induces a period of fiscal irresponsibility on the other side of the budget—exactly the opposite of what the "starve the beast" theory suggests.

• A new Brookings study, entitled Restoring Fiscal Sanity, illustrates the tradeoffs that the nation now faces in balancing the budget. The study puts forward three different plans for reaching balance in the unified budget by 2014: One approach primarily involves spending cuts and smaller government, another relies more heavily on tax increases to support an activist government, and the third suggests a balanced mix of spending cuts and tax increases along with a reallocation of government priorities. All three are designed to restore fiscal sanity over the coming decade and reach balance by 2014.

• To help create and enforce the steps needed to close the deficit, policy-makers should reinstate a set of workable budget rules. Unfortunately, the administration's proposal to apply pay-as-you-go rules to mandatory spending only, and not to revenue changes, is counterproductive:

• First, it would fail to foster the atmosphere of fiscal discipline that can come only from restraining both sides of the budget.

• Second, it would create strong incentives for accelerating the trend of disguising spending changes as revenue provisions, thereby creating "tax entitlements."

The Congress should restore pay-as-you-go rules to both mandatory spending and revenue changes, and should adopt more protections against gaming the rules with sunsets. It should also impose discretionary spending caps, although care must be taken to choose an appropriate level of spending allowed under such caps.

• In conclusion, the administration's budget is most notable for what is not in it, rather than what is. It doesn't contain serious entitlement reform. It doesn't contain serious reform of the tax system or the Alternative Minimum Tax. And it doesn't contain a serious plan to reduce the nation's budget deficit over the next 10 years, let alone over the long term.

## I. THE CHANGING BUDGET OUTLOOK

Table 1 examines the actual decline in budget outcomes between fiscal years 2000 and 2004. Despite recent assertions that domestic spending is skyrocketing out of control, the table shows that the vast majority of the recent increase in budget deficits is due to lower revenue, not higher spending. Between 2000 and 2004, the budget changed from a surplus of 2.4 percent of GDP to a projected deficit of 4.2 percent of GDP. Of this 6.6 percentage points of GDP change, 5.0 percentage points—slightly more than 75 percent—is due to lower revenues.

Much attention has been focused in particular on the growth of domestic discretionary spending. The table shows, however, that non-defense discretionary spending (which includes international assistance and pieces of homeland security) can account for less than 10 percent of the increase in the deficit as a share of GDP. The share of the deterioration attributable specifically to non-homeland security domestic spending (i.e., excluding both international assistance and non-defense homeland security) is well under 10 percent.

TABLE 1.—SOURCES OF CHANGE IN UNIFIED BUDGET, 2000–2004

[Percent of GDP]

| | 2000 | 2004 | Difference | Share of Change |
|---|---|---|---|---|
| Unified Budget Surplus (or Deficit) | 2.4 | −4.2 | −6.6 | 100 |
| Revenues | 20.8 | 15.8 | −5.0 | 76 |
| Spending | 18.4 | 20.0 | 1.6 | 24 |
| Net Interest | 2.3 | 1.4 | −0.9 | −14 |
| Non-Interest Spending | 16.1 | 18.6 | 2.5 | 38 |
| Mandatory | 9.8 | 10.8 | 1.0 | 16 |
| Discretionary | 6.3 | 7.8 | 1.5 | 23 |
| Defense | 3.0 | 3.9 | 0.9 | 14 |
| Non-Defense | 3.3 | 3.9 | 0.6 | 9 |

Other perspectives also support the view that revenue declines, not spending increases, are the main driving force behind the increase in deficits. Federal revenue in 2004 will be a smaller share of the economy than at any time since 1950. Spending, in contrast, is at its average share of GDP over the past 40 years.

II. 10-YEAR BUDGET PROJECTIONS

The Congressional Budget Office recently issued a new set of 10-year budget projections. These new projections again underscore how dramatically projected budget outcomes have deteriorated since January 2001. Under the official CBO baseline projections, the unified budget now shows a cumulative decline of $8.5 trillion over the 2002 to 2011 horizon, the equivalent of 6.5 percent of projected GDP over the same period. The changes are not temporary—they clearly represent a fundamental downward shift in fiscal trajectories. For example, the projected outcomes for 2005 and 2011 have each fallen by about 6.6 percent of projected GDP in that year.

The official CBO projections, furthermore, are not predicated on credible assumptions about the current thrust of budget policy, since statutory and other restrictions prevent the CBO from adopting more reasonable assumptions in its baseline. Figure 1 shows the sizable effects of adjusting the CBO projections in various ways. The CBO unified budget baseline for fiscal year 2005–14 projects a 10-year deficit of $1.9 trillion, with deficits falling sharply over time. Adjusting the CBO baseline by extending expiring tax provisions, reforming the Alternative Minimum Tax, and maintaining a constant level of real discretionary spending per capita generates a unified budget deficit to the tune of $5.5 trillion over the next decade.[2]

Other recent estimates are similar. The Center on Budget and Policy Priorities, for example, estimates a 10-year unified deficit of $5.2 trillion.[3]

Note also that the unified budget includes retirement trust fund surpluses of almost $3 trillion. The estimates in Figure 1 suggest that taking the retirement funds off-budget generates a 10-year deficit, other than retirement funds, of $8.5 trillion.

These figures, although based on the CBO baseline projections, underscore why the administration's budget substantially understates the fiscal imbalance likely over the next decade or so:

The administration's budget ignores many likely costs, such as:

- Fixing the Alternative Minimum Tax (see below). Preventing tens of millions of taxpayers from becoming subject to the AMT would reduce revenue by about $70 billion in 2009.
- Funding likely defense costs. The Center on Budget and Policy Priorities, using estimates from the Center on Strategic and Budgetary Assessments on the costs of financing the Future Year Defense Plan and other likely defense needs, recently concluded that defense discretionary outlays would total 3.8 percent of GDP in 2009.[4] The administration's budget, by contrast, shows defense discretionary outlays that are roughly half a percent of GDP lower in 2009. The difference amounts to about another $70 billion.
- The administration's budget likely excludes other costs, such as in international discretionary spending, raising the gap between a realistic projection and the figures in the administration's budget.

The budget also includes proposals, such as those creating Retirement Savings Accounts and Lifetime Savings Accounts, whose long-term costs are masked in the short term.

Finally, the budget does not include the cost of diverting Social Security revenue into private accounts, a step that the President has embraced. Over the next 10 years, such a proposal could expand the unified deficit by more than $1 trillion.

In summary, the administration's claim to cut the budget deficit in half over the next 5 years is not credible.

Even if the administration's claims about the unified budget were credible, two further points are worth noting. First, according to the administration's own numbers, the budget outside Social Security would still be running a deficit of 3.6 per-

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[2] William G. Gale and Peter R. Orszag, "The Budget Outlook: Updates and Implications," Brookings Institution, January 29, 2004. Note that these calculations assume that the bonus depreciation provisions from the 2002 and 2003 tax cuts are extended. The administration has indicated that it will not support extension of these provisions. As Table 3 below shows, if these provisions were not extended, the unified budget deficit over the next 10 years would be roughly $600 billion lower.

[3] Richard Kogan, David Kamin, and Joel Friedman, "Deficit Picture Grimmer than new CBO Projections Suggest," Center on Budget and Policy Priorities, revised February 1, 2004.

[4] Based on calculations in Richard Kogan, David Kamin, and Joel Friedman, "Deficit Picture Grimmer than new CBO Projections Suggest," Center on Budget and Policy Priorities, revised February 1, 2004.

cent of GDP in 2009. Second, the unified deficit would deteriorate rapidly after 2009, again as the administration's own figures show. Figure 2 is taken from the Analytical Perspectives part of the administration's fiscal year 2005 budget. It shows that even with somewhat faster productivity growth than assumed in the central projections, an extension of the administration's 2005 budget policies would be associated with large and growing deficits over time.

III. EXPIRING TAX PROVISIONS

As the figure suggests, the extension of expiring tax provisions has a substantial effect on the budget outlook over the coming decade. All of the tax cuts enacted in 2001, 2002, and 2003 expire or "sunset" by the beginning of 2011. A variety of other tax provisions that have statutory expiration dates are routinely extended for a few years at a time as their expiration date approaches. Making all of the provisions in the 2001 and 2003 tax cuts permanent would reduce revenues by about $2 trillion over the next decade. Counting the added interest payments to service higher levels of Federal debt, the total increase in the deficit would be $2.35 trillion.

Table 2 shows that about $600 billion of the cost associated with extending the tax cuts is attributable to the 50 percent bonus depreciation provision. The administration has indicated that it does not support extension of the bonus depreciation provision. Excluding the bonus depreciation provision, extension of the other provisions in the 2001 and 2003 tax cuts would reduce revenue by $1.5 trillion over the next 10 years and add $246 billion in debt service costs, for a total budget cost of $1.8 trillion. Extending other expiring provisions would cost another $400 billion, for a total cost of more than $2 trillion excluding the bonus depreciation provision.

TABLE 2.—EFFECTS OF EXTENDING TAX CUTS

[In billions of dollars]

| | 2005 | 2009 | 2014 | 2005–2014 |
|---|---|---|---|---|
| Expiring 2001 And 2003 Tax Cuts[1] | | | | |
| Extend Estate and Gift Tax Repeal | −1 | −2 | −61 | −206 |
| Extend Other Non-AMT Provisions of EGTRRA, JGTRRA | −13 | −16 | −182 | −748 |
| Extend AMT Provisions of EGTRRA, JGTRRA | −10 | −51 | −99 | −564 |
| Interest | −1 | −13 | −77 | −246 |
| Subtotal | −25 | −81 | −419 | −1,764 |
| Extend 50 Percent Bonus Depreciation from 2002 and 2003 Tax Cut | | | | |
| Revenue | −41 | −48 | −28 | −440 |
| Interest | −1 | −14 | −28 | −148 |
| Subtotal | −42 | −62 | −56 | −588 |
| Other Expiring Provisions | | | | |
| Revenue | 1 | −31 | −59 | −342 |
| Interest | 0 | −3 | −18 | −61 |
| Subtotal | 1 | −34 | −77 | −403 |
| All Expiring Tax Provisions | | | | |
| Revenue | −65 | −148 | −429 | −2,299 |
| Interest | −1 | −30 | −123 | −455 |
| Total | −66 | −178 | −551 | −2,754 |

[1] Excluding bonus depreciation provision.

The administration's budget displays a smaller cost of extending the 2001 and 2003 tax cuts (even excluding the bonus depreciation provision), but that is mostly because the administration's budget does not extend the temporary Alternative Minimum Tax (AMT) relief included in the recent tax cuts beyond 2005. The result is that an increasing share of the 2001 and 2003 tax cuts are "taken back" by the AMT over time. Figure 3 shows estimates from the Tax Policy Center of the number of taxpayers on the AMT under the administration's proposal. As the Figure shows, more than 33 million taxpayers would be on the AMT by 2010 under the administration's policies.

Table 3 shows that under the administration's policies, 34 percent of the tax cuts from the 2001 tax legislation would be erased by the AMT by 2010. For households with incomes between $100,000 and $200,000, the AMT would take back almost two-thirds of the 2001 tax cut by 2010. These shares would grow thereafter. The administration's estimates assume that the AMT substantially reduces the cost of extending the tax cuts in this manner.

TABLE 3.—EFFECT OF THE AMT ON 2001 INCOME TAX CUTS, 2010

| AGI Class (Thousands of 2001 Dollars) | Percent of Tax Filers With No Cut Due to AMT | Percent of Cut Taken Back By AMT |
|---|---|---|
| All | 5.1 | 33.8 |
| Less than 30 | 0.0 | 0.0 |
| 30–50 | 0.7 | 1.2 |
| 50–75 | 4.0 | 15.3 |
| 75–100 | 4.8 | 37.2 |
| 100–200 | 24.1 | 65.0 |
| 200–500 | 45.1 | 71.8 |
| 500–1,000 | 9.3 | 15.9 |
| More than 1,000 | 8.1 | 8.2 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

Assuming an AMT reform, the projected 75-year cost of the 2001 and 2003 tax cuts over the next 75 years is more than three times the projected 75-year actuarial deficit in Social Security. The tax cuts would cost more than 2 percent of GDP over the next 75 years in present value; the Social Security actuarial deficit over the next 75 years amounts to 0.7 percent of GDP in present value.

In evaluating the policy choices surrounding extension of the expiring tax cuts, it is worth emphasizing that they are highly regressive—they provide a much larger percentage cut in after-tax income for high-income households than for low-income households.[5] If the tax cuts were made permanent, the top 1 percent of the income distribution in 2011 would experience an 8.6 percent increase in their after-tax income, whereas the middle quintile of the income distribution would experience a 2.7 percent average increase in their after-tax income.

Is extension of the provisions expiring in 2010 necessary to ensure economic prosperity? In the short run, the answer is clearly no. Reducing taxes after 2010 can actually hurt the economy today because financial markets are forward-looking; larger projected deficits in the future can therefore raise long-term interest rates in the short term. In the long run, the answer is also clearly no. The tax cuts themselves may have a modest positive effect on the economy, but they also increase the budget deficit, which has a negative effect on the economy.

The net effect of the tax cuts, according to a variety of estimates, is likely to be negative, not positive, in the long run:

- Gale and Potter (2002) estimate that the 2001 tax cut will likely reduce GNP over the next 10 years; that is, they find that the negative effect of the decline in national saving outweighs the positive effect of reduced marginal tax rates.[6]
- Elmendorf and Reifschneider (2002) use a large-scale econometric model developed at the Federal Reserve and find that a reduction in taxes that appears similar to the personal income tax cuts in the 2001 law reduces long-term output and has only a slight positive effect on output in the first 10 years.[7]
- Auerbach (2002) estimates that the 2001 tax cut will reduce the long-term size of the economy unless it is financed entirely by spending reductions—that is, unless it has no net effect on the surplus or deficit.[8]
- Orszag (2001) concludes that the net effect of legislation resembling the 2001 tax cut would be to reduce GNP by 0.1 to 0.5 percent after a decade.[9]
- JCT (2003) found that the 2003 jobs and growth package would generate zero or negative effects on jobs and growth in the second half of the decade.[10]

Finally, the administration has claimed that the tax cuts need to be made permanent to reduce the uncertainty that taxpayers face. This argument is misleading. Making the tax cuts permanent would not help resolve the fundamental uncertainty

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[5] This section draws upon William Gale, Matthew Hall, and Peter Orszag, "Key Points on Making the Bush Tax Cuts Permanent," The Brookings Institution, January 21, 2004. These distributional estimates assume that the AMT exemption remains at $58,000 and the non-refundable credits are allowed against the AMT.

[6] William G. Gale and Samara R. Potter, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," National Tax Journal, March 2002, pp. 133–86.

[7] Douglas W. Elmendorf and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," National Tax Journal, May 2002, pp. 357–386.

[8] Alan J. Auerbach, "The Bush Tax Cut and National Saving" National Tax Journal, May 2002, pp. 387–408.

[9] Peter R. Orszag, "Marginal Tax Rate Reductions and the Economy: What Would Be The Long-Term Effects of the Bush Tax Cut?" Center on Budget and Policy Priorities, March 2001.

[10] Joint Committee on Taxation, Macroeconomics Analysis of H.R. 2, The "Jobs and Growth Reconciliation Tax Act of 2003, "108th Congress, 1st session, 2003.

about future tax rates or future policy. The reason is that the true underlying source of uncertainty in fiscal policy is how the fiscal gap is going to be closed-what combination of revenue increases and spending cuts will be used. Enacting another fiscally unsustainable policy (making the tax cuts permanent) on top of the already unsustainable fiscal situation does not make the situation more stable, only less so. This instability is particularly relevant given the risk of disarray that could ensue if financial markets become more concerned about how the fiscal gap will be addressed.

IV. ECONOMIC IMPLICATIONS OF BUDGET DEFICITS

The projections above indicate that the nation faces substantial deficits in the short-term and the medium-term, with no apparent relief within the next 10 years. Thereafter, the fiscal picture just gets worse as the baby boomers increasingly retire and ongoing health care cost increases drive up expenditures on Medicare and Medicaid. Several recent studies—including from the International Monetary Fund—have similarly warned about the unsustainable fiscal conditions in the United States.

If allowed to persist, the nation's fiscal gap will impose significant and growing economic costs over the medium term and potentially devastating effects over the longer term. The conventional economic analysis of sustained budget deficits emphasizes that ongoing budget deficits decrease national saving, which reduces domestic investment and increases borrowing from abroad. The reduction in domestic investment (which lowers productivity growth) and the increase in the current account deficit (which requires that more of the returns from the domestic capital stock accrue to foreigners) both reduce future national income, with the loss in income steadily growing over time.

As an example of the conventional analysis of budget deficits, President Bush's Council of Economic Advisers reported in the Economic Report of the President 2003 that "one dollar of [public] debt reduces the capital stock by about 60 cents" and "a conservative rule of thumb based on this relationship is that interest rates rise by about 3 basis points for every additional $200 billion in government debt." Applying the CEA calculations to the $8.5 trillion decline over the past 3 years in official CBO baseline projections for 2002–11 implies that interest rates will rise by 125 basis points. The CEA calculations also imply that the domestic capital stock will fall by $5.1 trillion by 2012 because of the deterioration in the fiscal outlook, even allowing for foreign inflows of capital. This means that the stock of net assets owned by Americans at the end of 2011 will fall by more than $5.1 trillion, and assuming a 6 percent return to capital, national income in 2012 would be more than $300 billion lower than it otherwise would have been.

An alternative set of assumptions used in the recent Brookings volume suggests the fiscal deterioration since January 2001 will raise interest rates by much more than 125 basis points, and that the reduction in national income would amount to $340 billion in 2012. This translates into a cost of more than $2,900 per household in that year alone. The adverse effect of deficits would persist (and grow) over time.

Robert Rubin, Allen Sinai, and I recently noted that the conventional analysis may understate the costs associated with large, ongoing deficits. As we wrote, "The adverse consequences of sustained large budget deficits may well be far larger and occur more suddenly than traditional analysis suggests, however. Substantial deficits projected far into the future can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad. The unfavorable dynamic effects that could ensue are largely if not entirely excluded from the conventional analysis of budget deficits. This omission is understandable and appropriate in the context of deficits that are small and temporary; it is increasingly untenable, however, in an environment with deficits that are large and permanent. Substantial ongoing deficits may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing negative cycle among the underlying fiscal deficit, financial markets, and the real economy * * * Although it is impossible to know at what point market expectations about the nation's large projected fiscal imbalance could trigger these types of dynamics, the harmful impacts on the economy, once these effects were in motion, would substantially magnify the costs associated with any given underlying budget deficit and depress economic activity much more than the conventional analysis would suggest. Indeed, the potential costs and fallout from such fiscal and financial disarray provide perhaps the strongest motivation for avoiding substantial, ongoing budget deficits."[11]

V. ADDRESSING THE FISCAL PROBLEM

Given the scale of the Nation's budget problems and the need to reduce our reliance on borrowing from abroad, the time has come to move beyond merely not digging the budget hole deeper. Balancing the budget over time will require a combination of expenditure restraint and revenue increases. On the revenue side, a key issue is the treatment of legislation that contains expiring tax provisions. As one of the tables above indicates, extending the expiring tax provisions would cost in excess of $2 trillion over the next decade alone. If these tax cuts are worth extending, they should be paid for.

On the expenditure side, let me emphasize that although spending restraint is critical to restoring fiscal discipline, it is unrealistic at this point to expect it to generate the lion's share of the adjustment over the next 10 years. Indeed, a recent Brookings volume edited by Alice Rivlin and Isabel Sawhill presents several possible avenues for restoring fiscal balance in the medium-term.[12] These proposals combine spending cuts and tax increases, phase in gradually over time, and avoid budget gimmicks.

Even the "smaller government" plan devised by the more conservative members of the Brookings budget team required revenue increases (relative to a baseline in which the tax cuts were extended). The smaller government plan includes extremely aggressive reductions in Federal spending—including elimination of all Federal discretionary spending for elementary and secondary education, housing and urban development, manpower training and related programs, and Environmental Protection Agency spending for clean water, drinking water, brownfields, targeted water infrastructure, Superfund, and related programs, as well as termination of the NASA's program of manned flight and all earmarks for local projects in the highway construction program. Yet even with these dramatic spending reductions, revenue increases were still necessary: The smaller government plan therefore includes measures such as an increase in the Federal gas tax of 12 cents a gallon and reform rather than repeal of the estate tax.

The Rivlin-Sawhill volume should be required reading for those serious about balancing the budget over the medium term. To be sure, people may disagree with the options presented in the volume. The fundamental point of the book, however, is to provide insight into the types of steps necessary; some other change would have to substitute for any objectionable provisions in order to restore balance by 2014.

Moving toward budget balance over the medium term should be coupled with more serious discussion of reforming our long-term entitlement programs. Given the scale of the long-term budget deficit, it is imperative that long-term entitlement reform not be predicated on accounting gimmicks or massive assumed general revenue transfers from the rest of the budget to the entitlement programs.[13]

Finally, to help create and enforce the steps needed to close the budget deficit, policy-makers should re-institute a set of effective budget rules that include both discretionary spending caps and pay-as-you-go constraints. The budget rules must apply to both sides of the budget, however. The administration's proposal to apply pay-as-you-go rules to mandatory spending only, and not to revenue changes, is counterproductive. By exempting revenue changes from the rules, the proposal has two fatal flaws. First, it would fail to foster the atmosphere of fiscal discipline that can come only from restraining both sides of the budget. Second, it would create strong incentives for accelerating the trend of disguising spending changes as revenue provisions, thereby creating "tax entitlements." The Congress should restore effective pay-as-you-go rules to both mandatory spending and revenue changes, and adopt tighter restrictions against gaming the rules with sunsets.

Chairman NUSSLE. Well, I appreciate that and I am going to reach for the bait just on one in particular, because you dangled

[11] Robert Rubin, Peter R. Orszag, and Allen Sinai, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray," Paper presented at the AEA–NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, January 2004.

[12] A. Rivlin and I. Sawhill, eds, Restoring Fiscal Sanity: How to Balance the Budget, Brookings Institution, January 2004.

[13] As one possible example, Professor Peter Diamond of MIT and I have recently proposed a Social Security reform plan that involves no transfers from the rest of the budget to Social Security. See Peter A. Diamond and Peter R. Orszag, Saving Social Security: A Balanced Approach (Washington, DC: Brookings Institution Press, 2004).

it out there. And I think the point about the car and lease or purchase, I think it is very valuable, and it helps me particularly, because the next time I buy a car, I may come and talk to you and figure out what is the best, because I still, to this day, have not figured out whether leasing or purchasing, whether it is used or new makes any sense. But the thing—and the reason why the analogy is less than perfect in dealing with the current circumstances is that it is not just a matter of leasing a car or purchasing a car and whether it is used or new and the economic impact of that, you have to add to that, I believe in my opinion the fact that the person just lost their job and would need a car to get to work and if they didn't have a car to get to work, they wouldn't have a job.

And in order to get the car, they may be even taking out a loan to buy it would make sense because of the return they would get from the income of that job. And add to that, the fact that they had a sick child during that same period of time and their roof collapsed or they had a robbery because of something going on. I mean——

Mr. ORSZAG. Family is in tough shape. I guess we miss sometimes the point. We parachute in. They parachute in to the current circumstance here on February 3 and they say oh, my God. Look at the size of the deficit. How in the world did that happen and they forget about the fact that we did have a robbery, 9/11, we did have a tough situation where lots of people lost their jobs and the economy was on its knees. So the analogies about this I think are important, but the investment that we made—and yes it required some borrowing to protect the country is important. And Mr. Cooper, you were talking about the bond and vis-a-vis Europe and the United States.

What would happen—what would have happened—it is impossible to answer this, but this is why we have these debates, what would have happened if we left America unprotected, which of course we did not do, and would not have done. But what investment incentive from a foreign investor would have been in an economy or in a country that was left unprotected, more than just 9/11 with ongoing incidents of terrorism and with no likelihood that that would be repaired. So confidence in the system, which we have—and quite frankly without being too disrespectful, Europe ain't got or certainly not to the extent in a long-term fashion that the United States has, I believe is much more important, or as important than taking it and parachuting in and only looking at one indicator and saying, that must be the cause and effect relationship and why we find ourselves today. I will let you respond.

Mr. ORSZAG. I guess just to extend the analogy here, not to make it too ridiculous, but I think the concern is that the low-income family who just lost the job and has a sick kid should not go out and lease an expensive Lexus. It should lease what will get the job done and not lock into long-term commitments that it can't afford. That would not be the advice that you would give and it is not the advice I would give to the family. So the problem here is not what is happening over the last year or 2 years. The problem here is that even after the economy is expected to recover under realistic projections, we still face a very large deficit. And that brings me to the concern about foreign competitors.

The paper I wrote with Bob Rubin and Alan Sinai highlights how sensitive we are now to the confidence of foreign creditors in our Nation. Bob Rubin is concerned that at some point, we can't predict exactly when, we keep running these large deficits and showing not enough concern about what the implications are and we could be faced with a very unpleasant set of circumstances.

Chairman NUSSLE. And I agree. I am only saying that confidence is more than just economic confidence. One last thing I would say to you or I would just ask and I think this is important, how tall is the Empire State Building?

Mr. ORSZAG. I don't know the answer to that.

Chairman NUSSLE. I don't know either. But it is some 90-some floors, or it is however many feet or how many inches or whatever. How do you know that? It is because it is in relative terms to something else. And the same is true with regard to our budget deficit. If you compare it to nothing, it is big. I mean every time my mother hears me talk about a billion dollars, she cringes, because have I lost my perspective. But it is only large or it is only whatever size it is if you compare it to something. And we have used the economy as a way to compare it. Would you say that is a fair comparison?

Mr. ORSZAG. Absolutely. And my concern about the deficit, again, under realistic projections, you are looking at unified deficits and I am talking not having AMT eat back a third of the tax cut. Under realistic projections, you are talking about 3, 3½ percent of GDP and unified deficits for the next decade. Outside of Social Security, it is 5½ percent. And frankly, the coming wave of the baby boomers makes that just not a good policy to be running over the next decade. We should be running much smaller deficits, or even surpluses.

Chairman NUSSLE. I agree.

Mr. Spratt.

Mr. SPRATT. Thank you, Mr. Chairman and thank you, Dr. Orszag, and I am sorry that we came to you so late in the afternoon, but we appreciate your perseverance in staying here and your willingness to come and testify. You mentioned the AMT, the alternative minimum tax. For several reasons, one being that the threshold amount which the AMT applies has not been indexed to inflation, another being that we are expanding deductions, credits, preferences as part of the tax cuts that have been passed. This AMT will apply to more and more taxpayers. Would it be correct in your estimation to say it is effectively a tax increase?

Mr. ORSZAG. It certainly prevents the tax cuts from taking effect. And from that perspective, it is a tax increase.

Mr. SPRATT. People say if they are affected by the AMT, they pay more in taxes than they would pay under the regular——

Mr. ORSZAG. They would pay more in taxes than under—than if the AMT were reformed. And the taxes will go up over time because the AMT is not indexed for inflation.

Mr. SPRATT. The Treasury Department has predicted that by 2010, 20 to 30 million tax filers may be affected by the AMT; find themselves paying under those higher rates than the regular rates in the rest of the code.

Mr. ORSZAG. Our estimates suggest 33 million taxpayers on AMT by 2010.

Mr. SPRATT. 33 million taxpayers as opposed to how many today?

Mr. ORSZAG. About 3 million or so.

Mr. SPRATT. That would mean for 30 million taxpayers, there will be a tax increase affected by the AMT?

Mr. ORSZAG. That is correct. Another perspective on the same point, again, as I mentioned, 34 percent of it, the 2001 tax cut would be erased by the AMT in 2010. For households with incomes between 100 and $200,000 in income, it is 65 percent. So we are frankly playing a cruel hoax on the American public if we are simultaneously saying you are getting these tax cuts and then not counting the cost of addressing the thing that is erasing the tax cut.

Mr. SPRATT. We give with one hand and take away with the other. And we are talking about 30 million people and what percentage can you estimate how much more—how great a percentage they will pay in taxes.

Mr. ORSZAG. That will vary by households. It will be increasingly concentrated in basically the upper middle class and then seeping down into the middle class itself, especially families with lots of children.

Mr. SPRATT. So we almost inevitably have a rendezvous with this problem over the next 5, 6 fiscal years.

Mr. ORSZAG. I think every independent budget analyst thinks this is an exploding problem on the horizon that needs to be addressed.

Mr. SPRATT. To be complete and frank and open you have to include some estimation of fixing, repairing or revising the AMT and any kind of tax cut agenda for the next 10 years.

Mr. ORSZAG. I would think you would either need to do that or be up front about the fact that the tax cuts that look like they are occurring on paper won't actually occur.

Mr. SPRATT. Let me ask you one other question. You have just done this, but if you elaborate a bit more, let me read what you wrote, Bob Rubin wrote. I got a feeling this is your prose. The adverse consequences of sustained large budget deficits may well be far larger and occur more suddenly than traditional analysis suggests. Substantial deficits projected far into the future can cause a fundamental shift in market expectations and a related loss of confidence at home and abroad. The unfavorable dynamic effects that could ensue largely if not entirely excluded from conventional analysis of budget deficits. This is understandable and appropriate in the context of deficits that are small and temporary. It is increasingly untenable, however, in an environment with deficits that are large and permanent. Substantial ongoing deficits may severely and adversely affect expectations and confidence which in turn can generate a self-reinforcing negative cycle among the underlying fiscal deficits, financial markets and real economy. Would you translate that for us?

Mr. ORSZAG. Bad things happen when you run really large deficits, and financial markets lose confidence if your fiscal probity.

Mr. SPRATT. And it could happen suddenly and unexpectedly?

Mr. ORSZAG. One of the features of financial markets is that confidence can shift rapidly and unexpectedly. And I want to note, Bob Rubin and I are not the only ones raising this concern. There have been a variety of others, including Mr. Mankiw talking about the dangers that could be associated with the so-called hard landing, at some point, if investors do lose confidence. And in my opinion, the scales of the Nation's fiscal imbalance is now so large that perhaps the biggest reason for us to get our fiscal discipline back on track is to avoid the possible risk of that kind of collapse. No one knows exactly when or if it could happen, but the costs, if it does happen, are large enough, that it is worth having a precaution against that from occurring.

Mr. SPRATT. Thank you very much.

Chairman NUSSLE. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman and Dr. Orszag for your patience with us. I was intrigued by a couple of things you said. One, if I could ask you about the minimum tax. How would you feel about keeping it in place, given what you said about the fact that it would take away from some of the tax relief that you believe is not appropriate to make permanent?

Mr. ORSZAG. In comparing sort of doing fiscal balancing, what I would call in an honest way or straightforward way or having kind of a stealth approach through the AMT, the stealth approach of the AMT is not as preferable because it adds complexity, people have to fill out two tax forms; it is less transparent, and for a variety of other reasons it would be better to do it up front and be straightforward with the American public. Other people may have different views.

Mr. PORTMAN. It would give them the compliance cost. Particularly I think it would be better to do it in a straightforward way, but it is interesting that the effect of it might be more or less what you think might be appropriate.

Mr. ORSZAG. One can argue that on both sides that the administration claims that it doesn't have a tax increase and then of course the AMT is. Those who oppose making permanent the tax cuts, I guess could count on the AMT to make that happen over time. Again, I don't think that is a particularly good policy.

Mr. PORTMAN. Why haven't interest rates gone up? If you were to listen to our former colleague and my friend Bob Rubin, it would be very surprising that interest rates had not gone up in the last couple of years.

Mr. ORSZAG. Two points: One is if you look at long-term interest rates relative to short-term interest rates, the so-called yield curve is quite steep and that occurs for a lot of reasons. The Federal Reserve has dramatically reduced short-term rates. It normally happens during recessions, et cetera. One cannot rule out the possibility that one of the things affecting the yield curve is also the fiscal outlook. Second point is at least in his experience and other people who are experienced in financial markets, there is this thought that might not make the most sense to some academic economists, but it does makes sense to the financial market types, which is that financial markets don't really focus on long-term forces during economic downturns. And it is only as the economy starts to recover that you will see that fact manifest itself.

Mr. PORTMAN. But the economy has begun to recover and you would have thought that 6 months ago when we first saw those signs of recovery and certainly that GDP number in the third quarter, you would have seen that long-term perspective by the bond traders and others and the financial markets beginning to respond. It is a curious thing. I think honestly we don't know much about our economy. Every time we seem think there is a certitude and it turns that it doesn't work that way. And interest rates being at what, a 40-year low, seems inconsistent with this notion that high deficits lead to high interest rates.

Final one, you talked saver's credit. You talked about the fact that it was not made permanent in the budget. There are two proposals as you know that relate to personal savings called the RSA and the LSA and there is a third one called the ERSA, which is basically consolidating the existing employer base defined contribution plans. What do you think about the LSA?

Mr. ORSZAG. Just to step back before getting to that specific proposal that the fundamental problem we have in retirement saving and frankly saving in general in the United States is that the incentives are upside down. We provide the strongest incentives for tax deferred saving for high income households who frankly would save anyway and who are generally better prepared for retirement and we do very little for moderate or lower income households who get a very small incentive under the tax code to save and who generally aren't as well prepared.

And actually that matches up interestingly with the fact that high income households tend to have more assets to shift into these tax deferred accounts so you don't get as much new saving as a result. From that perspective, both LSA and RSA proposals have the fundamental flaw that they provide too large of a subsidy at the top of the income distribution for savings that households would have done anyway. I would prefer a much more progressive policy and I certainly hope that you and Mr. Cardin and others who are very interested in these issues will come forward with something that is more progressive than RSA and LSA proposal is.

Mr. PORTMAN. I don't want to get into a debate. I do think there are income caps and the deductible IRA and there are income caps in the Roth IRA and the way the nondiscrimination testing works, I see a lot of low-income folks do get a benefit from the system. As you know, they don't all take advantage of it, but 75 percent of people in a 4019(k) take advantage of it.

Mr. ORSZAG. I think that is important, but just briefly and I know we are running out of time, that is within an employer-provided system. Outside the employer provided system, take-up rates in IRAs are very low. So one of the other problems——

Mr. PORTMAN. But still, the deductible income average is 29,000 bucks a year, so they are not maxing out obviously based on the data, but people are using it to some extent. But I don't disagree with your general point on the fact that we need to focus on those who have more modest income, because that is where most of the benefits are going to be in terms of the net national savings rate. But let me ask you just specifically on LSA versus other forms. Long-term versus short-term savings, is there a difference in terms of its impact on the economy?

Mr. ORSZAG. One of the concerns with LSA relative to RSAs is that the generous withdrawal provisions would allow more seepage out of the account system, and therefore less positive saving. Just analytically, that does have to be weighed against the positive effect of getting more people to save in the first place if they know they are not locking their funds in a liquid form for a long period of time.

So that is a trade-off that needs to be evaluated. My general conclusion is that especially as you go higher up the income distribution providing these tax subsidies that can be taken out at will is going to get you very little new saving.

Chairman NUSSLE. Mr. Shays.

Mr. SHAYS. Thank you, Doctor, for your patience, and I am assuming that you stayed—you were here for most of the questioning of the budget director.

Mr. ORSZAG. Indeed I was.

Mr. SHAYS. Can you list me all the suggestions you heard from members, particularly on the Democratic side of the aisle on ways to balance our Federal budget? What were the suggestions that you heard that you particularly liked?

Mr. ORSZAG. I don't believe I heard very many suggestions from either side of the aisle on specific proposals to balance the budget. And on that point, I was part of a Brookings team, bipartisan team that tried to look at three different scenarios for balancing the budget by 2014: Small government plan, large government plan and a so-called better government plan, and they involved a lot of pain. And they are not things that I think any member will wholeheartedly endorse, but they illustrate the scale of the problem we face in this country.

Mr. SHAYS. The challenge is we are not going to get support in passing this budget from frankly the Democratic side of the aisle. So we have to pass it on our own. And unfortunately, that makes it even more difficult. But I didn't hear many suggestions on ways to balance the budget on either side of the aisle. But I do know this, that we do need to move this economy forward. And I don't believe that the economy alone is going to reduce the overall deficits, so I do believe we have to make some tough choices. We did that last year at least in this committee. We cut 1 percent off what the President had suggested. A penny off a dollar doesn't seem like a lot, but even that we couldn't pass on the House floor.

We might have been more successful had we had organizations support what we did in the subcommittee. And we might have been more successful if people had come to our aid when we were adding 8 or 9 percent and 10 percent to veterans budgets and people were still calling it a cut. You know, that was really a tough one for us. We were spending so much more and yet people were still calling it a cut. It is a tough task. And I know that you are sounding some honest and heartfelt concern that we need to pay attention to, and I thank you for that.

Chairman NUSSLE. I thank you for your testimony and we appreciate the thoughts you provided us today. The committee, if there is nothing more to come before it, stands adjourned until tomorrow at 2 o'clock, where we will have a hearing with Secretary Snow from the Department of Treasury.

[Whereupon, at 6 p.m., the committee was adjourned.]