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FISCAL CLIFF: HOW TO PROTECT THE MIDDLE CLASS, SUSTAIN LONG-TERM ECONOMIC GROWTH, AND REDUCE THE FEDERAL DEFICIT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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FISCAL CLIFF: HOW TO PROTECT THE MIDDLE CLASS, SUSTAIN LONG-TERM ECONOMIC GROWTH, AND REDUCE THE FEDERAL DEFICIT

THURSDAY, DECEMBER 6, 2012

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 9:32 a.m. in Room 216 of the Hart Senate Office Building, the Honorable Robert P. Casey, Jr., Chairman, presiding.

Senators present: Casey, Bingaman, Klobuchar, Coats, Lee, and Toomey.

Representatives present: Brady, Burgess, Mulvaney, Maloney, and Cummings.

Staff present: Conor Carroll, Gail Cohen, Will Hansen, Colleen Healy, Ian Jannetta, Madi Joyce, Jessica Knowles, Patrick Miller, Robert O'Quinn, Christina Forsberg, and John Trantin.

OPENING STATEMENT OF HON. ROBERT P. CASEY, JR., CHAIRMAN, A U.S. SENATOR FROM PENNSYLVANIA

Chairman Casey. The Committee will come to order.

We want to thank everyone for being here today. I did not have a chance to personally greet our witnesses, but I will have time to do that later. I want to thank both of our witnesses for being here, Dr. Hassett and Dr. Zandi.

I will have an opening statement that I will make, and then I will turn to Dr. Burgess who will be making the opening. I know that Vice Chairman Brady will be with us, as well.

So thanks, everyone, for being here. We all know the challenges we confront here in Congress on a whole range of issues, which are sometimes broadly described under the umbrella of the terminology "fiscal cliff," but I think when we confront those difficult challenges we have to ask ourselves of course a couple of basic questions.

One of the basic questions I think we must ask is: What will be the result, and what will be the impact as it relates to middle-income families? What will happen to them in the midst of all of these tough issues we have to work out?

We know already that there is broad agreement that going over the so-called fiscal cliff would jeopardize the economic recovery. It would do that by increasing taxes on families, halting employment growth, driving unemployment up instead of down, and triggering deep cuts to programs that families across the country count on.

The job before the United States Congress is to reach an agreement that builds on the economic progress that we are making, and puts us on a path to fiscal sustainability. We need to cut more spending and generate more revenue, and we need to do it in a smart way that keeps our economy growing.

Earlier this year Congress extended the payroll tax cut through 2012. The 2 percentage point payroll tax cut has played an important role to sustain the recovery, boosting economic growth by an estimated one-half of a percentage point in 2012 alone, and saving or creating some 400,000 jobs.

We should continue the payroll tax cut through 2013. And yesterday I introduced legislation that would keep the employee payroll tax at 4.2 percent next year.

To keep the economy growing—and there is good evidence of that just in the last couple of months when we saw the numbers for August, September, and October, job growth of about 511,000—but to keep that momentum going, we should also provide tax credits to small businesses that add jobs or increase wages from one year to the next. My legislation includes such an incentive for small businesses to grow.

I am confident that Congress will again be successful in reaching a compromise in the days ahead, and I look forward to hearing today from the experts that we have before us on how to reduce the deficit while protecting middle-income families.

As we enter the holiday season, Americans should not have to face the uncertainty that many will face with regard to their taxes. There is no reason that middle-income families should go into this holiday season without knowing whether their taxes will go up next year.

Last year, Democrats and Republicans worked together to cut nearly a trillion dollars of spending. Now we need to continue that bipartisan work to cut more spending, and to bring in additional revenues.

If Congress fails to reach an agreement under the Budget Control Act of 2011, $1.2 trillion in automatic spending cuts will take place between 2013 and 2021. Republicans and Democrats agree that indiscriminate, across-the-board cuts are not the right thing to do at this time in our Nation's history.

If we go over the cliff, triggering the automatic spending cuts and tax increases, the gross domestic product will fall by half a percentage point in 2013, according to the Congressional Budget Office. In other words, we would return to recession, reversing the hard-fought gains of the past few years.

We cannot do this. We cannot afford to go backwards. Instead, we need a balanced and bipartisan approach, one that balances short- and long-term needs, distinguishes between core investments that must be preserved and spending that we can live without, and utilizes both spending cuts and revenue increases.

The first order of business should be to protect those middle-income families I talked about, protect them from a tax increase. The CBO estimates that simply extending the middle-class tax cuts would boost GDP by 1.3 percent and create 1.6 million jobs. Let me say that again: Boost GDP by 1.3 percent and create 1.6 million jobs from that tax cut alone that we can enact.

Importantly, it would resolve much of the economic uncertainty facing these middle-income families. There is broad recognition that the wealthiest among us can help us reduce the debt by paying more. It is encouraging in the last couple of weeks to see Republican Members of the House and Senate speak out on the need for a balanced approach that includes raising taxes on the wealthiest individuals, and moving right away to ensure that 98 percent of families do not face a tax increase.

We need to look at history, recent history, when it comes to the impact of raising individual rates at the highest income levels. As we saw in the 1990s and the 2000s, there is no relationship between lower marginal tax rates for the wealthiest among us and faster economic growth.

First, during the Clinton Administration to address the growing budget deficit, the top marginal tax rate was raised on the wealthiest individuals and the economy grew at its fastest rate in a generation, adding more than 22 million jobs.

During the following eight years, the top marginal rate was lowered for the wealthiest individuals, but the economy never regained the strength of the previous decade. Job growth slowed and wages stagnated, leaving middle-income families especially vulnerable when the Great Recession began at the end of 2007.

I hope today's hearing is helpful to people in not just Pennsylvania but across the country who are watching, who are weighing in, and who are waiting for Congress to act.

I just want to say—and I will say more at the end about some of our Members who are leaving the Congress—I want to say that it has been an honor for me to serve as Chair of this Committee, and also a great honor to serve with my friend Kevin Brady as the Vice Chair. He has been great to work with. We have worked well together, and I think some of the ways we worked together I hope can be a harbinger of future bipartisan success here in the Congress and I look forward to working with him as I change seats in a sense for the next Congress.

I am grateful to our witnesses that I will introduce, but before I do that I would turn to Dr. Burgess for his opening statement.

OPENING STATEMENT OF HON. MICHAEL C. BURGESS, M.D., A U.S. REPRESENTATIVE FROM TEXAS

Representative Burgess. I thank the Chairman for the recognition.

I observe that this is the concluding hearing of the Joint Economic Committee for the 112th Congress. So, Mr. Chairman, on behalf of Vice Chairman Kevin Brady, on behalf of the Republican Members and myself, I wish to thank you for your service as the 36th Chairman of the Joint Economic Committee.

The American people in their wisdom in 2010 gave us a divided Legislative Branch. Consequently, this unique Committee was also equally divided. People are used to seeing such division producing gridlock in Washington, but Chairman Casey and Vice Chairman Brady have worked together and shared responsibility for organizing the Committee hearings. Because of your bicameral and bipartisan cooperation, the Joint Economic Committee has emerged

as a widely respected national forum for debating important national issues.

Therefore, I wish to thank you, Chairman Casey, for your leadership in the 112th Congress, and also I want to join you in recognizing the retiring Members from this Committee: Senator Bingaman from New Mexico, Representative Hinchey from New York, and Senator Jim Webb from Virginia.

In Federalist 70, our first Secretary of the Treasury, Alexander Hamilton observed, "Energy in the executive is a leading character in the definition of good government." In a divided government, the President—the President—must lead and must not abdicate his or her responsibility.

President Obama has the responsibility to propose a real, bipartisan plan to avert the fiscal cliff that can in fact pass both the House and the Senate. Drawing from the recommendations from the Simpson-Bowles Commission, the President could propose a plan that not only averts the so-called fiscal cliff but also helps us avert the yawning fiscal abyss by reforming Social Security, Medicare, Medicaid, and let us not overlook the looming Affordable Care Act. If President Obama were to offer such a plan, Republicans would likely act favorably.

Going over the cliff in fact is unnecessary. Yet, as Kimberley Strassel observed in The Wall Street Journal, "The President is boxing in the Republicans—offering them a deal they cannot accept, a deal that they cannot even be seen as treating seriously."

First, the President has repeatedly called for a "balanced" solution involving both more revenue and less spending. But what is intuitively obvious to the most casual observer is this plan is not balanced.

The fiscal cliff involves nearly $4 of anticipated revenue from higher taxes for every $1 of spending cuts. Yet, the President wants even more revenue and fewer spending cuts than if we in fact fell off the cliff. His plan includes a new round of stimulus spending. A new round of stimulus spending? You've got to be kidding me.

What the President's plan lacks is any reform in our entitlement system. The unrestrained growth in entitlement spending is driving federal spending, driving the budget deficits, and driving the debt even higher as a percentage of our Gross Domestic Product.

The unfunded liabilities of the United States Government are estimated to be as high as $128 trillion. Even if we confiscate all of the income in excess of $1 million, we cannot pay for the entitlement commitments that the Federal Government has made. We have made promises to ourselves that we simply cannot keep.

Without some sensible entitlement reform, our credit rating will likely be downgraded again, and we are well on the road to becoming a country that none of us would recognize.

Secondly, fiscal consolidation plans such as the President's, which were heavily weighted toward higher taxes, fail to achieve their government budget deficit and debt reduction goals.

Dr. Hassett has examined fiscal consolidations in 21 other developed countries. On average, unsuccessful plans were composed of 53 percent revenue increases and 47 percent spending cuts, while

successful plans were composed of 15 percent revenue increases and 85 percent spending cuts.

Moreover, the higher revenues in successful plans were generally drawn from non-tax sources such as asset sales and adjusted fees for government services.

Thirdly, the President argues that if the 2001 tax reductions for the middle class are extended, raising marginal tax rates on the top 2 percent will not harm the economy because it won't affect consumption expenditures.

However, Drs. Robert Carroll and Gerald Prante of Ernst and Young analyzed the combination of the expiration of the 2001 tax reductions for the top 2 percent and the expansion of the Medicare tax and its extension to capital income.

Under the President's preferred tax policy, the top rate will go from 35 percent to 40.9 percent on ordinary income; from 15 percent to 44.7 percent on dividends; and from 15 percent to almost 25 percent on capital gains.

The long-term consequences of President Obama's preferred tax policies will have a profound negative effect. Output will fall, capital stock will be smaller, employment will fall by about 700,000 jobs, and real after-tax wages would fall by almost 2 percent. Fewer jobs and lower wages resulting from higher taxes harm the middle class.

The Statistics of Income data from the Internal Revenue Service reveal three important facts about the income and tax payments of high-income earners.

The income and tax payments of the wealthy raise much faster than the income and tax payments on everyone else during economic booms, but they also fall much faster during economic busts.

The wealthy earn and report more income when income tax rates are low than when they are high. Adjusting for the business cycle and stock prices, higher effective tax rates on the wealthy will actually generate only about 10 to 20 percent of the revenue anticipated on a static basis.

There are better ways to increase federal revenue than hiking tax rates. Congress could enact a pro-growth tax reform that lowers rates while eliminating or limiting special interest tax deductions, credits, or exclusions.

The President could open more federal lands and offshore areas for energy exploration. And his Administration could take a more balanced approach to new regulations.

Economic growth can help solve our fiscal problems. If the economy had grown by 16.8 percent—as it had averaged in other postwar recoveries—instead of the 7.4 percent that occurred, and revenues had returned to the 18.2 percent of GDP that they were in the third quarter of 2007, the Treasury could have collected an additional $650 billion in fiscal year 2012, and the federal budget deficit would have fallen from more than $1.1 trillion to $436 billion—still bad, but remarkably better than where we find ourselves today.

Republicans stand ready to work with President Obama for a truly balanced bipartisan solution. So far, we haven't seen evidence of that.

Let's temper our fears by creating a long-term solution that does not burden individuals and gives businesses the optimism that going forward they will again invest in the American economy and our economy can grow for all our citizens.

With that, I look forward to the testimony of today's witnesses and I yield back my time.

Chairman Casey. Dr. Burgess, thanks very much.

I want to introduce our two witnesses right now, Dr. Mark Zandi. Dr. Zandi is the Chief Economist of Moody's Analytics. His research includes macro economics, financial markets and public policy. He is an influential source of economic analysis for policymakers, businesses, and journalists. Recently he published a report assessing the challenges of approaching the fiscal cliff and the most effective ways to achieve long-term fiscal stability. Dr. Zandi received his Ph.D. at the University of Pennsylvania. That will be a recurring theme in these introductions.

[Laughter.]

And he received his B.S. from the Wharton School at the University of Pennsylvania.

Dr. Zandi, thank you for being here.

Dr. Kevin Hassett is the Director of Economic Policy Studies and a Senior Fellow at the American Enterprise Institute. He holds a Ph.D. in Economics from the University of Pennsylvania. His research areas include the U.S. economy, tax policy, and the stock market. Previously Dr. Hassett was a senior economist at the Board of Governors of the Federal Reserve System, a professor at the Graduate School of Business of Columbia University, and a policy consultant to the Treasury Department during the George H.W. Bush and Bill Clinton Administrations.

Dr. Hassett, we're grateful you are here. And since you both went to Penn, I am sure you are going to agree on everything today.

But I will turn to Dr. Zandi first.

STATEMENT OF DR. MARK M. ZANDI, CHIEF ECONOMIST, MOODY'S ANALYTICS, PHILADELPHIA, PA

Dr. Zandi. Thank you, Senator. I want to thank you and Dr. Burgess and the rest of the Committee for the opportunity here. It is really an honor to be here with Kevin, a good friend of mine.

Let me say that these remarks are my views and not those of—they don't represent the views of Moody's Corporation. They are my own personal views.

Lawmakers have to quickly resolve three issues:

First is the fiscal cliff, scaling back the cliff so that it's manageable.

Second, raising the Treasury debt ceiling, which as you know is becoming an issue fairly soon.

And third, achieving long-term fiscal sustainability. That is, deficit reduction, tax revenue increases, spending cuts that allow the Nation's debt-to-GDP ratio to stabilize by the end of the decade.

Those three things need to be done now.

In terms of the fiscal cliff, by my calculation if policy is unchanged and we go over the cliff and there's no change after that, the hit to GDP in 2013 will be 3½ percentage points. So the econ-

omy is growing 2 percentage points. If you subtract 3½, that is a severe recession. And I think the CBO and other modelers like myself are probably under-estimating how severe it would be because confidence is very, very weak and I think businesses and consumers, investors, would pull back, and it is unclear how the Federal Reserve would respond to this. So we need to scale back the cliff.

I think at the very minimum, the cliff needs to be scaled back so that it is only a hit to GDP of 1½ percentage points, at most. That in my view is the fiscal speed limit. If you have cuts, tax increases that have more of a drag than that, then it becomes counterproductive in that the economy will weaken and the budget situation will deteriorate.

We are seeing the limits of fiscal drag in Europe currently, and they are pulling back on some of their fiscal drag.

I would argue that we should smooth in the fiscal drag even more. I would make policy changes so that next year the hit to GDP is half the speed limit, something like 7/10ths, 6 to 7/10ths of a percent of GDP. That would be consistent with extending the current Emergency UI program and some form of the Payroll Tax Holiday.

In terms of the debt ceiling, that at minimum needs to be increased until the other side of the election, and it would be nice to extend it past the next Presidential election, and it would be even nicer than that to get rid of it altogether. I think it is an anachronistic law that is a problem. It creates a great deal of uncertainty and angst. As we can see, you can do a lot of damage to the economy.

There are a lot of reasonable proposals that are being considered to eliminate the debt ceiling, and I think they should be carefully considered.

But this is—at the very minimum, we should push this to the other side of the election. We do not want to address the debt ceiling on a regular basis. It is doing a lot of damage to confidence.

And most importantly, in terms of fiscal sustainability, by my calculation we need deficit reduction over the next 10 years of about $3 trillion. And to get there, I think a balanced approach would be $1.4 trillion in tax revenue, half of which would come through tax reform, half of which would come through higher tax rates; $1.2 trillion in cuts to programs—Medicare, Medicaid, Social Security, and other budget items; and that would leave you with approximately $400 billion in net interest savings.

So if you do the arithmetic, $1.4 [trillion] plus $1.2 [trillion] plus $400 billion gets to $3 trillion.

I think it is appropriate to throw into the mix the spending cuts that were implemented as part of the Budget Control Act, the caps to discretionary spending which were worth about $1.1 trillion. And if you add it all up, if you go down the path I've just articulated, the spending cuts would be, to revenue, increases would be 2 to 1.

I think that is appropriate, and I think that is very consistent with Simpson-Bowles. I think that is in the spirit of Simpson-Bowles and would be a good goal to achieve. And I think it is doable both from an economic perspective and a political perspective.

Finally, let me say you've got to nail this down. Uncertainty is killing us. It is hurting business investment. You showed a very nice chart about that. It hasn't affected hiring and layoff decisions yet, but it will if we get into next year and we get into February and we haven't nailed this down. The economy and investors will bail and the economy will begin to struggle.

But if you address this problem reasonably gracefully, I think the fundamentals of this economy are in very good shape. We have made a lot of progress since the Great Recession. And if we nail this down, we will be off and running and we will have created a lot of jobs and unemployment will be moving south in a very consistent way.

Thank you.

[The prepared statement of Dr. Mark M. Zandi appears in the Submissions for the Record on page 36.]

Chairman Casey. Dr. Zandi, thanks so much.

Dr. Hassett.

STATEMENT OF DR. KEVIN HASSETT, SENIOR FELLOW AND DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. Hassett. Thank you, Mr. Chairman, and Members of the Committee. It is always a pleasure to appear before this Committee. I wish the rest of Washington could study the Joint Economic Committee. I think under your and Mr. Brady's leadership this has always been a very collegial place to testify, and I am not trying to preempt tough questions later on, but thank you. It is an honor to be here.

My testimony is broken up really into two parts. In the first part I discuss the short-term consequences of going off the fiscal cliff. In that section of my testimony I concur with Mr. Zandi that if we were to go off the fiscal cliff with no policy changes, then the near-term negative economic consequences would be significant and would almost surely throw us into a recession.

And then in the second part of my testimony, which I will focus on in my spoken remarks, I discuss the tradeoffs that we face, however, between sort of putting off the tough problems for tomorrow because we are worried about near-term effects.

I think that the evidence of the long-term effects of high government debt and high government debt-to-GDP ratios is really now quite overwhelming. It began with an early analysis by Reinhart and Rogoff, two economists who analyzed the impact on economic growth of high debt levels. And subsequent work by economists at the IMF, Kumar and Woo, confirmed their findings that high levels of government debt lead to lower levels of growth.

In fact, the paper that I like the best now because these literatures evolve and get more sophisticated, is a paper by Caner, Grennes and Koehler-Geib. And they identify actually a tipping point in gross debt-to-GDP ratios where if the gross debt-to-GDP gets above about 77 percent—and we're above that now—then it has a significant, very significant negative effect on economic growth.

To put their results in perspective, in my testimony I do a simple calculation which provides some intuition for the result. If we were

to, all else equal, run a deficit of 6 percent of GDP for the next 10 years, then that would add to the debt-to-GDP ratio by about 60 percent—not quite, because GDP is growing—but then that increase would be enough at the end of the decade to reduce, according to these econometric estimates, to reduce the annual growth forecasts by about a whole percentage point a year.

These long-run crowding-out effects are very, very significant.

Now that growth story might be alarming, but the picture looks even worse if you think about the potential of financial calamity and the kind of risks that we're seeing actually become a reality in Europe. This year, much of Europe has been in turmoil because of the Greek debt crisis, but in many ways the sickest European nations are actually in better shape than us.

While the U.S. debt may seem manageable to many who look at struggles in other countries and take consolation in our relative stability, the situation in the U.S. today when taken in the long run is actually farther from debt stability than many other developed countries.

I cite in my testimony a recent study by the OECD that examined long-term projections for OECD countries' debt burdens and found that the U.S. needs a bigger fiscal adjustment than any of the European nations. I think that puts in perspective the urgency that we have to try to act.

Given the previous research that has estimated the effect of higher debt-to-GDP ratios on economic growth, it is also possible to theorize about how a continuation of today's policies could hurt growth farther out into the future.

I cite in my testimony a recent paper by Stanford's Michael Boskin who shows that if we don't act on this, then we basically are producing a fundamentally different America than the one that we're used to. Boskin's estimates, which again are based on this widely accepted literature, suggests that we're going to move into a world by say 2040 where economic growth in the U.S. is not what we normally expect to see each year; that there is so much crowding out of private activity by the government that we are in a world where you do not wake up each January and expect that we will have positive GDP growth that year.

So that is how urgent it is to act.

So then what should we do? In my testimony I cite another now large and burgeoning literature that looks at fiscal consolidations. Using my own study as an example, along with two colleagues I've written an analysis exploring policy mixes of successful and unsuccessful consolidations. And our metric of success is did they just achieve their own objectives of deficit reduction? Based on our analysis, we found that the fiscal consolidations that were very heavily weighted towards spending were much more likely to be successful than fiscal consolidations that were heavily weighted toward tax increases.

We speculate, Mr. Chairman, in our study that this is because—that we find this result because the tax-heavy fiscal consolidations tend to not take the tough choices on entitlements, and because spending reductions are more real and more sure than tax revenue increases when you lift marginal tax rates.

I know that it is very easy for an economist to discuss reforms that could put the U.S. back on a positive trajectory, and I think Mr. Zandi and I probably agree pretty much on the rough outline of what that would look like, and I know that the political challenge is a very, very heavy one, but I think if you look forward to the America that we are creating with this large and out-of-control deficit, then we all have to agree that the stakes could not possibly be higher.

Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Kevin Hassett appears in the Submissions for the Record on page 47.]

Chairman Casey. Thanks so much, Dr. Hassett.

I wanted to start with a comment about something we're probably not talking enough about in Washington, and I think it is a component part of what we have got to confront. Even as we are wrestling with trying to get an agreement on the fiscal cliff, we cannot lose sight of the urgent priority of making sure that we have job growth and—job creation, I should say, that leads to economic growth.

Dr. Zandi, many of the components that you have outlined, and both of you have, that comprise, or are kind of under the broad description of fiscal cliff, whether it is the expiring tax cut provisions, the expiring payroll tax cut extension, and of course spending cuts as well, if you consider all of those, and more that you could add to that list, which of those—and you may have several—but which of those would you consider having the biggest bang for the buck in terms of economic impact of those that we're discussing here today, in terms of the impact that they will have?

Dr. Zandi. Well I think, let's just take as given that we will extend the current tax rates for taxpayers that make less than $250,000 on a joint basis. I mean, I think that is given and that is absolutely necessary. And then we consider the panoply of other things that are happening when we get to January 1st, in terms of bang-for-the-buck, or dollar-for-dollar, the Emergency Unemployment Insurance Program is very effective. It is small in the grand scheme of things. CBO is estimating that it would cost—if extended as currently configured for calendar year 2013, about $30–$35 billion.

But the benefit to GDP, to economic activity, to job growth, to the unemployment rate would be measurably more than that. And I think the UI Program, the Emergency UI Program, is going to wind down on its own. It already is. At its peak, Emergency UI had 5.96 million people in the program. We are now down to 2 million, and it is falling 800,000, 900,000 per year. I would expect it to fall even more than that in the coming year, just because unemployment rates are falling, the decline in the economy, the job market is slowly improving, and also there are some limits to how much emergency UI you can collect.

There are downsides to the program. There are disincentive effects. There's some really good work that's come out of the Federal Reserve documenting that. So it's not a slam-dunk positive, but on that it's a very significant positive, and I would consider that to be very significant.

I think the payroll tax holiday has also been very effective. It has a very high bang-for-the-buck. It is kind of hidden. You know, people do not really recognize it. It is kind of a stealth tax cut. But it gets spent. And it is generally designed—it is designed a way that helps generally lower- and middle-income households.

It is expensive, though. It is over $100 billion in calendar year 2013. So you might want to consider scaling that back. Right now it's a 2 percent holiday. You could go to 1 percent. Or there are some good proposals to go back to—remember "Making Work Pay?" That was a pretty good middle ground cost. It cost about half the current payroll tax holiday. And it was probably more effective in the sense that it is designed to help even more lower- and middle-income households, less than the payroll tax holiday. So I think that is also a very effective program.

Chairman Casey. Dr. Hassett, do you have any comments on this question?

Dr. Hassett. Yes. Thank you for asking me that, Mr. Chairman. I disagree with my distinguished friend on this.

I think that Keynes himself wrote about the kind of place where we are right now, which is that you can get into a cycle of dependence on short-term measures, and that it can lead to a kind of a downward spiral as the national debt gets bigger and bigger because you keep trying to stimulate things with one-year shots.

I think that—and perhaps I could—I don't mean to ask Mr. Zandi a question, it's not my place, but I speculate that he might——

Chairman Casey. You're not allowed to do that.

[Laughter.]

Dr. Hassett. No, I understand that. But I speculate that he might concur that the best possible thing we could do right now for unemployed Americans is fix our big problems; that if all of a sudden America's businesses had clarity about what the future would look like, people didn't fear radical changes to fiscal policy because they could see that we have a sustainable policy over the next 10 years, the sigh of relief rally from such a thing would dwarf anything you might get from tinkering with UI benefits or payroll taxes.

Chairman Casey. I appreciate that. I am out of time, but I will try to come back to these issues in a moment.

Dr. Burgess.

Representative Burgess. Thank you, Mr. Chairman.

Well, Dr. Hassett, it's an interesting proposition. Since you cannot ask the question, Dr. Zandi, let me pose Dr. Hassett's question to you.

If the best thing that could be done is a long-term fix for our problems—in other words, to get out of this cycle of recurring difficulties that we are in—would you agree with Dr. Hassett on that?

Dr. Zandi. Yeah, I think that in a sense that I agree that we do not want to get into a cycle of dependency; that we need to phase out the temporary supports that we have been providing to the economy. And in fact that is what we have been doing.

If you go back to 2009, federal fiscal policy was a source of major fiscal stimulus, adding 2.5 percentage points by my calculation to GDP. By 2011, federal fiscal policy was neutral with respect to the

economy. In this calendar year, 2012, it is going to subtract from growth .8 of 1 percent. So we have already gone from fiscal stimulus to fiscal drag. And all I am arguing is for calendar 2013 to smooth in the fiscal drag.

Really, no one is talking about stimulus in the sense that the government is going to be providing a tailwind to the economy. All we are debating now is how much of a headwind it will be. So I think that we should smooth in that drag, and I think it would be easier for the economy to digest and in the longer run we will all be better for it.

Representative Burgess. And since you are not allowed to ask Dr. Hassett a question, let me ask Dr. Hassett——

Dr. Zandi. Is that like a committee rule, or——

[Laughter.]

Representative Burgess. It's Mr. Casey's rule.

Chairman Casey. I don't think it's a rule; we're just trying to keep it to a minimum.

[Laughter.]

Representative Burgess. But, Dr. Hassett, let me ask you for your response to Dr. Zandi's observation on the cycle of dependency.

Dr. Hassett. You know, I think that it is quite possible that that is where we are. And I think that——

Representative Burgess. Can I just interject here? It feels that way to me, just as a simple country doctor and a legislator; it seems like we are in the cycle of dependency, and we deal with 2011 debt limit, and we dealt with the stimulus in 2009. It just seems like the same things with different labels keep coming to us over and over and over again. And quite frankly, I am having difficulty seeing the way out of this cycle. But I would be interested in your observations.

Dr. Hassett. Thank you, Mr. Burgess. And in fact, the way I can think about this, I like to think about this, and I think at Moody's they have always been careful to put this complete perspective into their analysis that has even often been quite supportive of the stimulus, is that the way you can think about what happens if you're playing the Keynesian game, is that you, say, decide to spend a lot this year, or mail checks, helicopter checks to folks this year, that has some multiplier effects.

So maybe if you spend 1 percent, you get 2 percent more GDP this year. But then when you take it away next year, then you are starting out with GDP growth of about 2 percent lower. The two effects are equal and opposite. You go up, and then you go back down.

The hope is that you abate a calamity by going up. That would be the Keynesian hope. But the problem is that the Keynesian policy, really you have to look at all three acts. And the third act is when you pay for it.

And so you go up. And then you go down. Those two effects are equal and opposite. And then there is a third phase where you pay for it, and that is a negative.

And so if we look at sort of the 10-year full-cost of doing a Keynesian policy, it is a net negative. Because in the end it is going

to cost something, either to pay the interest or to have the tax hikes to pay for it.

You see that even in the long-run CBO analysis of these policies. And the problem is that we are now kind of in the hangover phase from these things.

Representative Burgess. It feels like a hangover.

Dr. Hassett. But I can say that there is a way out, and it is a very promising way out, which is that again if we just now recognize that we are out of the emergency period, and if we fix our big problems we can get over the hangover, then I think that we can find bipartisan agreement for moving the Nation ahead.

Representative Burgess. Let me just ask you on the issue of fiscal consolidations that you brought up, and the President is proposing the 47 percent spending cuts and 53 percent revenue increases. You argue for 85 percent spending cuts, 15 percent revenue, not all of it from taxes.

Why in the world would we even consider the President's plan under the scenario that you describe?

Dr. Hassett. You could argue—the argument against our paper being a guide is that there are many smaller countries that maybe have to be more aggressive about spending because people who lend them money might head for the exits quicker.

But the thing that I know is true is, if you want to base our consolidation on the things that succeeded in the past, then you would be 85 percent spending. And then I think that you could have quite a great deal of comfort that it would be successful, because I think the arguments that we might be able to handle having a little bit larger revenue share than that because we're such a big lump of a country. But if we copied the successful ones, then we should almost surely succeed. But if we err towards the half-and-half approach—and you can look in our paper, when it came out almost two years ago now, we said in the paper ex ante that the UK consolidation was going to fail because it had too much revenue.

And as we're seeing now, like all the millionaires headed for the exits and so on, it's exactly the kind of thing that will happen here if we lean on taxes on the rich only.

Representative Burgess. Thanks, Mr. Chairman. I will yield back.

Chairman Casey. Dr. Burgess, thank you. Representative Maloney.

Representative Maloney. Thank you.

First I would like to congratulate the Chairman on his re-election, and on the fine work that he has done as Chairman of this Committee; and to congratulate Mr. Brady on being selected as the Chair of this Committee in the next Congress.

Both of our distinguished witnesses agree that what we really need to do is have a long-term solution. I would like to first ask Dr. Zandi how we achieve that? We are roughly $700 billion apart between the President's proposal and Leader Boehner's proposal. How would you close that gap?

First I would like you to outline briefly the President's proposal, briefly Speaker Boehner's proposal—I believe it's $700 billion—how would you close that in a bipartisan way so that we could get this behind us, get people employed, and move our economy forward?

Dr. Zandi. O.K. Thank you, Congresswoman, for the opportunity to address this question.

I apologize. There are going to be a few numbers, a fair number of numbers here.

The President's tax proposal, tax revenue proposal, amounts to about $1.6 trillion over a 10-year period. And I apologize if I don't get the numbers exactly right.

Representative Maloney. Yes, we understand. We want the broad picture.

Dr. Zandi. Right. Of that $1.6 trillion, roughly $1 trillion is from higher tax rates; roughly $600 billion is from tax—some form of tax reform. He's got his own proposal. There are a number of other different proposals that are all reasonably good proposals.

Speaker Boehner's proposal on the revenue—first I will do the revenue side, and then I will go to the spending side. Speaker Boehner's proposal is roughly $800 billion in tax reform. So we're about $800 billion apart on taxes.

My view is that we should roughly split the difference. I would propose $1.4 trillion in tax revenue; $700 billion would come through tax reform. And again we can discuss what that might look like. And $700 billion would come from higher tax rates.

So the President would scale back his trillion dollar target for tax—revenue from tax rates to about $700 billion. We could talk about how we might do that.

On the spending side, the President has proposed $600 billion in spending cuts over the next 10 years. And of course this subtracting from the BCA spending cuts that are already in law.

Of the $600 billion, $350 billion approximately is Medicare/Medicaid; $250 billion is Ag subsidies and other government programs.

Speaker Boehner has come forward with some proposals, but it is unclear exactly how much it adds up to. I am not quite clear how much the spending cuts he has proposed.

Let me just say this, though. I think the President's proposal is short. I think to get to where we need to go, my $3 trillion target, fiscal sustainability, we need $1.2 trillion in spending cuts. And I do think we need to focus both on entitlements—now the President has put Social Security outside his plan. I think it is likely it should be part of the process, and we can do some things to reform Social Security. But at the end of the day, it has got to be almost double what he is proposing.

Now one other point I would make. Because if you actually sit down and do the arithmetic on the spending cuts, particularly when you look at Medicare and Medicaid, when you kind of think through what we're going to do here, it is really, unless you are proposing big structural change in the programs, which I do not think that's on the table at the moment, it is difficult to get that six hundred—say go from $350 billion to $600 billion in Medicare and Medicaid cuts. It is really tough.

So I think if you got to a run rate of about $600 billion in cuts by the 10th year of the plan, I think that is O.K. because again the bottom line is we want fiscal sustainability at the end of this 10-year horizon. If we do that, then investors are happy, rating agencies are happy, and we are off and running.

Representative Maloney. My time is about to expire, but Dr. Hassett, I would like to hear your analysis of how far we are apart and how we could close that $700 billion gap.

Dr. Hassett. Thank you. I think the way to think about the challenges that we have are tremendous, as a Nation, a tremendous opportunity to make sure that we hand off a thriving economy to our kids. And in my testimony I mentioned that if we were to run $600 billion deficits for the next 10 years, then at the end of 10 years the debt, just from that deficit, just the $600 billion a year over the next 10 years, would reduce our long-run GDP forecasts by about 1 percent per year forever.

So that if we were to cut, with a fiscal consolidation, that $600 billion deficit to $300 billion, then we would be buying future generations about half a percent a year of GDP growth in the long run. If we had a bigger cut, we would be buying even more. If we have a smaller cut, we would be buying even less.

And so in terms of how big of a cut can we make, can we afford to make, then I think it is really ultimately a question of what kind of world do we want to live in 10 years from now. If we want to live in a world that grows kind of the way Europe has been growing for the last few decades, then we should have a very small consolidation like the smaller consolidation proposed by the President.

I think that we are going to have very unacceptable growth if we do that. And I think that if we want to have the kind of growth that I hope we would have, you would have a bigger consolidation than has even been proposed by Mr. Boehner.

Representative Maloney. My time has expired. Thank you.

Chairman Casey. Thank you, Representative Maloney. Representative Mulvaney.

Representative Mulvaney. Thank you, Mr. Chairman.

I want to come back to do something—focus on something that is probably more of interest to the economists in the room than the ordinary people.

I share, Mr. Hassett, your enjoyment of these Committee meetings. I swear, though, I think we will put people to sleep if we do this more frequently.

Let's talk about ratios. Because what I heard you lay out, Dr. Zandi, was your sort of ideal situation where we have a $1.4 trillion revenue increase, a $1.2 trillion spending reduction, and then you add an anticipated .4 trillion, $400 billion interest savings, it gets you to roughly a $3 trillion deficit reduction over the course of the 10 years. That is a roughly 1.1 ratio. And then you went on to add the $1.2 trillion that we have already saved as a result of the negotiations over last year's debt ceiling.

I would suggest to you, by the way, that while that does get you to 2-to-1, that the $1.2 trillion from last year is already in the baseline. So the new number would really be 1-to-1. But that is not my question.

My question is, I want to go to what's actually being discussed now. And you started in response to Mrs. Maloney to lay out the President's offer. We looked at the President's offer today and we're trying to find any spending reductions at all.

What we have found so far is what you mentioned accurately, the $1.6 trillion in tax increases. The stimulus spending. The extension

of the Unemployment Insurance, which is an increase in spending. The extension of the payroll tax cut, which is really an increase. The delay in the sequester cuts, which would be a reduction in the spending reductions we're anticipating. And then no entitlement reform whatsoever.

So I guess the question I have to ask you is: Does the President's current offer meet your own test of a 2-to-1 ratio? We can have a discussion later as to whether or not 2-to-1 is sufficient, but do you think that what the President has offered meets the 2-to-1 test?

Dr. Zandi. No. It is short. He needs to come up with more spending cuts. He needs to come up with, roughly in my calculation, about $600 billion more in spending cuts over the next 10 years.

I will say, though, in defense of the White House, I do think there are significant reforms in Medicare, Medicaid, agricultural subsidies, and other programs in the budget, at least what I looked at, and those are pretty difficult things to implement. I mean, it takes a lot of guts to propose those things. So I would not discount them. I think they are important.

But to answer your question specifically, I think we need more spending cuts, yes, to get to my ideal.

Representative Mulvaney. And I am looking now at your testimony from page 9. It says: "Fourth, to achieve the 2-to-1 ratio, policymakers need to reform entitlements." You go on to say that some of the suggestions that my party has offered may be too radical for you, but I appreciate the candor, by the way, on entitlements.

One of the disappointing things to me is that I do see members of the other party, most notably Mr. Hoyer, say that entitlements were on the table. Although then I read the details and it said "not now." They are on the table for later discussion.

But I have been disappointed that all of the discussion seems to be focused on the revenue side, and not on the spending side. Most specifically, on the entitlement side.

I want to move very quickly to the debt ceiling. There was something very interesting in your testimony that caught my attention that I was not familiar with in this form, which is your support for the initiative offered by Senator Rob Portman.

When we talk about the debt ceiling, you say, and I'll read now:

"Separately, lawmakers could adopt a version of the so-called dollar-for-dollar rule first proposed by Ohio Senator Rob Portman to address the 2011 debt ceiling. Under Portman's rule, policymakers would agree at the beginning of each fiscal year to cut spending equal to the amount the debt ceiling must be raised to cover that year's budget. The spending cuts would be phased in gradually over the following 10 years. Adopting some form of this rule would be a good safeguard in case Congress misses its deficit reduction targets."

I can tell you that, while I appreciate Senator Portman's input, that was actually I think the Speaker who was talking about exactly those types of same structure, which is a dollar of spending reduction for every dollar of debt increase.

So my question to you, Dr. Zandi, is: Isn't this exactly what we did in the BCA that now everybody is trying to get out of? We had

a dollar of spending reductions, 1.2 already in place, the other portion coming in the sequester, in exchange for the same amount of increase to the debt ceiling. Isn't that what we did? And if that is such a good idea, why are you and others now suggesting that it is not a good idea; we need to peel back, or at least delay the implementation of the sequester cuts?

Dr. Zandi. Well let me say a few things.

First, you have to put this in the broad context. So I think we need to get rid of the debt ceiling law. That is anachronistic. I think it is a problem and we need to get rid of it.

But I do think, if we are going to do that, we need to have some new budget mechanisms to ensure that there is some discipline going forward. I suggest in the testimony readoption of full PAYGO. I think that is a reasonable thing to do.

And I did also suggest that some version of the dollar-for-dollar rule should be implemented, or at least considered, both on the spending side and on the tax revenue side. It doesn't have to be one-for-one. It could be 50 percent; some mechanism to make sure that there is some future fiscal discipline.

But that is now going forward. I mean, my view is we need to nail down how we get to fiscal sustainability, the $3 trillion that I propose. Get rid of the debt ceiling law as it is currently configured. And adopt some budget rule—and I am throwing that out as an idea—but we need some form of budget rule to make sure that there is some discipline going forward.

Representative Mulvaney. Some structure.

Dr. Zandi. Yes, some structure. Because the other thing, you can lay out a plan but it has to be a credible plan. I mean, it has got to convince everyone that we are going to stick to this plan.

Representative Mulvaney. Thank you, Dr. Zandi. Thank you, Mr. Chairman.

Chairman Casey. Thank you, Representative Mulvaney. Senator Bingaman.

Senator Bingaman. Thank you all very much for being here. I appreciate the testimony.

Dr. Hassett, Dr. Zandi has indicated that he thinks the debt limit crisis we had in August of 2011 was bad for the economy and bad for the country and we should avoid that in the future.

Do you agree with that?

Dr. Hassett. Thank you, sir. Yes, I think that the best estimate of this was done by a University of Chicago economist Steve Davis and co-authors where they have this very cool index of economic uncertainty. It is a new way of doing it. It is a very innovative paper.

And they estimated that that debt-limit struggle probably subtracted about 1½ percent from GDP growth during that summer when it was happening because of the uncertainty and all of the sort of inactivity that was caused by high levels of uncertainty.

And so I think that each time we go through that, we bear a negative short-run cost. But I would just like to add that if that is what it takes, though, to get spending under control, then we have to concede that in the long run there is a benefit, which is that we do not have these massive deficits that are crowding out long-run economic growth.

And so in the fullness of time, whether a struggle like we had last summer was worth it would really depend on whether the deficit reduction buys space for private capital or not. If we have the spending cuts and deficits are lower, then we might have higher economic growth in the long run because we went through that struggle last year.

Senator Bingaman. So you think—your position is that we should be ready to go through that struggle again, and in fact default on the national debt if necessary in order to enforce spending limits?

Dr. Hassett. That is of course not my position, Senator. My position is not that we should ever default on the national debt. My position is that the politics of deficit reduction, as you all know better than me, are very, very difficult. And I am not a political expert. And if there is a mechanism out there, a thing that we have to do now and then that helps deficit reduction occur, then I am not so willing to stop that process for all of time.

Senator Bingaman. But you are saying that defaulting on the national debt may be one of those things we have to do now and then.

Dr. Hassett. No, it is not. No, sir. We did not default on the debt last summer.

Senator Bingaman. We did not, and—but the threat is there again that we might here in January or February default on the debt. Is it your position that we should be willing to default on the debt if that is necessary in order to force spending cuts?

Dr. Hassett. I would not be willing to default on the debt under any circumstance. I could add that if you look at the history of debt limit increases, which I have done, that there is a long history of especially parties out of power using that debt limit as a moment to extract concessions from the party in power. And so the history of debt limits, it's not obvious to me that if we had an academic seminar about the impact of the debt limit struggle on fiscal policy, that we would say that it was a negative. Because there are often times when having that extra little bit of power over the opposition is useful for either party, if they're in the opposition.

Senator Bingaman. Well I can say that, at least in the 30 years that I have been here in the Senate, I have never, until last—until August of 2011, I had not seen any serious effort, or any serious threat made by the leadership of Congress to refuse to give the Secretary of the Treasury the ability to borrow to meet the obligations Congress had already adopted.

And so I thought that was a new experience for us. It certainly was for me to see that happen.

Dr. Zandi, you have said you think we just ought to repeal this law that tries to set a debt limit and concentrate more on taxing and spending policies that cause us to raise the debt, as I understand it?

Dr. Zandi. Absolutely. I think it is just a really bad law, a bad way to conduct policy, and it's a big problem. I mean, we could see that in July and August of 2011. It was a mess, and it really undermined our economy. S&P downgraded the debt. And it really had an impact, dollars and cents. It means CBO is estimating the

interest costs—it's costing us money because we've gone down this path.

And, it's pretty clear that this is not going to get any better going forward. It's just going to get—the brinkmanship is just going to get worse. So this is a really bad way of doing things. We need to get rid of this.

Now having said that, we need budget rules. We need to be able to figure out a way to try to be credible in terms of what we are saying about future tax and spending policy, but this approach, the debt ceiling approach, is just the wrong way of doing it.

Senator Bingaman. Thank you, Mr. Chairman.

Chairman Casey. Thanks, Senator Bingaman.

Senator Coats.

Senator Coats. Thank you.

I want to just pursue that question a little bit, because this was on my mind also. My experience is that the political system, and the political animal finds it awfully difficult to say no to constituents, with re-election in mind, or just the natural human tendency to want to please people rather than not disappoint them.

I had the privilege of having dinner with Christine Lagarde, the head of the IMF, and I asked her the question about the reforms taking place in Europe. And I asked her the question, "Would any of these reforms be taking place without Europe being in fiscal crisis mode?"

Her answer was, "Absolutely not." She said, unless the revolver is at the temple of the politician, with the finger on the trigger, they are not capable of summoning the collective will to take the necessary steps to tell the people that they represent that they have to take some steps to resolve the problem, and it will cause some disappointment and some pain in order to do so.

And my experience in the years that I have had involved in politics is exactly that. We never would have gotten the BCA, whether you think that was enough or not enough, in August of 2011, in my opinion, without the threat of defaulting on our debt.

And to think that we could put a structure in place today that perhaps we would all be comfortable with in terms of solving our long-term problem, and be assured that 10 years from now the Congress would not have modified that dozens of times to the responsive constituents who are banging on the door saying, "This is too much pain; we can't sustain this in the long run." We can hardly sustain a policy for months around here, let alone 10 years.

And so if we really want to fix our long-term situation that's been described, I think there is a consensus that without that long-term fix and a credible fix we can't get from here to there, relative to where we want our debt-to-GDP ratio to be to provide that kind of growth and what we want to hand off to future generations.

We have to factor in a big factor of the political system here and the way politicians think and react, and the history of that. And we need leverages in order to address that.

I am really not asking for a response, because you have already responded to that, and I think stated your positions. I just wanted to add my two cents' worth in terms of why I think it is so important that we had those leverage points.

Now maybe there are other ways of doing this, but my experience is the next Congress, or even the current Congress can undo that in a pretty big hurry, as the constituents line up outside our doors.

Thank you, Mr. Chairman.

Dr. Zandi. Can I just, in response?

Senator Coats. Yes.

Dr. Zandi. Because you make some good points. I would say, though, it is a mistake to put your revolver to your head on a regular basis. In the case of Europe, this is hopefully a once-in-five-generation event that we are going through now, and they nailed this thing down.

We do not want to do this on a regular basis, and that is what we are setting ourselves up for with the current law. And that is going to be a problem for our economy. Business people are not going to engage unless they have clarity with respect to this thing.

The other thing I would say is, I have more faith in you than apparently you have in this institution. At the end of the day, you do the right thing. If you look at the history of this body, it ultimately comes up with roughly the right answer. And we have not done it with the debt ceiling since the beginning of our country. So I think we are very capable of doing it, and we can do it without this kind of an anachronistic law.

Senator Coats. Well I would just respond by saying we have been talking about dealing with our cascading debt and deficit for decades, and I would say we have been far short of doing the right thing that has put us in the position to look for a healthy fiscal future.

Chairman Casey. Thank you, Senator Coats.

Senator Klobuchar.

Senator Klobuchar. Thank you very much, Mr. Chairman. I would just add, Dr. Zandi, that I agree that we usually do the right thing. But what did Winston Churchill say? "After we try everything else."

And I think that time has come. And I actually see this obviously as a scary time in that we need to protect our still-fragile economy. But I also see it as an incredible opportunity to move forward to give the people of this country and the markets faith to invest and to really take what is now a time of relative stability, but move it forward if we can get this right.

And so my first question is just based on, you know, your predictions that we need to get this done. What do you think the time frame is before we see a negative reaction from the markets and a possibility of further downgrades from the credit rating agencies?

Dr. Zandi. First let me say, I am obviously not part of the rating agencies so I have no particular inside information. I read what they say, and so this is my interpretation of the perspective coming from the rating agencies.

Obviously there is a lot of uncertainty here. I don't know for sure but this is my guess based on experience. And I do think that people outside the Beltway have a lot more faith in you than you do. There will not be a reaction, a negative reaction, because we can even go into next year. And by the way, I would counsel not coming up—I would not come up with a deal unless it is a really good deal,

before the end of the year. I would take it into next year if that means you are going to get a better deal, a deal to solve the three fiscal issues that I brought up.

Senator Klobuchar. So what you are saying is a deal that really does not mean much probably would not help us?

Dr. Zandi. It would not be helpful. And if you read what the rating agencies say, to avoid a downgrade of the U.S. Treasury debt we need something that is pretty close to fiscal sustainability. You have to get to my $3 trillion.

Senator Klobuchar. You have to show that you're talking——

Dr. Zandi. Yes, because, if you read what they say, they say that if we fall short of that we've got a problem.

Senator Klobuchar. O.K. You brought up Social Security. Do you see that as, and I think there is some general agreement we should do some reforms to make it more solvent, do you see that as the money going back into Social Security if we were to embark on that, set up a commission, do it separately? I think there is a lot of talk about, O.K., we should do that. But the funds should go back into Social Security to keep it solvent.

Dr. Zandi. Yes, I think that is a perfectly reasonable way to do it.

Senator Klobuchar. O.K. My colleague, Senator Coburn, said yesterday that in the near term he would rather see rates go up for the wealthiest Americans versus an approach that would simply close some of the deductions and loopholes that are available because he believes it gives us a greater long-term change to reform the tax code.

Do you agree with his assessment? And then also, do you think this is a wise course? We have all talked about that we have to have these spending cuts in that $2.2 trillion we're talking about, plus we can get $700 billion which I support by simply going back to the Clinton levels over $250,000.

Do you agree with his assessment?

Dr. Zandi. I'm not sure I exactly got it right.

Senator Klobuchar. His assessment was that we have to look at tax rates. That we should look at raising tax rates on the wealthiest, instead of just saying we should look at deductions and loopholes.

Dr. Zandi. Oh, I think we need to do both. To get to my $1.4 trillion, if you're going down my path, we need both. There is no way to get to that number with tax reform alone, if you consider that we are not going to take away charitable deductions, and if your goal is not to raise taxes from lower- and middle-income households. If it's the folks that are at the top bracket, the $250,000 plus, then there is no way to do the arithmetic.

There are a lot of good ways of doing reform, a lot of good proposals, but there is no good way of doing it to raise that kind of revenue. So we need to do both. We need tax reform, and we need higher tax rates on upper income households.

Senator Klobuchar. And it would seem to me that you could do the tax rates at the end of this year, because then you could make the kind of deal that you want; and then do some of the closing of the loopholes and subsidies. And I would hope, as a state that has some incredibly strong businesses that support doing this,

you could bring the corporate tax rate down and work on the debt in part by closing these loopholes and subsidies.

Dr. Zandi. Yes. I don't think tax reform is complicated, and entitlement reform is even more complicated. I'm not arguing that you nail those down. I'm just saying nail down the framework, and then go to work and try to figure this out precisely.

In terms of corporate tax reform, I think that is absolutely necessary. But I think the goal there would be to make that revenue neutral, if you can, because you want to bring down those corporate rates so that we can become more competitive.

Senator Klobuchar. And, Dr. Hassett, what did you think of Senator Coburn's assessment? You know that he's worked very hard on this and wants dearly to reduce the debt, like so many people at this table.

Dr. Hassett. Yes, I disagree with—I have a great deal of respect, of course, for the Senator, but in this I disagree. I think that the fact is that we have so many tax expenditures, both in the corporate and income tax side, that accomplish very little in terms of economic efficiency, that precisely now with unemployment still unacceptably high, and manufacturing jobs fleeing overseas, we need to seek ways to make ourselves a friendly place for investment, for capital, for small businesses.

I am very concerned, for example, that I've seen that the President continues to say that 97 percent of small businesses would not be affected by the top rate. But it is a very, very misleading statistic because anyone who has any profit from a sale on eBay would put it on their Schedule C and we're calling them a small business. But the fact is that real businesses that employ people, we are looking at more than half the income is in that bracket. And I think it is just a bad time to be keeping all of the tax candy, the tax expenditures, and lifting taxes on the few people who are actually creating jobs in this economy. And so I kind of very strongly disagree.

Senator Klobuchar. Yes, I just heard different things from some of our businesses that want this major, big term deal, and they are willing to make some sacrifices as long as we really are on the right path. Because they see that as their own long-term viability if we go that way.

But thank you to both of you. I appreciate it.

Chairman Casey. Thank you, Senator Klobuchar. My colleague from Pennsylvania, Senator Toomey.

Senator Toomey. Thank you to my colleague from Pennsylvania, Senator Casey, and thanks for convening this hearing.

First I would like Dr. Hassett to see if you agree with the way I am looking at the President's proposal, the most recent proposal, that had some specifics in other areas. It was very unclear exactly what he is getting at, but I think it is clear that there is a headline tax increase that he wants of $1.6 trillion. And I think what the Administration would describe as $600 billion in spending reductions.

But when you drill down, it looks to me like there is much less even than that in spending restraint. For instance, it looks like $200 billion of what they put under the $600 billion heading is in

fact revenue—fees and various other forms of revenue. That is not spending restraint at all.

There is a deferral of the sequestration. I'm not sure it is clear how long that deferral is meant to be, but if it is for one year, that is $100 billion. And I would think it is intended to be at least that.

Then there is additional stimulus spending, and various other forms of spending, the doc fix and other things that add up to at least $100 billion. So that is $400 billion, anyway, that you should legitimately I think deduct from the headline $600 billion if you wanted to arrive at what might be a legitimate spending restraint.

So then if you go back and say, well, O.K., it is $1.6 trillion in new revenue, they certainly want that. And maybe we have got $200 billion in spending restraint. Is it fair to say that this is about an 8-to-1 ratio?

Dr. Hassett. That is about right.

Senator Toomey. Where revenue, tax increases are eight times the spending restraint?

Dr. Hassett. That's right, even in the specific proposal. But it's sort of part of—there's some recidivism here in the sense that I think that the spending reductions have systematically been overstated in recent years by the President, and often double-counting the Iraq War savings and things like that.

Senator Toomey. Yes.

Dr. Hassett. But it appears to me that there's a heck of a lot of tax increase and almost no spending reductions.

Senator Toomey. And in fact, you know, spending programs that you launch, they surely happen. That money gets spent. Promises of future savings? Much less so. And so when the President talks about new stimulus spending, if he had his way I'm quite sure that would happen.

I am not sure the savings would materialize at all. What I am suggesting is, in reality the President's proposal is almost entirely new taxes and virtually nothing—that is specific, anyway—on the spending restraint.

And your research suggests, if I understood it correctly, that the most successful forms of consolidation are those in which the ratio is almost the reciprocal of that.

Dr. Hassett. Exactly.

Senator Toomey. Is that right?

Dr. Hassett. Yes. In fact, I can say with absolute certainty that a consolidation that has the shape that the President has proposed would fail.

The way to think about it is this, too. That in the economy that we have now, with the highest corporate tax in the developed world, very high individual income tax rates that are going up, and taxes on dividends maybe skyrocketing almost to 45 percent, in that kind of a world it's impossible to envision generating the kind of healthy economic growth that would ever make us willing to have the spending cuts that we promised to do two years from now.

Senator Toomey. Which——

Dr. Hassett. Two years from now, GDP growth will be 1½ percent, and we will be saying, oh, we can't afford to cut government spending because it will throw us into recession.

Senator Toomey. Right. So that kind of brings me to the next issue I would like to discuss.

To get to the President's tax increase package that he is looking for, he is calling—well he has been very clear about this—calling for higher marginal tax rates. And in addition, a reduction in the value of deductions and other expenditures.

Higher taxes on capital gains. Higher taxes on dividends. The way I count this up, if you include the PEASE limitation, the top marginal tax rates for some would be between 41 and 45 percent. And that is just the federal level. We have states of course that have varying income tax rates from zero to double-digit levels, meaning that some Americans would be paying more than half of their income. Their marginal income tax rate would exceed 50 percent.

If the President got all the tax increases that he wants in this form that he has asked for, is it likely that that could precipitate a recession?

Dr. Hassett. It is not only likely, it would certainly do so. In fact, the dividend tax increase alone is positively cataclysmic. If we go from a 15 percent dividend tax to an almost 45 percent, once you are all in with the phase-out of itemized deductions and so on, then—I mean, that is ridiculously bad news for equity markets. And it is something we saw on the other side.

There is a very large academic literature, including a few papers that I have written as well, that looked at how firms responded to the dividend tax reductions, and there is a lot of positive movement in things like equity prices. And so I think that as a package, you know—and I guess there is a question of how negotiations work, and maybe you want to start negotiation with an extreme position, but I just cannot imagine anyone looking at that proposal and arguing that it would throw us into a recession.

Senator Toomey. You know, there is another approach that you can take in negotiations, and in my experience it has been a more successful one.

Rather than taking an extreme that is very harmful and that you know the other side cannot accept, what you do is you actually look for areas where the other side could meet you halfway. And you say, for instance, if because of the political imperative that has been created here, if revenue has to be part of this—I don't think that that's economically or fiscally necessary or optimal—but if it is politically necessary, should it not at least be generated in a way that does the least economic harm?

And in your view, would you do less economic damage by generating revenue through reducing the value of expenditures than raising marginal rates?

Dr. Hassett. Yes. And if you phase it in far in advance. So, for example, changing my Social Security benefits when I retire now, but doing so absolutely credibly, then you would have a positive growth effect right now from a commitment to a spending cut because you would give clarity to all the people that are worried about the future of America.

Senator Toomey. I see my time has expired. Thanks, Mr. Chairman.

Chairman Casey. Thank you, Senator Toomey. Representative Cummings.

Representative Cummings. Good morning.

Dr. Zandi. Good morning, sir.

Representative Cummings. Mr. Zandi, health care inflation is a significant driver of Medicare's escalating costs. What do you think should be done administratively to control that inflation?

I heard what you said about Medicare. It seems that no matter what you do you have still got this inflation going on, and it is a major factor. I would like to have your thoughts on that.

Dr. Zandi. That is a really big question. Let me say a few things, or a couple of things.

One is that health care inflation actually in the last couple of years has slowed quite sharply. It has been about 3½ percent per annum over the past two years, which is really a very positive development, some of the slowest growth in health care costs in decades.

Now some of that probably is due to the weak economy, which means less demand for health care services, but some of it likely is due to Affordable Care Act——

Representative Cummings. I was hoping you would say that.

Dr. Zandi. Yes. And I think there is growing evidence of that. We do not know for sure. We need more data points.

Representative Cummings. But it's happening.

Dr. Zandi. I think so. The second thing I would say is, there are some positive experiments in the Affordable Care Act that I think could reap benefit.

For example, the exchanges, the insurance exchanges should introduce competition and hopefully that will keep health care cost growth down.

There is the IPAB, the Independent Payment Advisory Board. We will have to see how that works out, but there is some possibility that that could be a big plus, too. And I am most encouraged about the Cadillac tax. This is a tax on gold-plated health insurance policies for folks like me. So I get a very good health care package from Moody's. So if I get sick, or if my family gets sick, I am unfettered in terms of my health care consumption. But with that tax, it is going to make it more costly and therefore I am going to start shopping for health care. And that I think will create more transparency with respect to pricing, and hopefully get the growth in health care cost down.

So my point is, we do not really know what is going to work but there are some really interesting new programs that have been implemented by the Affordable Care Act that has significant potential, and we should see how those work out before we I think engage in some very significant structural changes to the Medicare or Medicaid programs like a voucher program or a premium support.

You know, we may have to go down that path at some point, but it is much too premature in my view to do that. We should see how these developments work. They have some potential.

Representative Cummings. Following up on Senator Klobuchar's question, you wrote, and I quote: "If temporarily going

over the cliff is necessary to achieving a good agreement, then lawmakers should not hesitate to do so." End of quote.

How long do you think we could stay over the cliff without doing significant damage to the economy?

Dr. Zandi. I think you could go into early February. By early February, if it looks like you are not coming to a deal and the market, the investors begin to discount the likelihood that you are not coming to a deal, then you will see stock prices decline, the bond market will react. Consumer, business confidence would begin to erode. By mid-February you would be doing a lot of damage. And by the end of February of course then the debt ceiling—you can't navigate around the debt ceiling and really bad things will happen.

So I think you have got about a month. Now a lot does depend on whether the Treasury will, and is permitted, to freeze withholding schedules. I am going under the assumption that they can and they will do that. If they can't, then the damage will mount faster. You won't have as much time.

Representative Cummings. One of the things I have been saying is, a bad deal—a bad deal—well, no deal is better than a bad deal. And, you know, going back to—I'm just curious about, you know, given your findings, do you believe that the tax cuts say for the first $250,000 in income should be extended immediately, as the President has stated?

And let me ask the second part. And is there any reason that the renewal of these tax cuts should be tied to tax cuts for the wealthiest in our Nation?

Dr. Zandi. I think this has to be done as a package. I do not think you can break this apart, because it is just going to create brinkmanship, angst; and I think that nailing down the tax code, nailing down the spending cuts, nailing down the debt ceiling, and nailing down long-term fiscal sustainability, what we're going to do over the longer run, you have to do this all at once.

That is a good deal, and that is the only deal that I think works.

Representative Cummings. You think that can be done by the end of the year?

Dr. Zandi. No. I'm skeptical. But I do think it can be done before—early next year, before it does significant economic damage.

Representative Cummings. I see my time——

Dr. Zandi. I am hopeful that you can. I am an economist. I'm playing a political observer, but my guess is we will probably have to go into next year to see that happen.

Representative Cummings. Thank you very much.

Chairman Casey. Thank you, Representative Cummings.

Vice Chairman Brady.

Vice Chairman Brady. Well, Mr. Chairman, first I apologize for being late. But I want to thank you for your leadership of the Joint Economic Committee. You have been a terrific leader and have been tremendous to work with. I really appreciate your approach and just how you handle yourself and this Committee. So thank you, very much, for your years of work on this Committee. Thank you. Appreciate it.

I think there is a bit of a consensus in the sense that it is irresponsible to voluntarily go off this cliff, but it would be equally irresponsible to come to a solution that does not address the key issues

facing us both in authentic spending discipline, in fixing this broken tax code, and in dealing with our biggest challenges in Social Security and Medicare.

And so I want to ask two quick questions, one of Dr. Hassett and one of Dr. Zandi.

To you, Dr. Hassett, you know obviously economic growth works. Just an average recovery in this recession would have cut the deficit from $1.1 trillion to $430 billion. So more than half is just getting the economy going and returning to the pre-2008 levels.

What is missing today? We know consumer spending is above what it was before the recession. We know government spending is above what it was before the recession. Business investments in buildings, equipment, software, that area that actually drives job creation, is what continues to lag.

In your view, do you think raising taxes on the two marginal rates, as well as capital gains and dividends, does that encourage more business investment in the economy?

Dr. Hassett. No. And I think the threat of those increases is a very big, significant negative.

Mr. Brady, one of the things that economists use when they teach graduate classes in tax is something called The Handbook of Public Economics. And probably you [turning to Dr. Zandi] at some point had to study that too, Mark. I know I did. And in one of the later editions, there is a chapter on how taxes affect business capital spending that was co-authored by myself and Glen Hubbard of Columbia University.

We go into very, very gory detail about how negative this can be, but the fact is that dividend taxes, capital gains taxes, statutory tax rates, have a big effect on investment through the user-cost-of-capital. If the dividend tax is going to go up, then there are a lot of firms that are going to be hurt significantly by that, and they today would be paring back their capital spending in anticipation of higher taxes in the future.

Businesses look to the future when they decide what they are going to do, and right now there are a heck of a lot of businesses that think that their taxes are going to be higher, and they are therefore appropriately now investing. And so you absolutely see it in the investment data. It is one of the reasons why this recovery has been so slow, is that businesses have a lot of cash and are not making a lot of investment.

Vice Chairman Brady. Well do you think—so your point is this does not help the economy? In fact, it hurts the economy?

Dr. Hassett. That's right. And in fact you could go back and look at the writings of even Keynes himself who I think would have quite vehemently opposed President Obama's stimulus approach; that Keynes was a business-cycle scholar who identified very early on that business cycles, recessions, and recoveries tend to be driven by investment because consumers are pretty steady, but investment can be really wildly fluctuating. It can go way down and way up.

And so Keynes's view of sort of the problem of stabilization policy was to try to stabilize investment, and not to really focus on consumption. And I think that one reason why we have had such a disappointing recovery is that we have not really addressed the

fundamental reason why investment is so weak, which is that we are really an unattractive place for investors to invest right now.

Vice Chairman Brady. Right. Well, one of our questions the Republicans are often asked is why don't you just accept the higher tax rates? Because it would be politically very convenient. And the answer is: It does not solve the economy; it hurts it. It does not solve the deficit; I think it is eight days of federal spending. It is not a serious deficit proposal.

Dr. Zandi, I have often disagreed with you on some of your analysis of stimulus and other issues, but I think you are right in that the credit rating agencies are looking for a plan that ultimately lowers that debt-to-GDP ratio. I don't think there is a magic number, but I do think the focus on our biggest drivers going forward—Social Security and Medicare—and are we acting to find a sustainable path forward on them, will be more important than in fact a number on discretionary spending or tax cuts themselves.

Do you think the President's plan adequately—that is on the table today—adequately addresses the sustainability of Medicare and Social Security?

Dr. Zandi. I think he needs to go further. I don't think it's enough. I believe the proposals he has put forward are good ones. I think they are hard proposals to make because they are substantive. But to achieve fiscal sustainability in the context of $3 trillion in 10-year deficit reduction, I do think we need to do more.

Vice Chairman Brady. Looking at the Republican plan and the President's proposal, do you see any common ground in addressing those two important programs?

Dr. Zandi. I do. I think the common ground is that we are all looking at roughly the same proposals. The CBO has scored a number of different approaches to addressing Medicare and Medicaid. And I also think there is now general agreement that in the context of the current discussion we are not going to make any major structural changes to these programs. We are not going to block grant Medicaid. We are not going to voucher or premium-support Medicare.

So in that, I think we can all roughly agree to that. So in this context it becomes dollars and cents and really doing the hard arithmetic. And actually, Congressman Brady, when you look at, actually sit down and do the arithmetic and look at these proposals, it is really very hard. This is not going to be easy. And so I would suggest that in this quest for more reform to Medicare and Medicaid, that if we can say by the 10th year of the budget horizon we are on the right path, then I think that is O.K. Maybe we shouldn't because entitlement reform shouldn't be done in a 10-year horizon.

Vice Chairman Brady. Your point is, the number is not the 10-year point; it is whether we have solved the problem over the long term.

Dr. Zandi. Yes. Because entitlement reform is tough, and you cannot do it in 10 years, right? Because this is a long-term problem. So really we should be thinking about this in a 20- to 30-year horizon.

Of course CBO's scoring makes it incredibly difficult, but we don't want to make that CBO structure—force us to make wrong decisions about these programs.

Vice Chairman Brady. I agree.

Chairman, thank you very much.

Chairman Casey. Vice Chairman Brady, thank you. Senator Lee.

Senator Lee. Thank you very much.

I would like to take a step back for a minute and step in a slightly different direction from the fiscal cliff and talk more about the long-term and medium-term economic realities that we face.

Mr. Zandi, in your written testimony to this Committee you warned against kicking the can down the road indefinitely because of the adverse effect that might have on the economy, the medium- and long-term impact that it might have. And I thought your analysis was definitely something that we need to pay attention to on this point.

As you observed that any failure to make progress in this area now could signal that we've got bigger troubles ahead. And as you pointed out, the Moody's Analytics' model that you use breaks down in about 2028. And the reason it does that is because at that point the interest on our ballooning national debt will start to swamp and cripple our economy, thwarting our ability to fund everything from defense to entitlements, and everything in between, and we will be left without much recourse.

I mean, at that moment I'm not sure there is a tax increase on the planet that could suddenly fix that. I'm not sure we can print money fast enough to fix that. And if we did, we would go the way of Argentina and other countries that have tried that. And that does not ever end except in blood and tears.

So I tend to think of this medium- and long-term risk as the fiscal avalanche. The cliff is something we are approaching now. We can see where it is. Based on our current location, our direction, and our velocity we know when we are going to hit the cliff, if we're going to hit it.

But the avalanche is different. I come from a mountainous state where avalanches happen all the time. The only thing you know about avalanches is you know when the conditions are present when they might occur. You know when the snowpack has built up to the point when it could happen. You don't know exactly when it is going to happen; you just know it is coming. And you try to deal with the risk of it. But once it hits you, the avalanche becomes completely impossible to control.

Do you agree with this characterization about the avalanche? And could you sort of elaborate to us about that kind of threat?

Dr. Zandi. Would you mind if I steal that from you?

Senator Lee. Oh, I'd be happy for you to.

Dr. Zandi. I will give you credit.

Senator Lee. That would be great. It's not copyrighted.

Dr. Zandi. I love that imagery and the metaphor I think is right. I do think that that is why what you are doing right now is so important. I really think this is a once-in-a-generation opportunity for you to nail these things down, and we are not that far apart. I really don't think we are.

So if you are able to put us on a credible path to fiscal sustainability, roughly get to my $3 trillion, do it in a roughly balanced way, I think we are golden, I really do. And we are going to avoid that avalanche. But if we don't do that, if we kind of kick the can down the road, then ultimately I think it means that we're never really going to do it until we are forced by that avalanche to do it.

Senator Lee. How soon would we need to do that in order to avoid the conditions that would lead to the avalanche? How soon would we need to get to balance?

Dr. Zandi. I don't know the answer to that, but I do know, and that's why I put it into the testimony, my model breaks down—of course it's going to happen long before that point.

Senator Lee. Right. We're not going to get anywhere close to 2020 without it happening.

Dr. Zandi. No, no.

Senator Lee. In fact, it could happen within the next four, five, six years, certainly the next ten years, couldn't it, if yield rates start to jump?

Dr. Zandi. Yeah. Here's the thing. The problem is that if we don't address this and we kick the can, we are going to be stuck in this slow growth netherworld going forward. And most importantly, we are going to get nailed by something.

I don't know what it is but something bad is going to happen. And when that bad thing happens, that is going to be the thing that sets off that avalanche. Right? So——

Senator Lee. You mean like a credit downgrade, for example?

Dr. Zandi. No, no. It's going to be, something that we're not even contemplating that happens in the world to oil prices, to other geopolitical—or even to our own economy. It's just we don't know what that will be, but it will happen, and we will have set ourselves up for that avalanche because we did not get our fundamentals in the right place.

That is why it is so important to get this right right now.

Senator Lee. What about a credit downgrade? If that were to happen, doesn't that call into question all kinds of things like, you know, money market funds and other types of investment funds are chartered to invest only in a certain grade of funds. And if all of a sudden U.S. Treasuries were downgraded, would that not have a pretty significant effect on where we are relative to the avalanche?

Dr. Zandi. Right. So if there's downgrade to Treasury debt, this will likely trigger other downgrades. Anything that is backstopped by the government will be downgraded. Fannie Mae, Freddie Mac debt, Federal Home Loan Bank debt, SIFI banks, too-big-to-fail banks, they're still implicitly backstopped. They'll get downgraded. You know, it's the JPMorgan and Citi's of the world. State and local government debt will get downgraded.

And you are right. Money managers have in their relationships with their clients agreements not to invest in bonds that have ratings below a certain grade, and they will divest themselves because of the downgrades. And this will cause problems in the credit markets.

Now the credit markets will ultimately adjust because the reality of what's happened to the value of these bonds has not changed,

right? The economics have not changed for Fannie Mae and Freddie Mac. So you will see hedge funds, and private equity firms, and other players come in. But that is a process, and it will take time. In between now and then, it will create a great deal of turmoil.

But the most important thing is not what the credit rating agencies do or say; it is what this means. It means that we do not have the political will to nail this thing down—and we won't until we are forced by that avalanche. And people will recognize that, and we will go nowhere.

Senator Lee. So what you're saying is, if we want to preserve entitlements, get us to balance. If you want to preserve our ability to fund national defense, get us to balance.

Dr. Zandi. Get us to sustainability.

Senator Lee. O.K. Thank you, Mr. Chairman. My time has expired.

Chairman Casey. Senator Lee, thank you very much. I just have maybe one more question. I know we could be here awhile if we had the time, but I am grateful for the patience of our witnesses and the testimony.

I was looking at the testimony of Dr. Hassett, and on page 8—it gets into this question of the balance, the question of how you do the balance between cuts and revenue. And in the second full paragraph he says:

"Using a range of different methodologies, we find that the average unsuccessful fiscal consolidation relied upon 53 percent tax increases and 47 percent spending cuts, while a typical successful consolidation consisted of 85 percent expenditure cuts." So 85–15.

Dr. Zandi, I wanted to get your sense of that, whether you agree with that 85–15. And if not, why not? And what do you think is a—what would your approach be, if you can articulate it by way of a number?

Dr. Zandi. I think—I respect Kevin's work a lot, but I think that number varies considerably depending on the country, and it depends on where the economy is in the business cycle. It also depends on where the Federal Reserve is with respect to monetary policy.

I mean it is one thing if interest rates are 4 or 5 percent and they can lower rates in the context of consolidation. It is another thing if we are at zero, which is where we are today.

And there has been a lot of really good work revolving around these issues in trying to get good benchmarks for fiscal consolidation. In fact, there's a really great paper that came out of the IMF in just the last couple of days on this issue, and it makes a very strong case that, first, there was this fiscal speed limit. You can't have too much fiscal consolidation too quickly; otherwise, it becomes counterproductive in terms of your fiscal situation. You can see that in Europe.

And the other is that this balance between tax and spending in the context of the U.S., and particularly when the economy is weak and the Federal Reserve is at zero, the spending multipliers, when you cut spending they are very, very large, much larger than was previously thought.

So I don't buy into Kevin's 85–15. I think in the context of where we are today, that is not—I would think that is not right. That is not what we are observing today.

Now having said that, I would do something like I proposed, a 2-to-1 kind of ratio. If you do that, I think that is balanced. I think that gets us to a reasonably good place. I think that gets us to fiscal sustainability in avoiding that avalanche. It is still more spending than a tax, but it is more balanced.

The last thing I would say, to a point that Senator Toomey made, because we're talking about taxes and spending, and this is a really important point, tax reform is spending cuts. There is no difference if I give you a mortgage interest deduction or I cut you a check. No difference. You can treat it as a tax, or you can treat it as spending.

From an economic perspective, they are one and the same thing. So when we do tax reform, you know from an economic perspective that is a spending cut. That is a spending cut.

Chairman Casey. I don't have any more questions, unless the Vice Chairman does, or Representative Maloney.

Vice Chairman Brady. Thirty seconds?

Chairman Casey. Sure.

Vice Chairman Brady. I will be very brief.

I think concerning Dr. Hassett's work and looking at our global competitors who find themselves in significant fiscal financial crises, as we did, showed, if I recall, more than 20 times in 9 different countries, countries both cut what they owed in their spending and grew the economy at the same time.

They did that because their cuts were large, credible, and politically difficult to reverse. In other words, they were real and they were believable. What that did was create the confidence to make investments to grow an economy and it was proven over, and over, and over again.

I actually think that is the model for this fiscal cliff discussion: Making both the cuts and the reforms that are real, and credible, and politically difficult to reverse because that is the only signal we can send. I think the right signal to send to investors that we are serious about getting our financial house in order. I hope that we do that.

And again, Mr. Chairman, thank you again. This is your last Committee meeting and you will be missed. Thank you, again.

Chairman Casey. Thank you, Vice Chairman Brady, soon-to-be-Chairman. Representative Maloney, you had something?

Representative Maloney. Yes. Going back to the analogy of the avalanche, when we had the subprime crisis there was no warning. Just one day it just, the avalanche came, a total loss of confidence and a total really fall in the market.

And likewise we could have the same type of avalanche come tomorrow. There's no more confidence. No one buys our debt. They want to sell it, and we would have increased interest rates and huge economic problems.

We have two things in front of us. Not only the fiscal slope, but also the debt ceiling that Treasury estimates at the end—we have until February for the debt ceiling. So they are very close together.

In solving it, would it be better to put the debt ceiling in the package with the fiscal slope for a comprehensive solution? Or would it be better to do them separately? Dr. Zandi.

Dr. Zandi. My view is they should be done together; that this will not work if we try to break this thing apart. We need to scale back the cliff. We need to raise or eliminate the debt ceiling, and we need to achieve fiscal sustainability. This needs to be a package, and it has to be done relatively, you know, very soon.

Representative Maloney. And Dr. Hassett.

Dr. Hassett. I agree with Mr. Zandi.

Representative Maloney. Great.

Dr. Hassett. Thank you.

Representative Maloney. I want to thank both of you for your testimony, and really thank the Chairman for his outstanding leadership on the Committee.

Chairman Casey. Representative Maloney, thank you very much. I appreciate your good work and your leadership, as well.

Dr. Zandi, Dr. Hassett, thank you for your testimony. I think we made it a 90-minute meeting, or pretty close to that. That is pretty good.

I want to make a couple of final comments. First of all I want to thank both of our witnesses again for their testimony. And by the way, without objection both the full text of your opening statements will be in the record of this hearing.

We are grateful because I think it is clear to most Americans we do have a substantial challenge with regard to the cliff. We know that if we do not take the right steps that it could jeopardize our economic recovery. And we cannot afford to lose ground on the gains we have made the last couple of years.

I am confident though we can get this done, that the Congress of the United States can come together and successfully reach the compromise that we need that puts us on a path to fiscal sustainability while protecting middle income families.

I mentioned before this is my last hearing, and Vice Chairman Brady mentioned it a couple of times. I have really enjoyed this work as Chairman and also as a member of the Committee the last six years, and am looking forward to more work on this Committee as well.

But our work on job creation, deficit reduction, manufacturing issues that we raised, and other issues has been informed by the perspective of many of our Nation's top economists, two of them with us today, and from other leaders in the business community and the nonprofit sector.

So we are grateful for those insights as we seek to get answers. I mentioned at the outset the great working relationship I have had with Vice Chairman Brady. I am grateful for his work and the work of both parties on this Committee.

I would also like to recognize three retiring Members. Dr. Burgess mentioned them at the beginning, but I wanted to mention them again:

Senator Bingaman, who was here with us earlier, has served on the Joint Economic Committee continuously from 1987 forward, 25 years of service on the Committee. Congressman Hinchey from New York served from 1996 to 1998 and then from 2005 to the

present. And third, Senator Webb serving since 2007. They will all be retiring from Congress at the end of the year, and I would like to thank them for their contributions and wish them luck in the next chapter of their life.

The record for all here, the record will remain open for five business days for any member of the Committee who wishes to submit a statement or additional questions.

If there is nothing further, we are adjourned. Thank you.

[Whereupon, at 11:12 a.m., Thursday, December 6, 2012, the Committee hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

Written Testimony of Mark Zandi
Chief Economist and Cofounder, Moody's Analytics

Before the Joint Economic Committee

"Fiscal Cliff: How to Protect the Middle Class, Sustain Long-Term Economic Growth, and Reduce the Federal Deficit"

December 6, 2012

Lawmakers have three critical fiscal tasks to accomplish in the current budget negotiations: Scaling back the fiscal cliff, increasing the Treasury's statutory debt limit, and establishing a credible path to fiscal sustainability.

Unless Congress agrees to change current law, and reduces the coming tax increases and spending cuts, the U.S. economy will be in a severe recession by the spring. Equally important, policymakers must make long-term tax and spending changes that can, at a minimum, stabilize the nation's debt-to-GDP ratio by the end of the decade. Whether and how policymakers do this will determine how the economy performs for years.

Policymakers have a number of options. One is to do nothing after the economy hits the January 1 fiscal cliff. The tax hikes and spending cuts scheduled to take effect at the beginning of 2013 would precipitate a new economic downturn, which would likely be severe, as households and businesses panic and pull back. The Federal Reserve would attempt to mitigate the damage with more quantitative easing, but this would be insufficient. Fiscal sustainability would ultimately be achieved, but at great cost.

Congress could also decide to kick the can down the road by extending current policy, deferring significant tax increases and spending cuts. This would also be costly, because it would signal that political will is lacking to put the nation on a sustainable fiscal path. The U.S. Treasury would almost certainly lose its Aaa rating, adding to the uncertainty and doubt that already hang over business decisions and weigh on economic growth.

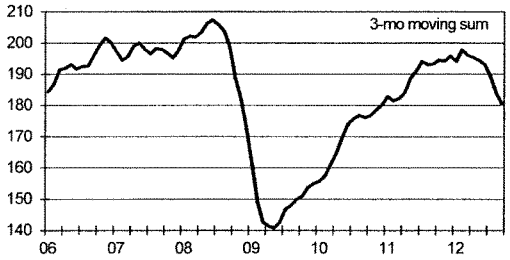
By far the most desirable choice would be an agreement that reduces the scale of the fiscal cliff, raises the Treasury debt ceiling, and credibly promises long-term fiscal sustainability. Such an agreement will not be achieved easily, and the economy will suffer if lawmakers remain deadlocked far into 2013. But there is room for compromise, and if Congress and the president can reach one in a reasonable time frame the economy's prospects will quickly brighten.

Policy uncertainty

Much work remains, and concern about Washington's ability to manage the developing crisis already appears to be taking a toll. Nervous businesses have pulled back sharply on investment in recent months (See Chart 1). This may partly reflect decisions by owners of S-corporations expecting higher personal tax rates next year. Since their business profits are taxed as personal income, it makes economic sense for them to delay investment into next year.

Chart 1: Nervous Businesses Pull Back

Orders for nondefense capital goods ex aircraft, $ bil



Sources: Census Bureau, Moody's Analytics

More important, businesses are simply unsure what lawmakers will do. Executives and planners cannot construct a plausible narrative of how the president and House Republicans will address fiscal issues. Business managers also know that if lawmakers botch the job, the economy will fall back into recession. Unable to handicap such a possibility, firms feel safer postponing risky investments.

Curiously, businesses have not significantly altered hiring and layoff plans. But after slashing payrolls and significantly increasing productivity during the Great Recession, firms know they cannot do so again. Additional job cuts would reduce output. CEOs also know that it costs less to delay a major equipment purchase than to halt hiring or lay off workers. Consumers also seem unfazed by the drama in Washington, perhaps because the job market has stabilized, gasoline prices have fallen, and house prices have begun to rise. Consumer confidence is as strong as it has been since before the Great Recession. Yet it is hard to see how this will last if fiscal uncertainty continues to mount.

Investors will also lose faith eventually. There already are some indications of market nervousness. Stock prices have weakened since the election, credit spreads have widened, and credit default swaps on Treasury bonds have begun to edge higher. Financial markets are more upbeat than they were when Congress battled over the Treasury debt ceiling in summer 2011—but as that period shows, market sentiment is fickle and unpredictable.

Over the cliff

The fiscal cliff is huge. Federal tax increases and spending cuts scheduled to take effect in 2013 total more than $700 billion, equal to 4.4% of GDP. If lawmakers were to allow all of them to take effect, GDP next year would be nearly 3.4% less than it would be otherwise. (See Table 1).

Table 1: Sizing Up the 2013 Fiscal Cliff

If all tax and spending changes slated for 2013 happen as currently planned, here is how it will affect the federal deficit and the economy.

	The federal deficit will shrink...	...but so will U.S. GDP		Implied
Fiscal Policy	*$ bil*	*$ bil*	*% of GDP*	Multiplier
Bush-era tax cut (below $250k income)	-198	-174	-1.06	0.88
Personal income	-171	-147	-0.90	0.86
Stimulus, EITC, CTC, AOTC	-27	-27	-0.17	1.00
AMT patch	-120	-59	-0.36	0.49
Payroll tax holiday	-115	-100	-0.60	0.87
Automatic spending cuts (sequestration)	-100	-105	-0.64	1.05
Defense cuts	-50	-54	-0.33	1.08
Nondefense cuts	-50	-51	-0.31	1.02
Bush-era tax cut (above $250k income)	-83	-40	-0.24	0.48
Personal income, PEP and Pease	-44	-31	-0.19	0.70
Capital gains & dividend income	-8	-5	-0.03	0.60
Estate tax	-31	-4	-0.03	0.14
Emergency unemployment insurance	-36	-51	-0.35	1.42
Affordable Care Act (Obamacare)	-23	-11	-0.06	0.48
Medicare doc fix	-20	-8	-0.06	0.40
Tax extenders	-20	-4	-0.02	0.20
Bonus depreciation	-12	-3	-0.01	0.25
Total	-727	-555		0.76
% of GDP	*-4.4*	*-3.4*		

Notes:

The difference in the budget deficit is based on a static analysis—it does not include the impact of the changing economy and the reaction of financial markets.

The difference in real GDP is based on a dynamic analysis using the Moody's Analytics macro model—it does include the impact of the changing economy and the reaction of financial markets.

Sources: CBO, OMB, Moody's Analytics

This would precipitate another recession. Total economic output in 2013 would decline by an estimated 0.3% from 2012, and the unemployment rate would continue to rise through 2014, peaking near double digits (See Table 2). This is similar to the Congressional Budget Office's estimate of the economic impact of permanently going over the cliff.[i]

Table 2: Real GDP Impact of Different Budget Scenarios
Calender year 2013

	Real GDP After Going Over the Cliff		Real GDP After Kicking the Can		Real GDP After Going the Speed Limit	
	2005$ bil	*% change*	*2005$ bil*	*% change*	*2005$ bil*	*% change*
2012	13,587	*2.2*	13,587	*2.2*	13,587	*2.2*
2013	13,546	*-0.3*	14,008	*3.1*	13,859	*2.0*
2014	13,741	*1.4*	14,466	*3.3*	14,405	*3.9*
2015	14,112	*2.7*	14,900	*3.0*	15,005	*4.2*
2016	14,635	*3.7*	15,273	*2.5*	15,519	*3.4*
2017	15,251	*4.2*	15,551	*1.8*	15,931	*2.7*
2018	15,844	*3.9*	15,831	*1.8*	16,314	*2.4*
2019	16,338	*3.1*	16,098	*1.7*	16,669	*2.2*
2020	16,763	*2.6*	16,362	*1.6*	17,038	*2.2*
2021	17,149	*2.3*	16,629	*1.6*	17,413	*2.2*
2022	17,526	*2.2*	16,892	*1.6*	17,789	*2.2*
Average Annual Growth 2012-2022		*2.6*		*2.2*		*2.7*

While a 0.3% drop in GDP would be about average as modern recessions go, the balance of risks to this outlook are tilted sharply to the downside. Most macroeconomic models, including those used by Moody's Analytics and the Congressional Budget Office, do not adequately account for the national mood, which is very fragile. Nervous businesses, investors and households, still feeling the fallout from the Great Recession, are likely to recoil more than the models suggest if they have to grapple with much higher taxes and slashed government budgets.

The models also fail to fully pick up the implications that flow from the weakened ability of policymakers to respond to a new recession. Unable to lower interest rates further, the Fed will be forced to undertake even more quantitative easing.[ii] And by definition, fiscal policymakers would have done nothing to mitigate the downturn.

With so many people out of work, and for a much longer stretch, a more virulent form of hysteresis would set in. The increase in the number of long-term unemployed workers has already raised estimates of the nation's full-employment unemployment rate, from 5% before the Great Recession to almost 6% now. More than 40% of the unemployed have not worked in six months or longer. A return to recession could add millions more to the long-term jobless rolls and raise the "natural" rate of unemployment still higher.

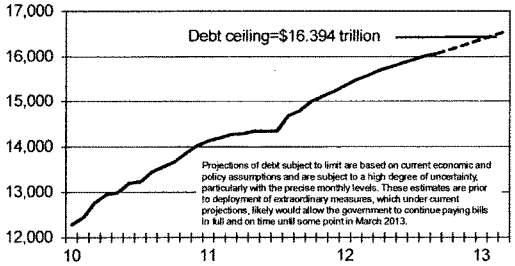
Some argue that going over the fiscal cliff would solve the government's longer-term sustainability problem. Tax revenues would rise and spending would fall, shrinking future budget deficits enough to stabilize the debt-to-GDP ratio. But this may be true only on paper. If the resulting recession were deep enough to weaken the economy's potential growth rate, fiscal sustainability could become elusive. Over the last two decades, Japan has had the highest ratio of government debt to GDP in the industrialized world, not because of imprudent fiscal policies, but because of painfully slow economic growth.

Breaking the ceiling

Adding to the economic threat posed by the fiscal cliff is the approaching Treasury debt ceiling. The law currently caps federal debt at $16.394 trillion. Based on recent government expenditures and receipts, the Treasury will approach that limit in a few weeks and be forced to use extraordinary accounting techniques to avoid crossing it (See Chart 2). However, the Treasury can only do this for so long, and by early March the Obama administration will be forced to make some difficult decisions.

Chart 2: The Debt Ceiling Is Fast Approaching

Treasury debt outstanding, $ bil



Sources: Treasury, Moody's Analytics

The administration could default on the nation's debt, but this would produce financial chaos and is inconceivable. The federal government could stop paying some bills, cut payments to Social Security recipients or Medicare providers, or shut some operations. Some 40% of government spending is financed by borrowing, so the cuts would have to be draconian. This also seems a highly unlikely outcome.

The president's other option would be to ignore the law and order the Treasury to continue issuing debt above the legal ceiling. During the debt-ceiling crisis in 2011, some argued that the president may do this under the Constitution's 14th amendment. The amendment was passed to deal in part with Civil War debts, but the courts could interpret it more broadly. Regardless, a constitutional crisis would ensue.

Fiscal sustainability

Most worrisome over the long run is whether lawmakers are up to the task of achieving fiscal sustainability. This means shrinking deficits enough, through some combination of higher tax revenues and lower spending, to stabilize the nation's debt-to-GDP ratio. The ratio nearly doubled during the Great Recession, through the automatic stabilizers in the budget and the additional costs of fiscal stimulus measures and the bailouts. Without changes to fiscal policy, the ratio will continue to rise, ultimately precipitating a fiscal crisis.[iii]

Under reasonable economic assumptions, policymakers need to reduce deficits by close to $3 trillion over the next decade to achieve fiscal sustainability. (This is on top of the more than $1 trillion in spending cuts via caps to discretionary spending agreed to as part of last summer's increase in the Treasury debt ceiling, but not the $1 trillion in automatic spending cuts known as sequestration agreed to as part of that deal.) Doing so will produce deficits later in the decade that equal less than 3% of GDP. Given expected GDP growth, this will stabilize the debt-to-GDP ratio.

The 2010 Simpson-Bowles commission called for even more deficit reduction. Simpson-Bowles proposed tax revenue increases through tax reform, higher rates on upper-income households and a gasoline tax, and enough cuts to discretionary and entitlement programs to substantially reduce the nation's debt-to-GDP ratio.[iv] This goes beyond simply achieving fiscal sustainability.

The Simpson-Bowles goals are appropriate. Reducing deficits by about $3 trillion will rebuild the fiscal cushion we will almost certainly need to cope with future events such as wars or recessions. Doing so would also help mitigate concerns that policymakers could backtrack on taxes and spending. A more aggressive program of deficit reduction could ensure that rating agencies do not downgrade the nation's debt. The agencies are looking for a plan that ultimately lowers the debt-to-GDP ratio.

Kicking the can

Going permanently over the fiscal cliff or colliding with the debt ceiling would have such widespread negative impacts on the economy that it is implausible to think lawmakers will allow it. Congress could avoid the cliff and debt ceiling altogether, extending current tax and spending policy for a few months or even another year, and raising the ceiling enough to keep the Treasury from hitting it in this period.

Without any fiscal drag, the economy would grow more quickly in 2013, but much more slowly over the long term. (See Table 2). A failure to make any progress toward fiscal sustainability now would signal that lawmakers are incapable of doing so without a serious financial crisis at hand.

When such a crisis might occur is unknowable, but it is instructive that in such a scenario the Moody's Analytics model breaks down in 2028, with interest on the ballooning federal debt swamping the budget and crippling the economy. Yet a crisis would almost surely erupt sooner than that, as global investors would sell off U.S. Treasury debt long before Washington was unable to make interest payments.

Fearful of this outcome, credit rating agencies would likely downgrade U.S. Treasury debt, and also the debt of institutions supported by the federal government, including Fannie Mae and Freddie Mac, the Federal Home Loan Bank system, state and municipal governments, and systemically important financial institutions.[v] Unlike in 2011, when the decision by Standard & Poor's to cut the nation's rating from AAA to AA caused few

financial repercussions, unified action by all the ratings agencies would likely affect financial markets significantly. Money market and other investment funds that are chartered to hold only top-rated securities could be forced to sell assets en masse, for example.

The cloud of uncertainty, meanwhile, would keep businesses unsure about their tax obligations, future government contracts, and the nation's long-term fiscal situation. The economy would throttle back to a new normal, characterized by much slower long-term growth. Real GDP growth toward the end of this decade would be almost half a percentage point per year slower than otherwise.

Fiscal speed limit

Given these dark prospects, lawmakers must do the right thing: Scale back the fiscal cliff, raise the debt ceiling, and establish a reasonably credible path to fiscal sustainability.

The cliff should be scaled back just enough to ensure that the recovery stays on course next year. Tax hikes and spending cuts together should equal no more than 1.5% of GDP, a level that can be characterized as a fiscal speed limit.[vi] The economy would still face a significant headwind, particularly during the first half of 2013, but it would be manageable. The U.S. would avoid another recession, with real GDP growing almost 2%, about the same as this year. It is important to remember that the economic drag from federal, state and local government in 2012 has also been considerable, amounting to 1.3% of GDP.

Changes to tax and spending policy could be combined in various ways to keep the fiscal drag from exceeding 1.5% of GDP. A reasonable course would involve letting the 2011-2012 payroll tax holiday expire (adding a fiscal drag equal to 0.6% of GDP), phasing out the emergency unemployment insurance program (0.35% of GDP), allowing the Bush-era tax rates for U.S. households making more than $250,000 per year to end (0.24%), and allowing taxes to rise on higher-income households to help pay for healthcare reform (0.06%). Together, these changes would create a fiscal drag on the economy in 2013 equal to 1.25% of GDP, safely below the recessionary limit.

Adopting this course would mean lawmakers also extend the Bush-era tax rates for households making less than $250,000 a year, eliminate spending cuts scheduled under the 2011 sequestration agreement, and extend such "temporary" policies as the inflation adjustment to the alternative minimum tax and Medicare's reimbursement schedule for doctors and hospitals.

As part of the fiscal cliff agreement, the debt ceiling should be raised enough so that it does not become an issue again until after the 2014 elections. Political brinksmanship surrounding the debt ceiling has escalated dramatically in recent years, weighing heavily on the confidence of households, businesses and investors. The last time the Treasury approached the debt ceiling in summer 2011, Congressional bickering nearly pushed the

economy into recession and prompted a downgrade of the nation's debt by rating agency Standard & Poor's.

To avoid an even worse outcome early next year, lawmakers need to agree to a broader program of deficit reduction, including reforms to the tax code and entitlements. Doing all this will be impossible in a short period; lawmakers should thus instead lay out a broad framework and leave it to congressional committees to hash out the details next year.

A plausible framework could include $1.4 trillion in revenue increases over the next decade, $800 billion through higher tax rates on upper-income households, and $600 billion through loophole closing and other reforms. A deal could also contain $1.2 trillion in spending cuts, including cuts to the entitlement programs.[vii] Including the approximately $1.1 trillion in spending cuts agreed to in the 2011 debt-ceiling deal and the net interest savings, the ratio of spending cuts to tax increases would be almost 2-to-1. If lawmakers could pull off something like this, future deficits would be small enough to stabilize the U.S. debt-to-GDP ratio by the end of this decade. This would please financial markets and likely keep the credit rating agencies at bay.

To be sure, generating the political will to reach this kind of an agreement may take into 2013. That means the U.S. may temporarily go over the fiscal cliff. The economy will not suffer significantly right away, particularly if the Treasury can hold off changing tax withholding schedules until a deal is reached. Government agencies could also delay their most draconian budget cuts for a while. However, the economic damage will mount if businesses, investors and consumers begin to doubt policymakers will come to terms. By early February, as the Treasury runs out of options to avoid the debt ceiling, stock prices will slump, bond and CDS spreads will widen, and business and consumer confidence will slide. Political pressure will become intense—but this may be precisely the stress needed to forge a substantive and durable agreement.

Achieving fiscal nirvana

As lawmakers hash out an agreement in the coming weeks, they may want to consider a few suggestions that could meaningfully improve the fiscal and economic outcome.

First, policymakers should not rush to reach a deal before the end of the year, unless it adequately addresses the fiscal cliff, the debt ceiling, and fiscal sustainability. If temporarily going over the cliff is necessary to achieving a good agreement, then lawmakers should not hesitate to do so. As has been appropriately pointed out, the fiscal cliff is really more like a slope. That is, the economy will not crater on January 1 if there is no budget deal in place. Lawmakers have until early February to reach an agreement before investors, businesses and consumers begin to lose faith and the economic costs become severe.

At the same time, any proposal to extend current tax and spending policy for even a few months should be rebuffed. Such a diversion would create policy uncertainty that will ensure the economy remains stuck in slow-growth mode and vulnerable to anything else that might go wrong. There is no guarantee, moreover, that lawmakers will find it easier to come to terms later. If anything, achieving a durable agreement will become more difficult the closer we get to the 2014 elections.

Second, given the still-fragile economy, policymakers should consider scaling back the January tax hikes and spending cuts well below 1.5% of GDP, the level at which a recession becomes likely. If the fiscal drag next year were only 0.6% of GDP, real GDP would grow closer to 3% in 2013. This would be sufficient to push unemployment definitively lower and speed growth enough to make it self-sustaining. The economy would experience a greater amount of fiscal drag in the future, but would be in a better position to handle it.

One way to lower the fiscal drag to 0.6% of GDP is to allow the Bush-era tax cuts for upper-income households to expire, increase taxes to pay for Obamacare, and even begin to implement tax reform. The 2% payroll tax holiday and the emergency unemployment insurance programs could be extended for another year. Taxes would rise on upper-income households but be unchanged for everyone else, thus cushioning the blow to economic activity.

Third, lawmakers should adopt a deficit reduction plan that both increases tax revenue and cuts spending. Simpson-Bowles proposed a 4-to-1 ratio of spending cuts to revenue increases, but the plan also assumed that the Bush-era tax cuts for upper-income households would end. Moreover, there have been substantial cuts to discretionary spending since the Simpson-Bowles plan was proposed at the end of 2010, including the caps included in the 2011 debt-ceiling deal.[viii] An updated version of Simpson-Bowles would thus propose deficit reduction with a spending-to-revenue ratio closer to 2-to-1, which seems an appropriate goal.

Fourth, to achieve the 2-to-1 ratio, policymakers need to reform entitlements. There is no need to radically change Social Security, Medicare and Medicaid, at least not yet. Privatizing Social Security, voucherizing Medicare, or block-granting Medicaid seem to be steps too far. But these programs do need significant changes to shore up their finances and to buy time to see whether the Affordable Care Act can bend the healthcare cost curve. The tax on high-end health insurance plans, the competition of healthcare exchanges, and the discipline of the Independent Payment Advisory Board may slow the growth of healthcare costs and thus put entitlement programs on firmer ground.

Fifth, tax reform is preferable to higher tax rates.[ix] Several approaches would limit deductions and credits in the tax code. Governor Romney suggested capping them at some dollar amount. President Obama proposed capping the top marginal rate to which deductions can apply. Harvard economist Martin Feldstein would cap them at a percentage of adjusted gross income. Each approach has pluses and minuses, but they all

raise significantly more revenue from higher-income households without raising their tax rates.

Given the strong lobbies for each deduction and credit, it seems politically unlikely that caps could raise enough tax revenue to meet the 2-to-1 spending-to-revenue goal. Some tax rate increases will thus be necessary. Moreover, since President Obama campaigned successfully on an explicit promise to allow the Bush-era tax cuts to expire for upper-income households, this seems a reasonable approach.

Finally, to solidify the credibility of their deficit reduction plan, lawmakers should revive the pay-as-you-go rule: Any future proposal to increase spending or lower taxes must be offset in full for by other spending cuts or tax increases. PAYGO has been around for some time but has not been implemented in recent years.

Separately, lawmakers could adopt a version of the so-called dollar-for-dollar rule first proposed by Ohio Senator Rob Portman to address the 2011 debt ceiling. Under Portman's rule, policymakers would agree at the beginning of each fiscal year to cut spending equal to the amount the debt ceiling must be raised to cover that year's budget. The spending cuts would be phased in gradually over the following 10 years. Adopting some form of this rule would be a good safeguard in case Congress misses its deficit reduction targets.

Conclusions

The next few months will be trying for the nation's collective psyche and the economy. The political battle between the president and Congress may extend into 2013, with nerve-wracking brinksmanship that causes businesses to rein in expansion plans even more than they already have. Growth is expected to come to a near standstill early in the new year.

But out of this political cauldron, a substantive budget deal must emerge. Nearly all parties agree that we must address our fiscal problems, and the political stars seem roughly aligned to do it. The fiscal cliff will be scaled back to a manageable size; the debt ceiling will be raised enough to get past the 2014 elections, and a credible path to fiscal sustainability will be established.

The economy will quickly regain its footing once a deal is struck. By this time next year, the U.S. recovery should be back on track. Real GDP will grow around 2% in 2013, doubling that pace in 2014 and remaining near 4% in 2015. Job growth will accelerate from approximately 2 million jobs per year to a pace closer to 3 million. Unemployment will fall definitively as job creation picks up pace, and the economy will be back to full employment—a jobless rate below 6%—by summer 2016.

But this upbeat forecast will come to pass only if the president and Congress address our fiscal problems in a reasonably graceful way. The beauty of the American political

system is that our elections, however contentious, have always shown us the way. Hopefully, the most recent election did the same.

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[i] This study can be found at http://www.cbo.gov/publication/43694.

[ii] According to the Moody's Analytics model, going over the cliff permanently would cause the Federal Reserve balance sheet to double in size from $3 trillion to $6 trillion. The 10-year Treasury bond yield would fall to almost 0.75% through much of 2014.

[iii] The direct cost of the policy response to the Great Recession was $1.8 trillion, including several rounds of fiscal stimulus measures; the bailouts of the banking, auto and housing industries; and the takeovers of Fannie Mae and Freddie Mac. The nation's publicly traded Treasury debt-to-GDP ratio rose from close to 35% in fiscal 2007 to 70% in fiscal 2012.

[iv] The Simpson-Bowles plan assumed that personal tax rates for households making more than $250,000 a year would rise back to their pre-Bush rates.

[v] The rating agencies give a ratings premium to systemically important financial institutions under the assumption that they are too big to fail and will be backstopped by the federal government. A downgrade of Treasury debt would weaken that backstop and therefore reduce the rating premium. This premium is already smaller than it was prior to the passage of Dodd-Frank, suggesting that regulatory reform reduced the too-big-to fail risk, at least in the eyes of the rating agencies.

[vi] This fiscal speed limit varies across nations. Smaller, open economies with flexible exchange rates, independent monetary policies, and interest rates above the zero bound have higher speed limits. For example, the U.K. has a high fiscal speed limit, while peripheral European countries have lower speed limits. The U.S. is closer to the U.K., even though it is a more closed economy that possesses the globe's reserve currency.

[vii] This is on top of the spending cuts related to the spending caps on discretionary spending agreed to as part of the Budget Control Act and savings from the end of the Iraq and Afghan wars. This totals approximately $1.9 trillion over the next decade. The $1.2 trillion in spending cuts excludes approximately $400 billion in net interest savings from the lower debt load due to the other program spending cuts and higher tax revenues.

[viii] The expiration of the Bush-era tax cuts for upper-income households is worth approximately $1 trillion over 10 years. The caps on discretionary spending that came with the debt-ceiling deal are worth another $1 trillion. Lawmakers also agreed to nearly $500 billion in 10-year spending cuts in an April 2011 deal.

[ix] It is important to note that from an economic perspective, there is no difference between a cut in government spending and a reduction in tax deductions and credits. For example, there is no difference between receiving the mortgage interest deduction via the tax code or via a check from the government.

American Enterprise Institute for Public Policy Research

Testimony before the Joint Economic Committee

Fiscal Cliff: How to Protect the Middle Class, Sustain Long-Term Economic Growth, and Reduce the Federal Deficit

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December 6, 2012

The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

Chairman Casey, Vice Chairman Brady, and Members of the Committee, thank you for inviting me to appear today to discuss the effects of the fiscal cliff on the economy.

The "fiscal cliff," that is, the combination of automatic spending cuts and the end of multiple temporary tax cuts scheduled to expire at the end of this year, is estimated by the CBO to reduce the federal deficit in fiscal year 2013 by around $607 billion, or $560 billion after taking into account its effect on the overall economy[1]. Around two thirds of the $607 billion in savings stem from four tax increases that are scheduled to take place in 2013.

This dramatic budgetary shift would, of course, have a very large impact on the overall economy. In this testimony, I examine the potential short and long term effects of failing to address the fiscal cliff, and then relate lessons from the economics literature on the likely impact of various policy responses to the coming deadline.

What is the "Fiscal Cliff"?

Coined by Ben Bernanke in February, the "fiscal cliff" comprises multiple scheduled tax increases and spending cuts that will take place at the beginning of 2013. The chart below lists the major components of the budgetary shifts, along with the amount that they will reduce the deficit in calendar year 2013. There are different estimates as to the cost of each policy, but these estimates give a rough picture of what we are to expect at the beginning of 2013 under current law.

Scheduled Revenue Increases	
Income, capital gains, and dividend rate increases on high income earners	$52 billion
Remainder of 2001 and 2003 tax cuts	$171 billion
End of 2 percent payroll tax cut that went into effect in January 2011	$115 billion
Expiration of AMT patch	$40 billion
Increased tax rates on earnings and investment income of high-income tax payers & Medicare surtax due to Affordable Care Act	$24 billion
Estate and gift tax expirations	$31 billion
Expiration of business tax provisions, including partial expensing of investment property	$59 billion
Total:	$492 billion[2]

Scheduled Spending Cuts	
Automatic cuts in Defense spending due to Budget Control Act	$37 billion
Other cuts in spending due to Budget Control Act	$42 billion

[1] Congressional Budget Office. "Economic Effects of reducing the Fiscal Restraint that is Scheduled to Occur in 2013". May 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf>

[2] Based on: Williams, R., E. Toder, D. Marron, and H. Nguyen. "Toppling off the Fiscal Cliff: Whose taxes rise and how much?". Tax Policy Center. October 1, 2012. <http://www.taxpolicycenter.org/UploadedPDF/412666-toppling-off-the-fiscal-cliff.pdf>

Expiration of extended emergency unemployment benefits	$30 billion
Reduction in Medicare payments rates to physicians	$14 billion
Total:	$123 billion

Based on estimates by the CBO, Macroeconomic Advisors, and the Tax Policy Center

Scheduled payroll tax and income tax rate increases will affect all income earners, while higher income earners will also face the expiration of an AMT patch and increased tax rates on their income due to legislated changes in the Affordable Care Act. Meanwhile, government expenditures will decline due to provisions of the Budget Control Act.

Short -Term Effects

The economic consequences of all of that fiscal tightening would be profoundly negative. In May of this year, the CBO released a study estimating the effects of the spending cuts and revenue increases on economic growth in the short term. Their estimation predicts that real GDP will grow by .5 percent in 2013 if these scheduled budgetary changes come into effect, as opposed to their estimate of 4.4 percent growth if all current policies are continued. Further, they predict that the first half of 2013 will experience an annual rate of contraction of 1.3 percent of GDP, followed by growth in the second half of 2013 at an annual rate of 2.3 percent[3]. In an updated analysis in November, the CBO predicted that GDP would actually shrink by .5 percent over 2013 with scheduled budgetary changes[4]. This pattern of growth, they note, would likely be considered a recession by the National Bureau of Economic Research.

Macroeconomics Advisors LLC has a similar analysis, stating last week that in their analysis, "GDP would contract in the first half of 2013 and grow just 1.1% over the four quarters of the year"[5]. This growth rate is slightly more optimistic than that of the CBO, but predicts a similar dynamic. The unemployment rate is also expected to increase in 2013 if all of the spending cuts and tax increases are realized.

While there is a significant amount of uncertainty regarding the exact scale of these effects, the fact that the fiscal cliff contains both tax increases and spending reductions means that even the most devout Keynesians and Supply Siders should agree that a recession would be likely next year if no deal can be struck to avoid these large and sudden changes.

The one bit of good news associated with this dire scenario is the dramatic improvement of the budgetary situation that would ensue. The CBO estimated that the deficit would be reduced by 4.7 percent of GDP between 2012 and 2013, resulting in an average annual deficit of 1.4 percent of GDP between 2013 and 2022, even when factoring in the weaker economic growth that they predict will happen in 2013.

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[3] Congressional Budget Office. "Economic Effects of reducing the Fiscal Restraint that is Scheduled to Occur in 2013". May 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf>

[4] Congressional Budget Office. "Economic Effects of Policies Contributing to Fiscal Tightening in 2013". November 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/11-08-12-FiscalTightening.pdf>

[5] Macroeconomic Advisors LLC. "Is the Cliff a Bargain?" Macroeconomic Advisors' Macro Focus, Volume 7, Number 2. November 29,2012.

Long-Term Effects

While the short term effects of the fiscal cliff have received wide spread attention throughout the past few months, discussion of the long term effects of high deficits that would result from an extension of current policy has been less prevalent. At the end of the CBO's November report on the economic effects of the policies comprising the fiscal cliff, after long discussion of growth effects in the short term, they conclude with a statement that:

> "Although reducing the fiscal tightening schedule to occur next year would boost output and employment in the short run, doing so without imposing a comparable amount of additional tightening in future years would reduce the nation's output and income in the longer run relative to what would occur if the scheduled tightening remained in place."

Large government deficits crowd our private resource accumulation, reducing economic growth in the medium and long terms. While a steep recession would follow from failure to make a deal, growth prospects in the medium and long term could improve if deficit reduction of that scale is accomplished.

These beneficial long term growth effects, of course, would depend on the form that the deficit reduction might take. But holding off discussion of that for a moment, research into the long term effects of high government debt has confirmed that it can negatively impact GDP growth, especially above a certain threshold. If we extend current policy and continue incurring annual deficits of close to 6 percent of GDP, then we will surely experience slower GDP growth in the long term as a consequence. Any discussion of the fiscal cliff and its consequences must include an examination of the tradeoffs between short term and long term growth, because while the short term effect of the fiscal cliff is negative, reversing it would have negative effects in the long term.

Evidence of the long term effects of high government debt to GDP ratios has been supplied by a number of recent studies. In a widely cited paper reviewing forty-four countries over about two hundred years, Reinhart and Rogoff document a strong relationship between high debt levels and slow GDP growth[6]. They find that this relationship is especially strong when countries exceed a gross debt to GDP level of 90 percent. This relationship holds true when examining all of the countries in their sample and when they restrict their analysis to developed economies.

Although the Reinhart and Rogoff analysis has been criticized for implying only correlation and not controlling for other factors that may impede growth and lead to high levels of debt, a separate IMF Working Paper by Manmohan S. Kumar and Jeajoon Woo confirmed their findings that higher levels of government debt lead to lower levels of growth[7]. They estimate that a 10 percentage point increase in Debt as a percentage of GDP is associated with an annual decrease in .2 percentage points of GDP growth. They also find some evidence that this effect is stronger with higher levels of debt.

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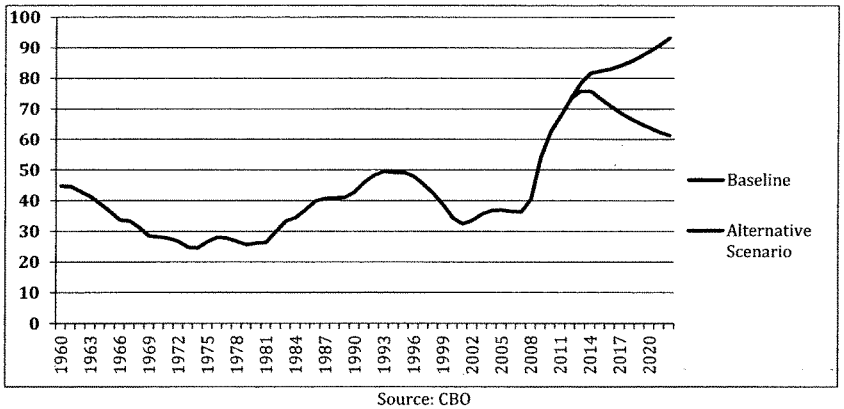
[6] Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt." National Bureau of Economic Research Working Paper 15639. January 2010. <http://www.nber.org/papers/w15639>

[7] Manmohan S. Kumar and Jaejoon Woo, "Public Debt and Growth." IMF Working Paper WP/10/174. July 2010. <http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf>

These results are further corroborated in a study by Mehmet Caner, Thomas Grennes, and Fritzi Koehler-Geib which tries to identify a "tipping point" in debt to GDP ratios that leads to lower growth[8]. In their estimate, debt to GDP ratios above about 77 percent lead to slowed annual GDP growth, with an increase in each percentage point of debt reducing annual growth by about .017 percentage points.

A simple calculation can help provide some intuition for this result. If we were to, all else equal, run deficits of 6 percent of GDP for the next 10 years, then the debt to GDP ratio would climb by nearly 60 percentage points. That increase would be enough, at the end of the decade, to reduce annual growth forecasts by around 1 percentage point per year.

Taken together, these studies suggest that the United States is headed down a path to lower annual growth if we maintain our current policies. A simple chart of the growth in the Debt to GDP ratio shows why.

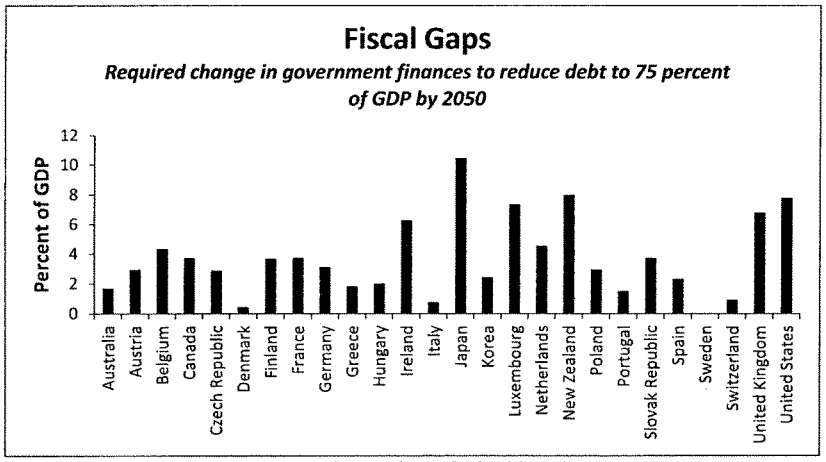


Source: CBO

Under the CBO's "Alternative fiscal scenario" projection, which assumes that all current tax levels are extended, with the exception of the payroll tax holiday, the AMT is indexed for inflation, Medicare's payment rates are held constant and the sequester required by the Budget Control Act does not happen, deficits between 2013 and 2022 will average 5.3 percent of GDP. This would lead to an increase in the deb to 93 percent of GDP within ten years. In its "baseline" projections, the debt as a percentage of GDP would decrease to 61.3 percent by the end of 2012[9].

[8] Mehmet Caner, Thomas Grennes and Fritzi Koehler-Geib, "Finding the Tipping Point – When Sovereign Debt Turns Bad." May 19,2010. Available at SSRN: http://ssrn.com/abstract=1612407

[9] Congressional Budget Office. 'Updated Budget Projections: Fiscal years 2012 to 2022." March 2012. <http://www.cbo.gov/sites/default/files/cbofiles/attachments/March2012Baseline.pdf>



Source: Merola, R. and D. Sutherland (2012) OECD.

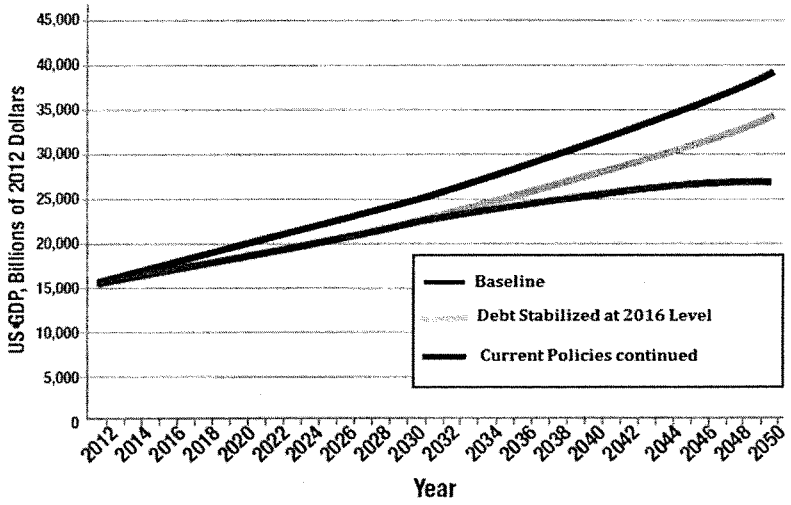
That growth story might be alarming, but the picture looks even worse when we compare ourselves to our developed trading partners. This year, much of Europe has been in turmoil because of the Greek debt crisis, but in many ways, the sickest European nations are actually in better shape than us. While the US debt may seem manageable to many who look at struggles in other countries and take consolation in our relative stability, the situation of the US today, when taken in the long run, is actually further from debt stability than many other developed countries. A recent study by Merola and Sutherland of the Organisation for Economic Co-operation and Development (OECD) examined long-term projections for OECD countries' debt burdens[10]. Taking into account growth in the cost of pensions and health care in the future (but including assumptions that policies will be put in place to control their quickly rising costs), the researchers calculate how much governments would need to immediately and permanently change their fiscal patterns to reduce their debt to 75 percent of GDP by 2050. For the US, this number is 7.78 percent of GDP – the third highest in the sample.

As bad as the medium growth outlook becomes, if we look past the medium term, the story gets even worse. For most of us, we have grown accustomed to living in an America that can be expected to post positive economic growth each year. Our irresponsible fiscal policies suggest our children may expect no such thing.

Given that previous research has estimated the effect that higher debt to GDP ratios have on economic growth, it is possible to theorize about how a continuation of today's policies could hurt

[10] Merola, R. and D. Sutherland (2012), "Fiscal Consolidation: Part 3. Long-Run Projections and Fiscal Gap Calculations", *OECD Economics Department Working Papers*, No. 934, OECD Publishing. http://dx.doi.org/10.1787/5k9h28p42pf1-en

growth in the future. Michael Boskin, in a recent SIEPR policy brief[11], did just that. Using both the IMF Working Paper's estimates and estimates from Reinhart and Rogoff's work, Boskin calculates the effect on GDP if current policies are continued and compares it to a scenario in which deficit reduction is started and the debt is stabilized at its 2016 level and a baseline in which growth is not affected. The chart below is a representation of GDP growth factoring in the effect of debt as estimated in the IMF Kumar and Woo study.



Factoring in lowered GDP growth, Boskin calculates that if current policies are continued GDP will be 30.4 percent lower in 2050 than if there were no effect of debt on growth. Even if the debt is stabilized in 2016, GDP will still suffer in the future; its level in 2050 would be 12.1 percent lower compared to the baseline. According to his calculations, growth will essentially stagnate by the 2040s.

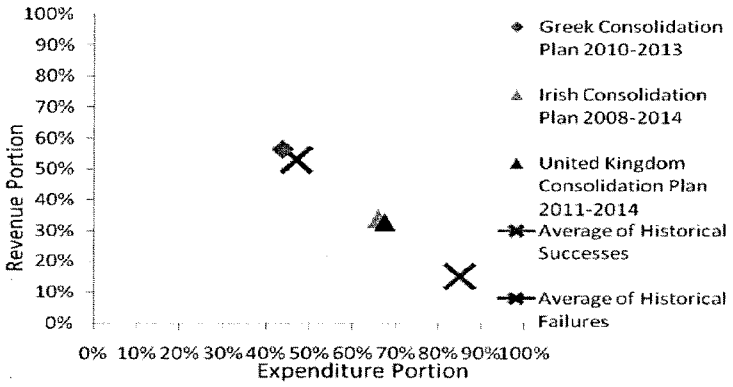
What can we do?

While the fiscal cliff may lead to smaller economic growth in the short term, it may also provide us with an opportunity to discuss the deficit reduction that will become necessary to prevent further stagnation in the future. The path of current policy is clearly not sustainable in the long term, and a change is needed in order to stabilize the debt in the long run and provide ourselves a path to economic prosperity in the coming decades.

[11] Boskin, Michael. "A Note on the effects of the Higher National Debt on Economic Growth." SEIPR Policy Brief. Stanford University. October 2012.
<http://siepr.stanford.edu/?q=/system/files/shared/pubs/papers/briefs/pb_11_2012.pdf>

Luckily for policy makers here, other countries have undergone fiscal consolidation in the past, providing us examples of what policies are successful and which ones have failed. Along with two colleagues, I have written an analysis[12] exploring policy mixes in successful and failed fiscal consolidations in 21 OECD countries. Based on the evidence that we found, along with previous economic literature on the subject, we have concluded that fiscal consolidations based more heavily on expenditure cuts than revenue increases are more likely to be successful at producing lasting reductions in debt.

Using a range of different methodologies, we find that the average unsuccessful fiscal consolidation relied upon 53 percent tax increases and 47 percent spending cuts, while a typical successful consolidation consisted of 85 percent expenditure cuts. We also found that cuts to social transfers were more likely to reduce deficits than other expenditure cuts. The chart below shows the composition of average successful and unsuccessful consolidation plans, along with a few measures taken recently by other countries.



Other research has reported similar findings, most notably and earlier paper by Alesina and Perotti[13], which found that consolidations successful in reducing debt consisted of 64 percent spending cuts and 36 percent tax increases. Similarly, McDermott and Wescott[14] found in a survey

[12] Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," AEI Economic Policy Working Paper 2010-04 (2010) http://www.aei.org/paper/100179.

[13] Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects," *NBER Working Paper* 5730 (1996)

[14] McDermott, C. John and Wescott, Robert, An Empirical Analysis of Fiscal Adjustments (June 1996). IMF Working Paper, Vol. pp. 1-26, 1996. Available at SSRN: http://ssrn.com/abstract=882959

of fiscal consolidations that expenditure-based consolidations had a 41 percent chance of success; while revenue-based consolidations have only a 16 percent success rate.

Recently, Alesina, Favero, and GiaVezzi have produced an analysis[15] of the effect of fiscal consolidations on growth. In examining evidence from seventeen OECD countries between 1980 and 2005, they find that consolidations consisting mainly of tax increases generally have a more negative effect on growth than policy mixes dominated by cuts in expenditures. This is important, as one great concern of deficit cutting policies is their effect on short term growth. What their research suggests is that we may be able to avoid some of the expected effects of fiscal consolidation if policy is designed correctly. Indeed, a recent analysis by Cogan, Taylor and Wolters underscores how important fiscal consolidation will be for growth in the US, even in the short term[16]. The economists studied the potential effect of a gradual reduction in spending on growth in the overall economy. Even in the short term, implementation of this debt reduction strategy, they found, would lead to an increase in GDP, and the level of the overall economy remains higher than a baseline without deficit reduction in the long run.

Alesina and Ardagna added to this research by looking at how other policies adopted with fiscal consolidation can help or harm growth. Along with confirming that cutting expenditures was preferable to increases in taxes, they find that pro-growth reforms, such as labor market liberalization, can mitigate some negative outcomes of fiscal consolidation policies[17]. These lines of research, based upon previous fiscal consolidations and their outcomes, can inform the debate today about what policy mix we should aim for in addressing the growing debt.

Under current law, the fiscal cliff consists of about 80 percent revenue increases, with an estimated increase of $492 billion dollars in tax increases and $123 billion in spending cuts. This differs greatly from those consolidations that the economics literature identifies as successful. The proposal put forward by President Obama is even more unattractive and, indeed, would be guaranteed to fail given our past experience.

It is easy for an economist to design a reform that puts the U.S. back on a positive and sustainable economic path. I understand how difficult the politics of spending reduction can be, but if deficit reduction is pursued with a "balanced approach" that is weighed heavier on tax increases than about 15 percent, then the consolidation will almost surely fail. At that point, the pessimistic growth outlook discussed above would become a reality, and our children would live in a fundamentally different America than the one we are accustomed to. The stakes could not be higher.

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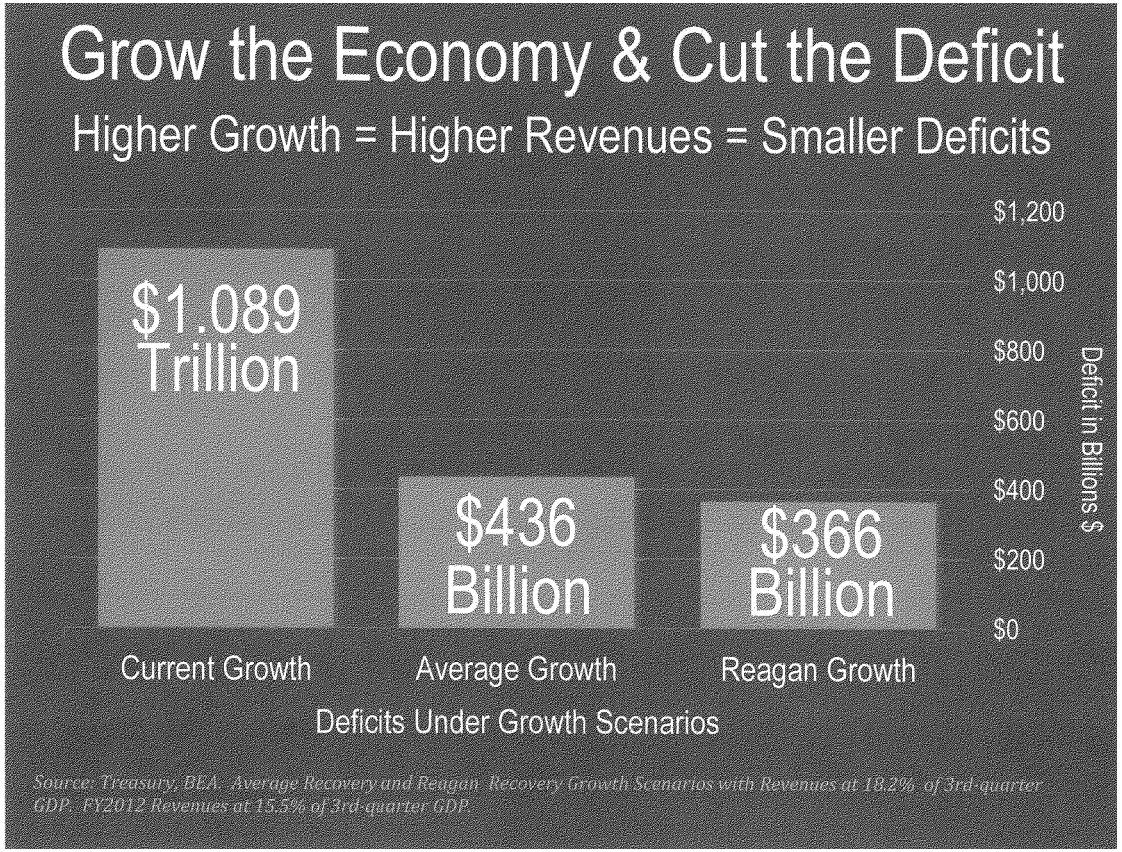
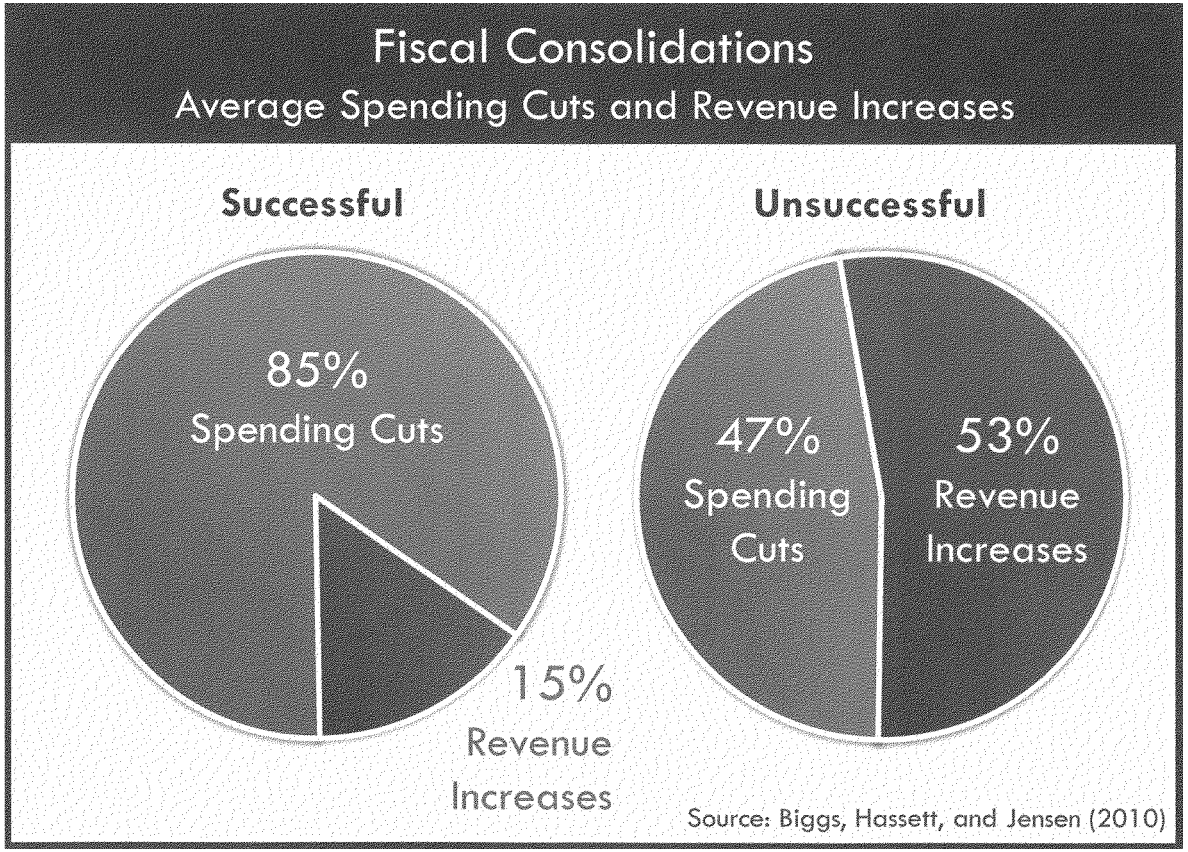
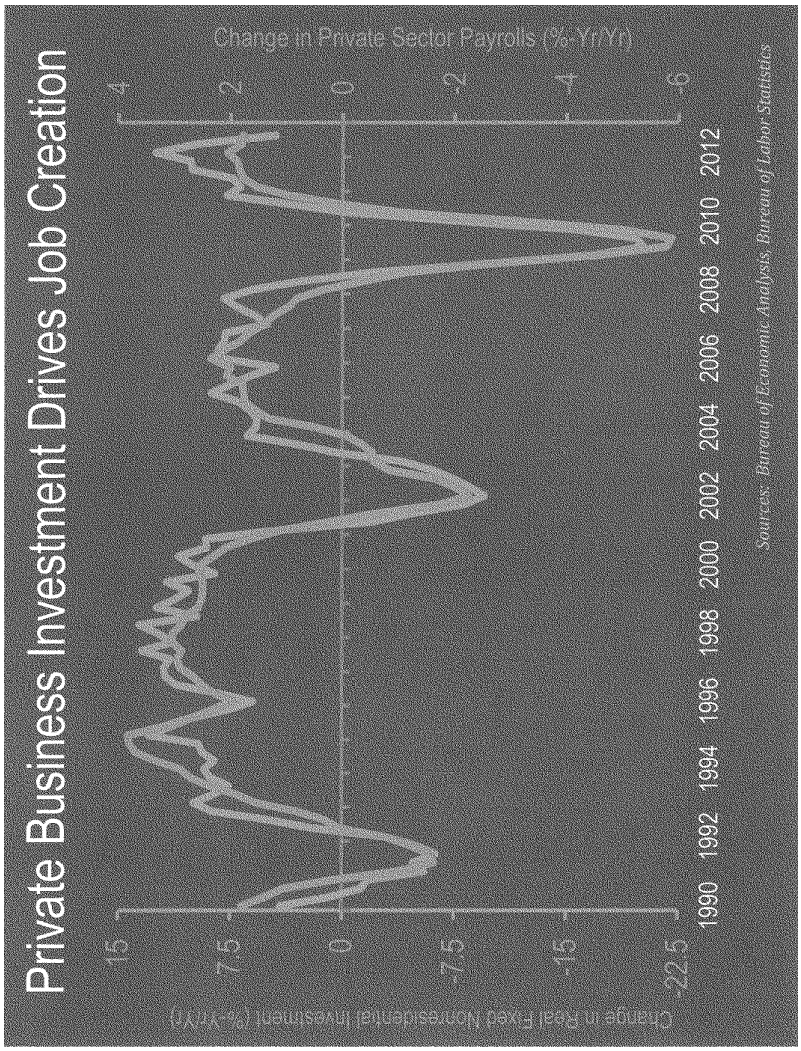
[15] Alesina, Alberto, Carlo Favero and Francesco GiaVazzi, "The output effect of fiscal consolidations", August 2012. NBER Working Paper 18336.

[16] Cogan, John F., John B. Taylor, Volker Wieland, and Maik Wolters, "Fiscal Consolidation Strategy" September 21, 2012

[17] Alesina, Alberto and Silvia Ardagna, "The Design of fiscal adjustments", October 2012. NBER Working Paper 18423.


Grow the Economy & Cut the Deficit
Higher Growth = Higher Revenues = Smaller Deficits
$1,200
$1,000
$800
$600
$400
$200
$0
Deficit in Billions $
$1.089 Trillion
$436 Billion
$366 Billion
Current Growth
Average Growth
Reagan Growth
Deficits Under Growth Scenarios
Source: Treasury, BEA. Average Recovery and Reagan Recovery Growth Scenarios with Revenues at 18.2% of 3rd-quarter GDP. FY2012 Revenues at 15.5% of 3rd-quarter GDP.


Fiscal Consolidations
Average Spending Cuts and Revenue Increases
Successful
85%
Spending Cuts
15%
Revenue
Increases
Unsuccessful
47%
Spending
Cuts
53%
Revenue
Increases
Source: Biggs, Hassett, and Jensen (2010)


Private Business Investment Drives Job Creation
Change in Private Sector Payrolls (%-Yr/Yr)
Change in Real Fixed Nonresidential Investment (%-Yr/Yr)
15
7.5
0
-7.5
-15
-22.5
4
2
0
-2
-4
-6
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics

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