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HOW THE TAXATION OF LABOR AND TRANSFER PAYMENTS AFFECT GROWTH AND EMPLOYMENT

HEARING

BEFORE THE

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WEDNESDAY, MAY 16, 2012

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

The committee met, pursuant to call, at 2:15 p.m. in Room G–50 of the Dirksen Senate Office Building, the Honorable Kevin Brady, Vice Chairman, presiding.

Senators present: Bingaman.

Representatives present: Brady, Burgess, Duffy, and Mulvaney.

Staff present: Conor Carroll, Gail Cohen, Colleen Healy, Patrick Miller, Matt Salomon, Robert O'Quinn, and Steve Robinson.

OPENING STATEMENT OF HON. KEVIN BRADY, VICE CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Vice Chairman Brady. Good morning, everyone.

I want to welcome you to the hearing on "How the Taxation of Labor and Transfer Payments Affect Growth and Employment."

Today the Joint Economic Committee is holding the second of two hearings on how taxes affect America's economy. This hearing is on the taxation of labor. The first hearing was focused on the taxation of capital.

My goal, as Vice Chairman of the Joint Economic Committee, is to ensure that America has the strongest economy in the world throughout the 21st Century. To do that, we have to get our monetary policy right, our fiscal policy right, our regulatory policies right, and open new markets to American exports.

A sustainable fiscal policy requires more than just closing the trillion dollar gap between federal spending and federal revenues. A sustainable fiscal policy requires economic growth.

A growing economy improves our fiscal outlook by increasing federal revenues and reducing federal spending relative to the size of our economy.

Sadly, however, economic growth and job creation is lagging under President Obama. To understand how poorly our economy is performing compared with its potential, let's look at this chart and compare the big government-oriented, I think, Obama recovery to the free-market-oriented Reagan recovery.

From its low point in February of 2010 following the recent recession, the Obama recovery produced private sector job growth of

4 percent. Over the comparable time frame, the Reagan recovery far eclipsed the Obama recovery with 10.1 percent private sector job growth.

If President Obama had had the same growth rate of private sector jobs as President Reagan enjoyed, we would have over 6.5 million more jobs today. That is more than one job for every two workers currently counted as unemployed.

From its peak in October 2009, the unemployment rate has declined by 1.9 percentage points under the President. Over the comparable time frame, the unemployment rate dropped by 3.4 percentage points under President Reagan.

Under President Obama, the average GDP growth—real GDP growth rate has been 2.4 percent over the 11 quarters following the recession. Over the comparable time frame, President Reagan delivered an average real GDP growth rate of almost three times that amount, 6.1 percent.

More than anything, hardworking American taxpayers need cohesive monetary, fiscal, and regulatory policies that encourage business investment—business investment in new buildings, equipment, and software. Joint Economic Committee Republicans have shown that such private sector business investment is the key to robust economic growth and private sector job creation.

Leading economists believe that taxes affect the incentive to work, the incentives to save, and invest. Thus, federal tax policy not only determines how much the Federal Government collects, but also how much the U.S. economy grows and how many jobs are created.

Other economists seem to believe taxes don't really matter. In their view, one tax increase to reduce the federal budget deficit is just as good as another.

The purpose of this hearing is to examine the empirical evidence offered by both sides of this thoughtful debate.

In his written testimony, Dr. Rogerson presents evidence that taxes on labor substantially reduce employment and economic output. When these taxes are used to fund transfer payments and social services, the adverse effects on jobs and economic growth are even greater.

Dr. Biggs presents evidence that these adverse effects depend in large part on the specific tax and benefit rules of each entitlement program. Older workers are especially sensitive to the marginal net tax rate. That is the additional after-tax income received in exchange for working and paying taxes an additional year.

For his part, Dr. Johnson presents evidence that our taxes are lower than they have been at times in the past; and they are lower than many other countries' taxes today.

The question we face today is whether tax policy really matters. Can Congress allow the tax reductions of 2001 and 2003 to expire without any adverse effects on jobs and economic growth?

Would this be, as many leading economists and my Republican colleagues have suggested, a "taxmageddon"? Or, as President Obama and many of my Democrat colleagues contend, can Congress increase other federal taxes on the businesses and the "wealthy" with economic impunity?

Should Congress instead focus on fundamental tax reform and carefully consider which tax policies will provide the greatest boost to long-term growth and job creation in the private sector?

Hopefully, today's hearing will help us answer those significant questions. I look forward to the testimony of our distinguished witnesses.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 30.]

[Chart titled "A Tale of Two Recoveries" submitted by Representative Brady appears in the Submissions for the Record on page 31.]

Senator, would you like to make an opening statement?

Senator Bingaman. I did not plan to make an opening statement. I appreciate the witnesses being here. I look forward to hearing their testimony, and then I will have some questions. Thank you.

Vice Chairman Brady. Thank you. And, Senator, thank you for being here today, as well as the witnesses joining us at the table.

I would like you to just be aware that we are reserving five minutes for the written testimony, or for the verbal testimony. We want to make sure your full testimony is written into and subjected into the record.

With that, Dr. Rogerson, you are recognized.

STATEMENT OF DR. RICHARD ROGERSON, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY, PRINCETON, NJ

Dr. Rogerson. Thank you.

So I would just like to make a few verbal comments summarizing what was in my written testimony, consistent with just the comments we heard.

My written testimony is concerned with the basic question of long-run size of government, the activities the government is involved in, how they are financed, and what the consequences of that are for the overall performance of the U.S. economy.

Most importantly, the issue is the size—government needs to be financed. As a practical matter, most of the financing of government comes from taxation on labor. And a key question is: To what extent do taxes on labor provide a disincentive for individuals to work?

We all know that in terms of our material wellbeing in the United States, that is critically related to the level of economic activity. Labor input is a key input into producing output in the U.S. economy.

If we have policies which discourage people from working, that will reduced the amount of output produced and lead to lower material standards of living. So that is the issue.

I want to start with—I am going to basically talk about some empirical evidence—but before i do that, I do want to make one small comment about the kind of underpinnings in economic theory. And I think this is critical, for the following reason:

There is a tendency I think for people to talk in generalities about taxation on labor, as if you tell me what the tax on labor is and I can tell you what the effects are, and there may be controversies about that.

What I want to emphasize is that economic theory tells us very clearly that, if you want to think about the effect of what taxes on labor income do to economic activity, you have to also talk about what the revenues from that labor taxation are being used for. And in particular, I will contrast two different types—two different scenarios.

One scenario is when the revenues are being used either as direct cash transfers—for example, things like unemployment insurance, disability, social security; or, alternatively, I'll say something like defense, which is not something that individuals would necessarily go out and buy on their own if the government were not providing it.

The theory tells us that the large effects we find are when the labor revenues are being used to fund transfer payments, either cash transfers to individuals, or provision of services that people would have purchased on their own.

So when we look for evidence of labor taxes on economic activity, we have to do it with an eye towards how revenues are being used.

Now having said that, where should we look for evidence? Economists to a large extent make their living by trying to do very detailed studies based on extensive data sets. What I want to simply point out here is, I think the simplest, most transparent place to look for data is what economists call "natural experiments." We would like to find a situation in some country where there was a sizeable increase in the taxes on labor used to fund transfer payments, holding everything else constant. That would give us kind of clean evidence of what happens in response to those types of effects.

In reality, it is relatively difficult to find those types of clean experiments. One of the issues which I think has clouded the inference that people make from making at the data is some people look at the U.S. historical record, the last 50 years. They claim that there are different times when there have been changes in taxes on labor, and they try to infer from what they saw happening in the U.S. data what the effect of those taxes are.

But in fact, in the U.S. the changes in those taxes have been relatively small. There are all kinds of other things that have also gone on in the U.S. economy—in particular, demographic change, the entry of women into the labor force for I think reasons unrelated to taxes which cloud conclusions. So in my testimony, what I argue is the best source of evidence for people in the U.S. is to actually look outside the U.S. where other countries have had much larger changes in labor taxation to fund transfer programs.

In my testimony I talk about looking at a study of 15 OECD countries between 1960 and 2000. And just as a punch line that comes out of that, I find that a 10 percentage point increase in taxes on labor used to fund transfer payments is consistent with a decrease in labor supply of about 12.1 percent.

This, in terms of a simple experiment, if there was a small increase in the size of the U.S. Government funded by labor taxes, the magnitude of the jobs lost is similar to the jobs lost during the most recent Recession.

I will stop there.

[The prepared statement of Dr. Richard Rogerson appears in the Submissions for the Record on page 32.]

Vice Chairman Brady. Thank you, Dr. Rogerson. Dr. Biggs.

STATEMENT OF DR. ANDREW G. BIGGS, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. Biggs. Vice Chairman Brady, Senator Bingaman, Members of the Committee:

Thank you for the opportunity to testify today with regard to the effects of taxes and transfer payments on labor supply and employment.

The 12.4 percent Social Security Payroll Tax on earned income is the largest tax paid by most Americans. Social Security benefits, which are paid in exchange for payroll taxes, are the largest source of income for most retirees. The potential for Social Security taxes and benefits to influence labor supply decisions is obvious.

The theory of Optimal Taxation states that taxes should be highest in circumstances in which individuals are least sensitive to the tax, and lowest when individuals are most sensitive to tax rates.

Following this rule will tend to minimize the harmful effects of taxation on work and the economy. Social Security's treatment of older workers is precisely the opposite of what economic theory recommends.

Social Security pays the lowest reward to work to older workers who are near to retirement. These individuals, research indicates, are almost the most sensitive to tax rates because they have the easiest option to leave the workforce and retire.

The conjunction of high effective tax rates on particularly tax-sensitive individuals leads to suboptimal outcomes for individuals and for the economy as a whole.

Social Security's benefit formula is roughly actuarially fair for individuals who choose to delay claiming benefits. However, Social Security is not actuarially fair with regard to the extra taxes the individuals pay when they delay retirement and remain in the workforce.

Most near-retirees who extend their work lives receive little or no additional benefits for any extra taxes they pay. There are three reasons for this.

First, Social Security benefits are based upon an individual's highest 35 years of earnings. So an additional year of work is unlikely to boost benefits.

Second, most female retirees receive a spousal benefit based upon their husband's earnings. So any additional taxes they pay rarely lead to higher benefits.

Third, once individuals reach the full retirement age, they are ineligible for Social Security Disability Benefits but must, nevertheless, continue to pay the 1.8 percent Disability Payroll Tax.

In a 2009 research paper with David Weaver and Gail Reznick of the Social Security Administration, I found that for each dollar of additional taxes a near-retiree pays into Social Security, he or she receives back only around 2.5 cents in extra lifetime benefits.

Simply put, Social Security provides almost no incentive to keep working. This would not be of major policy importance if near-retirees were not so sensitive to tax rates.

A middle-aged worker with a family to support may continue working even in the presence of high implicit tax rates. But once he or she reaches age 62, the option to retire becomes more attractive.

Moreover, most retirees receive pension and Social Security benefits which can increase the marginal income tax rates they pay on earned income. Economic research finds that older Americans are significantly more sensitive to after-tax rewards to work than younger workers.

I have proposed reducing or eliminating the Social Security Payroll Tax for older workers as an incentive to remain in the workforce. Doing so would lower Social Security tax revenues, but an increased labor supply from older workers would raise other revenues such as for federal income taxes, Medicare Payroll taxes, or state income taxes.

Eliminating the Payroll Tax for workers over age 62 would reduce annual Social Security revenues by roughly 2.2 percent, or about $16.2 billion in terms of today's tax collections.

Using parameters from research by Eric French of the Federal Reserve, eliminating the Payroll Tax at age 62 would increase overall labor supply by around 1.4 percent. A larger workforce would increase federal income and Medicare taxes by around $14.7 billion, with an additional increase of state income tax revenues of around $3.6 billion.

In other words, eliminating the Payroll Tax rate on older workers would effectively pay for itself through additional tax revenues. While eliminating the Payroll Tax for older workers would come at little cost to the budget, the gains to individuals and the economy could be substantial.

Simply working one additional year would boost average private pension income by almost 5 percent. This would reduce poverty in old age and contribute to overall retirement income security.

Social Security's poor returns to older workers discourage delayed retirement which would strengthen the economy and it's the single best option available to many individuals who reach retirement age with insufficient savings.

Policy options such as lowering the Payroll Tax rate on older workers could increase labor supply, boost the economy, and raise retirement incomes.

Thank you, very much.

[The prepared statement of Dr. Andrew G. Biggs appears in the Submissions for the Record on page 44.]

Vice Chairman Brady. Thank you, Dr. Biggs. Dr. Johnson?

STATEMENT OF DR. SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Dr. Johnson. Thank you very much.

I would like to make three points:

First of all, considerable damage has been doing to the balance sheet of the United States over the past decade and a half under a most unfortunate combination of circumstances. As a result, if we are to put ourselves onto a more sustainable and less fragile fiscal path, we need to restore revenue.

By the end of the 1990s, there was a relatively robust revenue system in the United States. Since that time, we had large tax cuts in the beginning of the 2000s, two foreign wars, Medicare Part D, and most unfortunately the financial crisis.

The Congressional Budget Office estimates that the net impact of the financial crisis on our debt relative to GDP over the cycle is to increase it by about 50 percent of GDP. Call that $7.5 trillion in today's money.

This is the situation that we find ourselves in today. And I think that the parallel with the situation in the mid- to late 1980s under Ronald Reagan is apt. President Reagan recognized under those circumstances with pressure from—perceived pressure from the bond market, and concern about the predominance of the United States and the role of the U.S. dollar, he and his Administration agreed with Congress on the need for strengthening revenue. And I think that is the moment which we find ourselves in today.

Now with regard to where you should get the revenue and the effects of that, I agree with Professor Rogerson that we should look for natural or quasi-natural experiments. And I accept his caveats about how difficult it is to find this in any historical experience, including across the OECD.

I would point out—and I have written at length, both in my testimony and in a recently published book on the effects of the Bush-era tax cuts—that the effects of those tax cuts, the reduction in higher marginal income tax rates, reduction in estate tax, and a number of other tax reductions, did not have major stimulative effects in terms of increasing labor supply, boosting productivity, or otherwise moving trend growth in the United States.

It is not perfect evidence, to be sure. But if we are talking about realistic ways in which revenue might be raised in the near term, I think not extending the Bush-era tax cuts is absolutely going to be on your agenda. And I would encourage you to look at that seriously.

That revenue is available. Going back to the revenue system of the late 1990s, again not a perfect system, no tax system is perfect, but that is an absolutely feasible and attainable political choice.

The evidence—and we reviewed this evidence that was also compiled during the George W. Bush Administration—evidence that these tax cuts would pay for themselves, or stimulated, moved trend growth in the ways that, Mr. Brady, you outlined, we absolutely have to do in this country, that evidence is very limited.

Now the third point I would make is with regard to the international context. I am the former—among other things—the former Chief Economist of the International Monetary Fund, and I would like to impress upon you the fragility of the European situation today.

I think that it will be very dangerous for the world, including for our export markets, including for financial markets with which we are deeply interconnected, if we have any kind of fiscal crisis, or perceived fiscal crisis, in the United States.

Refusing to raise revenue, or signalling that revenue is absolutely not on the table under any circumstances, can be read in a very negative manner by financial markets. These markets can turn against us very quickly.

I would remind you that the impact of the controversy and debate over the debt ceiling last year, while it did not increase yields in the United States for government bonds, it did absolutely put pressure on weaker countries around the world, including in Europe.

The last thing the Europeans need right now is further disruption to financial markets, and a more difficult environment for their government bonds.

If the United States were to take steps in a reasonable compromise—and there are a range of compromises already on the table, and we propose other versions in our book—with some combination of raising revenue, including through high tax rates, and controlling future spending, that would send an enormous signal to world financial markets. The U.S. would be propelled back to its, until recently, unquestioned predominant role in the world economy. We would again become a bastion of financial stability.

That would be a tremendous contribution towards European financial and fiscal stability. And I urge you to take seriously—consider seriously the policy that would lead us towards a more balanced approach to restoring revenue and underpinning fiscal stability and bringing the debt to GDP under control in the United States.

Thank you very much.

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

Vice Chairman Brady. Thank you, Dr. Johnson.

Can I ask my fellow members for a point of privilege here? I was remiss in not keeping with me the bios of our three distinguished witnesses today. I would like to briefly tell you about the people we just heard from because I think it is important.

Dr. Richard Rogerson is a Professor of Economics and Public Affairs at Princeton University. He also serves as co-editor of The American Economic Journal Macro Economics and is Associate Editor of Review of Economic Dynamics. He previously served as coeditor of the American Economic Review and Associate Editor for the Journal of Monetary Economics. He is a Visiting Scholar at the American Enterprise Institute; a Research Associate at the National Bureau of Economic Research; and a Fellow of the Econometric Society.

Dr. Rogerson, thanks for traveling to be with us today.

Dr. Biggs is a Resident Scholar at the American Enterprise Institute here in Washington. His work at AEI focuses on Social Security reform, as is clear from his testimony; state and local government pensions, and comparisons of public and private sector compensation. Prior to joining AEI he was a Principal Deputy Commissioner of the Social Security Administration. In 2005 he worked on Social Security reform at the National Economic Council. In 2001 he was on the staff of the President's Commission to Strengthen Social Security.

Dr. Biggs, thank you.

Dr. Johnson, I would like to welcome as well. He is the Ronald A. Kurtz Professor of Entrepreneurship, Professor of Global Economics, and management of MIT's Sloan School of Management. He is also a Senior Fellow at the Peterson Institute for International Economics, a member of the Congressional Budget Office's Panel of Economic Advisers; and a member of the FDIC's Systemic Resolution Advisory Committee, among other honors.

Dr. Johnson, thank you for being here.

Let me get to the heart of the matter.

[Pause.]

Votes have been called. We will be brief. I thought all three testimonies were very interesting.

Dr. Biggs, if more seniors read your analysis of the cost/benefit analysis of working late in life and Congress does not take steps to reform, I think we have got a bigger challenge on our hands with Social Security than we do today.

Dr. Rogerson, your point goes to the heart of does taxation on labor matter. Your point is that over the last 40 years, that labor taxes in America—or frankly, labor taxes among our OECD competitors, have risen at three times the rate of the United States.

As a consequence, worker hours worked among those same competing countries, while ours have increased, on average our OECD competitors' hours have decreased. And it has a direct economic consequence as a result.

You make the point that if the tax rate on labor is increased by 10 percentage points, hours of work will decrease by 12.1 percent.

Another way to look at tax rates is to calculate the after-tax return. My question is: If the tax rate is 25 percent, and the after-tax return is 75 percent, I asked my staff to recalculate your data on that basis. They concluded that a 10 percent change in the after-tax return to labor would result in 12.1 percent change in hours worked. Would that be consistent with your results?

Dr. Rogerson. Yes, definitely. Those are two different ways to summarize the patterns that are in the data. So those two estimates are in fact consistent with each other.

Vice Chairman Brady. And the net result is if you raise taxes on labor you get less of it and fewer jobs as a consequence?

Dr. Rogerson. Yes. With the caveat that the—it depends what the revenues are being used for——

Vice Chairman Brady. Sure.

Dr. Rogerson [continuing]. And across countries the revenues are being used either for transfer payments, or provision of services in kind. So that is implicit in those estimates.

Vice Chairman Brady. Sure. Right. Thank you. I wanted to be brief because of the vote.

Senator Bingaman.

Senator Bingaman. Since there is a vote on the House side, maybe you would want some of the House Members to go ahead with their questions, because we do not have a vote and I can stay when you folks have to go vote.

Vice Chairman Brady. Great. Thank you, Senator.

Dr. Burgess.

Representative Burgess. Yes, we have noticed they do not vote often in the Senate.

[Laughter.]

Sorry. I couldn't resist.

Let me just ask a question because it is the point of some discussion. The Speaker gave a speech yesterday at the Peterson Foundation and talked about the fact that we all knew December of this year was likely to be a pretty dreadful month, and it is his opinion that we ought to move things out of the so-called lame duck session and tackle those problems during the time that we have left, between now and the election. And I agree with him.

I may not agree with everything that he outlined, and I rather suspect our panelists do not agree with everything that he outlined, but fundamentally do you think that is a more coherent approach to the problems that face this country? What with the expiration of existing tax policy, the Bush-Obama tax cuts, the possibility of facing yet another debt-limit crisis toward the end of the year, should we move this forward and get it done during the summer, or during the early fall? And I would appreciate an answer from each of you.

Yes, Dr. Rogerson, we will start with you and then move down.

Dr. Rogerson. Okay. I mean, my view on that issue is I believe uncertainty is bad for the economy. And so when there are important decisions to be made, rather than let them sit and people be worried about what may happen, I think it is important to take action. So from that perspective, taking action sooner so that individuals and businesses can understand what they're going to be working with moving forward, I think that makes good sense.

Representative Burgess. Right. It is not like these things are not going to happen.

Dr. Biggs.

Dr. Biggs. I agree with Professor Rogerson regarding uncertainty. I think I would just add that I am not an expert on the political process, but it strikes me that the longer people from both parties have time to consider the sorts of choices and the sorts of compromises they might have to make, the more likely it is an agreement can be come upon.

So beginning today, and talking as much as you can today, I think is more likely to produce a good outcome than pushing it all to December and then trying to rush it through at the end.

Representative Burgess. Well that is typically what we have done.

Dr. Johnson.

Dr. Johnson. I think it depends on what sort of deal you think you could come up with in the interim, Dr. Burgess. If revenue is on the table. If you have a balanced approach to bringing the debt under control, this would amazingly shock and impress world financial markets. And you would substantially remove the risk of a fiscal crisis in this country for the foreseeable future.

But if revenue is completely off the table, if this kind of debate would just reaffirm that, that one part of the political spectrum will not compromise or change its view with regard to tax rates and bolstering revenue, then I fear that the financial markets may take that adversely. So you would resolve the uncertainty, to be sure, but resolve it in a negative direction with regard to medium-term fiscal sustainability.

Representative Burgess. Let me just ask you a question, Dr. Johnson. In your testimony you said that the expiration of existing tax policy would be desirable.

Now when the President talks about it, he talks about preserving existing tax policy for people who earn under $250,000 a year for a couple. Is it your view that the entire existing tax policy from 2001 d 2003 needs to go away?

Dr. Johnson. Yes. What exactly our view is is that the so-called Bush-era tax cuts—perhaps we should call them the Bush-Obama tax cuts now—should not be extended. And if you feel that the effect, short-term effect on the economy would be too dramatic, I would propose that you replace that with a temporary payroll tax linked to employment relative to total population.

So as employment recovers, the payroll tax would fade away. That is a way to offset the anti—if you want to be Keynesian about it, and I do not particularly urge a Keynesian perspective here, but if you want to take a Keynesian perspective then you could replace the effects of those expiring tax cuts with the temporary payroll tax cut linked to a rule.

Representative Burgess. Well suffice it to say we are not going to come to a conclusion today, but I appreciate all of your views on that. And this is something that again I am glad the Speaker brought it up because we do need to face it. Although it may be politically unpalatable to do so before election day, it needs to happen.

I will yield back, Mr. Chairman.

Vice Chairman Brady. Thank you, Dr. Burgess.

Mr. Mulvaney.

[No response.]

Mr. Duffy.

Representative Duffy. Thank you. I want to be clear, Mr. Johnson, as well. When we—we talk about allowing the Bush tax cuts to expire, how much revenue would that bring in in the first or second year of that expiration?

Dr. Johnson. Well the usual time frame for the numbers used are $4 trillion over 10 years. And roughly speaking, you would expect that to be evenly spread over the 10-year period. So that is a substantial amount of revenue.

But the key thing, and the contrast that I would emphasize between our situation and let's say the European situation, is that we do not need to make a precipate, immediate fiscal adjustment. We have time to get our debt onto a more sustainable path.

I recommend bringing debt down to 40, 50 percent of GDP. And as a result, taking that revenue more gradually through some sort of offsetting temporary tax cut could also be considered to be entirely reasonable fiscal policy. The point is to change the medium-term forecasted future.

Representative Duffy. So roughly, you're saying, about $400 billion a year, is that right, would come in in revenue for these increased tax rates?

Dr. Johnson. That is the standard CBO calculation.

Representative Duffy. And the rest would come from tax cuts? I'm sorry, spending cuts? You're proposing spending cuts as well, right?

Dr. Johnson. We are proposing to limit future increases in spending and, at least in our framework you do that over a two-decade horizon. So you can phase in some of those spending cuts. You can also begin to limit tax expenditures.

Representative Duffy. Is that Medicare reform? Social Security reform? Is it the military? What do you guys look at?

Dr. Johnson. All of the above.

Representative Duffy. Okay. And in your analysis, when we allow tax rates to increase there is an offsetting impact on the economy? Isn't that right? The economy does not grow more with tax increases? It would probably grow less? Is that right?

Dr. Johnson. Presumably—look, nobody likes high taxes, and higher taxes must have some distortive effect. But the question is: How much effect do they have?

This is not a high-tax country. These are not—we are not—our experience with these tax rates is not consistent with the view that they have caused a major slowdown.

Representative Duffy. But you would agree that if you raise taxes, that that will have a slowing effect on the economy? It does not grow the economy more? It would grow it less? Increased taxes, yes?

Dr. Johnson. Well actually in the standard CBO framework, the question is: What is the medium-term picture for the deficit?

So if you are cutting taxes and have a larger deficit as a result, that in the CBO framework will actually slow growth because you are crowding out private investment as you issue more government debt.

Representative Duffy. Is your testimony, then, that if we raise taxes we will increase American growth?

Dr. Johnson. My testimony is that what you need—as the Chairman said at the beginning—is a sustainable fiscal future consistent with economic growth. And in order to do that, you should constrain, for sure, future spending; and strengthen revenue in part by increasing tax rates.

Representative Duffy. And isn't the best way to strengthen revenue to the federal coffers a growing economy? I mean, doesn't a growing economy have a far better impact on revenues to the federal coffers, as opposed to tax increases?

I mean, if you look at correlations in American history with regard to growing economies and tax increases, don't you have a better correlation with growing economies which mean more people are working, more people are making more money, which means more people are paying taxes? As opposed to raising tax rates?

There is not that correlation, is there?

Dr. Johnson. Of course we want to have economic growth. But as the Europeans have discovered, if you run persistent deficits and you refuse to fund the government on a responsible basis, you get a fiscal crisis. Bond yields go up. Private credit contracts. That is the worst possible thing to do for economic growth.

Representative Duffy. And I would say that we are in a global economy. I think it has changed over the course of the last 10 or 12 years. There is far more competition from India, China, Mexico, Vietnam, Brazil, Canada. And I guess I would look at it like this:

You know big box retailers, right? Wal-Mart, Target, Kmart? If you were to advise Kmart today, you say: Kmart has to bring a little more revenue to keep their stores open. Your advice to Kmart would be to bring in more revenue, you would have to raise the price of the goods that you are selling by 2 percent, 5 percent. And if you raise your prices of the goods sold, that will bring in more revenue.

But everyone here knows that if Kmart raises its prices, right, you will see shoppers go to Wal-Mart and Target. If we raise the price of doing business in America, doesn't that also drive business elsewhere in the world from American shores to China, India, Mexico, other parts of the world that are more competitive?

Dr. Johnson. Congressman, we certainly have to worry about competitors. You are absolutely right. It is a globalized world, and globalized financial markets. If the financial markets decide that you do not have a responsible fiscal policy, if they are concerned about the sustainability of your debt, that is the worst shock of all. That is where the Europeans are.

These are rich, proud countries. These are our competitors in Europe who have inflicted upon themselves an awful fiscal disaster that absolutely is going to undermine growth for the foreseeable future. We do not want to go there, and we do not need to.

Representative Duffy. And I would agree with that. But I do not think we get there by raising—I mean, I think we have done a study here where you could raise your top tax rates on the two top brackets to 100 percent and you still could not balance your budget.

So we think we have to grow our economy, number one, and reduce our spending. And my time is up and I yield back.

Vice Chairman Brady. Thank you, sir.

The House Members will be going back to the Chamber to vote, and I will yield to Senator Bingaman for questioning.

Thanks.

Senator Bingaman [presiding]. Thank you very much.

I am advised that I should ask my questions, and then we will put the hearing in recess until the Vice Chairman Brady can return. And he will be back in just a few minutes, as soon as they vote in the House.

Let me ask a couple of questions that have occurred to me, just hearing the discussion here. If the concern is to have a robust, growing economy, raising taxes can interfere with that; cutting spending can, as well. The proposed spending cuts would also drag down our economic growth, as I understand it.

Are those two roughly comparable in the effect? In other words, do policies that raise additional revenue through tax increases and policies that cut spending have a comparable effect on the growth rate of the economy?

Dr. Johnson, I would ask you first.

Dr. Johnson. Yes, Senator, in the short term they are roughly comparable. If you consider what the European discussion is right now about austerity, in some European cases they are cutting spending. In other European cases, they are raising taxes.

If you do either one of those in a forced, precipitant manner, that will, generally speaking, have a contraction effect on the economy, depending on what else is going on.

Over the medium term, the task of the United States is to control spending, control it as a percent of GDP; not to cut it dramatically in a way that would damage the economy. Control spending and make sure that it is funded more completely with revenue.

We have relied a lot on issuing debt in the past decade-and-a-half. Half of our national debt is now owned by foreigners. That is not a sustainable situation. Sooner or later the Asian economies and oil-producing economies will save less and/or there will be competing currencies in which people can put these investments when they want to invest internationally.

We should have a more sustainable funding basis for the activities of the Federal Government, including the social insurance programs—Social Security, Medicare, other forms of health care funded through the government in the form of insurance for people who cannot afford health care otherwise. That has to be funded on a sustainable, realistic, and reasonable basis.

Senator Bingaman. Let me ask about payroll tax cuts. The conventional wisdom here in Washington is we are not going to extend the payroll tax cut at the end of this year, when it is due to expire. The President's budget does not propose to extend this tax cut beyond 2012, and Members of Congress have given speeches saying the payroll tax should go back to where it was, 6.2 percent on the employee, 6.2 percent on the employer. It still is 6.2 percent on the employer right now. But they are saying at the end of this year, we should go back to that level of taxation on employees.

The debate is now about what do we do about the income tax cuts—the so-called Bush tax cuts or as some have called them today the Bush-Obama tax cuts since they were extended a couple of years under President Obama.

My impression is that if you want to maximize employment in a society, you would try to find a way to keep the payroll tax as low as possible, and you would get your revenue from somewhere else on an ongoing basis.

I know that the argument is made now that we've got to go back to the previous level of the payroll tax in order to fund the Social Security Trust Fund, but there are bound to be alternative ways to put funds into the Social Security Trust Fund if the economy would benefit substantially from keeping the payroll tax low on the workers themselves.

Dr. Rogerson, do you have some thoughts about whether it makes sense for us to contemplate some way to keep the payroll tax from going back to where it was?

Dr. Rogerson. The main comment I would make is that in a—there are issues about what happens in the immediate aftermath of the change in terms of how long it takes various prices and such to adjust from a long-run perspective, conditioned upon talking about raising money from taxing labor whether it is labor income tax, the establishment part of the payroll tax, or the worker side of the payroll tax, to first approximation I view all of those as the same.

Senator Bingaman. So with regard to the long-run effect on the economy, it does not matter whether we get the revenue from letting the payroll tax go back to where it was, or get the revenue from increasing the income tax?

Dr. Rogerson. Yes. As I say, the first approximation there are—if we go into additional level of details, there are some distributional consequences because of the structure. So there are issues about if you are just increasing the payroll tax in its current form, of course it is capped at a certain income.

If you are talking about changing the income tax on labor, there is the question about how you do that across the income spectrum. But assuming you are sharing the burden of that taxation equally in the two systems, whether it comes from payroll or taxing income from labor I say is neutral.

Senator Bingaman. Yes, Dr. Johnson.

Dr. Johnson. Well, Senator, as you know, the original presentation of Social Security under President Roosevelt was very much as a social insurance program; that you are paying in and you are getting it out. We are insuring you against outliving your other assets and your family's ability to survive you.

And I think that that motivation and explanation for Social Security is very important to keep in place. Social Security is mildly regressive on the taxation side because we do not tax all of your income, or even all of your labor income. I should think the cap should be lifted, or indexed more appropriately, but not removed completely.

And it is a somewhat progressive policy on the receipt of Social Security. So it is a mildly progressive, but not massively progressive, or redistributive policy. And I do not think you should shift the burden of financing that away from the payroll tax onto income tax, where income taxes, as you know, are paid more by middle income and higher income Americans.

I think people value the fact that they are paying into the system, and they get out a form of social insurance both for Social Security and for Medicare. Medicare is the same motivation. We are insuring you against ill health when you are in your 70s, 80s, and 90s, because there has never been private insurance that will cover you for those risks, and there never will be, irrespective of what you try and do to the health care system. Those are uninsurable risks from a private perspective. Therefore, you have a social insurance program which you fund appropriately.

Senator Bingaman. Let me ask both Dr. Rogerson and Dr. Johnson to give me their reaction to the proposal that Dr. Biggs has made. As I understand it here, it is essentially saying that the payroll tax should not apply to a person when they reach the age of 62 and are then eligible for Social Security. He sees benefits in keeping people in the workforce, allowing them to build up additional pension, value if we provide that incentive. He says the current system of payroll tax, as I understand it—and correct me if I am misstating your position, Dr. Biggs—but as I understand what your point is, that the current payroll tax is a disincentive for folks who stay in the workforce once they are 62 years old? Is that accurate?

Dr. Biggs. That's correct. For younger individuals, the payroll tax shouldn't be a significant disincentive because they're aware that they are earning benefits that compensate for the taxes they are paying.

For people who are near retirement, on average they earn almost no additional benefits. So the Social Security Payroll Tax would be what you would call a "pure tax." It is money they pay that they are never going to get back. When you have the option of retiring, that makes retiring seem more attractive relative to working.

Senator Bingaman. And your proposal is that at age 62 they would no longer be required to pay the worker's portion of the payroll tax? Is that what you are suggesting?

Dr. Biggs. To make the system actuarially fair for individuals in that age range, you would have to eliminate both the employee and the employer side of the tax, the full 12.4 percent.

Senator Bingaman. I see. So what is your reaction to that kind of proposal, Dr. Rogerson?

Dr. Rogerson. I guess the most general comment I would make is that, as Dr. Biggs has testified, the details of benefit programs such as he is talking about I think are very important. They can have very large incentive effects.

Just to draw on some cross-country evidence, the U.S. system of paying out is quite different than what exists in some other countries. In some countries, for an individual to receive their social security they actually have to stop working at their existing job.

A system such as that creates a huge incentive for individuals to stop working at a point where the benefits that are eligible to them have been maxed out and may well be as large as the income they get from their job. There is simply no benefit to working.

So I think those types of institutional details exist in other countries. What Dr. Biggs has talked about is that type of detail. It is a little bit of a smaller scale in the context of the U.S. system, but I agree with the idea that we need to be very careful about the incentives for work as they apply to workers in those situations.

Senator Bingaman. Dr. Johnson, did you have a point of view on Dr. Biggs's proposal?

Dr. Johnson. Well I agree that we should encourage people to work longer. And one of our proposals is, in the context of strengthening Social Security and raising revenue to support it, we should also index the age at which you can receive a full pension to life expectancy.

Americans who are 65 today should expect to live 3 years longer—this is on average—3 years longer than Americans who were 65 in 1970. So, roughly speaking, Americans could retire one year—under our proposal, retire one year later every generation, one year later than your parents retired.

Senator Bingaman. So you are saying that that indexing should occur with regard to Social Security benefits?

Dr. Johnson. With regard to the age at which you could receive a full pension, not the age at which you can begin to receive a pension which would remain at 62.

Now on Dr. Biggs's proposal, which I think is interesting, I need to study it further. I think I would have some questions about the behavioral basis on which people make this decision of whether to continue working when they are older.

Certainly some older Americans take the view that they are, through the additional income they are earning from their job, that they are helping to protect themselves against let's say a tail outcome of living a very long time. And there are many Americans who want to continue to work until the age at which they can absolutely get the maximum benefit.

So I think there is one issue of what is actuarially fair. There's another issue of the basis on which Americans, older Americans, make those decisions. And I think we should look at that.

We have had great success in extending life expectancy. We need to avoid becoming a society in which people retire younger and younger. That is one of the mistakes that has been made in Europe. We have not gone that route. I think we need to push gently in the other direction at the same time as raising the payroll tax over the medium term in order to help rebalance the Social Security Trust Fund.

Senator Bingaman. Let me ask Dr. Johnson, just so I clearly understand what you suggest in your testimony. Your suggestion is: Allow the Bush tax cuts to expire at the end of the year, as they are scheduled to, and in order to be sure that you do not have too adverse an effect on the economy, we should have some kind of a reduction in the payroll tax that would be linked to employment, and the total population? Maybe you could just explain how that, how the two would interact, and what the trigger would be for getting the payroll tax back to where it is today, or where it is scheduled to be?

Dr. Johnson. Certainly, Senator. And this proposal, I should say, has also been made by Peter Orszag, who was the former Budget Director in the Obama Administration and a former head of the Congressional Budget Office. The idea is that the payroll tax would be—you would cut the payroll tax, and you would phase it back in based on employment relative to total population.

You don't want to do it——

Senator Bingaman. Cut it from what it is today? Or from what it will become on the first of January if we do not change the law?

Dr. Johnson. Well from what it is today. If you want to have a stimulative effect relative to what it—that should be taken as the appropriate baseline. But you want to restore it, eventually, to the rate at which it was before, or we are actually suggesting that the payroll tax rates should gradually over a period of decades actually increase as a way to rebalance the Social Security Trust Fund.

And the key point is, Senator, not to link this to unemployment because the number of people who are unemployed depends on how the labor market is. People get discouraged. They drop out of the labor force. And that reduces unemployment. What you really want is to get people back to work. You want to restore employment back to where it was preferably before the financial crisis of 2008.

So the temporary payroll tax cut would be phased out as employment rises relative to the total population. There would be a formula, a rule that you would set in law, and then you would hope that subsequent Congresses did not overturn that rule. And if people believe you are not going to overturn it, then you have a credible path towards medium-term fiscal sustainability at the same time as you preserve what people may feel is a stimulative effect of the tax cuts.

Senator Bingaman. Dr. Rogerson, did you have a point of view as to what the Congress ought to do at the end of the year on the Bush tax cuts, on the payroll tax change? Or any of the other crises that we are expected to confront here at the end of the year?

Dr. Rogerson. I have a very boring answer to that. I do not have a strong view on those particular things, piecemeal. I think what is critical is to have a long-range, coherent view of what programs are going to be supported and how they are going to be financed.

And to talk piece by piece about each one individually I think is actually counterproductive, and in some ways it is hard—ultimately, we need to talk about the package of things that the government is going to do and how they are going to be financed. And you can't parcel out the effects of things one by one without knowing what is going to be adjusted to compensate.

So that is my boring answer.

Senator Bingaman. Dr. Biggs, did you have a point of view?

Dr. Biggs. Well I agree with Professor Rogerson's view that you want to think in terms of package deals, in the sense that we have to think of what we want government to do for us and what we are willing to pay for it.

With regard to the Bush tax cuts, though, I think it is worth pointing out, there is a perception that the Bush tax cuts have starved the Federal Government of revenue. And if you look historically, if you look at CBO's projections going forward, I think that is just really not the case.

I mean, historically the Federal Government has collected total revenues equal to somewhere around 18 percent of GDP. I don't have the precise figures in my head, but that is about right.

If you look at CBO's projections of federal revenues going forward relative to GDP, if you retain the Bush tax cuts they rise to record levels relative to GDP. They are around 20 percent of GDP on average.

So certainly retaining the Bush tax cuts means less tax revenues than getting rid of the Bush tax cuts. Does it mean less revenues than we have lived with in the past? The answer to that is: Clearly, no. We will have as much revenue relative to the size of the economy as we have in the past.

And so the question we have to say is: Is that enough? Or do we need more? But my main point is the idea that we are being starved of revenue, pushed below historical levels by the Bush tax cuts, I think is not correct.

Senator Bingaman. Dr. Johnson.

Dr. Johnson. Well the—just to Dr. Biggs's point, the nature of society has changed fundamentally. It is an aging society, and the major activities of the Federal Government, if we are looking out over a period of decades, is maintaining and running the social insurance programs, which as we discussed involve individuals paying in when they are young and receiving benefits, both pension and health care, when they are older.

So if you cap artificially spending levels at 18 percent, or some other number, then you are squeezing the ability of the people themselves to participate in the social insurance programs run by the government. And I am not sure why you would want to do that.

We should be ensuring that older Americans can have a reasonable retirement with decent health. This is a great achievement, one of the greatest achievements of this country. I do not see why we want to undermine that.

Senator Bingaman. Well I have heard people refer to the Federal Government as a big insurance policy with an army. And maybe that is what we are headed toward here.

I think it has been useful. Thank you all for being here and testifying. As I indicated before, Mr. Brady had asked that you please stay around for a few minutes, if you would, until he can return and ask a few more questions.

Thank you. We will go into recess here for a few minutes.

[A brief recess is taken.]

Vice Chair Brady [presiding]. Good afternoon, everyone. Thanks for understanding the delay as we finished our House votes. And we will have I think some of our Members returning for questioning, as well.

I have a question for each of you.

Dr. Rogerson, I believe you are familiar with the 2010 CRS Report that referred to the study you co-authored in 2006 published by the Federal Reserve Bank of Kansas City. Do you think the CRS Report correctly stated the findings of your study?

Dr. Rogerson. Absolutely not. The quote that I read in it was basically the complete opposite of what we claimed our findings were.

Vice Chairman Brady. Yes, that was my understanding. In fact, when we asked CRS about this at our last hearing, they admitted their report was in error. They then proceeded to give us another description of your study. You may be familiar with it. Do you agree with their latest description?

Dr. Rogerson. I do not. I have read their report and personally find it quite puzzling to try and make sense of the arguments being made in relation to what we have done. In particular, our study and the testimony I presented today are very clear about the important role of how tax revenues are used. To return to the language of kind of intermediate micro, there's income and substitution effects. If you tax somebody, there's an income and a substitution effect. When you give it back as a transfer, that undoes the income effect. You are left with a substitution effect. That is critical to the results, and they do not seem to appreciate that.

Vice Chairman Brady. Well be aware, I think CRS ought to be accurate, especially in describing other studies. So we are going to be asking for a correction, or at least an acknowledgement that in future papers that your study is described accurately.

People read these. They count on them. It matters. So thank you, Doctor.

Dr. Rogerson. Thank you.

Vice Chairman Brady. Dr. Biggs, in your testimony you said Social Security payroll taxes cannot be viewed in isolation. A key point. Benefits also have to be considered. On a lifetime basis, you say benefits are equal to 78 percent of the taxes paid by a typical couple. But for those nearest retirement, additional benefits are equal to only about 2.5 percent of the additional taxes paid.

Do you think there is any evidence that workers are aware of that significant disparity?

Dr. Biggs. Well, there's been some work done looking at how well individuals understand the Social Security rules. And they understand them a little bit better than my gut would tell me would be the case, because the Social Security Benefit formula was extremely complicated. And so no one can understand that in full.

The general incentives though, I think they do understand. And when I was at Social Security, I would occasionally talk to people. And they would ask you: What am I going to get if I continue working? And the answer I would have to give them is: Well, pretty much nothing. I mean, your benefit will be increased to account for the fact that you are delaying claiming, but the taxes you pay between today and the eventual date of retirement, very few people are going to get very much of that back.

Vice Chairman Brady. You think overall they understand it in a general sense?

Dr. Biggs. I think they do, yes. And their behavior reflects that.

Vice Chairman Brady. As opposed to—explain that a little further, "and their behavior reflects that"?

Dr. Biggs. Well, I mean if you go back to the 1950s, the typical person claimed Social Security benefits around 68. Today they claim them earlier. And there's been changes in the benefit rules, which I think would help push that. But I think there's just kind of a gut feeling of, you know, what am I getting out of this?

And when people are younger, younger folks in particular don't think they're getting very much out of Social Security but they don't have much choice. You know, if you want to eat, you have to work. And so they are going to try to work regardless.

When somebody is in a situation where they can retire, though, if they do not feel the system is paying them back in exchange for what they are paying into it, they are going to take that option to retire.

One point I would make, in thinking about our budget solutions going forward, is that raising the Social Security payroll tax rate could exacerbate this in the sense that if you raise Social Security taxes people's after-tax earnings are going to be lower. And for near-retirees, the Social Security benefit they could get is going to look more attractive relative to what they could get by working.

So by doing that, we could push more people into retirement. So there are going to be difficult choices involved with Social Security reform, but we have an aging population. If there are things we can do to keep people on the job and keep them working, that is good for the economy. It is good for the federal budget. And most of all, it is good for the people who do it.

Vice Chairman Brady. Well can I, to follow up on that, in your testimony you suggest one way to increase employment would be to eliminate the payroll tax for older workers. The obvious objection, which you identified as well, is a potential loss of revenue.

Other people have suggested that we raise the retirement age. The obvious objection there is most people want to retire sooner rather than later, even though they are living longer.

So what about both? In your view, what would be the offset of linking your payroll tax elimination to an increase in the age of eligibility?

Dr. Biggs. Well you could do transfers from the rest of the budget back to Social Security. In my testimony, I point out that the increases in federal income taxes, federal medicare taxes, and state income taxes, would roughly compensate for the reduction in Social Security revenues.

So you could simply make transfers from the rest of the budget back to Social Security. Alternately, you could——

Vice Chairman Brady. So the offset is obviously not within the mandatory side of it, but it's in the general revenue?

Dr. Biggs. That's correct.

Vice Chairman Brady. From the economic growth.

Dr. Biggs. So Social Security, by cutting the payroll tax rate, will lose revenue. The question is how much other revenue do you gain? Do you want to compensate Social Security back for it? I would tend to think you would.

Things like raising the retirement age, those will also encourage people to work longer. There is evidence that as the retirement age has shifted from 65 to 66, more people have targeted that age 66 retirement age.

So I believe in sending a whole range of signals to people that says, you know, you need to work longer but we want you to work longer. Raising the retirement age is sort of the stick of saying if you do not work longer you are going to get a lower benefit. Cutting the payroll tax rate is the carrot. It says to individuals, and it also says to employers, you know, we want you to work. we want to make it worthwhile for you to do this.

Vice Chairman Brady. Do you think—I serve on the Social Security Panel over in the Ways and Means Committee—you know, the number of people choosing to retire at 62 is pretty striking. When you talk with them, the first answer that comes out is that, I don't know about the finances of Social Security in the future; I'm frankly going to access my benefits now while I can.

Do you think that is a part of the thinking, rational expectations of a worker at that age?

Dr. Biggs. I think it's actually irrational expectations. I think that many people are thinking that. They say, I'm going to get it while I can get it.

Vice Chairman Brady. Yes.

Dr. Biggs. The political reality is, the chance of cutting benefits significantly for current retirees, or near-retirees, is pretty small. The only way you could really do that is by cutting cost-of-living adjustments, and retiring earlier is not going to fix that.

So I think that is something where workers are scared, and they are retiring early when they really should not do that. So I think by getting Social Security reform on the table, and really discussing it, yes, it raises some tough choices that people do not want to think about, but it can also reassure people who are near retirement that we are not going to pull the rug out from underneath you.

Vice Chairman Brady. Thank you, Dr. Biggs. Before I turn the questioning over to Mr. Mulvaney, Dr. Johnson, this is a little bit off-topic but since we have got you here I would like to ask you a question about a topic you have written a great deal about: Too big to fail.

Do you believe that Dodd-Frank has helped protect our economy from systemic risk? Or simply made the problem perhaps even bigger and potentially more problematic?

Dr. Johnson. Some parts of the Dodd-Frank Financial Reform legislation are steps in the right direction. I would point particularly to Title II, the resolution authority which is being designed by the FDIC.

I have worked with them on this, and I have helped with some of their outreach efforts. It is a tough technical problem, particularly dealing with cross-border issues for the global megabanks as currently structured, and there are a lot of political issues that would need to be overcome if you were actually to manage the orderly liquidation of one of these colossal banks like a JPMorgan Chase or a Bank or America-Citigroup, and so on.

I do think we need to support the FDIC in this effort. I think it is very helpful to have Congress reaffirm the need for an orderly resolution mechanism. Relying purely on bankruptcy to handle these kinds of failures is not a good idea. That was the big lesson from the collapse of Lehman in the fall of 2008.

I would also urge you to consider proposals that are now resurfacing with regard to reintroducing some version of Glass-Steagall. For example, Tom Hoenig, who as you know is now the number two person at the FDIC, is absolutely I think on target when he says large commercial banks of the kind that are essential to the functioning of this economy should not be allowed to have trading desks. They should not be allowed in any way to engage in speculative, high-risk activities.

That part of banking should become boring. I think Mr. Hoenig is exactly on target. I work in part with Sheila Bair on some of these issues. I think she is exactly on target with regard to having much more equity capital throughout the financial system, particularly in these global megabanks.

So all of this suggests we should move further. I hope we can move further on a bipartisan basis. I certainly hear plenty of Republicans as well as Democrats saying they are very worried about our existing financial structures. You should be worried. We should all be worried, particularly given the situation in Europe, the weakness of their big banks, and the connections through these black box of derivatives in particular to our very big banks that can absolutely damage our economy again.

Making the banks small enough and simple enough to fail, so that we can then use bankruptcy for them, is absolutely the right goal to have as you consider future legislation on this issue.

Vice Chairman Brady. All right. Thank you, Dr. Johnson.

Mr. Mulvaney.

Representative Mulvaney. Thank you, Mr. Chairman.

Mr. Johnson, just a couple of things. There are obviously a lot of different topics we could go over today, but I want to go over a couple of small pieces of your testimony. And specifically you advocate for strengthening the revenue base of the Federal Government, returning closer to the tax rates of the late '90s. This is in conjunction with the writing you have done regarding the expiration of the Bush-Obama tax cuts.

I think you are right, by the way, to call them the Bush-Obama tax cuts. Not a lot of folks in this town do that, but you are absolutely right in that they were approved by this President in a Congress controlled by his Party at the end of 2010. So I applaud at least the candor on that front.

But the testimony you've got has a sentence that struck me, which is that: "We need to strengthen the revenue base of the Federal Government" and then—"returning closer to the tax rates from the 1990s."

Now it strikes me those two things are not exactly the same things are they? The base is the size of the economy, or the number of people who are paying into the system. And the rates are what those people pay, or what you charge against that side of the economy? Is that right? The base and the tax rate are really not the same thing, are they?

Dr. Johnson. You are absolutely right. The base is the taxable base, that part of the economy which you feel you can tax. And the rates are what you are applying against that base.

Representative Mulvaney. And you put that together and that is where you get your revenue. So let's talk about the base. Because one of the things we have talked about in this committee in the past is the size of the base. And you are advocating for a return of the Bush-era, the Bush-Obama tax cuts. Do you believe that will broaden the base?

Dr. Johnson. Well just increasing the rates in any tax system doesn't address the base issue. We also propose to eliminate or phase out a lot of so-called tax expenditures which, as you know, are both on the individual tax side and on the corporate tax side, are part of what narrows the base.

And when people talk about tax reform, they talk about doing both. We are in favor of tax reform, but we would rather have tax reform that raised revenue rather than being revenue neutral or in the context of revenue cutting. So that is the difference, pure and simple.

Representative Mulvaney. And that is something we all agree on, in terms of ending the tax expenditures in an effort to broaden the base. One of the things we hear regularly, gentlemen, is that roughly half the folks do not pay the income tax. And that as a result, they do not pay for the operation of government. They may pay the payroll tax, which pays for their specific benefits, most notably Social Security and Medicare, but they do not actually pay for the running of the government.

So I will ask you, Dr. Johnson, a question I have asked a couple of other people. Which is: Do you think that everybody should help pay for defense?

Dr. Johnson. Absolutely, Congressman. And I believe that everybody does. Now you are right, of course, that payroll tax is notionally marked as going to Social Security and going to Medicare. Those are of course very big government programs. Twenty percent of government spending is on Social Security, 15 percent and rising is on Medicare. But people across the income spectrum pay lots of other taxes at the state, local, and federal level, including property tax and sales tax.

This all contributes to the funding of the government.

Representative Mulvaney. Agreed. But let's—because it's come up in previous hearings, and you have not been party to those so I understand that you want to focus on a broader issue, but the issue we have talked about on this committee before is specifically defense.

Which is, if I pay my local property taxes, I am paying for schools. I'm paying for my local roads. If I pay my gasoline tax, I'm paying for roads. If I pay my state sales tax, I'm paying for everything that the state provides me. But defense is somewhat unique, isn't it? Tell me how everybody is paying for defense? Because it may be and I just don't see it.

Dr. Johnson. Well money is fungible, Congressman. And to the extent you are contributing to government and you are supporting all the activities of government across the different levels of government—state, local, and federal—I think anybody who is paying into that system, anybody who is paying any kind of tax, anybody who is participating in the modern taxed economy, is helping to support government.

So that we don't pay—none of us pay a particular tax marked for defense, but even if we did it would be somewhat meaningless. Money is coming in and money is going out of the budget, and that is the overall balance which we need to take care of.

Representative Mulvaney. Sure. And obviously I agree with the concept that money is fungible, but I can assure you that the money that we pay to the state is not fungible for the money that the Federal Government uses to provide defense. Would you agree with me on that?

Dr. Johnson. Well a lot of the Federal Government spending is shared with, or passed down to state level. So I think that the—while it's absolutely true that if the state decides to go off and spend an extra marginal one dollar, the Federal Government does not necessarily back that; a lot of funding, a lot of projects are actually joint. It is a great thing about the fiscal federal system that we've established and run for 200 years, and something the Europeans do not have and desperately need to have, exactly this kind of balance between the different levels of government and a shared funding and a shared burden of funding across all citizens, all taxpaying citizens.

I think the American system has much to commend it around the world. Particularly, I commend it all the time to the Europeans.

Representative Mulvaney. Got 'cha, and I don't mean to belabor the point, but there's been other folks—you are the first person to actually claim that everybody is paying for defense by virtue of the fact that they're paying the payroll tax, they're paying their property taxes, they're paying the gasoline tax, and they're actually in effect paying for defense. So I apologize for drawing that out. Maybe we can visit that another time.

With the Chairman's indulgence? Can I continue for a few minutes?

Vice Chairman Brady. Sure.

Representative Mulvaney. Thank you. You have got a statement also in your testimony, Dr. Johnson, number four, that says:

"The idea that the recent increase in public debt is due primarily to 'runaway spending' since 2008 is completely at odds with the historical record—although it is true that spending was not under control in the period 2000–08 . . . . The worsening deficits since 2008 have been primarily due to a big drop in tax revenue and the sharp fall in GDP due to the finance-induced recession."

Let me deal with a very quick credibility issue. So I'm hoping I don't get the answer that I think I just read, which is: Are you saying that spending wasn't a problem in 2008 until now? But it was a problem from 2000 to 2008? Not a driver of our deficits, maybe a synonym for problem?

Dr. Johnson. Part of the problem from 2000 to 2008 was, part of what happened, was two foreign wars. Obviously that is spending. Medicare Part D. That is in addition to social insurance. That is spending, no matter how you look at it.

The big hit since 2008 was the Recession. Again—well probably I am quoting the Congressional Budget Office there, and partly I'm quoting the IMF. The details are in the book chapter to which I refer there. I would be happy to send that to you. The point is, when you have an enormous recession caused by any financial sector blowing itself on the scale we experienced, that blows a big hole in the tax revenue.

Also, you get some additional spending from unemployment insurance, which is a completely sensible social safety net you have in the event, for examples, your banks blow themselves up because they were reckless and took crazy risks.

So that is a consequence of the financial crisis. And the fall in GDP, of course, means that even if you were—even if you kept spending at the same level, it would look bigger relative to the GDP, again because the banks have blown such a big hole in your economy. So that is the specific sense in which I mean it, Congressman.

Representative Mulvaney. And I understand. You go on later in your testimony to—I think you quantify the Bush tax cuts' impact on the deficit in 2010 as being roughly $270 billion. You may not be aware that Mr. Van Hollen, the Ranking Member on Budget, asked the CBO to quantify the effects of the Recession on the 2010 deficit as well, and they placed it at roughly $370 billion, which gets us somewhere in the realm of $600 billion, which was half of the deficit.

So can we at least agree that maybe half of the deficit is driven by a spending problem and not necessarily by GDP or the Bush tax cuts?

Dr. Johnson. I'm afraid not, Congressman. I'll have to look at the details of what the CBO said—I haven't had a chance to review that—but if you're saying the effect of the Recession, a large part of the effect of "the Recession" is precisely the loss of tax revenue.

In fact—and this is not specific to the United States. Across all developed countries with any kind of modern, sensibly functioning government, when you have a big recession you lose revenues.

In fact, in many countries this is referred to as the automatic stabilizers and regarded as not a bad thing; it's a good thing. From a point of view of thinking about the tax burden on the economy, it automatically falls when you go into a recession; therefore, it helps to buffer the losses.

Representative Mulvaney. But now you're being Keynesian. You said you wouldn't do that.

Dr. Johnson. Well I know that people feel strongly about Keynesian, and I'm not particularly a Keynesian on much of this analysis, I have to tell you, but the view that there is an automatic stabilizer in the sense that you tax less in a recess and tax more relatively speaking in a boom, that is actually a reasonable notion.

The Keynesian issue is: Can you stimulate the economy? Can you micro manage the economy, particularly using fiscal policy? On that, I have deep reservations. Fiscal policy, as the Chairman said at the beginning, is for the medium run. Fiscal sustainability to support growth. That's the right approach to fiscal policy.

Representative Mulvaney. Dr. Johnson, I respect your position. I just look at the numbers, and I look at the growth in spending, the top-line spending—and I recognize that a recession will have an impact on the receipts of the government and thus an impact on the deficits on the government, but if you look at spending in nominal terms—I have not had a chance to do the math and convert it—but you are talking about a government that's grown on a nominal basis by 100 percent in the last decade. In fact, it grew 20 percent in just the 2009 fiscal year by itself. The expenditures of the government in 2000 were $1.78 trillion, and they are going to be roughly $3.8 trillion this year. So more than 100 percent over the course of the last 12 years.

So I hear what you're saying. And I cannot but agree that part of the problem would be coming from the GDP, and certainly if you lower taxes and bring in less money that may contribute in a short term to the deficit. But to say it is not a spending problem I think undermines the overall argument.

But let me get the last issue to everybody. Because the one thing we have not heard about today is productivity. And I think one of the lessons that we can learn from Europe is that they have been fairly locked into low productivity rates for a long time. They may be contributing to their structural deficits and the issues they are dealing with. They are probably not solving their productivity problem even if their countries are making steps to solve their fiscal problem, productivity is still not particularly healthy in Europe.

We had a little boost here during the early stages of the 2008 Recession. But in the long term, I do not think we are seeing any dramatic increases in productivity. In fact, the Chairman mentioned more folks leaving the workforce at 62, which generally speaking would be a time of their lives when they would be productive members of society; now they are turning into retirement ages.

So tell me, gentlemen, am I right to be focusing on this, number one? And then if I am, tell me. And I am specifically looking at Dr.

Johnson, now, tell me—and I will go last to him—tell me how raising taxes is going to increase our productivity?

Dr. Rogerson.

Dr. Rogerson. Well I will say for starters, I think you are right on base to say that productivity growth is absolutely essential to the long-term health of the economy. I think there is widespread agreement that productivity growth lies behind the sustained improvements in living standards. So absolutely we need to be focused on policies that influence productivity growth in thinking about what policies are good for productivity growth.

Having said that, I certainly do not think that raising taxes are good for productivity growth. I would——

Representative Mulvaney. Is that a gut feeling, Dr. Rogerson? Can you back that up?

Dr. Rogerson. I know of no evidence to have supported that. I mean, I will temper it on the other side that I do not think that all taxes need be bad for productivity growth. I think some taxes might be relatively neutral in terms of productivity growth.

If you think that a major source of productivity growth is the incentives to innovate, many tax policies may not be a first-order importance in terms of the incentives for innovation, for example.

But taxes on—progressive taxes on labor income, for example, the more productive you become the higher tax rate you pay, that obviously can provide a disincentive for people to accumulate skills which would be a negative factor for productivity.

So I think productivity is absolutely important. Taxes certainly—some taxes I believe can have important negative effects on productivity, but I would not go so far as to say all taxes are negative for productivity.

Representative Mulvaney. Dr. Biggs.

Dr. Biggs. When I think about the EU, I mean it is not—it's not that a French or a German worker is necessarily less productive than an American workers for each hour that they work. They are skilled people and they are good at what they do. The issue is that they are simply not working the same sorts of hours that American workers are doing. And the question is: Why?

I think Professor Rogerson's research provides compelling evidence that one reason why they work so many fewer hours is the tax rates are a lot higher today than they had been in the past. And that obviously does, it leads to issues in terms of skills' accumulation.

Because if you know you are going to be working more hours over the course of a year, or having a longer career, building up human capital provides a larger payoff to you.

In addition, when you have individuals who are shut out of the labor market for a long period, as you had in Europe for quite some time, and unfortunately as increasingly we're having here, their skills deteriorate. Their connection to the workforce becomes more tenuous. And so even when they do get back to work, that is when their productivity suffers, when their output-per-hour actually will fall.

So I think there is a connection, and I think the fact that Americans work 100 hours or so more a year than many Europeans, I think that is not disconnected from tax rates. I'll say that.

Representative Mulvaney. And finally, Dr. Johnson.

Dr. Johnson. I have three responses, Congressman.

First of all, I am not proposing anything close to European tax rates. No one has been a more outspoken critic of the European fiscal system. And to your other interests, Mr. Brady, the monetary system, than I have. I have written extensively about this. It is a disaster.

And we don't want to go there, and I don't think we are going to go there, and I don't think that is what we're talking about.

Secondly, on labor market participation, Dr. Biggs has already given you exactly the right answer. Which is: If people start to fear that Social Security will not be there, then they will retire earlier. That was his point about retiring at 62, because you don't think the pension is going to be there.

People have to believe that the system is going to continue in order for older Americans to remain working. We should be increasing labor force participation, including through people working the hours they work, including these older Americans who have very valuable skills that we need to stay engaged with the labor force.

The third answer is, to Professor Rogerson's point, we should be taxing consumption more and income less. I have testified, I think not before this committee but before a number of other Congressional committees, on the advantages of a Value Added Tax of some form.

That, to your point about productivity, is a very good way to address your concerns. If you think we're taxing your income too high, if we can agree on the role of government and how to fund it, we should be funding it more with taxes on consumption and less with taxes on income. It would address exactly your concerns. But I understand there is bipartisan hesitancy to move towards a VAT, despite the fact there are only two G–20 countries that don't have a VAT: Us, and Saudi Arabia. And Saudi Arabia doesn't have a shortage of revenue.

Representative Mulvaney. Gentlemen, thank you very much. And I especially appreciate the indulgence by my Chairman for the extra time.

Vice Chairman Brady. Thank you, Mr. Mulvaney. I went over on my time, as well.

I want to thank our witnesses today. This is a very interesting conversation and the testimony really was very insightful, and I appreciate that as well. I appreciate Senator Bingaman and the Members, Mr. Mulvaney, who were able to attend. But for those who were not, as a courtesy I would like to leave the record open for five days for questions to be submitted in writing. We will pass them on to our witnesses, and I would ask you to respond in a timely manner.

With that, thank you all very much for being here. The hearing is adjourned.

[Whereupon, at 3:47 p.m., Wednesday, May 16, 2012, the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE KEVIN BRADY, VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

Today the Joint Economic Committee is holding the second of two hearings on how taxes affect America's economy. This hearing focuses on the taxation of labor. The first hearing on April 17th focused on the taxation of capital.

My goal, as Vice Chairman of this Committee, is to ensure that America has the strongest economy in the world throughout the 21st Century. To do that, we must get our monetary policy right, get our fiscal policy right, get our regulatory policies right, and open new markets to U.S. exports.

A sustainable fiscal policy requires more than just closing the trillion dollar gap between federal spending and federal revenues. A sustainable fiscal policy requires economic growth.

A growing economy improves our fiscal outlook by increasing federal revenues and reducing federal spending relative to the size of our economy.

Sadly, however, economic growth and job creation are lagging under President Obama. To understand how poorly our economy is performing compared with its potential, let's look at this chart and compare the big government-oriented Obama recovery to the free market-oriented Reagan recovery:

- From its low point in February 2010 following the recent recession, the Obama recovery produced private sector job growth of 4.0%. Over the comparable time-frame, the Reagan recovery far eclipsed the Obama recovery with 10.1% private sector job growth.
- If President Obama had the same growth rate of private sector jobs as President Reagan enjoyed, we would have over 6½ million more jobs today—that is more than one job for every two workers currently counted as unemployed.
- From its peak in October 2009, the unemployment rate has declined by a meager 1.9 percentage points under President Obama. Over the comparable time-frame, the unemployment rate dropped by 3.4 percentage points under President Reagan.
- Under President Obama, the average real GDP growth rate has been 2.4% over the 11 quarters following the recession. Over the comparable time-frame, President Reagan delivered an average real GDP growth rate of 6.1%.

More than anything, hardworking American taxpayers need cohesive monetary, fiscal, and regulatory policies that encourage business investment—business investment in new buildings, equipment, and software. Joint Economic Committee Republicans have shown that such private sector business investment is the key to robust economic growth and private sector job creation.

Leading economists believe that taxes affect the incentive to work, save, and invest. Thus, federal tax policy not only determines how much the federal government collects, but also how much the U.S. economy grows and how many jobs are created.

Other economists seem to believe taxes don't really matter. In their view, one tax increase to reduce the federal budget deficit is just as good as another.

The purpose of this hearing is to examine the empirical evidence offered by both sides of the debate.

In his written testimony, Dr. Rogerson presents evidence that taxes on labor substantially reduce employment and economic output. When these taxes are used to fund transfer payments and social services, the adverse effects on jobs and economic growth are even greater.

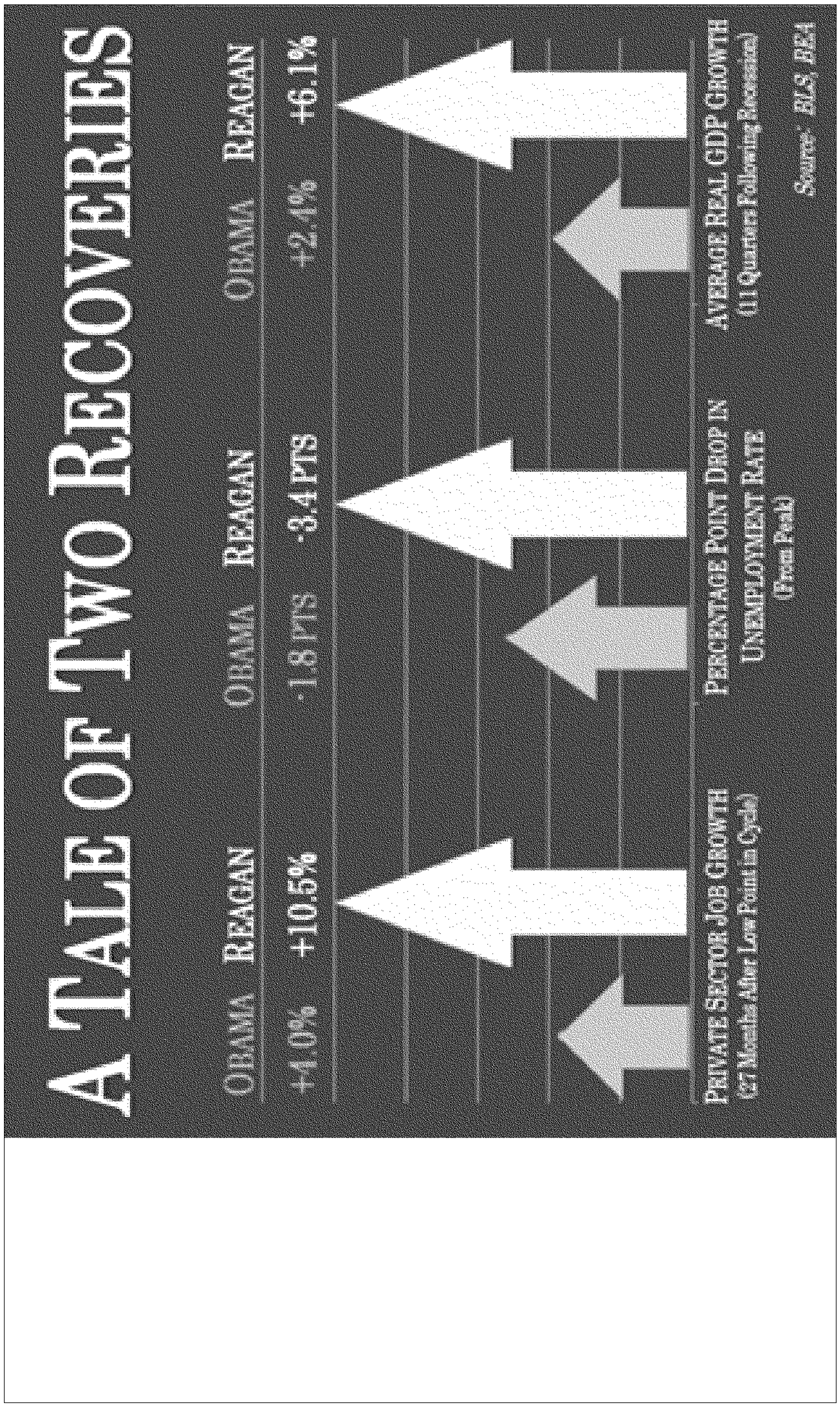
Dr. Biggs presents evidence that these adverse effects depend in large part on the specific tax and benefit rules of each entitlement program. Older workers are especially sensitive to the marginal net tax rate. That is the additional after-tax income received in exchange for working and paying taxes an additional year.

For his part, Dr. Johnson presents evidence that our taxes are lower than they have been at times in the past; and they are lower than many other countries' taxes today.

The question we face today is whether tax policy really matters. Can Congress allow the tax reductions of 2001 and 2003 to expire without any adverse effects on jobs and economic growth? Would this be, as many leading economists and my Republican colleagues have suggested, "taxmageddon"? Or, as President Obama and many of my Democratic colleagues contend, can Congress increase other federal taxes on the businesses and the "wealthy" with economic impunity?

Should Congress instead focus on fundamental tax reform and carefully consider which tax policies will provide the greatest boost to long-term growth and job creation in the private sector?

Hopefully, today's hearing will help us answer these questions. I look forward to the testimony of our distinguished witnesses.


A TALE OF TWO RECOVERIES
OBAMA
REAGAN
+4.0%
+10.5%
PRIVATE SECTOR JOB GROWTH
(27 Months After Low Point in Cycle)
OBAMA
REAGAN
-1.8 PTS
-3.4 PTS
PERCENTAGE POINT DROP IN UNEMPLOYMENT RATE
(From Peak)
OBAMA
REAGAN
+2.4%
+6.1%
AVERAGE REAL GDP GROWTH
(11 Quarters Following Recession)
Source: BLS, BEA

Testimony by Richard Rogerson
Prepared for the Joint Economic Committee
Hearing on May 16, 2012
How the Taxation of Labor and Transfer Payments
Affect Growth and Employment

Introduction

The US faces important long run decisions about the size of its government spending programs. Pressure for change comes in part from the budgetary imbalances associated with changing demographics (the aging of the baby boomers age and increasing life expectancies) as well as from the increasing relative cost of health care. Effective public policy decisions about the longer-run scale of various government programs requires a careful assessment of both the costs and benefits associated with the size of these programs and the manner in which they are funded. A key feature of reality is that most of the revenues that fund these programs are raised by taxing labor income, either directly or indirectly. As a result, an unfortunate reality of more government spending is that it can create a disincentive for individuals to work. Because labor is an essential input used in producing output, less labor implies less output, which in turn means that overall consumption and living standards must decrease. Or, as some commentators like to put it, the reliance of governments on labor taxes means that expanding the size of government programs shrinks the size of the pie that everyone must share.

But how large is this disincentive effect? Is it large enough that it is of first order importance for policy makers to take it into consideration, or is it sufficiently small that it can safely be ignored? Some policy makers seem to believe that these effects are small and that they can therefore be ignored. Some policy makers will cite various studies by economists as support for this view. Over the last ten or so years I have devoted a great deal of effort to investigating this issue, including an assessment of the methodology behind many of these studies. Based on this research I believe that the disincentive effects of labor taxation are of first order importance and should be taken into account in any analysis of the costs and benefits of long run government spending. The focus of my testimony today is to present what I believe is some transparent and striking evidence on this issue. An important aspect to the evidence that I report is that it comes from outside of the US.

To understand why, it is important to realize that probably the most transparent and compelling evidence on this or any number of other issues comes from what economists refer to as a natural experiment, which in this context would describe a situation in which a country changes its scale of government spending in a permanent manner, financed by an increase in labor taxes, while holding all else constant. The key phrase here is "holding all else constant". Because there have been changes in the scale and design of government spending and labor taxes in the US over the last fifty or so years, one might look to the historical data from the US to tell us about the magnitude of the effects of labor taxes on hours of work. While this is a good idea in principal, certain realities serve to obscure these disincentive effects in the US data. Central among them is the fact that the changes in these programs in the US over the last fifty years have not been particularly large relative to other economic and demographic changes. Because there are many changes both large and small that impact on the economy over any time period, this implies that the changes in government spending in the US are just one among many other changes taking place over the last fifty years. When many changes are happening simultaneously, it is difficult to reliably determine the contribution of any one particular factor to the overall economic changes that we observe. Some would say that we have a situation where the "signal to noise ratio" is relatively small.

Failure to appreciate this fact has led to many fallacious attempts to argue that higher taxes on labor do not lead people to work less. An example is useful. In the context of recent debates, several policy makers have observed that labor taxes increased during the 1990s, but that total hours of work in the US economy nonetheless grew substantially. This is proposed as evidence that higher taxes do not create a disincentive for work. But this argument is fallacious for the simple reason that it neglects to take into account that at the same time that taxes were increased, something else very substantial was also affecting the US economy. In particular, the period of the 1990s was characterized by high investment, high productivity growth and high output growth. Some proclaimed it as the advent of the "New Economy". It is hardly surprising to find that total hours of work increased during a period featuring an investment boom and high productivity growth. Since no one suggests that the high rate of investment and high productivity growth were due to the increase in taxes, it follows that economic outcomes in this period are likely dominated by these other factors. In short, this episode provides no information about the disincentive effects of higher labor taxes.

A second source of information that policy makers often rely on to support the view that the disincentive effect is small, is a large literature in the field of labor economics. This literature studies data on the choices that individual workers in the US make in different situations to infer how they would respond to changes in tax and transfer programs. Much of this literature concludes that the overall disincentive effects are relatively small. Once again, the foundation for these conclusions is very thin. First, the immediate findings of these studies are typically very sensitive to what we now know to be unreasonable assumptions. Second, the conclusions regarding the disincentive effects for the overall economy come from making extrapolations that are not at all justified by the analyses. Unfortunately, many policymakers continue to base their analysis on these estimates. While I have written several papers that relate to this issue, I will not go into these details in today's testimony, preferring to present the evidence in its most transparent form. I should emphasize that I, along with others, have analyzed this data using more sophisticated methods, and that the results from those more complex analyses confirm the findings that I will focus on today.

So why should we turn to the experiences of other countries for evidence? As I said above, one would ideally like to have a situation where we witness a large permanent change in the scale of tax and transfer programs, where we can reasonably think that the changes are large compared to other changes, and where we have allowed sufficient time for individuals to respond to the changes. While the US does not fit this ideal situation, it turns out that other advanced economies do.

A striking feature of the evolution of labor taxes in other advanced economies is that there have been very dramatic differences across countries in the extent to which they have changed over time, and that these changes have been permanent. For example, since 1960, taxes on labor have increased by more than three times as much in some European countries than in the US. It follows that looking at the changes in hours worked and labor taxes across OECD countries provides an excellent opportunity to learn about the disincentive effects of labor taxes.

Let me emphasize that my testimony today is solely about the long run effects of the long run level of government spending and labor taxes. As the economy continues to recover from the largest recession in the post WWII era there has been much discussion of the desirability and efficacy of various temporary policies on short-run economic outcomes. The short term effects of temporary changes in various economic policies, especially those enacted in unusual circumstances, can be very different than the longer run effects of permanent changes in policies. As a result, the effects that I discuss today should not be interpreted as bearing directly on the likely effects of the various temporary stimulus measures that have been enacted.

The testimony that follows is based on my 2010 monograph *The Impact of Labor Taxes on Labor Supply. An International Perspective.* This represents a relatively non-technical presentation of some key evidence. I have pursued this analysis in a much more technical fashion in a series of other papers, most notably my work with Lee Ohanian and Andrea Raffo (2008), and with Johanna Wallenius (2009).

Some Basic Theory

While I do not want to devote much time or space to a discussion of economic theory, I do want to note one point. A very robust implication of basic economic theory is that if the government taxes labor income and uses the proceeds of the tax to fund transfer payments to individuals (e.g., social security) or alternatively, provides them with goods or services that they would otherwise have bought for themselves (e.g., education or health care), then individuals will choose to work less. This reduction in hours may take many forms: an individual may choose not to work while in college, a family may choose to only have one member in the labor force, an individual may not take on a second job, or may retire earlier. In contrast, if the revenues are used to fund other types of spending, like national defense, for example, then basic economic theory does not have a robust prediction. Moreover, many economists interpret long run evidence from the US to imply that in such a case there will be no effect on individual labor supply.

The key message from this is that it is labor taxes used to fund transfer payments or provision of services that individuals would otherwise buy for themselves that are of key interest in terms of assessing the impact of labor taxes and government spending on labor supply. But, these are in fact the dominant forms of government spending, and the dominant form of projected future increases.

Labor Taxes in the OECD

Table One shows effective average tax rate on labor in several OECD countries in 1960, 1980 and 2000. In each case the value is the average for a five year interval centered on the year in question. The source for these tax rates is McDaniel (2006), and they represent the average effective tax rate on labor income that captures not only direct taxes on labor income but also payroll taxes and consumption taxes. A basic message of economic theory is that taxes on consumption distort the labor supply decision in very much the same way as taxes on labor earnings: in both cases the individual would get less consumption per unit of time devoted to work.

Table One

Average Effective Taxes on Labor Income

	1960	1980	2000	Change 1960-2000
Australia	15.8	24.6	27.2	11.4
Austria	31.3	43.6	48.5	17.2
Belgium	29.0	43.6	50.0	21.0
Canada	20.7	28.5	36.0	15.3
Finland	26.0	40.4	52.4	26.4
France	36.6	43.7	49.7	13.1
Germany	33.5	43.4	47.7	14.2
Italy	25.5	33.2	49.1	23.6
Japan	18.4	23.4	30.5	12.1
Netherlands	32.1	49.2	45.1	13.0
Spain	16.0	24.4	35.6	19.6
Sweden	31.6	53.9	59.1	27.5
Switzerland	17.3	25.1	32.7	15.4
United Kingdom	25.7	36.1	36.0	10.3
United States	22.1	26.4	28.6	6.5
Average	**25.4**	**36.0**	**41.9**	**16.5**

The last row of this table is striking--it shows that in terms of averages, tax rates on labor increased by more than 16% over this time period, almost three times the 6.5% increase that was observed in the US. In fact, the US was the only country to have an increase that was less than 10%. Some countries even had increases in excess of 20%. Importantly, the table also shows that these increases have been permanent, since almost two-thirds of the overall increase takes place during the first 20 year period, and there was no tendency for taxes to decrease in the last twenty years. Recalling the earlier discussion about natural experiments, it follows that countries other than the US are much more likely to provide a cleaner look at the effects of higher tax rates on aggregate hours of work.

Hours Worked in the OECD

Table Two shows hours worked in 1960, 1980 and 2000 for the same set of countries as Table One. These hours data come from the OECD Labor Markets Database and the Groningen Growth and Development Database. They are the product of employment and annual hours of work per person in employment, divided by the size of the population aged 15-64 and then expressed as weekly values.

Table Two				
Weekly Hours Worked Per Person Aged 15-64				
	1960	1980	2000	% Change 1960-2000
Australia	24.0	22.7	23.9	-0.6
Austria	26.8	21.4	20.0	-25.5
Belgium	25.5	18.7	17.6	-30.9
Canada	22.2	22.8	24.4	9.8
Finland	28.7	23.9	21.0	-26.7
France	25.5	20.0	17.2	-32.5
Germany	28.3	21.1	18.4	-35.2
Italy	23.4	17.9	16.7	-28.7
Japan	29.5	26.9	25.4	-13.8
Netherlands	22.6	17.5	18.6	-17.6
Spain	23.3	19.3	19.1	-17.9
Sweden	26.6	22.9	22.5	-15.4
Switzerland	29.1	24.5	25.3	-13.0
United Kingdom	28.1	23.0	22.5	-20.0
United States	23.6	23.4	26.3	11.3
Average	**25.8**	**21.7**	**21.3**	**-17.6**

These data are interesting in and of themselves, so we begin by noting some of their features. First consider what happened to the average value for hours worked. Hours worked decreased dramatically from 1960 to 1980, followed by a small decrease thereafter. The overall drop in hours from the beginning to the end of the period is more than 17%. This is an enormous drop in hours worked, and to appreciate this fact it is useful to provide some perspective. Everyone is familiar with the fact that the labor market exhibits fluctuations associated with the business cycle, with more total work being done during expansions and less total work being done during recessions. The counterpart of this is that unemployment tends to be higher in recessions and lower in expansions. In fact, trying to understand these fluctuations in the total amount of work being done has long been viewed as one of the key puzzles in macroeconomics. But going from normal times to a fairly severe recession is usually associated with a drop in total hours worked of about 3%. The size of the average drop that we see across countries is more than five times as large. So this drop in hours worked over time is indeed something very dramatic.

The second striking pattern in these data is the dramatic differences in the overall change in hours worked across countries. At one extreme is the US, which actually witnessed an increase of more than 11% between these two dates, and at the other extreme are Germany and France, with declines of more than 30%. If we contrast the differential changes between the US and Germany, the difference is more than 45%. These differences in changes in working hours are staggering.

While the US is at one extreme, it is important to note that the US is not an outlier. Canada also displayed substantial growth in hours of work, and Australia had basically no change in hours worked. Moreover, among the countries that exhibited substantial decreases in hours worked, there is still a lot of variation. Switzerland, for example, had a decrease in hours worked of 13%, which is much less than what occurred in France, Germany and Belgium.

Changes in Taxes and Changes in Hours of Work

We now put together the two key pieces of data: the changes in labor taxes and the changes in hours worked.[1] It is instructive to begin with a look at what happened to the simple averages across countries for both labor taxes and hours worked. Between 1960 and 2000 the labor tax rate increases by 16.5 percentage points, and hours of work decrease by 17.6 percent. This suggests a strong negative effect of taxes on hours of work. In fact, if one considers the fact that this period also coincides with the dramatic increase in female labor force participation, for reasons largely unrelated to changes in taxes, these values represent an underestimate of the effects of taxes.

While it is interesting to look at the averages, it is obviously a more powerful test to examine the pattern of changes across countries. That is, to what extent is it the case that countries which had larger increases in taxes also had larger decreases in hours worked? The correlation between the percentage point change in tax rate and the percent change in hours of work is equal to -.60.

Another way to represent this information is to run a simple regression of percent change in hours of work on change in tax rate:

$$log\,(h_{i2000})-log(h_{i1960}) = a(\tau_{i2000}-\tau_{i1960})+\varepsilon_i$$

where h_{it} is hours worked in year t in country i, and τ_{it} is the labor tax in country i in year t. The result of this regression is a coefficient of -1.21 on the change in tax rates,

[1] A more structured analysis of these data in the context of a formal model of labor supply can be found in Ohanian et al (2008). See also Prescott (2004).

implying that if tax rates increase by ten percentage points, then hours of work will decrease by 12.1 percent.

One may ask the following: if taxes exert such a significant negative effect on labor supply, how is it that hours of work in the US have increased at the same time that taxes on labor have increased? Does this not contradict the main message? In other work (Rogerson (2007) and Rogerson (2010)) I have dealt with this issue directly and shown that there is indeed no contradiction. The key point is that the period from 1960 to 2000 is a period of sustained increases in female labor force participation and a movement from home production to market production. While there is still much ongoing research on this dramatic secular trend, no one believes that the underlying cause is directly related to taxes. In Rogerson (2010) I show that if one controls for the movement from home production to market production, the US data provide a similar estimate.

Cultural Differences

If someone were to only look at the data shown for the year 2000, one would see that hours worked are lowest in the continental European economies of Belgium, France, Germany and Italy, are at intermediate levels in the UK, Finland and Sweden, and are the highest in the US, Canada, Australia, Japan and Switzerland. Many commentators are content to explain away these differences as being due to cultural differences, with the idea being that people from some countries either enjoy leisure more or are less focused on work.

This view leads some people to argue that US policy makers should not look to these other countries for information about how tax policies influence hours of work. In particular, they would argue that the reason many Europeans work less than Americans is not because of high taxes on labor and generous transfer systems, but instead because preferences toward work and consumption are systematically different across countries.

A closer look at the data suggests that this is not a very compelling story. Specifically, if one looks back at the data for 1960, one sees that hours of work are actually higher in Germany, France, and Belgium than they are in Canada, the US and Australia. That is, fifty years ago the relative work levels of these countries were reversed. This evidence seems inconsistent with the view that claims Europeans work less because they either value leisure more or do not care so much about consumption.

The above piece of evidence tells us to focus on the following key fact. Back in 1960, hours of work in many European countries, including France and Germany, were slightly higher than they were in the US. Since that time, hours have increased somewhat in the US, but decreased dramatically in most European countries. The question is why? Something has changed in Europe relative to the US during the last forty years that has led to these very different changes in the amount of work being done. The above analysis leads us to conclude that relative changes in the rate at which labor is taxed is the dominant force in explaining these very different changes.

Moreover, it should be noted that the way I have examined the data actually allows for the possibility that Europeans have different attitudes about how much they want to work. To see why, it is important to note that the above estimates of tax effects did not come from comparing the relative level of work in Europe with the relative level of labor taxes in Europe. This procedure would in principle mistakenly attribute differences that might be due to preferences to differences in taxes. Instead, the above analysis focused entirely on the changes in work in each country with the changes in taxes in that same country. In a country where people like to work a lot, for whatever reason, this will manifest itself as higher hours worked in both 1960 and 2000, and hence does not affect the change in hours between these two dates. Similarly, in a country in which people prefer not to work so much, this would manifest itself as lower hours of work in both 1960 and 2000. Once again, this has no bearing on the change in hours between 1960 and 2000.

Other Explanations for Differences in Hours Worked

The evidence just presented shows that there is a strong negative correlation between changes in hours and changes in labor taxes in a sample of 15 OECD countries. I have interpreted this as evidence in support of the notion that the changes in taxes were the source of the changes in hours worked in these countries. But one still needs to be concerned with the possibility that the changes in hours worked might be due to some other change that might be going on at the same time as the changes in labor taxes, and that because of this we are misguided in claiming that the change in hours of work is due to taxes.

An example will help to illustrate the point. It is well known that the economies of continental Europe differ from the US economy in several respects other than taxes. For example, these economies tend to have more regulated labor markets in terms of features such as employment protection policies, which are policies that make it difficult for firms to adjust their workforce downward. Many researchers argue that such policies lower the incentives for firms to hire workers, thereby adversely affecting total hours of work. Unions are also more prevalent in these economies. And many researchers argue that unions adopt policies that have negative consequences for overall employment and hours of work.

It is plausible that at the same time that these economies were increasing their taxes on labor that they might also have been increasing the degree of employment protection and increasing the role of unions. After all, in some sense transfer payments, employment protection and greater union presence are typically viewed as common aspects of the European welfare state. So maybe it is changes in employment protection or unionization that are driving the changes in hours worked and we are incorrectly interpreting these changes as being due to increases in taxes, simply because we have not looked for changes in these other factors. In this section I deal with this critique.

To be sure, no matter how many other stories one considers regarding the decline in hours worked in these other countries, it is always possible that someone comes up with yet another one. If we are trying to come up with plausible stories about changes that might account for a small change in hours worked, then there are presumably many stories that one would have to consider. But if the changes in hours worked are very large, then we need to come up with some large changes that took place in the economy, and there are typically many fewer large changes going on at any point in time. Recall from the data presented in the previous section that in some economies, hours worked decreased by more than 30% between 1960 and 2000. If we are trying to understand what might account for this it stands to reason that we can focus our attention on big changes in the economy.

It turns out that it is quite difficult to come up with examples of big changes in the 15 economies that I have been studying that have the right qualitative pattern, i.e., that changed much more in countries like France than in the US. I have shown elsewhere that factors such as unionization or employment protection do not seem to work.[2]

Supporting Evidence: Home versus Market Production

If higher taxes are largely responsible for the large differences in hours worked across countries, then perhaps there are other pieces of evidence that would also support this view. In this section I will describe some related evidence that has to do with cross-country differences in time devoted to household production.

If taxes increase, this creates an incentive for individuals to do more things for themselves rather than purchase them in the market. The intuition is simple: if you are working to purchase something in the market, then higher taxes imply that you have to work more hours in order to earn enough money to purchase a particular item. Since time spent in home production is not taxed, higher taxes serve to make it more economical to do things for oneself rather than purchasing them through the market.

It follows that holding all else constant, if one economy has higher tax rates than another economy then we would expect to see more time devoted to home production in the economy with a higher tax rate on labor. And if the effects of taxes are sizable, then these effects should also be sizable. In (Rogerson 2010) I reported data showing how time allocated to home production has changed over time in the US. Unfortunately, the data that would permit a cross-country comparison of time series changes in time devoted to home production are not available. However, there are a few data sets that provide a

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[2] This finding is contrary to the conclusions reached by Alesina et al (2005). In my discussion of that paper I argued why the results of Alesina et al are not compelling.

recent snapshot of how time devoted to market and home production differ across some countries.

Four recent studies offer information about differences in home and market work between the US and European countries based on time use studies. A common finding is that differences in market work are indeed significantly offset by differences in homework. Freeman and Schettkat (2001) study time allocation data for married couples in Germany and the US in the 1990s. Whereas Americans devote more time to market work than do Germans, Germans in turn devote more time to home production than Americans. The striking finding is that when one adds up total time devoted to work (i.e., market work plus home production) it turns out that the two countries are virtually the same. This study also shows that the patterns of consumer expenditure differ in a corresponding fashion, i.e., Germans spend more time on meal preparation at home and spend less money at eating establishments.

Freeman and Schettkat (2005) extend this analysis to a larger set of countries and report that as of the early 1990s, time spent in home production in European countries is about 20% higher than in the US. This implies that increased time in home production only partially offsets the decrease in time devoted to market work.

Using data from the recent Harmonized Time Use Study, Ragan (2005) compares several European countries with the US and finds that on average, individuals in Belgium, France, Germany, Italy and the Netherlands studied here have between 15 and 20% more time devoted to home production than do Americans.[3]

In another study of time use data, Burda et al (2008) reach a similar conclusion based on information for Germany, Italy, the Netherlands and the US. In particular, they find that Europeans engage in 15 to 20% more time in home production than do Americans.[4]

Related work has also been carried out by Davis and Henrekson (2004). Consistent with the tax effects on home versus market production discussed above, they show that countries with higher marginal tax rates systematically have lower employment in those market activities for which there are good nonmarket substitutes. The magnitude of the estimated effect is large. An increase in taxes of one quarter of one percent leads to a

[3] Alesina, Glaeser and Sacerdote (2005) present data from another source which challenges this conclusion. As noted by these authors, however, their data set seems ill-suited to cross-country comparisons. The Harmonized Time Use data set used by Ragan was designed to specifically address the shortcomings mentioned by Alesina et al, and hence seems more reliable.

[4] In comparing countries using the 2003 data it is important to be aware of changes in survey design in the US. Relative to earlier surveys in the US, the American Time Use Survey, initiated as part of the CPS, tends to generate larger amounts of time reported to child care. In the US this results in an almost 50% increase in time devoted to child care relative to the 1985 time use survey data.

decrease in the employment share in the broad set of sectors that have good home produced substitutes equal to 2.4%. They find that tax effects are most noticeable in precisely these sectors.

Summary

I have examined changes in hours of work and labor taxes in a panel of countries between 1960 and 2000. These data suggest a very substantial effect of permanent increases in labor taxes on the long run level of labor supply. Using these estimates, if the US were to increase the overall long run size of government spending relative to GDP by as little as 3 percentage points, and finance it entirely by increased taxes on labor, the effect on total hours of work would be equivalent to a loss of between 6 and 9 million jobs- a decrease of about the same magnitude as experienced during the recent recession.

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STATEMENT OF ANDREW G. BIGGS, PH.D., RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE*

Vice Chairman Brady and Members of the Committee: Thank you for the opportunity to testify with regard to the effects of taxes and transfer payments on labor supply and the employment.

While taxes are designed to raise revenue for the government, tax policy can also have important effects on individuals' decisions to work. The behavioral impact of tax policy has been studied by economists for decades with an aim to minimizing the economic costs of raising a given level of revenues. However, relatively little attention has been given to how Social Security's taxes and benefits affect labor supply. While the program's effects are not large for individuals in their prime working years, Social Security tax and benefit rules present significant work disincentives for individuals considering delaying retirement. Altering these rules could increase labor supply and improve retirement security at little cost to the federal budget.

Social Security is the largest single domestic spending program of the federal government. Unlike most federal programs, it levies a dedicated tax on earnings and pays retirement, survivors and disability benefits in return. The 12.4 percent Social Security payroll tax on earned income is the largest tax paid by most Americans, and thus it has significant potential to affect their labor supply decisions. In exchange for their payroll taxes, individuals can become entitled to future benefit payments for themselves and eligible family members. The effect of Social Security taxes on labor supply cannot be analyzed in isolation from the benefits those taxes "purchase."

Social Security analysts think of these issues in terms of the "net tax rate," which is equal to the statutory 12.4 percent payroll tax rate net of the present value of any future benefits those taxes purchase. The present value of benefits is a function of the time until benefits will be paid, the expected duration of benefit receipt, the riskless rate of interest at which individuals might invest, and any risk premium individuals apply to Social Security benefits due to solvency or political risk.

If the benefits an individual becomes entitled to are equal to the taxes he pays, his net tax rate is zero. In such cases, the Social Security program should have relatively little effect on an individual's labor supply decisions. If an individual's net tax rate is negative, which can be the case for lower-earning individuals, then Social Security might encourage work. And if his net tax rate is positive, then labor supply is discouraged.

According to Social Security's actuaries, a middle income two-earner couple retiring in 2014 can expect to receive lifetime Social Security benefits equal to around 78 percent of the taxes they pay.[1] This implies that on a lifetime basis, around 78 percent of the Social Security payroll tax (or 9.7 percentage points) can be viewed as a "contribution" which will be repaid at retirement or disability, while the remaining 2.7 percentage points can be viewed as a "pure tax" for which no benefits will be received.

However, labor supply decisions are not generally made on a lifetime basis. Rather, at any given point in time an individual may decide whether and how much to participate in the labor force. Thus, what matters in terms of Social Security's impact on labor supply is what might be called the marginal net tax rate, that is, the benefits an individual receives in return for working and paying taxes over a given period of time, such as a year.

In general, the theory of optimal taxation states that taxes should be highest in circumstances in which individuals are least sensitive to the tax and lowest when individuals are most sensitive to tax rates. Following this rule will tend to minimize the harmful effects of taxation on work and the economy.

However, Social Security's treatment of older workers is precisely the opposite of what economic theory recommends. Social Security pays the lowest reward to work to older workers who are near to retirement. These individuals, research indicates, are among the most sensitive to tax rates, because they have the easiest option to leave the workforce and retire.

Social Security's benefit formula is roughly actuarially fair for individuals who choose to delay claiming benefits. For instance, imagine a person who leaves the labor force at age 62. He can claim retirement benefits at any age from 62 through 70. For each year he delays claiming benefits, his eventual monthly benefit rises by

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

[1] This figure is based upon current law scheduled benefits. Reform could alter these figures and, to close the program's financing gap, must necessarily reduce the ratio of total benefits received to taxes paid.

around 7 percent. Over the course of an average lifetime, total benefits are about the same if you claim at age 62, 70 or any age in between.

However, Social Security is not actuarially fair with regard to individuals who delay claiming and remain in the workforce. Most near-retirees who extend their work lives receive little or no additional benefits for any extra taxes they pay. Thus, their net tax rate is very close to the statutory rate of 12.4 percent and therefore discourages labor supply at older ages.

There are three reasons for this. First, Social Security benefits are based upon an individual's highest 35 years of earnings. An additional year of work, particularly if it is part-time, is unlikely to boost benefits. Second, most female retirees receive a spousal benefit based upon their husbands' earnings. Any additional taxes they pay are unlikely to lead to higher benefits. Third, once individuals reach the full retirement age they are ineligible for Social Security disability benefits, but must nevertheless continue to pay the 1.8 percent disability payroll tax.

In a 2009 research paper with David Weaver and Gayle Reznik of the Social Security Administration, I found that for each dollar of additional taxes a near-retiree pays into Social Security, he or she receives only around 2.5 cents in extra lifetime benefits.[2] Simply put, Social Security provides almost no incentive to keep working.

This would not be of major policy importance if near-retirees were not so sensitive to tax rates. A middle-aged worker with a family to support will likely continue working even in the presence of high implicit tax rates, but once he or she reaches age 62 the option to retire becomes more attractive. Moreover, most retirees receive pension and Social Security benefits, which can increase the marginal income tax rates they pay on earned income. Economic research finds that older Americans are significantly more sensitive to after-tax rewards to work than younger workers.

In a 2009 study that relied on differences in state income tax tax rates, Lucie Schmidt of Williams College and Purvi Sevak of Hunter College found that a 10 percent increase in after-tax earnings would increase labor force participation by 7.5 percent among men and 11.4 percent among women.[3] These estimated labor supply elasticities are 2 to 5 times higher than the Congressional Budget Office assumes for the working-age population.[4] In forthcoming research, John Laitner and Dan Silverman of the University of Michigan find that eliminating the payroll tax at age 59 would cause individuals to delay retirement by an average of 1.1 years.[5] And in a 2005 study, Eric French of the Federal Reserve Bank of Chicago found that a 10 percent increase in wages as of age 62 would dramatically increase work by seniors, sufficient to boost overall labor supply by 1.1 percent.[6]

I have proposed reducing or even eliminating the Social Security payroll tax for older workers as an incentive to remain in the workforce. Doing so would lower Social Security tax revenues, but increased labor supply from older workers would increase other revenues, such as for federal income taxes, Medicare payroll taxes, or state income taxes.

Using the Policy Simulation Group's Social Security models, I estimate that eliminating the payroll tax for workers over age 62 would reduce annual Social Security revenues by roughly 2.2 percent, or about $16.2 billion in terms of 2012 tax collections. Using French's parameters, eliminating the payroll tax at age 62 would increase overall labor supply by around 1.4 percent.[7] The offsetting increases in non-Social Security revenues depend upon tax rates paid by older workers. The average 62-year old working full time in 2010 earned around $58,800,[8] implying a federal income tax rate of about 15 percent. Adding the 2.9 percent Medicare payroll tax and a 4.4 percent average state income tax rate,[9] total non-Social Security revenues would rise by around $18.3 billion, of which the federal government would collect about $14.7 billion.

These figures are approximate, but higher non-Social Security revenues could at a minimum compensate for much of Social Security's revenues lost to a payroll tax

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[2] Reznik, Gayle, Weaver, David A. and Biggs, Andrew G. "Social Security and Marginal Returns to Work Near Retirement." Social Security Administration. Issue Paper No. 2009–02. April 15, 2009.

[3] Lucie Schmidt and Purvi Sevak. "Taxes, Wages, and the Labor Supply of Older Americans." Research on Aging, March 2009; vol. 31, 2: pp. 207-232. *http://roa.sagepub.com/content/31/2/207.abstract*

[4] Congressional Budget Office. "Labor Supply and Taxes." January 1996.

[5] Journal of Public Economics, forthcoming.

[6] Eric French. "The Effects of Health, Wealth, and Wages on Labor Supply and Retirement Behavior." Review of Economic Studies, April 2005, 72(2), 395–427.

[7] Eliminating the payroll tax would raise wages by around 13.3 percent (106.2/93.8), times a labor supply elasticity of 0.1067 = 1.41%.

[8] Source: American Community Survey.

[9] See *http://www.nber.org/taxsim/state-marginal/avrate.html*

cut. As part of a Social Security reform package, transfers of general tax revenue could compensate Social Security for losses in payroll tax revenue, thereby making the payroll tax cut neutral with regard to Social Security's solvency.

While eliminating the payroll tax for older workers would come at little cost to the budget, the gains to individuals and the economy could be substantial. Simply working one additional year would boost average private pension income by almost 5 percent.[10] This would reduce poverty in old age and contribute to overall retirement income security.

Labor force participation among older Americans has ticked upward as near-retirees seek to rebuild their 401(k)s. This demonstrates that, even in a very challenging employment environment, highly motivated individuals can often find positions. But overall, Americans today still retire several years earlier than in prior decades, despite less strenuous jobs and significantly longer life spans. The typical American will spend one-third of his adult life in retirement, financed by entitlement programs that cannot bear the strain. Social Security's poor returns to older workers discourage delayed retirement, which would strengthen the economy and is the single option available to many individuals who reach retirement age with insufficient resources. Policy options such as lowering the payroll tax rate on older workers could increase labor supply, boost the economy and raise retirement incomes.

[10] Author's calculations using Policy Simulation Group models.

Testimony to the Joint Economic Committee hearing on "How the Taxation of Labor and Transfer Payments Affect Growth and Employment," Wednesday, May 16, 2pm (embargoed until the hearing begins).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; co-founder of http://BaselineScenario.com; member of the CBO's Panel of Economic Advisers; and member of the FDIC's Systemic Resolution Advisory Committee.[1]

A. Main Points

1) The US faces a serious medium-term budget deficit problem – realistic forecasts show a rising trajectory for US government debt over the next two decades.
2) The primary drivers of the large increase in public debt over the past decade were: the George W. Bush-era tax cuts; wars in Iraq and Afghanistan; Medicare Part D; and the financial crisis that began in the fall of 2008. This is the sixth surge in national debt in US history; the previous 5 surges were all caused by war (see Chapters 1 and 2 in *White House Burning* by Simon Johnson and James Kwak, on the history of U.S. national debt).
3) The current nature of our financial sector generates system risk that has negative macroeconomic implications in the United States, including for our public finances.
    a. To assess just the fiscal impact of the recent finance-induced recession, consider changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO projected that over the next eight years debt will rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion.
    b. Most of this fiscal damage is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the United States are relatively weak); and another 14% is due to increased interest payments on the national debt – because we now have more debt.[2]
    c. In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget

[1] This testimony draws on heavily on joint work with James Kwak, including *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (Pantheon, 2010) and, on the history and outlook of the US budget, including the system of taxation, *White House Burning: The Founding Fathers, The National Debt, And Why It Matters To You* (Pantheon, April 2012). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy. For important disclosures relative to affiliations, activities, and potential conflicts of interest, please see my bio on BaselineScenario.

[2] See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

in the United States. It also damages the nonfinancial sector both directly – when there is a credit crunch, followed by a deep recession – and indirectly through creating a future tax liability.

d. Despite reform efforts since the crisis, including the Dodd-Frank legislation, big banks today still create major structural system risks.[3] Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program (TARP) summarized the situation well in his January 2011 report, emphasizing: "perhaps TARP's most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are 'too big to fail.'"

4) The idea that the recent increase in public debt is due primarily to "runaway spending" since 2008 is completely at odds with the historical record – although it is true that spending was not under control in the period 2000-08 (see Chapter 3 in *White House Burning*.) The worsening deficits since 2008 have been primarily due to a big drop in tax revenue and the sharp fall in GDP due to the finance-induced recession.
5) Looking forward, as society ages we face increasing pressures on social security, Medicare, and other forms of basic social insurance. Healthcare spending – not just the government paid part of healthcare – needs to be brought under control. Efforts to reform the healthcare system more broadly met great resistance. Phasing out or otherwise limiting Medicare spending, while not addressing the increase in healthcare costs, is not an appealing approach – as the Congressional Budget Office has pointed out, this will likely just increase healthcare spending as a percent of GDP.[4]
6) In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. Part of that should include additional tax revenues, phased in over the next two decades.[5]
7) The best way to strengthen revenues would be to introduce a value added tax – shifting taxation towards consumption and away from income. But this is unlikely to receive widespread political support in the near future.
8) A "tax reform" that reduces tax expenditures would be helpful – these tax expenditures are a form of disguised government spending and should be viewed on that basis (we make proposals along these lines in Chapter 7 of *White House Burning*). But too many tax reform proposals today involve reducing or limiting government revenue. We need to strengthen the revenue base of the federal government – returning closer to the tax rates of the late 1990s.
9) The most feasible way to strengthen revenue is not to extend any part of the Bush-era tax cuts that expire at the end of this year.

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[3] Andrew Haldane (Bank of England) and Anat Admati (Stanford University) both refer to system risk in this context as a form of pollution, i.e., a negative social spillover that should be discouraged by regulation and/or taxation.

[4] For the details of the CBO's assessment, see this column and the links it contains: http://baselinescenario.com/2012/05/03/mitt-romney-and-paul-ryans-budget/.

[5] Scrapping the existing tax system would not make sense, for example under the so-called "Fair Tax" proposal – this would be a huge undertaking with big downside risks. The benefits of such a system have been greatly exaggerated by some of its proponents. See Bruce Bartlett, "Why the Fair Tax Won't Work," *Tax Notes*, December 24, 2007, pp.1241-1254, and Chapter 9 in the President's Advisory Panel on Tax Reform (http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_8-9.pdf), a report prepared during the administration of President George W. Bush.

10) There is no evidence that those tax cuts led to an economic boom, stimulated productivity or otherwise boosted labor supply – the next section reviews in more detail exactly what happened. Similarly, we should expect that the removal of those tax cuts would not have any medium-term effect on the economy.
11) If there is concern for the short-run impact on the economy – depending on the precise situation at the end of this year – the Bush tax cuts could be replaced with a temporary payroll tax cut, linked to employment relative to total population (based on a rule set in law). This would ensure that revenue recovered as the economy picks up and as we return towards full employment.
12) Raising taxes is never easy or pleasant. But we need to put funding for the federal government on a more sustainable basis and the best way to do this is to strengthen revenue through not extending the Bush-era tax cuts.

B. Recent History of Tax Cuts

The election of George W. Bush gave the Republican Party control of the White House and both branches of Congress.[6] Deficits were off the agenda. Instead, as the new president was inaugurated in January 2001, the CBO was projecting trillions of dollars in surpluses over the next decade, including a 2010 surplus of $796 billion.[7] The actual 2010 deficit was almost $1.3 trillion--a difference of over two trillion dollars.

True to his campaign pledges and to the conservative base, the first major item on President Bush's agenda was large income tax cuts. Originally justified as a way of returning budget surpluses to the people, the tax cuts were repositioned as a way to stimulate a weakening economy--an example of touting tax cuts as the appropriate response to any situation.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was the third-largest tax cut in modern history.[8] It lowered tax rates for nearly everyone who paid income tax (with the top rate falling from 39.6 to 35 percent), increased deductions and exemptions for high-income households, made it easier to shield retirement savings from taxes, increased family tax credits, and eventually repealed the estate tax.[9] The advertised impact of the tax cuts was $1.3 trillion over ten years, but their true size was significantly higher. In order to avoid the

[6] In May 2001, Senator Jim Jeffords left the Republican Party and began caucusing with the Democrats, giving them a 51-49 majority in the Senate. However, the Republicans were able to attract the few Democratic votes necessary to pass their budgetary proposals. From 2003 to 2007 the Republicans had majorities in both houses of Congress.

[7] CBO, *The Budget and Economic Outlook: Fiscal Years 2002-2011*, January 2001, Table 1-1, p. 2. The projected 2010 surplus in the CBO's baseline would climb to $806 billion by May 2001. CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2002*, May 2001, Table 1, p. 12. In retrospect, the CBO's economic forecast was too optimistic, but it was no more optimistic than forecasts by private sector economists. In January 2001, the CBO forecast average real GDP growth of 3.0 percent for the 2001–2010 period; the Blue Chip consensus forecast (and average of private sector economists' forecasts) was for average real GDP growth of 3.3 percent. CBO, *The Budget and Economic Outlook*, January 2001, Table 2-2, p. 30.

[8] The largest as a share of GDP was the 1981 Reagan tax cut; the second largest was the 1964 Kennedy-Johnson tax cut. In 2010, when fully phased in, EGTRRA was projected to reduce tax revenues by $176 billion, or 1.1 percent of GDP (as then projected by the CBO), making it larger than the Revenue Act of 1978. In real dollar terms, EGTRRA was the second-largest tax cut in modern history. We exclude the major tax cuts enacted as a result of the end of World War II. CBO, "Pay-As-You-Go Estimate, H.R. 1836: Economic Growth and Tax Relief Reconciliation Act of 2001," June 4, 2001; Jerry Tempalski, "Revenue Effects of Major Tax Bills, Treasury Department Office of Tax Analysis Working Paper 81, September 2006, Table 2, pp. 16–20.

[9] For a summary, see CBO, "Pay-As-You-Go Estimate, H.R. 1836," June 4, 2001. The estate tax repeal was phased in for 2010 only.

threat of a filibuster in the Senate, the tax cuts were passed through the budget reconciliation process,[10] which meant that they could not permanently increase deficits, and so all of the tax cuts were scheduled to expire by the end of 2010.[11] In order to reduce the total ten-year cost of the tax cuts--to make them easier to pass--several of them were deferred, with over 70 percent of the total tax reduction coming after 2006.[12] By 2010, when most of the tax cuts would be in effect, they were officially expected to cost $176 billion (1.1 percent of GDP), not counting the additional interest payments they would require.[13] But the real impact of the 2001 tax cuts would be even bigger, because they increased the number of households exposed to the Alternative Minimum Tax (AMT); since Congress can be counted on to "patch" the AMT to shield middle-class households,[14] this meant that future patches would have to be even bigger.[15]

The complicated phase-ins made the impact of the 2001 tax cuts much larger in 2010 than in 2001--and President Bush's goal was to make them permanent at the 2010 level. The 2010 sunset provision made it possible to argue that allowing the tax cuts to expire would amount to a tax increase. As early as 2004, when Congress began extending provisions of the 2001 tax cuts, Representative Jim McCrery argued, "Anyone voting 'no' is voting for a tax increase for the American people, especially the middle class."[16] When 2010 rolled around, Republicans opposed, as a tax increase, any proposal to let any of the tax cuts expire; aided by a financial crisis and a major recession, which created an economic argument against "raising" taxes, the tax cuts were extended through 2012 with the support of a Democratic president and Democratic majorities in Congress. The 2001 tax cuts had become a Trojan horse that threatened to make a permanent, structural change in the tax system.[17]

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[10] By Senate rules, most measures require sixty votes in order to end debate and move to a vote; a filibuster allows forty-one Senators to prevent a vote. The budget reconciliation process, originally created by the Congressional Budget and Impoundment Control Act of 1974 to expedite budgetary legislation, provides an exception to this rule for bills that change revenue and mandatory spending laws. Allen Schick, *The Federal Budget: Politics, Policy, Process*, 3rd ed. (Brookings Institution Press, 2007), pp. 142-47.]

[11] Under the "Byrd rule" in the Senate, a bill that goes through reconciliation cannot increase deficits in any year after the period specifically covered by the initial budget resolution.

[12] CBO, *An Analysis of the President's Budgetary Proposals*, May 2001, p. 6.

[13] CBO, "Pay-As-You-Go Estimate, H.R. 1836," June 4, 2001. The GDP estimate is from CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2002*, May 2001, Table 5, p. 16. Actually, it's even more complicated because some tax cuts were phased out before 2010; if those were extended to 2010 (which some eventually were), the 2010 tax cut would become even bigger.

[14] The AMT is an alternative tax system originally designed to ensure that the very wealthy paid at least some tax; it does this by disallowing many common tax deductions for high-income taxpayers. Because the AMT is not indexed for inflation, it would affect a growing number of middle-class households as time passes. Therefore, Congress regularly "patches" the AMT (raising the thresholds to account for inflation), but only for a few years at a time.

[15] Taxpayers must calculate their tax liability under both the regular income tax and the AMT and pay whichever is greater. The 2001 tax cuts, by reducing ordinary income taxes, meant that more people would have to pay the AMT. Therefore, the official assumption (based on current law) was that AMT revenues would increase, partially offsetting the reductions in the ordinary income tax. In practice, this only meant that future actions to patch the AMT would cost even more in foregone revenue than they would have otherwise. See Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, "The AMT: Projections and Problems," *Tax Notes*, July 7, 2003: 105-117.

[16] Iwan Morgan, *The Age of Deficits: Presidents and Unbalanced Budgets from Jimmy Carter to George W. Bush* (University Press of Kansas, 2009), p229.

[17] At the time, the Center on Budget and Policy Priorities estimated that the 2001 tax cut would cost $4.1 trillion in its second decade (from 2012 through 2021), not counting additional interest on the larger national debt. Joel Friedman, Richard Kogan, and Robert Greenstein, "New Tax-Cut Law Ultimately Costs As Much As Bush Plan," Center on Budget and Policy Priorities, revised June 27, 2001.

By 2003, the surplus was gone, the victim of the 2001 tax cut and an economic slowdown.[18] But President Bush repeated the 2001 strategy: large tax cuts justified as an economic stimulus and passed through the reconciliation process, their total size masked by phase-outs, with intense pressure from conservative groups to keep Republican legislators in line. In addition to Americans for Tax Reform, the Club for Growth attacked moderate Republicans who wavered.[19] This time, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) lowered the tax rate on capital gains (profits on the sale of investments) and dividends (payments made by corporations to their stockholders) to a maximum of 15 percent; it also accelerated several of the 2001 tax cuts so they kicked in sooner than originally scheduled. The official ten-year cost was $350 billion, but again that figure relied on early phase-outs that few people expected to occur.[20] (Not surprisingly, the major 2003 tax cuts were later extended through 2010 by the Tax Increase Prevention and Reconciliation Act of 2005.[21])

While most households that paid income taxes saw their taxes go down in 2001 and 2003, the biggest beneficiaries by any measure were the wealthy. When fully phased in, 67 percent of the tax cuts passed during the Bush administration went to the richest 20 percent of households; 15 percent of the benefits went to the richest 0.1 percent of households.[22] Households making between $40,000 and $50,000 saw an average 2010 tax reduction of $962, but households making more than $1 million got an average of $168,052.[23] And this is not just because the rich pay more taxes to begin with. The richer you are, the larger the percentage increase in your after-tax income (8.2 percent for the wealthiest one-thousandth of all households, but only 2.6 percent for the median family) and the more percentage points were shaved off your effective federal tax rate.[24]

One major reason for the unequal distribution of the tax cuts is that they focused on the income tax, while most people pay more in payroll taxes--the taxes on wages that are dedicated to Social Security and Medicare--which were unaffected by the tax cuts.[25] Another is that the 2003 tax cut primarily benefited people who earn taxable income from investments rather than

[18] CBO, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, January 2003, Summary Table 1, p. xvi. The CBO was projecting surpluses to return in 2007, but this was solely because of off-budget (Social Security trust fund) surpluses. On-budget surpluses would only return in 2012, but that assumed that the 2001 tax cut would expire.
[19] Jacob C. Hacker and Paul Pierson, *Off Center: The Republican Revolution and the Erosion of American Democracy* (Yale University Press, 2005), pp. 53-54.
[20] CBO, "Cost Estimate, H.R. 2: Jobs and Growth Tax Relief Reconciliation Act of 2003," May 23, 2003.
[21] Morgan, note 16, above, p. 230.
[22] Tax Policy Center, Table T08-0157, Individual Income and Estate Tax Provisions in the 2001-08 Tax Cuts with AMT Patch Extended, Distribution of Federal Tax Change by Cash Income Percentile, 2010, available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1866&DocTypeID=2. We chose the 2010 impact because this was the last year before the tax cuts were scheduled to expire; we chose the version with the extended AMT patch because the AMT has been patched.
[23] Tax Policy Center, Table T08-0156, Individual Income and Estate Tax Provisions in the 2001-08 Tax Cuts with AMT Patch Extended, Distribution of Federal Tax Change by Cash Income Level, 2010, available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1865&DocTypeID=1.
[24] Tax Policy Center, Table T08-0157, note 22, above.
[25] 76.1 percent of all taxpaying households pay more in payroll taxes than in income taxes, including the employer share of payroll taxes. 50.6 percent of all taxpaying households pay more in payroll taxes than in income taxes when only counting the employee share of the payroll tax. These calculations are based on 2011, when the payroll tax was unusually low because of the December 2010 tax cut. Tax Policy Center, Table T11-0192, Distribution of Tax Units that Pay More in Payroll Taxes than Individual Income Taxes, by Cash Income Percentile, Current Law, 2011, available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3073&DocTypeID=2.

income from labor--that is, the rich.[26] It is true that most taxpaying households did see their taxes go down, but those same households have to pay for the tax cuts in the form of reduced government services, lower future benefits, or higher future taxes; seen as a complete package, it's likely that most households were made worse off.[27] The sharp decrease in taxes for the very rich also contributed to increasing income inequality, as the top 1 percent of all households saw their share of the entire population's income rise steeply from 2002.[28]

The Bush tax cuts certainly weakened the federal government's situation. Total government revenues fell from 20.6 of GDP in 2000 to 16.1 percent in 2004, the lowest level in more than half a century. That decline was due in part to the stock market collapse of 2000 and the brief recession of 2001. A better comparison is that during the 1991–2000 economic expansion (the period between two recessions), revenues averaged 18.9 percent of GDP; during the 2001–2007 expansion, they averaged only 17.3 percent--a difference worth about $200 billion a year.[29] Supporters have argued that the tax cuts actually increased tax revenues by stimulating economic growth. In 2007, President Bush claimed, "It is also a fact that our tax cuts have fueled robust economic growth and record revenues."[30] But there are two problems with this claim. One is that real economic growth was not particularly robust, averaging only 2.7 percent per year during the 2001–2007 expansion, as compared to 3.7 percent during the 1990s expansion (when tax rates were higher).[31] The other is that multiple economic analyses have shown that the economic growth caused by a tax cut can at best offset a portion of the revenues lost by that tax cut.[32] In addition, while a tax cut may increase growth in the short term (because

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[26] While many middle-class households have investments, a large proportion of those investments are in their houses--which are largely shielded from capital gains taxes--or in retirement savings accounts, which also enjoy tax preferences.

[27] Douglas W. Elmendorf, Jason Furman, William G. Gale, and Benjamin H. Harris, "Distributional Effects of the 2001 and 2003 Tax Cuts: How Do Financing and Behavioral Responses Matter?" Brookings Institution, June 2008. The authors model the financing of the tax cuts either as an equal-dollar loss for all households or as a loss that is proportional to income; on these assumptions, either 17 percent or 22 percent of households would benefit from the tax cuts. As they say, "To be sure, if one assumes that the financing occurs entirely through spending reductions and that the foregone spending is worthless to individuals, then the standard distributional analysis applies. However, despite decades of stump speeches about unnecessary government spending, the political process has been persistently unable to identify significant outlays that voters will blithely forego." Their analysis also incorporates behavioral effects of the tax cuts, which increases the proportion of households made better off to 34 percent. Ibid., Table 5.

[28] Emmanuel Saez, "Striking It Richer: The Evolution of Top Incomes in the United States (Updated with 2008 Estimates)," July 17, 2010, available at http://elsa.berkeley.edu/~saez/saez-UStopincomes-2008.pdf, Figure 2.

[29] We only include fiscal years that were entirely during periods of economic expansion; we excluded FY 1991 because the economy was in recession until March 1991; we excluded FY 2001 and 2002 because the economy was in recession until November 2001, which was during the 2002 fiscal year. In addition, after correcting for the effect of the economic cycle, tax revenues still fell from 20.1 percent of GDP in 2000 to 16.5 percent in 2004; cyclically adjusted revenues ranged from 19.5 percent to 20.1 percent of GDP from 1998 through 2000, but only from 15.4 percent to 18.9 percent from 2003 through 2009. (We omit 2001 from the comparison because the first Bush tax cut took place during the 2001 fiscal year.) CBO, *Measuring the Effects of the Business Cycle on the Federal Budget: An Update*, September 1, 2009. Finally, the Bush tax cuts were not fully phased in during part of the 2001–2007 expansion; had they been fully phased in at the beginning, average revenues would have been lower.

[30] George W. Bush, "What the Congress Can Do for America," *The Wall Street Journal*, January 3, 2007.

[31] GDP data are from BEA, National Income and Product Accounts , Table 1.1.6. Growth is measured from the first quarter following the end of a recession to the last quarter preceding the beginning of the next recession.

[32] In 2005, the CBO (then headed by a Republican appointee, Douglas Holtz-Eakin) estimated that the economic effects of a 10 percent cut in income taxes would offset between 1 and 22 percent of the revenue loss in the first five years; in the following five years, the economic effects might offset up to 32 percent of the revenue loss, but might also *add* 5 percent to the revenue loss. CBO, "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in

people will have more money to spend), a tax cut that increases deficits tends to reduce economic growth in the long term (because more government borrowing increases interest rates for everyone), according to a study by the congressional Joint Committee on Taxation (issued in 2006, when Republicans controlled both the House and the Senate).[33]

Together, the Bush tax cuts (including the higher interest payments they caused) added about $270 billion to the 2010 deficit.[34] Over the past decade, their cumulative effect has been to increase the national debt by close to $3 trillion.[35] They are not the primary reason why the national debt is so much bigger today than expected in 2001: tax cuts take second place to economic weakness, in particular the severe recession triggered by the financial crisis.[36] But of the conscious policy choices of the current century, the tax cuts (and their extension in December 2010) made the single largest contribution to today's budget deficits and to the recent growth in the national debt.[37]

Income Tax Rates," Economic and Budget Issue Brief, December 1, 2005. A paper co-authored by Gregory Mankiw, a former chair of President Bush's Council of Economic Advisers, calculates that 32.4 percent of the static revenue loss of a capital gains tax cut and 14.7 percent of the static revenue loss of a labor tax cut could be offset in present value terms (ignoring short-term Keynesian effects). N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," *Journal of Public Economics* 90 (2006): 1415-33, p. 1430. An offset of 32.4 percent is a lot, but far less than 100 percent. Even then, Mankiw and Weinzierl assume that government spending falls to keep the budget in balance. Ibid., p. 1417. If instead the tax cuts are financed by additional debt, their ultimate effect can be to lower economic growth in the long term, depending on the eventual consequences of the larger debt. Eric M. Leeper and Shu-Chun Susan Yang, "Dynamic Scoring: Alternative Financing Schemes," *Journal of Public Economics* 92 (2008): 159-82, pp. 166-69.

[33] The Joint Committee on Taxation estimated that a ten percent cut in individual income tax rates would reduce economic growth in the long run if the tax cut were financed by increased borrowing. Joint Committee on Taxation, "Exploring Issues in the Development of Macroeconomic Models for Use in Tax Policy Analysis," JCX-19-06, June 16, 2006.

[34] In 2007, the CBO estimated the 2010 impact of the tax cuts, including interest payments, at $269 billion. Peter R. Orszag, Letter to the Honorable John M. Spratt, Jr., July 20, 2007.

[35] Through 2008, the Bush tax cuts accounted for $1.7 trillion in deficits and over $200 billion in additional interest costs. Kathy Ruffing and James R. Horney, "Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits," Center on Budget and Policy Priorities," May 10, 2011, p. 8. For 2009 through 2011, the CBO estimated a total impact of $729 billion, but that was before the December 2010 tax cut extension. Orszag, note 34, above. The 2010 extension added almost $200 billion to the 2011 impact of the tax cuts, not counting the new payroll tax cut and another AMT patch. CBO, "Estimate of Changes in Revenues and Direct Spending for S.A. 4753, an Amendment to H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," December 10, 2010.

[36] An analysis by the Pew Charitable Trusts broke down the components of the increase in the 2011 national debt since the CBO's projection in January 2001. The largest factor was lower revenues due to economic changes and technical re-estimates (28 percent). The second largest was the 2001/2003 tax cuts (13 percent); the December 2010 tax cuts, which largely extended the 2001/2003 tax cuts, contributed 3 percent, while other tax cuts contributed 5 percent, for a total of 21 percent attributable to tax cuts. That does not include additional interest payments because of the larger debt created by those tax cuts. (The 2009 stimulus bill, by contrast, was responsible for only 6 percent of the increase in the debt.) Pew Fiscal Analysis Initiative, *The Great Debt Shift: Drivers of Federal Debt Since 2001*, April 2011, Figure 3, p. 5.

[37] Ibid; Ruffing and Horney, note 35, above; Teresa Tritch, "How the Deficit Got This Big," *The New York Times*, July 23, 2011; Chad Stone, "What's Driving Projected Debt?" Off the Charts (blog), Center for Budget and Policy Priorities, May 20, 2011. Brian Riedl of the Heritage Foundation has argued that focusing on the Bush tax cuts is arbitrary, since the projected deficit could also be blamed on Social Security, Medicare, or other programs. Brian Riedl, "The Bush Tax Cuts and the Deficit Myth," *The Wall Street Journal*, July 13, 2010. The Bush tax cuts, however, were a policy choice made after the long-term deficits in Social Security and Medicare were clearly visible, yet without making any effort to offset the tax cuts in any way. Riedl argues that deficits must be the fault of increasing spending because tax revenues remain roughly stable at around 18 percent of GDP. But this argument

In the conservative playbook, the reason to cut taxes is not just to put more money in people's pockets, but more importantly to force the government to shrink. If the Bush administration had cut spending to match the tax cuts, then the national debt would be far smaller today. But instead, the administration increased spending, which grew from 18.2 percent of GDP in 2001 to 20.7 percent of GDP in 2008.[38] Half of this increase was due to defense spending, largely because of the Afghanistan and Iraq Wars, which so far have cost well over one trillion dollars.[39] Democrats often blame the Iraq War on the Bush administration, which mounted a concerted campaign to build public support for the war. On the other hand, the Congressional resolution authorizing the invasion was backed by a majority of Democrats in the Senate and a near majority in the House.[40]

In any case, what mattered for the federal budget was how we chose to pay for those wars: increased borrowing. President Lyndon Johnson resisted raising taxes to fight the Vietnam War because he was afraid higher taxes would undermine support for his domestic initiatives;[41] President Bush resisted raising taxes to fight the Iraq War because tax cuts *were* his major domestic initiatives. Instead, Bush introduced his 2003 tax cut in January,[42] while he was building international support for the invasion, and it was passed in May, two months after the war began. The administration reconciled war with tax cuts in part by downplaying the costs of the war. When Lawrence Lindsey, director of the president's National Economic Council, estimated that the upper bound on the war's costs would be $100–200 billion (which, he added, was "nothing"), he was shot down by Mitch Daniels, director of the Office of Management and Budget, and Lindsey soon left the administration.[43] Secretary of Defense Donald Rumsfeld claimed the cost would be no more than $50–60 billion.[44] Tom DeLay, by then House Majority Leader, said, "Nothing is more important in the face of a war than cutting taxes"--going even further than the original War Hawks of 1812, who merely declined to find a way to pay for the war they had just declared.[45]

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ignores the fact that tax cuts--including the Bush tax cuts--are the very mechanism that keeps tax revenues from growing much higher than 18 percent of GDP for very long.

[38] OMB, *Fiscal Year 2012 Budget of the U.S. Government: Historical Tables*, Table 1.2.

[39] Defense spending grew from 3.0 to 4.3 percent of GDP--half of the total increase in GDP terms. Ibid., Table 8.4. As of January 2011, appropriations through 2010 were $1,104 billion, with appropriations for 2011 running at an annual rate of $159 billion. CBO, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, January 2011, Box 3-2, p. 77. This does not include additional interest payments on the larger national debt, which came to $64 billion through 2008. Ruffing and Horney, note 35, above, p. 8. The appropriations include $126 billion for war-related activities not specifically associated with Afghanistan and Iraq. Linda Bilmes and Joseph Stiglitz have estimated the true cost of the Iraq War at over $3 trillion. Linda J. Bilmes and Joseph E. Stiglitz, *The Three Trillion Dollar War: The True Cost of the Iraq Conflict* (W.W. Norton, 2008). This figure, however, includes economic losses suffered by Americans that do not add to the government debt. See Peter Orszag, "Estimated Costs of U.S. Operations in Iraq and Afghanistan and of Other Activities Related to the War on Terrorism," testimony before the House Budget Committee, October 24, 2007, pp. 10-14.

[40] Voting information for the Authorization for Use of Military Force Against Iraq Resolution of 2002 is available at http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HJ00114:@@@R.

[41] Dennis S. Ippolito, *Why Budgets Matter: Budget Policy and American Politics* (Pennsylvania State University Press, 2004), p. 175.

[42] Richard W. Stevenson, "Bush Unveils Plan to Cut Tax Rates and Spur Economy," *The New York Times*, January 8, 2003.

[43] Elisabeth Bumiller, "White House Cuts Estimate of Cost of War with Iraq," *The New York Times*, December 31, 2002; Matthew Engel, "Cost of War Put at $200bn, but That's Nothing, Says US Adviser," *The Guardian*, September 16, 2002.

[44] Morgan, note 16, above, p. 235.

[45] Quoted in James Surowiecki, "A Cut Too Far," *The New Yorker*, April 21, 2003.

While many conservatives were happy to spend more on national defense, where they really wanted to cut spending was in the major entitlement programs: Social Security and Medicare. When asked what his ideal policies were, Grover Norquist said,

> The first would be personalizing Social Security, privatizing Social Security, instead of having the state take 12 percent of your income and then promising to pay you something if you make it to 65 or 67. Instead, they should let you put that money into a 401(k), and then you would control it.[46]

Structural Medicare reform had already been one of House Speaker Newt Gingrich's major goals in the 1995 budget fight.[47] By the Bush years, it was clear that current Social Security and Medicare policies would lead to large long-term deficits. But even here, President Bush's policies only increased long-term entitlement spending. In 2003, the president and his congressional allies *added* a new prescription drug program to Medicare--at the request of elderly people struggling with rising drug prices--without finding a way to pay for its benefits in full. The new program was officially estimated to cost $395 billion over ten years;[48] Medicare's chief actuary estimated it would cost $500–600 billion, but was ordered by the program's administrator, a political appointee, not to provide his estimates in response to congressional requests.[49] In any case, the prescription drug benefit has made Medicare's future funding problems much larger: today, almost one-third of Medicare's long-term deficit is due to the prescription drug program.[50] After the 2004 elections, President Bush also made reforming Social Security a top priority. He proposed allowing people to divert part of their payroll taxes into individual accounts that they would control and keep; but since those accounts would have reduced the amount of money available to pay current benefits, the government would have had to borrow up to one trillion dollars over the next ten years, adding to the national debt.[51] Because of widespread opposition, Social Security privatization never came close to a vote.

The tax policies of the Bush administration were a lopsided victory for the tax revolt--a victory that produced vast increases in government deficits and the national debt. The 2004 deficit reached $413 billion (3.5 percent of GDP); modest economic growth reduced the deficit to $161 billion in 2007 (1.2 percent), but it would have been significantly larger without a Social

[46] Nick Gillespie, "An Alliance for Freedom?" *Reason*, August/September 2008.
[47] See Jonathan Oberlander, *The Political Life of Medicare* (University of Chicago Press, 2003), pp. 175–76.
[48] CBO, "Estimate of Effect on Direct Spending and Revenues of Conference Agreement on H.R. 1," November 20, 2003.
[49] Robert Pear, "Inquiry Confirms Top Medicare Official Threatened Actuary Over Cost of Drug Benefits," *The New York Times*, July 7, 2004. The administrator, Thomas Scully, resigned after the bill passed to become a lobbyist for health care companies.
[50] The seventy-five-year deficits of the three major components of Medicare, in present value terms, are: Part A (Hospital Insurance), $3.1 trillion; Part B (Medical Insurance), $13.9 trillion; and Part D (Prescription Drug Coverage), $7.5 trillion. (Part C refers to Medicare Advantage plans, which are provided by private insurers but subsidized by Medicare.) *2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, Tables III.B9, III.C15, III.C23, pp. 83, 130, 146.
[51] CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2006*, March 2005, pp. 47–49. Participants diverting money into individual accounts would presumably receive lower guaranteed benefits when they retired. But money going into individual accounts would no longer be available to pay promised benefits to current retirees, requiring additional borrowing. The shortfall could have been reduced by lowering benefits for current retirees, but the president did not explicitly propose such a plan.

Security surplus that could not last once the Baby Boom generation began retiring.[52] Even before the financial crisis, the outlook for 2010 had shifted from the $796 billion surplus projected in 2001 to a $241 billion deficit.[53] And it was clear that demographic trends would soon turn against the federal government.[54]

Focusing on the politics of taxes rather than the politics of spending may seem simply a matter of framing. Arguably, if increases in the national debt can be blamed on one side's insistence on tax cuts, they could as easily be blamed on the other side's insistence on spending increases. More concretely, Republicans may claim that the growth of the national debt is the fault of higher spending on Social Security and Medicare, not tax cuts. When considering the recent history of deficits and the debt, however, this is a false equivalence. In politics, there is a major difference between action that changes policy and inaction that simply preserves existing policy. The national debt was on a certain course in 2001, and it was the policies of the tax revolt that shifted it to a different course, with higher deficits. Republicans invested heavily and successfully in tax cuts that were meant to be permanent. Democrats, by contrast, made no significant efforts to expand spending on the major social insurance or welfare programs: Social Security has gone untouched, and while the Obama health care reform bill of 2010 increased certain types of health care spending, on balance it reduced future deficits rather than increasing them.[55] (The only recent entitlement expansion that significantly increased deficits was the Medicare prescription drug bill of 2003.) Insofar as Social Security and Medicare spending has increased since the days of surpluses, it is because of policy choices made decades before and simply left unchanged.

Even then, Social Security and Medicare have been relatively small contributors to the national debt. From 1984 (the year after the last major adjustment to Social Security) through 2007 (the last year before the recent financial crisis and recession), the two programs together ran a cumulative deficit of $270 billion--a small fraction of the $5 trillion national debt at the end of 2007.[56] More than one-quarter of that cumulative deficit was due to the Medicare prescription drug benefit added in 2003.[57] (Since the beginning of the recession, which triggered sharp declines in payroll taxes and increases in benefit payments, Social Security and Medicare have contributed another $597 billion to the national debt--while the total national debt has grown by $4 trillion.[58]) In other words, the deterioration of the federal budget in recent years and the resulting increase in the national debt are not the fault of Social Security and Medicare. Growing

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[52] In 2007, Social Security ran a surplus of $81 billion, not counting interest received from the rest of the federal government. Without that surplus, the 2007 government deficit would have been $242 billion. The 2007 surplus was the sixth largest in history after 2000–2002 and 2005–2006. OMB, note 38, above, Table 13.1.

[53] CBO, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008, Summary Table 1, p. xii.

[54] CBO, *The Long-Term Budget Outlook*, December 2007, Figure 1-2, p. 4.

[55] Douglas W. Elmendorf, CBO's Analysis of the Major Health Care Legislation Enacted in March 2010, testimony before the Health Subcommittee of the House Energy and Commerce Committee, March 30, 2011, Table 1, p. 2.

[56] OMB, note 38, above, Tables 13.1 and 7.1. To calculate program deficits in any year, we take the actual trust fund surplus or deficit and subtract any interest received from the rest of the government and (for Medicare Parts B and D) any transfers from general government revenues; this yields the program's true impact on the overall federal deficit in that year. Including interest payments from the rest of the government (but not transfers from general revenues), the programs together ran a surplus over the same period. The $270 billion figure does not include additional interest payments, so the true impact on the 2007 national debt is slightly larger.

[57] *2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, Table III.C19, p. 139. To calculate the Medicare Part D deficit, we take all income except for transfers from general revenue and subtract all expenditures.

[58] Almost one-quarter of that $597 billion is due to the Medicare prescription drug program. Ibid.

spending on these programs is a major factor in the future growth of the national debt (as we discuss in *White House Burning*) but not in the story of how we got to where we are today.

Despite the tax cuts of the Bush years, few people in 2007 thought that budget deficits amounted to a national emergency. Foreign investors' growing appetite for Treasury bonds ensured that significant budget deficits could be financed easily. The national debt was only 36 percent of GDP, right around the average for the previous fifty years.[59] As of January 2008, the CBO's baseline projection was for the national debt to fall to 23 percent of GDP by 2018 (assuming that all of the Bush tax cuts would expire on schedule).[60] The next president, it seemed, would inherit a significant long-term deficit problem, but not a crisis. The financial meltdown of fall 2008 changed this situation dramatically.

C. Background: Sources of Revenue for the Federal Government

In 2010, the federal government collected $2.2 trillion in revenues, the vast majority of that from taxes. The **individual income tax** (for which returns are due on April 15) was the largest source of government revenues, accounting for $899 billion, or 42 percent of the total. Each household has to pay a percentage of its income, ranging from 0 percent for the first few thousand dollars it earns to 35 percent for income that exceeds several hundred thousand dollars per year.[61] (Because of various exemptions, deductions, and tax credits--as well as basic poverty--almost half of all households pay no federal income tax at all.[62]) This structure means that the individual income tax is progressive: rich people generally pay a higher percentage of their income than poor people.

Individual income taxes have fallen over the past thirty years, from 8.5 percent of GDP in the 1980s and 8.4 percent in the 1990s to 7.4 percent since the 2001 tax cut and 6.2 percent in 2010--the lowest level since 1950.[63] Even if we ignore the recent recession (which lowered income taxes, since people have been making less money), individual income taxes were significantly lower as a share of the economy during the 2001–2007 economic expansion than during the 1991–2000 expansion, largely thanks to the Bush tax cuts.[64]

[59] OMB, note 38, above, Table 7.1. Government debt as a percentage of GDP averaged 36.7 percent from 1958 through 2007.

[60] CBO, *The Budget and Economic Outlook*, January 2008, Summary Table 1, p. xii. By law, the CBO baseline projection must follow certain rules that make it unrealistic. Most importantly, it must assume that current law remains unchanged; in 2007, this meant assuming that the Bush tax cuts would expire on schedule and that the AMT would be allowed to hit middle-class households. Despite this problem, because it is constrained to follow a consistent set of rules, the CBO baseline projection is often the best way to compare the government's fiscal position at different points in time.

[61] These are marginal tax rates, meaning that even if you are in the 35 percent tax bracket, you only pay 35 percent on income above a certain threshold, now around $400,000. The current tax brackets were set by the 2001 tax cut; if it is allowed to expire, the top marginal rate will go back up to 39.6 percent. Technically speaking, there is no zero percent tax bracket, since taxes start at 10 percent on any taxable income. In practice, the personal exemptions and the standard deduction ensure that some of your income is not taxable.

[62] Rachel Johnson, James Nunns, Jeffrey Rohaly, Eric Toder, and Roberton Williams, "Why Some Tax Units Pay No Income Tax," Tax Policy Center, July 2011.

[63] The 7.4 percent average is for fiscal years 2002--the first year for which large components of the 2001 tax cut were in effect--through 2010.

[64] Individual income taxes averaged 8.7 percent of GDP in fiscal years 1992–2000 and 7.6 percent of GDP in fiscal years 2003–2007. We exclude fiscal years 1991, 2001, and 2002 because the economy was in recession for part of each of those years.

As individual income taxes have been falling, the government has come to depend more on **social insurance contributions**, which brought in $865 billion in 2010, or 40 percent of total revenues. The vast majority of this money comes from the dedicated payroll taxes for Social Security and Medicare, which are only levied on income from work, not income from investments.[65] Under current law, 12.4 percent of each person's wages goes to the Social Security trust funds.[66] That money is used to pay benefits currently owed to retirees and disabled people; in previous years, when payroll taxes exceeded benefit payments, the surpluses were invested in Treasury bonds, meaning that they were lent to the rest of the federal government. Another 2.9 percent of wage income goes to another trust fund that pays for the Medicare Hospital Insurance program (Part A). Medicare's Medical Insurance and Prescription Drug Coverage programs (Parts B and D), however, are *not* funded by the payroll tax; instead, they are paid for by beneficiaries' premiums and copayments and by money from general government revenues (that is, other taxes). Together, the payroll tax, premiums, and copayments barely cover half of Medicare's total expenses, which means that the program is heavily subsidized by the rest of the federal government.

The Social Security tax is only collected on each person's wage income up to a cap, which was $106,800 in 2011 (and is indexed to inflation), while the Medicare payroll tax is collected on all wage income.[67] This means that payroll taxes on the whole are regressive: poor and middle-income people pay a higher percentage of their income than rich people.[68] As social insurance contributions have grown (due to rising tax rates), from 2 percent of GDP in the 1950s to over 6 percent in the first decade of the 2000s, an increasing share of government revenues has come from regressive rather than progressive taxes, shifting the overall tax burden onto lower-income people.[69]

The third major source of federal revenues is the **corporate income tax**, which in 2010 brought in $191 billion, or 9 percent of total revenues. Businesses routinely complain that the United States has one of the highest corporate tax rates in the world, with a federal tax rate of 35 percent; including state corporate taxes, we have the second-highest tax *rate* among all advanced economies.[70] But the effective tax rates that U.S. corporations actually pay have been falling for decades as powerful business interests successfully lobby for tax loopholes and companies become more aggressive at taking advantage of those loopholes.[71] Figuring out ways to book

[65] Self-employed people also pay the same payroll taxes.
[66] Technically speaking, the employee pays half of each payroll tax and the employer pays the other half. In addition, the December 2010 tax cut lowered the Social Security payroll tax by two percentage points for 2011 (since extended through February 2012).
[67] In addition, beginning in 2013, a higher Medicare payroll tax rate will be charged on earnings above certain thresholds designed to affect high-income taxpayers.
[68] Someone who makes $50,000 a year ordinarily pays 15.3 percent of her salary, or $7,650, in payroll taxes. Someone who makes $200,000 a year, however, pays only $19,043 in payroll taxes because of the cap on the Social Security tax; this works out to a tax rate of only 9.5 percent.
[69] The tax system as a whole remains modestly progressive, however. For example, in 2010, top-quintile households had 53.5 percent of pre-tax income and paid 68.6 percent of federal taxes, while middle-quintile households had 13.9 percent of pre-tax income and paid 9.8 percent of federal taxes. Tax Policy Center, Table T11-0094, Distribution of Cash Income and Federal Taxes by Filing Status and Family Type, Under Current Law, by Cash Income Percentile, 2010, available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2975&DocTypeID=7.
[70] David Kocieniewski, "Where Pay for Chiefs Outstrips U.S. Taxes," *The New York Times*, August 31, 2011.
[71] See David Leonhardt, "The Paradox of Corporate Taxes," *The New York Times*, February 1, 2011; David Kocieniewski, "U.S. Business Has High Tax Rates but Pays Less," *The New York Times*, May 2, 2011.

profits in overseas subsidiaries where corporate tax rates are lower has become a lucrative pastime for many companies from General Electric to Google, which have claimed billions of dollars in tax benefits.[72] While the corporate tax amounted to 4.8 percent of GDP in the 1950s and 3.8 percent in the 1960s, it fell to 1.9 percent by the first decade of the 2000s and only 1.3 percent in 2010.[73] Including state taxes, corporate taxes in the United States are among the lowest as a share of GDP in the industrialized world.[74]

Tax loopholes not only reduce government revenues but also lead large companies to expend time and money on activities that serve no purpose other than reducing their taxes. It also puts smaller companies, unable to afford expensive lawyers and accountants, at a competitive disadvantage. Our low effective corporate tax rates have led to calls from liberals for corporations to pay higher taxes, but it is important to remember that companies are not real people. If they did pay higher taxes, it is hard to identify how that burden would be spread across employees (as lower wages), shareholders (as lower profits), or other capital owners (as lower rates of return).[75]

In addition to individual income taxes, social insurance taxes, and corporate income taxes, the federal government brought in another $208 billion in 2010 from sources such as alcohol, tobacco, and gasoline taxes, customs duties, and estate taxes. From any perspective, the total revenues of $2.2 trillion (less than 15 percent of GDP) were remarkably low. Not since 1950 were total federal taxes such a small part of the economy as in 2009–2010. Leaving aside the recent recession, federal taxes averaged 17 percent of GDP during the 2001–2007 economic expansion; the last time taxes were so low during a period of growth was in 1958–1960.[76] Including federal, state, and local taxes, the total tax burden in the United States was 24 percent of GDP in 2009, the second-lowest level among the thirty-four industrialized countries in the Organisation for Economic Co-operation and Development (OECD).[77] Compared to other rich countries, we are not an overtaxed country.

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[72] David Kocieniewski, "G.E.'s Strategies Let It Avoid Taxes Altogether," *The New York Times*, March 24, 2011; Jesse Drucker, "The Tax Haven That's Saving Google Billions," *Bloomberg Businessweek*, October 21, 2010.

[73] This may be due in part to the fact that pass-through entities, where tax is paid only on the individual level and not on the company level, are becoming increasingly popular in the United States. The high corporate tax rate in the United States may also be inducing companies to shift their income to other countries. See Tax Policy Center, "International Taxation," in *The Tax Policy Briefing Book: A Citizens' Guide to the 2008 Election and Beyond*, available at http://www.taxpolicycenter.org/briefing-book/.

[74] Over the past decade, the United States has had the eighth-lowest corporate taxes among thirty-one OECD countries, measured as a percentage of GDP. Taxes averaged 2.5 percent of GDP over the 2000–2008 period, compared to an average of 3.5 percent for the OECD. Data are not yet available for 2009 for all countries; data are not available for the entire period for Chile and Mexico. OECD.StatExtracts, Revenue Statistics.

[75] For overviews of this debate, see Alan J. Auerbach, "Who Bears the Corporate Tax? A Review of What We Know," chapter 1 in James M. Poterba, ed., *Tax Policy and the Economy*, vol. 20 (MIT Press, 2006); Rosanne Altshuler, Benjamin H. Harris, and Eric Toder, "Capital Income Taxation and Progressivity in a Global Economy," *Virginia Tax Review* 30 (2010): 355–88, pp. 360–70.

[76] Again, we exclude fiscal years where the economy was in recession for part of the year. The average tax level in fiscal years 2003–2007 was 17.3 percent. The economy expanded from April 1958 to April 1960, leaving only one full fiscal year of expansion (1959), when taxes were 16.2 percent of GDP.

[77] OECD.StatExtracts, Revenue Statistics. Among all OECD countries, the only ones with lower total tax rates as a percentage of GDP in 2009 were Chile and Mexico. Arguably, we pay less in taxes because we have to pay more to the private sector for health care (because the government pays for a smaller share of our health care than in comparable countries). On the other hand, however, our government pays more for health care in absolute terms than most other comparable governments. David A. Squires, "The U.S. Health System in Perspective: A Comparison of Twelve Industrialized Nations," The Commonwealth Fund, Issues in International Health Policy, July 2011, Exhibit 3, p. 4.