Testimony

Growing Risks to the Budget and Economy

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Introduction

Chairman Price, Ranking Member Van Hollen and members of the Committee I am honored to have the opportunity to testify on the vital topics of the economic and budgetary outlook. These topics are closely interlinked; going forward better budgetary outcomes will require stronger economic growth and more rapid trend economic growth will depend, in part, on improved budget policies.

In my testimony, I wish to make three simple points:

- More rapid trend economic growth is the most pressing policy issue facing the Congress,
- Improved economic performance will require moving away from a policy regime characterized by high taxes, extensive regulation and temporary, targeted "stimulus" toward permanent structural reforms, and
- Structural reforms to entitlements, taxes, regulations, education, immigration, and trade agreements are the most promising policy mix to restore economic growth, generate rises in the standard of living, and lead to a sustainable budget outlook.

Let me discuss these in turn.

The Growth Challenge

More rapid trend economic growth is the preeminent policy challenge. The nation has experienced a disappointing recovery from the most recent recession and confronts a projected future defined by weak economic growth. Left unaddressed, this trajectory will result in failing to bequeath to the next generation a more secure and more prosperous nation.

Even more troubling than the recent past is the outlook. The Congressional Budget Office (CBO) projects that the long run potential for U.S. economic growth is 2.0 percent. This rate of growth is below that needed to improve the standard of living at the pace typically enjoyed in post-war America. During the early postwar period, from 1947 to 1969, trend economic growth rates were quite rapid. Gross Domestic Product (GDP) and GDP per capita grew at rates of 4.0 percent and 2.4 percent, respectively. Over the subsequent two and one-half decades, however, these fell to 2.9 percent and 1.9 percent, respectively. During the years 1986 to 2007, trend growth in GDP recovered to 3.2 percent, while trend GDP per capita growth rose to 2.0 percent.

These were rates quite close to the overall historic performance for the period. These distinct periods and trends should convey that the trend growth rate is far from a fixed, immutable economic law that dictates the pace of expansion, but rather subject to outside influences including public policy.

More rapid growth is not an abstract goal; faster growth is essential to the well-being of American families.

Table 1

The Importance of Trend Growth to Advancing the Standard of Living

Trend Growth Rate Per Capita (%)	Years for Income to Double
0.50	139
0.75	93
1.00	70
1.25	56
1.50	47
1.75	40
2.00	35
2.25	31
2.50	28
2.75	26
3.00	23

The trend growth rate of postwar GDP per capita (a rough measure of the standard of living) has been about 2.1 percent. As Table 1 indicates, at this pace of expansion an individual could expect the standard of living to double in 30 to 35 years. Put differently, during the course of one's working career, the overall ability to support a family and pursue retirement would become twice as large.

In contrast, the long-term growth rate of GDP in the most recent CBO projection is 2.0 percent. When combined with population growth of 1.0 percent, this implies the trend growth in GDP per capita will average 1.0 percent. At that pace of expansion, it will take 70 years to double income per person. The American Dream is disappearing over the horizon.

Economic Growth and the Federal Budget

A second benefit of improved economic growth is budgetary. The federal government faces a problematic budgetary future, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. The core, long-term issue has been outlined in successive versions of the CBO's Long-Term Budget Outlook. In broad terms, the inexorable dynamics of current law will raise federal outlays from an historic norm of about 20 percent of GDP to upwards of 30 of GDP. Any attempt to keep taxes at their historical norm of about 18 percent of GDP will generate an unmanageable federal debt spiral.

This depiction of the federal budgetary future and its diagnosis and prescription has all remained unchanged for at least a decade. Despite this, lasting action (in the right direction) has yet to achieve the force of law.

In the past several years, the outlook has worsened significantly. Over the next ten years, according to the CBO's latest baseline projections, the deficit will average over $850 billion. Ten years from now, in 2026, the deficit will be $1.2 trillion. As a result of the nation's irresponsible spending binge, in 2026 debt held by the public will have more than doubled from its pre-financial crisis level in 2007 to over 80 percent of GDP and

will continue its upward trajectory.

High levels of indebtedness, coupled with weak projected growth, crowd out productive investment and further suppress economic growth. This combination eventually leads to a spiral of higher interest rates, debt service payments, and damaging fiscal policy. Within the current budget window, interest payments make up more than half, meaning the existing debt portfolio is already constraining policymakers and jeopardizes the budget's capacity to absorb another recession or geopolitical crisis.

Despite the nation's significant budgetary challenges, even incrementally higher economic growth can ameliorate the fiscal outlook by increasing taxable income and suppressing reliance on the social safety net. According to the CBO, a persistent 0.1 percentage point increase in the real growth rate translates into about $300 billion in budget savings.[1] A robust pro-growth agenda could realize multiples of this "rule of thumb" in deficit reduction.

A Policy Regime for Faster Trend Growth

It is desirable to change the style of policy to produce better growth. Economic growth policy is more a philosophy than a piece of legislation. It is a commitment at every juncture in the policy process to evaluate tradeoffs between social goals, environmental goals, special interest goals and economic growth – and err on the side of growth. The Obama Administration contemplated a health care law that raised $700 billion in new taxes and created two new entitlements at a time when the spending-swollen federal debt was already exploding. The White House also chose social objectives over growth. It unleashed the Environmental Protection Agency, choosing a green agenda over growth. It launched the National Labor Relations Board on a union agenda at odds with growth.

The second flaw in recent policy approaches has been its misguided reliance on temporary, targeted piecemeal policymaking. Even if one believed that countercyclical fiscal policy ("stimulus") could be executed precisely and had multiplier effects, it is time to learn by experience that this strategy is not working. Checks to households (the Economic Stimulus Act of 2008), the gargantuan stimulus bill in 2009 (American Recovery and Reinvestment Act), "cash for clunkers" (the Car Allowance Rebate System), tax credits for homebuyers (the Federal Housing Tax Credit, the HIRE Act (consisting of a $13 billion payroll hiring credit, expensing of certain investments, $4.6 billion for schools and energy), the Small Business Jobs Act of 2010, and the state-local bailout Public Law 111-226 ($10 billion in education; $16 billion in Medicaid) have all failed to generate adequate growth.

As the policy regime of macroeconomic fiscal (and monetary) fine-tuning backfired in the 1960s and 1970s, leaving behind high inflation and chronically elevated unemployment, it is working no better in the 21st century. Instead, there should be a commitment to raising the long-term growth rate of the economy through permanent reforms.

This Committee can contribute greatly to moving toward a better, long-term oriented set of policies. The founders recognized that the government had important roles in national security, basic research, education, and infrastructure. Congress should reflect these principles in their budgets. As it turns out, however, these areas are funded in the annual appropriations bills – precisely the area of the budget that was the focus of caps in the Budget Control Act. Growth-oriented policymakers should reject mechanistic budgeting like caps in favor of funding core roles of government contingent on quality analysis and outcomes.

In defense, budgets should reflect the capabilities needed to address the threats identified in the Quadrennial Defense Review – not simply a desire to spend more without justification. Similarly, infrastructure projects should receive funding only if a rigorous analysis shows they improve economic outcomes. Education dollars should reward actual achievement and progress, while health dollars should be contingent on quality outcomes. And most importantly, poverty programs must be re-oriented away from a focus on making sure enough money gets to the poor and towards the real solution to poverty: economic self-sufficiency.

The key issue is that it is a budget strategy focused on annual funding of programs consistent with our founding principles and focused on quality outcomes.

Of course, something has to give and the obvious candidates are the large, and ever-growing, entitlement programs. Reforming entitlement programs turns out to be the right thing to do for reasons beyond budget math. The U.S. economy is characterized by big federal debt – now 75 percent of GDP and rising unsustainably – and poor growth. A lesson of other countries faced with this unpleasant economic cocktail is that the route to better economic performance is to keep taxes low and cut spending to deal with the budget imbalance. But not all spending is created equal. Instead, it is better to cut transfer programs and preserve core functions of government. The historical lesson dovetails perfectly with a pro-growth budget strategy.

Importantly, the large entitlement programs need reform in their own right. Social Security is a good example. The "plan" – the law of the land – will cut across the board the retirement checks of those in retirement by 21 percent in two decades. That is a disgraceful way to run a pension system. It is possible to reform Social Security to be less costly overall and financially sustainable over the long term.

Similar insights apply to Medicare and Medicaid, the key health safety nets for the elderly and poor. These programs have relentless appetites for taxpayer dollars yet do not consistently deliver quality outcomes. Reforms can address their open-ended draws on the federal treasury and improve their functioning at the same time.

The growth-oriented fiscal strategy will re-orient spending priorities away from dysfunctional autopilot spending programs and toward core functions of government. It will focus less on the dollars going into programs and more on the quality of the outcomes of those programs. It will do so because it is the principled approach; because it coincides with the best strategy to deal with the debt and growth dilemmas; and because it will force a restructuring of the entitlement programs to generate a quality social safety net.

Structural Reforms to Enhance Trend Growth

Entitlement Reform and a Sustainable Debt Trajectory

The policy problem facing the United States is that spending rises above any reasonable metric of taxation for the indefinite future. Period. There is a mini-industry devoted to producing alternative numerical estimates of this mismatch, but the diagnosis of the basic problem is not complicated. The diagnosis leads as well to the prescription for action. Over the long-term, the budget problem is primarily a spending problem and correcting it requires reductions in the growth of large mandatory spending programs—entitlements Social Security and federal health programs.

At present, Social Security is running a modest cash-flow deficit, increasing the overall shortfall. There are even larger deficits and future growth in outlays associated with Medicare, Medicaid, and the Patient Protection and Affordable Care Act (ACA). These share the demographic pressures that drive Social Security, but include the inexorable increase in health care spending per person in the United States.

For this reason, an immediate reform and improvement in the outlook for entitlement spending would send a valuable signal to credit markets and improve the economic outlook. The spending future outlined above represents a direct impediment to job creation and growth. The United States is courting further downgrade as a sovereign borrower and a the ensuing increase in borrowing costs it would generate. Any sharp rise in interest rates would have dramatically negative economic impacts; even worse an actual liquidity panic would replicate (or result in an experience worse than) the experience of the fall of 2008.

Alternatively, businesses, entrepreneurs and investors perceive the future deficits as an implicit promise of higher taxes, higher interest rates, or both. For any employer contemplating locating in the United States or expanding existing facilities and payrolls, rudimentary business planning reveals this to be an extremely unpalatable environment.

In short, entitlement reform is a pro-growth policy move at this juncture. As summarized by an American Action Forum paper, research indicates that the best strategy to both grow and eliminate deficits is to keep taxes low and reduce public employee costs and transfer payments.[2]

The Role of Infrastructure in Faster Trend Growth

Among the most common policy proposals are those that increase federal outlays on "infrastructure" (defined in a variety of ways), with the assertion that it will generate more rapid economic growth. This would be true if infrastructure spending had a long-term impact on productivity. Over the long-term, higher productivity—the ability to generate more output and income from each dollar of capital or hour of work—is the key to higher labor earnings and improved standards of living. Because higher productivity is so central to economic growth, it must be an explicit concern – rather than a presumed outcome – when contemplating increased infrastructure spending. The notion that investing in infrastructure will generate productivity has an intuitive appeal: imagine an economy with trucks but no roads, or trains and no tracks. Moreover, there are countless testimonials across the country asserting that a new road, or airport, or other project generated a boom in economic activity.

High-productivity infrastructure investments can generate improvements in economic well being by increasing connectivity or reducing congestion or providing a necessary productive input. If so, this is a critical dimension of improving long-term employment, allowing labor to enhance its productivity at lower cost and encouraging private capital investments in structures, equipment, and technologies to reap higher returns from American industry.

But there are reasons to be cautious as well. First, the test for a high-productivity public investment is that it should generate a rate of return to society that exceeds the market return in the private sector. The resources for any public investment are ultimately drawn from the private sector through taxes and fees, or in some cases by borrowing from the private sector. In each case, the dollars used to make these investments constitute foregone opportunities to make other market investments.

To meet a productivity test, federal investments should have a greater impact in terms of raising future standards of living than other uses of funds as measured by the return on other market investments. Thus, to ensure the

best use of taxpayer dollars, government must channel funding to the projects that offer the highest returns to society.

That means choosing programs that do the most to enhance long-term productivity. A second concern is that politics interfere with making sure that the right projects are chosen. Not every road, high-speed rail, or water project can meet the test. Will public policy actually consist of a portfolio of well-selected and thoughtfully targeted investments that may make a substantial contribution to aggregate economic productivity?

A third issue is that any shift in resources creates losers as well as winners. A dollar spent on any project means a dollar less to spend on another project. In an environment of finite resources, funding infrastructure projects will generate some productivity, but at the expense of jobs that could have been created in other sectors had the money been used differently. This is why reform to direct government spending to the most productive investments is so crucial. Even if infrastructure always raises productivity, its net effect on the economy as a whole—taking into account the benefits that will be foregone as a result of reduced public spending in other areas of the economy—will be positive only if government investments are rigorously selected to meet productivity criteria.

Shifts of investment and employment occur not just across industries and sectors, but also across counties and states. Even a sub-optimal investment is likely to be able to show some positive output impacts, especially in the short-term, from the perspective of the winning state or city. But from a national perspective and over time these gains could be—and often are—outweighed by losses elsewhere. Federal infrastructure policy should guide federal dollars so as to produce a net gain for the economy as a whole, rather than for one area or region in the short-term.

The construction of the Interstate Highway network, for example, created jobs near interstate interchanges as new and existing businesses were drawn to locations where they could take maximum advantage of the accessibility afforded by the new highway system. Towns that were bypassed by the Interstates, however, lost jobs as some of their businesses moved to these new locations and as other businesses that stayed “died on the vine” because they could no longer compete. Nevertheless, the federal investment creating the interstate highway network was justified because overall gains exceeded overall losses.

Evidence

The histogram below, reproduced from Bom and Ligthart [2014] summarizes 578 estimates from 68 studies that cover various time periods, nations or states, levels of government (municipal, state, federal), and types of public capital.

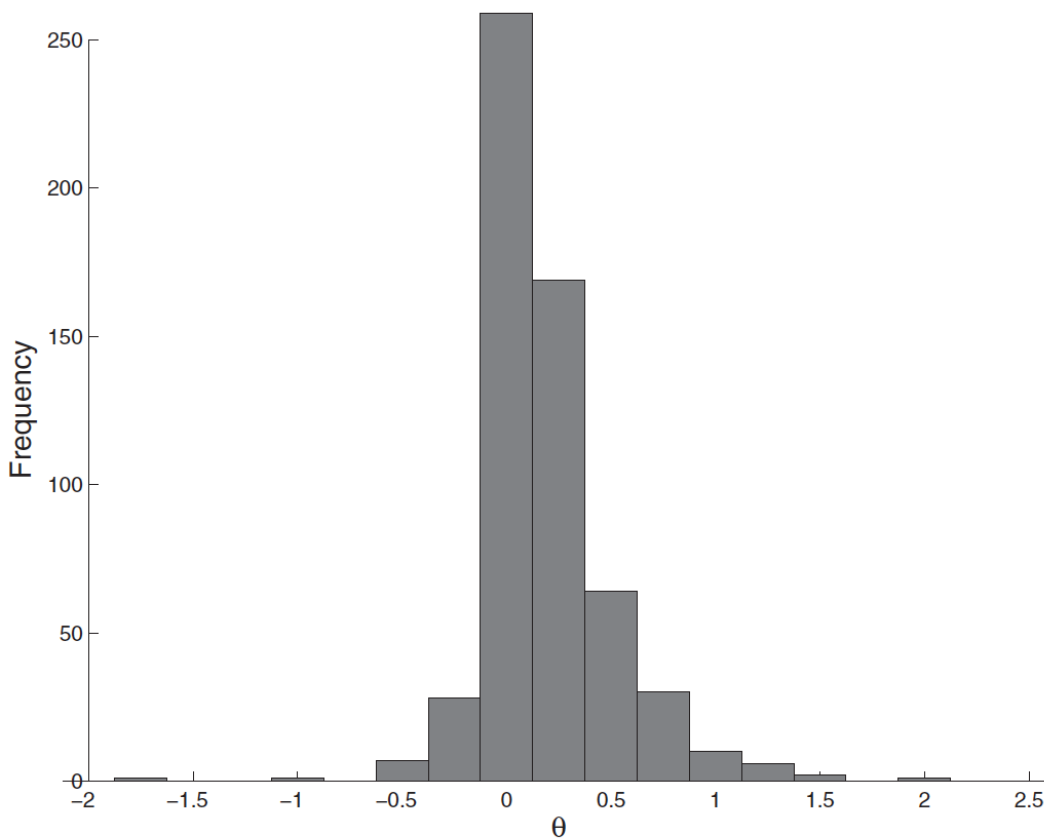

Figure 1

The histogram shows the distribution of what the researchers call "q", the percentage increase in output for a comparable percentage rise in infrastructure. As one can see by inspecting the figure, there are large positive (over 2.0) and large negative (below -1.5) examples in the literature. However, the bulk of the estimates cluster closely around zero. The overall shape of the distribution does suggest a greater chance of positive impacts than negative ones, so a consensus estimate of the elasticity might be slightly above zero.

What does this mean? Government general capital is roughly $10 trillion, according to the Bureau of Economic Analysis of the Department of Commerce, so $100 billion for additional infrastructure spending is roughly a (100/10000 =) 1.0 percent increase. Using a productivity elasticity of, say, 0.03, that suggests that the level of productivity and output eventually rises by 0.03 percent. Since GDP is roughly $18 trillion, then $100 billion in extra infrastructure spending generates $5.4 billion in extra output per year, which is hardly a productivity boom.

Tax Reform

The U.S. tax code is broadly viewed as broken and in need of repair, and for good reason – it hasn't been overhauled in 30 years. Whereas this administration would instead make the tax system worse – adding higher rates and new taxes, including on the middle class – the Committee should support a fundamental overhaul of the nation's tax system.[3] A sound reform of the U.S. tax code is an essential element of any pro-growth strategy, and could substantially increase trend economic growth, boosting the economy and tax revenue.[4]

Fundamental modernization and simplification of the tax system has been an elusive dream for Congresses and

administrations over the past 30 years, and a wholesale reform of the code is invariably difficult during an election.

The last time the United States undertook a fundamental tax reform was with the Tax Reform Act of 1986 (TRA). If history is any guide, a 1986 style reform offers faster economic growth. This is borne out by retrospective analysis of the TRA that found that the 1986 tax reform produced about one percentage point higher growth over a long period. Further studies have shown that the negative relationship with higher marginal rates and taxable income, hours worked, and overall economic growth.[5]

A more robust reform along the lines proposed by the recent task force proposal offers even greater growth benefits. Highly respected economists David Altig, Alan Auerbach, Laurence Kotlikoff, Kent A. Smetters, and Jan Walliser, simulated multiple tax reforms and found GDP could increase by as much as 9.4 percent from tax reform.[6] The highest growth rate was associated with a consumption-based tax system that avoided double-taxing the return to saving and investment. The study also simulated a "clean," revenue-neutral income tax that would eliminate all deductions, loopholes, *etc.*; and lower the rate to a single low rate. According to their study, this reform raised GDP by 4.4 percent over ten years—a growth effect that roughly translate into about .4 percent higher trend growth, resulting in faster employment and income growth.

<u>Regulatory Reform</u>

Another important step is a new approach to regulation. The recent rapid increase in burdensome regulations comes at a considerable cost to American businesses, consumers, workers, and the economy in general. Over the last decade the federal government imposed over $962 billion in compliance costs and an estimated 698 million net paperwork burden hours on American businesses and individuals.[7] These are not just abstract cost but take a real toll on employment. Just $1 billion in new regulation burden is associated with a 3.6 percent decline in industry employment.[8] The cumulative effect of regulation is significant and that policymakers should take existing regulatory burdens into account when writing new rules. A comprehensive re-evaluation of existing regulations, starting with the most burdensome, duplicative, and costly, should be undertaken to limit the

<u>Immigration reform</u>

Immigration reform can raise population growth, labor force growth, and thus growth in GDP. In addition, immigrants inject entrepreneurialism in the U.S. economy.[9] New entrepreneurial vigor embodied in new capital and consumer goods promises a higher standard of living.

Without this policy effort, low U.S. birth rates will result in a decline in the population and overall economy. A serious, economically-based immigration reform would raise the pace of economic growth substantially, raise GDP per capita, and reduce the cumulative federal deficit.

<u>Education reform</u>

Education in America is in crisis. Of 100 children born in 1983 who started kindergarten together in 1988, 30 of them would not have graduated on time in 2001. Of the 70 who would have graduated, 50 would start college, and just 28 of those 100 kindergartners would have a college degree by spring 2007. But it gets worse.

Our nation continues to report significant achievement gaps between students based on race and socioeconomic

factors. On average, students of color have a much lower, 67 percent likelihood of graduating. Of those students of color who do graduate, they typically exit high school with the functional equivalent of an 8th or 9th grade education. Despite more than $16 billion annually in targeted federal aid, our poor neighborhoods usually lack fundamental resources such as great teachers. This feeds an embarrassingly persistent and worsening gap between our students' performance and that of students in the rest of the industrialized world. The Organisation for Economic Co-operation and Development (OECD) found that in 2006, America ranked 25th out of 30 industrialized countries in math and 24th in science.

In the past, only parents with enough money could choose a school outside their government assignment – and money can still buy escape. However, around the "assigned sector" of public education, there is a whole other world slowly emerging. Increasingly, there are more choices in the public sector that families can access, among them public charter schools and access to private schools with scholarship or tax credit support.

The tragedy is that the government near-monopoly has prevented these new choices from being fully implemented; from throwing open doors to the students that need them most. While thousand of parents have accessed choice programs immediately as they become available, thousands more sit on waiting lists while their children and their hopes languish. Better options driven by parental choice can expand as quickly as we can provide them the students and the resources to do so.

Trade Agreements

Trade is an important driver of productivity and economic growth in the U.S. and globally. Trade creates jobs, increases GDP, and opens markets to American producers and consumers. The U.S. is the world's largest participant in global trade—with $1.5 trillion in exports of goods and services and imports of over $2 trillion—and has established free trade agreements with 20 countries.[10] The U.S. is the largest exporter of services in the world.[11] Trade supports over 11 million jobs in the U.S.[12] and U.S. exports comprise a full 13 percent of U.S. GDP.[13]

These numbers are significant, and pursuing a robust trade agenda in 2016 offers the opportunity for improved economic growth. The Trans-Pacific Partnership (TPP), finalized in 2015, is on balance a pro-growth trade agreement. Two other trade agreements, the Transatlantic Trade and Investment Partnership (TTIP) and Trade in Services Agreement (TiSA), are currently being negotiated and offer opportunities for expanding global markets. TTIP would fully open EU markets, boost GDP by $125 billion, and create more than 740,000 U.S. jobs.[14] TiSA, the first trade agreement in services since 1995, could bind together 70 percent of the world's $55 trillion services market.[15] If effectively negotiated, these agreements offer significant economic potential.

Conclusion

More rapid trend economic growth is the most pressing federal policy issue. Fortunately, the roots of subpar growth are found in subpar growth policies. Changing the policy strategy to focus on permanent structural reforms to entitlement, tax, regulatory, immigration, education and trade polices holds the promise of improving the economic outlook for this generation and those that follow.

NOTES

[1] https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/49892-Outlook2015.pdf

[2] http://americanactionforum.org/insights/repairing-a-fiscal-hole-how-and-why-spending-cuts-trump-tax-increases

[3] http://americanactionforum.org/insights/ooops

[4] http://americanactionforum.org/research/economic-and-budgetary-consequences-of-pro-growth-tax-modernization

[5] See: Feldstein, Martin, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act." *Journal of Political Economy,* June 1995, (103:3), pp 551-72; Carroll, Robert, Douglas Holtz-Eakin, Mark Rider and Harvey S. Rosen, "Income taxes and entrepreneurs' use of labor." *Journal of Labor Economics 18(2)* (2000):324-351; Prescott, Edward C., "Why do Americans Work So Much More Than Europeans." Federal Reserve Bank of Minneapolis July 2004; Skinner, Jonathan , and Eric Engen. "Taxation and Economic Growth." National Tax Journal 49.4 (1996): 617-42; Romer, Christina D., and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks." National Bureau of Economic Research NBER Working Paper No. 13264 July 2007 Web. http://www.nber.org/papers/w13264

[6] Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters and Jan Walliser, "Simulating Fundamental Tax Reform in the United States." *American Economic Review, Vol. 91, No. 3* (2001), pp. 574-595

[7] https://regrodeo.com/

[8] Batkins and Gitis, "The Cumulative Impact of Regulatory Cost Burdens on Employment".

[9] Holtz-Eakin, "Immigration Reform, Economic Growth, and the Fiscal Challenge."

[10] https://www.census.gov/foreign-trade/balance/c0004.html; https://ustr.gov/trade-agreements/free-trade-agreements

[11] https://www.wto.org/english/res_e/booksp_e/world_trade_report15_e.pdf

[12] http://www.trade.gov/mas/ian/build/groups/public/@tg_ian/documents/webcontent/tg_ian_005500.pdf

[13] http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS

[14] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/245085/TTIP_and_the_50_States_GovUI

[15] https://ustr.gov/TiSA