Democratic Policy Committee Hearing
"Is the Bush Economic 'Stimulus' Plan Effective, Fair, and Fiscally Responsible?"
January 21, 2003

DORGAN: Good morning. We are going to begin the hearing this morning. This is a hearing of the Democratic Policy Committee - a hearing to discuss this proposal to put our economy back on track.

Two years ago, we saw an economy that had been through an unprecedented period of economic growth. In the past two years, we have seen a number of very significant events occur. First, we have experienced a recession in our economy. Second, the technology bubble burst, which caused significant stock market gyrations. We also experienced the devastating attack on this country on September 11th, which had a profound impact upon the economy. We then had a war against terrorism that is costly and difficult. We endured the corporate scandals, unprecedented in my judgment in our country's history, or nearly unprecedented, corporate scandals. We had federal budget surpluses turn to very large deficits, and we had fewer jobs and more unemployed.

And while many of us have pressed for action, believing that the economy has fallen off-track and want some action to put it back on-track, President Bush and his economic team, for some long while, have maintained that the economy was fundamentally sound. He said the problem was that they inherited a recession, and in addition to that a war on terrorism and the acts of September 11th exacerbated the problems with the economy.

But within the last month the President has fired his economic team. He has replaced the Secretary of the Treasury and the Chief Economic Adviser in the White House. In addition to replacing his economic team, he indicated that our economy needs a jump-start, that we need an economic plan to jump-start the economy.

Now the question is not whether there will be a new plan to put the economy back on track - the question is how. The principles that I believe that are important are that a plan to put the economy back on track and to jump-start the economy should be temporary, should be short-term, should be fair, and, most importantly, should be effective.

President Bush's plan, regrettably, in my judgment, is none of these. Slightly over one half of the President's plan - which is a plan of $675 billion over ten years - slightly over half of it is a dividend exemption. Most economists say that less than one-tenth of what the President is proposing in tax cuts will have a stimulative effect. It is quite clear, in the out years, all of that the President proposes to cut in taxes especially for the upper-end taxpayers will be borrowed. I don't believe the President's plan will work. To jump-start the economy, I think, requires temporary, short-term, effective approaches. The President's plan is the equivalent of using a flashlight battery to try and jump-start a car. It simply cannot and will not work.

So the question is: what can we do, what should we do, that will work? We are going to hear from a number of witnesses today: economists, thinkers - and incidentally they are not mutually exclusive - citizens. What do they think of the President's plan? How would they propose to put our economy back on track? In the end, the only thing that really matters is what works. What works to put the economy back on track, put people back to work, and give businesses an opportunity to profit once again?

I am joined by a number of colleagues, including the Democratic leader of the House, Nancy Pelosi. Let me call on some opening statements from my colleagues who have now joined us. Let's call on the ranking member of the Budget Committee, Senator Conrad.

CONRAD: Thank you, Senator Dorgan, and a special thanks to the witnesses for being here today. We appreciate that very much. I would just like to set, from my perspective, the background that we have to consider any proposal against. You will recall, in January 2001, we were told that there would be nearly $6 trillion in surpluses over the next decade, and how dramatically that has now changed. We look at January of this year, and instead of $5.6 trillion in surpluses over the period from 2002 to 2011, we see $1.6 trillion in deficits. And that's if the President's policies are adopted. If we examine the package that the President has put before us, the stimulus package, the growth package, however it is termed, I think that the first thing that jumps out at you is that it is ineffective. Ineffective because if you look at the total cost, which is over $900 billion when interest costs are associated with it, only $36 billion dollars is effective in the first fiscal year. That is less than 5 percent. So 95 percent of the cost is after the period of economic weakness - the period that it would make sense to provide stimulus to the economy.

Some will ask, "I thought the President said it was $58 billion the first year." That is true, but he has not used a fiscal year basis, a typical scoring regime, instead he has looked at the first calendar year. It is kind of an unusual way. I think it reflects a defensiveness of the Administration because it represents a weakness of the ability of their plan. Again, only $36 billion of stimulus this year with $900 billion of cost over the next decade.

Then on the question of fairness, which I think is a test that has to apply to any plan, one sees that it is also terribly unfair. For those that are in the middle-income category in this country - you know they divide income categories in equal 20 percent groupings - If you take the middle 20 percent, they get a benefit of $265. Those who earn $1 million dollars a year get a benefit of over $88,000. Now the President, when he unveiled this plan, said it was fair. I must say that I don't see anything fair about it. If this meets the test of fairness, then we have a very, very serious problem in the country. If the President's idea of fair is that those who earn over $1 million a year get $88,000 of help, and those who are in the middle 20 percent get on average $265, something is radically wrong. I wouldn't say that in hailing distance of fairness.

Next, I think one has to evaluate the fiscal responsibility of the plan, and this chart shows over the last 20 years where we have been with deficits. You can see for two years we were able to climb out of deficit without using Social Security to pay for tax cuts or the other expenses of government. Those were two years during the Clinton era. When you see day one of the Clinton presidency we were reducing deficits, reducing deficits. We actually got to two years where we stopped the raid on Social Security, something everyone has pledged to do. Yet, under the President's plan we have plunged back into deficits. If we adopt his policies, you will see that we are not out of deficits the whole rest of the decade. In fact, we are using trillions of dollars of Social Security money to provide the tax cut and other expenses of government.

Why does that matter so much? Let me just focus on this for a minute. This shows, very clearly, that if we adopt the President's policies, we are going to be taking money from Social Security for the rest of this decade. Not by trivial amounts, but by trillions of dollars. Does it matter? It matters because we are about to see a very dramatic change. Right now we are in the sweet spot of the fiscal cycle. If you look at the Medicare Trust Fund, you can see that starting in 2002 through 2016, the Trust Funds are running surpluses. That is about to change. Medicare goes cash negative in 2016, and then it goes sharply negative. This is the message that I think has to be received by our colleagues and by the American people. We are in a circumstance unlike any before.

Let me just conclude by showing Social Security, which is even more dramatic. Again, we are in the sweet spot right now. Those Trust Funds are running substantial surpluses now, but they are about to turn to significant deficits, and when they turn, they turn in a very dramatic way. This is a window of opportunity to get ready for that challenge and that time. The President's answer is to dig the whole deeper. I think it is reckless, and I think it is profoundly mistaken. It is one thing to give lift to the economy when the economy is weak, but the vast majority of the cost of the President's plan is at a time when the federal government will be under enormous pressure because of the retirement of the Baby Boom generation. Thank you, Senator Dorgan, and thank you again for holding this hearing.

DORGAN: Senator Conrad, thank you very much. I mentioned at the beginning of this hearing that we would be joined by the Democratic Leader of the House. Often when we have held Democratic Policy Committee hearings, we have invited the leader the House. We have with us today the House ranking member of the Budget Committee as well as the Democratic leader of the House, Nancy Pelosi. Let me welcome Leader Pelosi, and ask if you have an opening statement.

PELOSI: Thank you, Mr. Chairman, and thank you so much for your leadership in holding this hearing today and bringing together House and Senate in a bicameral way about an issue of grave concern. I am pleased to be here with Mr. Spratt, who is not only the ranking member of the House Budget Committee, but also in the House leadership as an assistant to the Minority Leader, and he has played a critical role in putting together the economic stimulus package that was proposed by the House Democrats before the President proposed his so-called stimulus, which is not stimulus. It is not fair, it is not fiscally sound, and is not fast acting. Thank you again for convening the hearing and to our witnesses for their knowledge and expertise they bring to this.

One thing we all know is that the economy is failing, and the American people are looking for leadership. At the first order of business for this Congress, of course after protecting the American people, the first order of business domestically, is to jump start our economy and create jobs now. Instead, Republicans propose long-term tax cuts that do little to stimulate the economy in the short-term while exploding the deficit as far as the eye can see. Thank you, Senator Conrad, for making it so visual to us all that is jeopardized by this Republican package. This Administration has already tried to boost the economy with tax cuts that focus on the wealthy. It has not worked: look around you. Total job loss during the Bush presidency has reached to over 1.7 million jobs. The worst record on job creation since the end of World War II. The worst record in 58 years. All of our presidents have created jobs. President Bush is in the negative column of 1.7 million jobs lost. Democrats have made job creation the focus of our plan. Over 1 million jobs will be created this year under our proposal. According to the White House's own figures, the President's plan will create less than 170,000 jobs - less than one-fifth the Democratic proposal create this year. Most of the President's so-called stimulus will occur at the end of the decade. We need a stimulus now, not in 2010. If we need one then, we'll deal with it then.

The House Democratic Caucus has proposed a stimulus plan that is fast, fair, and fiscally responsible. It is fast in that is provides an immediate boost of $136 billion in 2003, sparking economic growth and creating jobs now. It is fair - I am trying to meet some of the criteria established by Senator Conrad - because it puts money in the hands of working families, small businesses that need it most. Finally, our plan is fiscally responsible it has a ten year cost that is one-seventh of what the President is proposing, allowing the budget to recover as our economy recovers. President Bush fails to meet these three vital criteria. Instead of a fast-acting plan that boosts the economy, a bulk of the plan will occur after 2003. Instead of fairly impacting all working Americans, the vast majority of the President's plan goes to the wealthiest 5 percent, which was so graphically presented: over $88,000 tax break for the wealthiest Americans versus something in the hundreds for those in the lower economic categories. Instead of being fiscally responsible it will explode the deficit over the next decade just as the Baby Boom generation becomes eligible for Social Security and Medicare.

In addition, President Bush has ignored the needs of the states in his plans. One could only conclude, in looking at his plan, that he has forgotten about the states. While our plan provides over $31 billion in targeted assistance for state and local health and for Homeland Security and infrastructure needs, the President's plan actually worsens state's fiscal outlooks, by eliminating the tax on dividends. Most states base their tax payments on the figures used by taxpayers on their federal forms, and would therefore collect less under the Bush plan.

Unless we address the needs of the state's budget shortfalls, we will dampen the stimulus effect of any efforts. Millions of working families are struggling in this economy, and those families will tell you that we need to do something different. Democrats are listening; the President is not.

The Republican excuse for eliminating $2.5 billion in Homeland Security funding for first responders, port security, border security, and nuclear security is that we have "a war-time budget." The President's excuse for not helping families by investing in their children's education and fully funding the No Child Left Behind Act, depriving it of $7.2 billion than what was promised in the much heralded Leave No Child Behind bill with the signing in the Rose Garden, etc. The excuse for not funding is we are in "a war-time budget." Their excuse for failing to ease the fiscal burden on the states is "a war-time budget." Their excuse for a proposed $300 million dollar cut in heating assistance Myheap (??) that will cut off 532,000 low income people in the middle of the coldest winter since 1976 is "a war time budget."

And yet there is room in a war-time budget for a tax cut of $88,000 dollars for people who make over a million dollars a year. The President's priorities are clear. He has already a passed a huge tax cut for the wealthiest. Look around you - again it hasn't worked. Now, he wants more of the same. The plan the Democrats are proposing will grow the economy by providing stimulus now, not a decade from now. It helps all Americans, not just the wealthy. It gives the economy a short-term boost without sacrificing long-term fiscal responsibility. Fair, fast and fiscally responsible; that is our approach. Most importantly our plan creates jobs. The President says that his plan for tax cuts will create jobs, but as our panelists today will illustrate the evidence indicates otherwise. Thank you again to our witnesses, and thank you again, Mr. Chairman, for this important hearing. I look forward to the witnesses' testimony.

DORGAN: Leader Pelosi, thank you very much for your comments. Next, I'll call on the ranking member of the House Budget Committee, Congressman Spratt.

SPRATT: Thank you very much, Mr. Chairman. Mr. Chairman, members of the Committee Mitch O. Daniels, the director of the Office of Management and Budget admitted last week what we all already knew. The President's budget will be in deficit next year, this year, and next year by two to three hundred billion dollars, not including the cost of any action against Iraq. And that budget will remain in deficit for the foreseeable future. Senator Conrad and I warned two years ago that the President was betting the budget on a blue-sky forecast. That he was making his tax cuts so large that he left no room for margin of error. And today we take no pleasure in saying so but events are bearing us out. We're watching fifteen years of fiscal discipline unravel as a cyclical deficit becomes a structural deficit again.

Faced with deficits are far out as we forecast, the President doesn't propose a budget summit as his father did in 1990. He prescribes more of the same: $674 billion dollars in additional tax cuts. When these cuts are combined with his proposal to make the tax cuts passed in June of 2001 permanent, the impact on the budget comes to $1.3 trillion, and with debt service to $1.6 trillion. Treasury says not to worry; another trillion or so in debt won't hurt anyone, particularly the economy. Well despite its enormous cost, the President's plan, as Senator Conrad has pointed out, does little to move the economy now when it's needed because only $59 billion or nine percent of its impact is injected into the calendar year 2003. The White House claims that its plan is about "jobs and growth," but its own Council of Economic Advisors estimates that the plan will generate only 190,000 jobs in 2003, which is not enough to make up for the 219, 000 private sector jobs lost over the last two months.

Mr. Chairman, if our object is to get a wobbly economy on its feet and running, our plan should work on the economy in 2003, and the elements of such a plan are not hard to figure. They're very, very straightforward. It should encourage consumers to spend, businesses to invest, and obviously it should help the hard-pressed states. Otherwise, as fifty states move to balance their budgets, they may very well counteract more growth than the federal government can possibly generate. As our leader, Nancy Pelosi, has just said, House Democrats presented such a plan on January 6. It pumps $136 billion into the 2003 economy - more than one percent of GDP, more than twice as much as the President's plan. Of that amount, $87 billion comes in the form of short-term tax relief. The plan rebates fifty-five billion dollars into the pockets of consumers who are most likely to spend it. It allows small businesses to expense up to $50,000 of assets purchased in 2003 and gives all businesses a fifty percent depreciation bonus for investing in new plant equipment in 2003. The President's plan forgets, ignores the states and rests on tax cuts that will make the states' revenue shortfalls even worse. Our plan directs thirty-one billion dollars in aid to the states. It increases the federal share of Medicaid on a one-time basis in 2003 by ten billion dollars. It adds five billion dollars to highway and transportation spending, and it gives the states grants for Homeland Security so that they can gear up first responders and strengthen security at airports and seaports and similar such facilities. Economic models, we've used three or four of them, all show that our plan will lead to the creation of more than a million jobs. When the Council of Economic Advisors own methodology is used, our plan generates more than four times as many jobs in 2003 as the President's plan.

Most importantly for those who think that deficits matter, the House Democratic package supplies short-term stimulus without sacrificing long-term balance. The impact of our plan is 136 billion in 2003, as I've said, but some of the costs are recovered after 2003, reducing the cost of the plan over time to one hundred billion dollars. And beyond 2003 except for a modest increase in debt service our plan entails no spending increases, no revenue decreases, so as the economy recovers the bottom line of the budget recovers too.

Since President Bush took office two years ago, 2.4 million private sector jobs have been lost and the surplus projected at $5.6 trillion has disappeared. With this score on the board at half time, it's no wonder that he replaced his economic team. But he hasn't changed his economic game plan. What's most disturbing about Mr. Daniel's announcement last week is not the admission of worsening deficits, but the absence of any solution. Indeed, what the Bush Administration proposes will take the government deeper into debt and make the deficit more intractable then ever. We have a plan that's taken from the playbook and used when the President came to office in January of 2001. The economy was then at full employment.

The budget was in surplus. The government was positioned to buy back treasury debt held by the public. Our plan moves us back in that direction away from never ending deficit for the short run and the long run we think it's the right way to go. Thank you Mr. Chairman.

DORGAN: Congressman Spratt, thank you very much. Next we'll hear from Senator Corzine.

CORZINE: Thank you Mr. Chairman, and I appreciate you holding this hearing. I think some common sense and serious discussion of the President's economic proposals is absolutely in order. I wanted to say stimulus program, but I've guess they've tried to blank that word stimulus out of the English language and talk about it in growth. But I think anyone who fairly wants to evaluate an economic program ought to look at what it does for job creation in a practical sense - what it does with respect to capacity utilization, labor markets, capital markets, national savings and investment, productivity - at the bottom line what it does to the standards of living of the American people.

Rhetorically, I guess, I ask this Administration, "Do they think we have a problem?" And I refer to that question in light of a statement by Vice-President Cheney on January 10 in which he said, "the President's policy, complemented by twelve interest rate cuts by the Federal Reserve, eased inflationary pressures and are succeeding. This economy is growing," he says. I ask, "Do we really care that we lost these 2.4 million private sector jobs - 1.7 million across the economy when you take into account the public sector? Do we care that our budget deficit has gone from a $200 billion surplus to what is projected to be roughly $300 billion dollars this year - by the way, that's taken from 2.3 percent positive percentage of GDP to 1.8 this year, this last year going to 3% in the future? Do we care that we've eroded the savings rate to the absolute lowest level its been in fifty years, 1.8% in the third quarter, and that we are borrowing at a rate of about $2.3 billion a day overseas to make up for that gap and failure in savings? Do we care that we've had two years in a row of negative business investment?

I don't know what statistics and common sense standards Vice President Cheney is looking at, but I think the American people understand that there's a problem with the economy, and not only is it now but it is one that we are building up in the future even greater imbalances, as my colleagues have pointed out with regard to the budget deficit. Certainly there have to be questions about fairness. We now have two tax cuts that give the benefit of the doubt without looking at interest costs at about $2.4 billion that are primarily targeted to the top five percent of the individuals in this economy. And we hear all about class warfare, but what about rising tides lift all boats?

When we have a fair and balanced economic policy, we created 22 million jobs in the '90s. I think actually there were more millionaires created in the 1990s then any other period of time. I don't know where the class warfare was. What we need to do is be dealing with creating stimulus now, immediate, strong and certain. We need to make sure that we're going to be fiscally responsible over the long cycle of economic measurement. And we need to make sure that we don't have anti-growth policies, which I think Leader Pelosi spoke about. About $90 billion cumulated deficit in the states. We got a program that's going to put $36 billion into the states, into the national economy. Where is that going to lead to economic growth in this country? In fact, it's anti-growth in many ways, because the state and local governments are going to have to end up having property tax increases. You know the headline number is 18.5% percent in the city of New York and 7.1 percent in the state of New Jersey.

Across this country at the state and local level, to make up for this failing economy we are ending up having to raise taxes and cut services dramatically at the state and local level. So I hope we can have a sensible integration of all these issues, a holistic approach, including, by the way, where the tax burden lies. There's an article in the New York Times today that shows if you look at state sales taxes, income taxes, real estate property taxes across the economy, tax burden is proportionate to income almost across the board. And the idea that we are jamming in tax cuts for those that are already doing well as a means for stimulating the economy along those fundamental issues of capacity utilization, job creation, is a wonder in most people's minds. And I think you're hearing that from people around the economic sector or the business sector as well. I'd only refer to the January 16 article of Steven Roach from Morgan Stanley. In an article, he says "No way to run the world's biggest economy." I'll stop there. Thank you.

DORGAN: Senator Corzine, Thank you very much, and the final opening statement will be offered by Senator Lautenberg.

LAUTENBERG: Thanks very much Mr. Chairman. Leader Pelosi nice to see you here, and welcome in particular John Spratt, who I worked with in my days on the budget committee, when we created a situation that had this country, I won't say we did it all alone John, but we helped get this country out of deficit and onto a path that would give confidence to the country as a whole. I am pleased to be here with my, I won't say my successor, but the very able now chairman, or ranking member, forgive me, I had a slight thing in mind here, the ranking member on the budget committee, my esteemed colleague Jon Corzine who knows a lot about business, about finance and about the way this country ought to be functioning. And when he says it, it has merit and value. So when I started my sabbatical two years ago, I thought things were in pretty good shape. I also thought if I came back I'd have tenure, but things have changed. We had full employment, low interest rates, the budget surplus for the year 2000 was a record $236 billion plus. And the CBO was forecasting a total surplus of $5.6 trillion over ten years from the 2002 period to the 2011.

What a difference two years makes. What a sorry picture for our country. The unemployment rate, you've heard, has increased fifty percent you're aware, to the highest level its been since 1994 when the country was emerging from the last Bush recession. The budget deficit this year totaled $200 billion and the prospect for next year is that we're going to break a record with $350 billion deficit. Next year, President Bush, President George W. Bush, will break the dubious record set by the former President Bush for presiding over the biggest budget deficit in our nation's history. More troubling a prospective $5.6 trillion surplus that was expected has vanished. We could have retired the public debt at that time. And now it's budget deficits as far as the eye can see just as the first wave of the Baby Boom is nearing retirement. Clearly the recession and the attacks on 9/11 and their aftermath share a responsibility, share some responsibility for our deteriorating fiscal health. But according to CBO data, the President's misguided 2001 tax cut, which will cost a minimum of $1.6 trillion dollars, is the largest single cause of our stunning reversal of fortune. And I see it as misguided because it had little if any stimulative effect on the economy, and it skewed its benefits to the wealthiest among us. They're doing just fine. And the amazing response that we are stimulating class warfare is as hollow a claim as one could make. Is an America divided between million dollar incomes getting a tax break of $90,000 dollars a year compare to the lowest 80% of our wage earners who get 21% of the total package? It's just not right.

The President has another proposal just like the first one and its deja vu all over again. Just like the President's first tax cut, his current proposal will cost upwards of a trillion dollars, won't stimulate the economy, will help the wealthiest among us, won't help out working Americans very much, and will wreck the long-term health of our economy. Other than that it's fine. To me, I see that as a different kind of warfare - its clash warfare, that's what I see. With people at the top getting so much of it, and leaving so little for the bottom share who desperately need help at meeting their obligations, and getting their kids educated and plan their futures.

So I look forward to hearing from our witnesses today, get their assessment of the Bush plan. To me, we can't build the confidence of our people, can not build the strength that's essential to continue to do eternally even as we prepare ourselves to do it externally. And I think that the tax plan that's been offered, the stimulus package so called that's been offered, does little to establish and restore that confidence, and I thank you, Mr. Chairman, for the opportunity.

DORGAN: Senator Lautenberg, thank you very much for your statement. I'm going to introduce all three of the witnesses on the first panel. They are all economists. They have different viewpoints on a number of issues, and let me introduce three of them, and then I'll call on them one by one.

Peter Orszag is the Joseph A. Peckman Senior Fellow in economic studies at the Brookings Institution and parenthetically I might say, for those you did not have the opportunity to know Joseph Peckman when he was here working on taxes, he was a breath of fresh air and that is quite a distinguished perch. Mr. Orszag. Mr. Orszag previously served as Special Assistant to the President of Economic Policy at the White House, as a senior economist and senior advisor on the President's Council of Economic Advisors. He is an adjunct professor of economic faculty at the University of California, Berkley.

Chris Edwards is the Director of Fiscal Policy at the Cato Institute. Mr. Edwards has nine years experience in tax and budget policy. Before joining Cato, he was a senior economist on the Joint Tax Committee, Joint Economic Committee rather, under the former Senator Mack from Florida, where Mr. Edwards worked on taxation, Social Security, and entrepreneurship issues. From 1984 to 1988 he was tax consultant and manager with Price-Waterhouse-Coopers, where he focused on revenue estimation, tax modeling, tax reform and international economic issues. Prior to that with the Tax Foundation, and Mr. Edwards, welcome.

And finally, Mr. Gale. William Gale is a Senior Fellow and holds the RJ and Francis Miller Chair at the Federal Economic Policy, in the economic studies program at the Bookings Institution. He is also Co-Director of the Tax Policy Center, a Joint Venture of Brookings and also the Urban Institute. His areas of expertise include tax policy, budget and fiscal policy, public and private saving behavior, pensions, and intergenerational transfers of wealth. So, as you can see, these are three witnesses with substantial backgrounds in economic policy, and we are very appreciative of them coming this morning to share their views with us. And why don't we start with Mr. Orszag. Mr. Orszag, welcome.

ORSZAG: Thank you, Senator Dorgan, Ms. Pelosi, and other members of the committee. Thank you for inviting me to testify this morning on the Administration's recent tax cut proposals. I'd like to address three areas involving the proposals this morning: the effect on the economy, the effect on the budget, and the effect on the distribution of income. My colleague Dr. Gale will address the effects of the proposal on whether it actually achieves the ostensible goal of taxing corporate income once and only once.

First on the economy, it's very important to separate the short run from the long run. In the short run, the primary problem facing the economy is a failure to use the capacity to produce goods and services that we have available to us. It's a lack of demand for the goods and services that firms could produce given current capacity. For example, according to the Federal Reserve Board of Governors, the capacity utilization rate in December 2002 was only 75%, which is well below its average of about 82% over the past three decades.

What we need to be doing is getting more demand for the products that firms could produce with existing capacity. From that perspective, the Administration's plan is woefully inadequate for two reasons. First, as Senator Conrad and others have indicated, a very small percentage of its effect occurs in 2003. It is back-loaded, and much of the effect of the proposal would occur after 2003, presumably after the economy has recovered. Second, even the amounts that are delivered in 2003 are directed to the wrong people. To boost spending, it's more effective to have a progressive policy where more of the money goes to lower and moderate income families that will be more likely to spend the funds than to higher income families, who would be less likely to spend the funds. Yet the Administration's policies, as I'll turn to in a moment, basically flips that. In addition, as has already been mentioned, the proposal would exacerbate the deficits facing state governments, and therefore also be counterproductive in the short run.

In the long run, the basic problem facing the economy is a different one. The question is not how we can use the capacity we have, but how quickly we can expand that capacity over time. And a key determinant for how quickly that capacity expands is our national savings rate. This proposal, by expanding the budget deficit and reducing the national savings rate, will reduce capacity over time relative to what we could achieve if we instead saved the funds. So in both the short run and the long run, this plan basically doesn't work. And it's not just me saying that. The Administration's own analysis shows that the effect of the plan on the economy in 2003 would be modest, under 200,000 jobs, which is basically just a blip on the radar screen, and, even more remarkably, according to the Administration's own analysis, the effect of the proposal in 2004 on job growth would be negative. That's not my analysis, that's the Administration's own analysis. Implicit in their numbers is an assumption that after 2004, and actually in more detail, after 2005, the effect of the plan on the economy would be negative. So that's the first area, what the effects are on the economy.

Second area is the budget. As has already been mentioned, once you include interest costs on the proposal, you're looking at upwards of $925 billion or more, over the next eleven years, through 2013. And that is only part of what the Administration is proposing. They're also proposing to make the 2001 tax cut permanent. They also acknowledged that we'll have to fix the looming problem in the alternative minimum tax. You add just those three things together, and add interest costs, and you're over two trillion dollars - in addition to the cost of the enacted 2001 tax cut.

So let me give you a couple of perspectives on that number. The first perspective, as the Administration claims, is that, well, we're going to have these tax cuts, but don't worry, fiscal discipline will be preserved, because we'll just constrain non-defense discretionary spending. So let's just look at what would have to happen to non-defense discretionary spending to make up for that more than $2 trillion in tax cuts that are being proposed. The answer is that you would have to reduce non-defense discretionary spending relative to the CBO baseline, which is already assuming a very low level of non-defense discretionary spending, by about 40%. Completely implausible. Especially in the face of homeland security and other needs that are contained in that category of spending. The implausibility of that claim underscores the fact that it is not at all conceivable that we could offset the costs of this tax cut through spending restraints. And that means that we're going to be running a large budget deficit, as Senator Conrad and others have suggested.

Another perspective on the same point: this new proposal will amount over the next seventy-five years to more than a quarter of the Social Security deficit. So if instead of passing this new proposal, we just saved the money and devoted it to Social Security, we would close more than a quarter of the long-term Social Security deficit. If you add in the other proposals that the Administration has either put forward or already enacted, the total costs of the tax cuts amounts to between two and three times the Social Security deficit. So as Senator Conrad and others have suggested, there's a clear question of priorities here. We are putting regressive and inefficient tax cuts well ahead of addressing Social Security reform and other priorities facing the nation. And that's in the face of the coming retirement of the Baby Boomers, which will be hitting us very soon, so I think that the word that Senator Conrad used - "reckless" - is unfortunately an apt characterization of the policies that are being proposed.

Finally, let me turn to the distributional implications of the proposal. The Administration has emphasized that the average tax cut for taxpayers in 2003 will be $1083. But I want to emphasize that averages can be very misleading. As former Secretary Robert Reich likes to say, the average of himself and Shaquille O'Neal is a man about 6 feet tall. And a similar thing applies to the Administration's tax proposal. The reality is, if you look at, across tax filers, 49% would get a tax cut of less than $100 in

2003, 69% would get a tax cut of less than $500, and almost 80% would get a tax cut of less than the Administration's touted average, $1083. So if you're out there in the American public and think that you're getting a tax cut of $1083, you better hope that you're in the top 20%, or else it's not going to happen.

It's also been claimed that this tax cut is progressive because the top 1% would get a smaller share of the tax cut than the share of federal income taxes they pay. But let's look at total federal taxes. The top 1%, in 2003, will pay will pay 24.8% of total federal taxes. This is leaving out the state and local taxes, which would make that share even lower. Just federal taxes, including payroll taxes and estate taxes. 24.8%. They would get 28.8% of the tax cut in 2003, more than their share, and they'd get 44% of the tax cut in 2010, because all that's left in 2010, or primarily all that's left in 2010, is the dividend exclusion proposal, which is very skewed toward the top end of the income distribution.

Another perspective on the same point: the bottom 80% pay a larger share in federal taxes than the top 1%. But they would receive about a third as much in 2010 as the top 1% would receive. Furthermore, the whole concept of looking at shares of the tax cut versus shares of taxes paid is flawed when you're reducing revenue. A more insightful way of looking at the question is what happens to after-tax income, and there what you see is that the after-tax income for the top 1% would go up by almost 4% in 2003. It would go up about 1% for the bottom 80%. So almost 4 times as large of a percentage increase for the top 1% as the bottom 80%.

So in conclusion, and again, Dr. Gale will speak to the issue of the technical details of the dividend exclusion, but in conclusion, the Administration stimulus plan will not boost economic growth in either the short run or the long run, it is fiscally irresponsible, and it is unfair. It would consume resources that could be put to much better use, especially in the wake of the coming retirement of the Baby Boomers, and at a time when we simply cannot afford more reckless tax cuts that failed to address the pressing problems that face the nation. Thank you.

DORGAN: Mr. Orszag, thank you very much. Next, we will hear from Chris Edwards, director of fiscal policy at the Cato Institute. Mr. Edwards, thank you for being with us today.

EDWARDS: Thank you very much, Mr. Chairman, and members of this committee. Thank you for allowing me to testify on President Bush's new tax proposals. President Bush has proposed a generally pro-growth package that would save taxpayers about $670 billion over ten years. The package may have positive effects on short-term economic growth. But far more importantly, in my mind, most features of the plan are winners for long-term economic growth. Long-term growth will be spurred by proposals to accelerate the individual tax-rate reductions, the expansions of small-business expensing, and the proposed reduction in taxes on capital income in the form of dividend and capital gains tax cuts. I certainly do share concerns expressed by Senator Conrad and other members of this Committee about the long-term fiscal deficits, and I think there's a question of different priorities here. I think creating strong long-term economic growth right now is probably a higher priority than immediate balancing of the budget. And I would also note that President Bush and the Administration has been somewhat hypocritical on this issue because their favored areas to increase spending over the last few years - Department of Education spending is way up, farm subsidies, defense spending - they have proposed a lot of spending increases, and they have not stood up and told us where they plan to reduce spending in order to balance the budget.

Back to the tax cut: the highest marginal rates in the federal tax system caused the largest distortions - they're so-called deadweight losses to the economy. The Bush plan focuses on reducing the very high tax rates. The current double taxation of corporate earnings paid out as dividends results in a top marginal federal tax rate as high as 60%. The Bush proposal would exempt dividends from tax at the individual level, effectively dropping the dividend tax rate to 35%, and making the tax treatment of dividends roughly similar to the treatment of interest. As the Administration and other economists have observed, high dividend tax rates reduce economic growth by creating numerous distortions. First, high dividend taxes add to the income tax code's general bias against savings and investing; high dividend taxes cause corporations to take on too much debt rather than equity financing; highly indebted firms are more vulnerable to bankruptcy during economic downturns; high dividend taxes reduce the incentive to pay out dividends in favor of retained earnings, and that may cause corporate executives to invest in wasteful or unprofitable projects; high dividend taxes create a bias against businesses organized in the corporate form; and finally, high taxes on dividends and other form of capital income greatly increase, in my view, the wasteful efforts of financial engineers to design ways of avoiding and evading taxes, which has been a big concern of Congress in the last few years.

The benefits of reduced dividend taxation have been recognized by nearly every other industrial country. Indeed, the latest data from the Organization for Economic Cooperation and Development, or the OECD, shows that the U.S. now has the second highest top tax rate on dividends, when considering both the corporate and individual rates. Figure 1 in my handout of my written testimony provides the top tax rates as calculated by OECD, for the thirty member countries of that organization. The OECD data include state and local taxes, but even just considering the top

U.S. federal rate of 60% would put us in fifth place, fifth highest among the thirty countries in the OECD.

The U.S. has the second highest tax rate on dividends for two reasons. First, the United States has one of the highest statutory corporate income tax rates in the world, at 35%. Again, looking at the thirty OECD countries, according to KPMG data, the U.S. has the fourth highest corporate tax rate in the world. Secondly, as I will discuss, twenty-seven of thirty OECD countries have adopted one or more ways of reducing, fully or partly, the double taxation on dividends. In the OECD, only Ireland, Switzerland, and the United States do not relieve dividend double taxation. But Ireland and Switzerland have much lower corporate tax rates than we do. I've detailed in Table 1 of my written testimony the different methods that the twenty-seven OECD countries use to partly or fully relieve dividend double taxation. The most popular way to relieve double taxation is to simply tax dividends at a lower flat rate at the individual level, a lower rate than the ordinary rate on wages. Countries that provide a special low tax rate on dividends include Austria, Belgium, the Czech Republic, Denmark, Denmark, Italy, Korea, the Netherlands, Poland, and Portugal. Some countries such as Finland, Norway, and Sweden have moved to so-called dual income tax systems about a decade ago. They essentially impose high and progressive rates on wage income, but lower flat rates on all forms of capital income. Those countries have lowered tax rates on capital income because of increasing global tax competition which is drawing billions of dollars of investment funds from high tax to low-tax countries.

Many countries are realizing that high tax rates on capital income are becoming more unsustainable in today's global economy. Two countries, Germany and Luxembourg, provide a fifty percent dividend exclusion to individuals. So if the individual received $1000 in dividends, they would only report $500 on their tax return. The country of Greece fully exempts domestic dividends from individual taxation, sort of akin to the Bush Administration's proposal. The traditional way to provide dividend tax relief, tax relief for the double taxation of dividends, is to provide individuals with a tax credit, sometimes called an imputation tax credit. Countries that offer tax credits to partially offset the corporate tax include Canada, France, and the U.K. Some countries provide tax credits to fully offset double taxation, such as Australia, Finland, Italy, Mexico, our NAFTA trading partner, and New Zealand. Norway provides a dividend tax credit that fully offsets the corporate tax, and has a flat rate of 28% on all corporate income, the result of which Norway has the lowest tax rate on dividends in the OECD of 28%, again, compared to our 60%. The New Zealand tax system is also very interesting. That country provides a credit, again, to fully eliminate the double taxation of dividends, but it has also dropped its individual capital gains tax rate on domestic investments to zero to eliminate any bias against retained earnings that may result from dividend tax reduction. Nonetheless, there has been a movement, over the last decade or so, to move away from these individual imputation credits towards a lower flat rate on dividends and all forms of capital income.

And finally, a couple of countries provide dividend tax relief by allowing corporations a partial deduction for dividends paid. The Czech Republic and Iceland are the two countries that pursue that approach. So, to conclude, there is a general global trend here of lower tax rates on all forms of capital income, including corporate income taxes, and individual income taxes, on dividends and capital gains. Policymakers in many countries are recognizing that high capital taxes distort savings and investment decisions and reduce economic growth. As just one example, Canada, for example, is currently implementing a phased-in tax cut to its federal corporate income tax rate from 28% to 21%. Our other NAFTA trading partner, Mexico, has a tax rate on dividends of just 35%, compared to our 60% rate. So in this country, I think Congress should begin to reform the tax code in line with global trends, and reduce high tax rates that are currently placed on dividends. With that, thank you very much for holding these important hearings, and I look forward to working with your committee on these issues.

DORGAN: Mr. Edwards, thank you very much. And finally, we will hear from Mr. William Gale, who is a senior fellow at the Brookings Institution. Mr. Gale, why don't you proceed?

GALE: Thank you very much, Mr. Chairman. Leader Pelosi, members of this committee, thank you very much for having me this morning to talk about these important issues. My testimony will focus on the Administration's proposal to cut dividends and capital gains tax rates. This has often been described as a dividends tax cut, but it's actually a hidden capital gains tax cut as well. And it's also been described as a method of eliminating the double taxation of corporate income, and what I'd like to do is put that problem in perspective, and put the Administration's proposed solution in perspective also.

First, most corporate income in the United States is not taxed twice. We hear about double taxation a lot, but it applies, as far as we can tell, to the minority of corporate income. A substantial share of corporate income is not taxed at the corporate level, either because of tax sheltering activities, corporate tax subsidies, or other factors. And recent evidence suggests that the use of corporate tax shelters has increased significantly. In addition, at the individual level, half of all dividends go to shareholders who are effectively untaxed on those dividends, or capital gains. This includes pension funds, and, in particular, nonprofit institutions or foundations. It's hard to get an exact set of numbers to allow definitive judgments, but it appears to be the case that at least as much corporate income is not taxed as is subject to double taxation, and a very large share, probably approaching half or more, of corporate taxation, is only taxed once. So the basic problem is not double taxation of corporate income; the basic problem in this area of the tax code is that some corporate income is never taxed, some is taxed once at a wide variety of rates, some is taxed twice. And in particular, the non-taxation or preferred taxation of corporate income is at least as big a concern from a tax policy perspective as is the double taxation.

Second, the Administration's proposal would have no effects on firms' incentives to shelter earnings or to retain earnings to the extent that the firm is held by tax-exempt shareholders. So for the half of dividends that go to tax-exempt shareholders, the firms that are owned by those shareholders face no new incentives under the Administration's proposal to reduce sheltering or to increase dividend payments. For firms that are owned by taxable shareholders, or conversely, to the extent that firms are owned by taxable shareholders, there is a reduction in the incentive to shelter and the incentive to retain earnings, but there's a question about how big that reduction is. So despite the Administration's claims to the contrary, the proposal does not eliminate incentives to shelter or to retain earnings, and it may not even reduce those incentives to a very significant degree.

On top of that, the Administration's proposal actually creates new shelters. You should always be worried when an economist can tell you how a new shelter would work, because economists don't really know how to set up shelters - tax lawyers do. So if an economist can set one up, it's a shelter that you can drive a truck through, and the Treasury Department, about a week after the Administration announced the proposal, the Treasury Department put out a fact sheet indicating how the proposal would work. The proposal has in it a built-in loophole, which basically would allow people to shift some of their business income to the 15% corporate tax rate and then pay themselves dividends, and hence avoid a high tax rate on that income. And that's only the most obvious tax shelter, and I'm sure that a good tax lawyer could come up with a half a dozen to a dozen more.

The bottom line is that the Administration's proposal to cut dividends and capital gains taxes does the easy part of a real corporate tax reform. That is, it cuts taxes. It assiduously avoids the hard part, the serious part, which is broadening the tax base and getting rid of corporate shelters and loopholes. In my view, that difference is what distinguishes tax reform from tax cuts, and I would argue that the Administration is using the tax reform language to hide the fact that this is basically just a tax cut. And I would encourage you to think about tax reform, but tax cuts for high-income households are neither feasible nor desirable at this point.

Let me mention a few other points in closing. One is, everything I've said about a complete dividend exclusion applies equally to a partial dividend exclusion. It has the same problems, the same conceptual problems, and again, it's a tax cut masquerading as tax reform. You'll know that the Administration is serious about corporate tax reform when they put forth a revenue-neutral plan that shuts corporate shelters, and taxes all corporate income once, and only once, at a non-preferential rate. This proposal falls far short of that ideal; it's just a tax cut that's being called tax reform.

Now one of the issues that comes up is how we tax dividends in this country compared to other countries, and I have no interest in disputing the figures that Chris just presented, I just want to put them in perspective. As I mentioned earlier, half of dividends in this country go to nonprofits and pension funds who do not pay individual income taxes on the dividends. That's a far greater shelter, a far greater amount in this country than in most other OECD countries. So you need to look at the effective tax rate on dividends, not just the tax rate that applies at the highest corporate tax rate level, and the highest individual tax rate level. The fact that a large share of corporate income is sheltered, and a large share of dividend income is not subject to tax, and that all capital gains, or almost all capital gains, are subject to preferential tax rates, suggests that the effective rate on dividends taxation in the United States is much lower than the official OECD figures suggest.

Now, the last point has to do with the economic impact of altering dividend taxation. There's a huge economic literature that talks about the potential benefits, but there are a couple of issues to think about in the context of this particular proposal, with the emphasis on the fact that this is not a solution to corporate tax integration. This is simply a tax cut. First is that the increase in interest rates will drive down investment. Particularly, it will drive down investment among small businesses who tend to be unincorporated, and in the housing sector, which is an interest sensitive part of the economy. Peter Orszag mentioned the CEA study of this program. I'll just mention the study put forth by Macro Advisors, a consulting firm in St. Louis. They found no GDP growth over the next five years, they found job growth that was one eighth as large as the Council of Economic Advisors, and they found productivity falling in the long-term, not rising, because of the reduction in the national saving.

So let me conclude by saying I would conjecture that there is no well-formed question about any serious economic problem that this country currently faces to which the Administration's tax proposal is the answer, and I would suggest that Congress has much more important things to do: stimulating the economy in the short run, and cleaning up the tax code and stimulating economic growth in the long run. Thank you.

DORGAN: Mr. Gale, thank you very much. Let me just ask a series of very quick questions and allow my colleagues to inquire. First, do all of you believe that we need some action that is immediate and temporary in order to respond to this country's economic troubles at this point? Mr. Orszag, do you believe that?

ORSZAG: I do, mostly as a policy against the risk of a much worse outcome than some economists currently expect.

DORGAN: Mr. Edwards, do you believe that the policies embarked upon now by the Congress and the President should be temporary and immediate?

EDWARDS: No, I think Congress should always be thinking about tax reforms in terms of long term tax reforms. We're always living in yesterday's long term, so I think that any tax proposals implemented now may or may not help the economy in the short run, but hopefully they will help long-term growth if they're structured properly.

DORGAN: I'm always reminded of John Maynard Keynes, who said that in the long run we're all dead. So the long term... I guess, your testimony as opposed to the other two is that you believe policies ought to be considered that are longer term than just stimulative policies to try to put the economy back on track today, is that right?

EDWARDS: Right. And you know, and an example of how we're always in my view living in yesterday's long term, is because we have those high corporate and personal tax rates on capital income, it has created a lot of problems that we're dealing with now. There's a story in the Washington Post today about Enron and their tax avoidance activity. We've had problems this last year with companies reincorporating in Bermuda. We've had problems with foreign corporations taking over American corporations, Daimler-Chrysler, Daimler taking over Chrysler. A lot of these result from those high tax rates. Which I, so I think we can go a long way to solving those problems if we think in the long term about where we want to go with the tax system.

DORGAN: Mr. Gale, do you think action to put this economy back on track should be temporary and immediate?

GALE: Yes, I think that it's important to design a tax policy with a particular goal in mind. If the goal is to stimulate the economy in the short run, then the way to do that is to get the money into the hands of people who are going to spend it, which are typically lower and middle-income households, and in particular to get money to the states for whom you'll get a one-to-one bang for the buck, since any dollar that goes there will be a dollar of taxes they don’t have to raise or a dollar of spending they don’t have to cut. Now I agree with Chris there are also longer term issues that are of interest in designing the tax code, but if the goal is to boost the economy now, then what you want to do is basically get money in people’s hands now and keep a lid on the long-term costs.

DORGAN: And Mr. Gale, what is the single most effective policy, in your judgment, with which to do that? Is there a particular tool or device in tax policy that is both short-term or temporary, immediate and would have a significant impact?

GALE: I would never want to make a universal claim about that under all circumstances, but under current circumstances my reading of the issue tells me that money that the federal government can transfer to the states makes a huge difference right now, both for short term and the long term. In the short term, as I said, the states are cutting spending and raising taxes due to their balanced-budget rules, so a dollar that goes to them is exactly one dollar of taxes they don’t have don’t have to raise or one dollar of spending they don’t have to cut, so you get, you inject the whole dollar into the economy right away. It would also help in the long term to help the states right now because the things they’re doing - it’s sort of skimping on homeland security, cutting back on education, cutting prison budgets - can’t possibly be things that are good for the long term health of the economy.

DORGAN: Mr. Edwards, did you take issue with my colleague’s, Senator Conrad’s, charts in terms of the distribution of the benefits of this tax cut over the ten-year period?

EDWARDS: Well, you know, again, there’s different ways of looking at it. I mean, Mr. Gale, for example, had a recent piece in Tax Notes where he shows the distribution of the current income tax payments. You know, for example, the average tax rate for folks making $20-30,000 a year is just 3.8 percent. Those folks making more than a million, 29 percent. So, and current Joint Tax Committee figures show that there’s fifty-one million out of 142 million households that don’t pay any federal income taxes now. So, it is very difficult to give an income tax with out benefiting the folks at the top.

DORGAN: Is there any reason to consider only income taxes when we talk about the tax burden? Should we not consider all federal, and for that matter, state and local taxes, but especially at the federal level, shouldn’t we consider all taxes paid? Private burden?

EDWARDS: No, absolutely, I mean the federal payroll tax at 15.3 percent is a pretty high tax, and it’s true that most folks at the bottom pay a lot more in payroll taxes than income taxes. However, we already have a mechanism in the income tax code, the Earned Income Tax Credit, that was brought in the '70s particularly to offset the high payroll tax burden for people at the bottom, and currently Treasury mails out checks totaling about thirty billion or so dollars a year to offset the high payroll taxes.

DORGAN: But let me just ask a final question without, and I'll ask Mr. Orszag as well. In some ways these things are not probably fair to do, but the, I think it was the Washington Post described who would get what kind of a tax cut under the proposal and it said that Vice-President Cheney would receive, I don't know, a quarter of a million dollars a year tax cut. Just take that as an example. Is there any belief that someone like Vice-President Cheney would go out and spend that money and therefore provide the incentive to the economy, the boost to the economy that one would expect with a stimulus plan?

Now, the reason I ask the question…I'll let you answer, the reason I ask the question, I had a CEO of a major corporation in my office about a week ago. And he said, Mr. Senator, I want you to know before I leave, I don't need a tax cut and if you give me a big tax cut, I make a lot of money, if you give me a big tax cut, he said, I'm not going to spend it. I'm going to put it away somewhere. So he said, just understand from my perspective, I don't need and I don't want a big tax cut. So the question is if someone gets a large tax cut at the upper income level, is that going to promote the stimulus to the economy, the additional spending that'll raise the economy?

EDWARDS: To be a little flippant about it, Mr. Cheney is a government employee and as such he probably doesn't generate economic growth as people in the private sector do. The Treasury put out figures last year that show that sixty-three percent of the people in the top thirty-nine percent bracket are small business people and entrepreneurs: S-corp income, partnership income, sole proprietorship income. I think those people are the folks who do generate economic growth. They will start more businesses; they will expand businesses and hire more workers if they have an incentive at the margin to increase their investment spending.

DORGAN: Leader Pelosi.

PELOSI: Thank you very much, Mr. Chairman. I want to focus on the states right now. I thank the witnesses for their very informed testimony. I want to return to the issue of the states and indeed to individuals, because all of this trickle down which is supposed to be trickle down in a positive sense, it's trickling down in a very negative sense to ordinary, everyday people in our states. We want to talk about what the impact is on the budgets of the states. For example, in our state of California, in order to deal with the budget ramifications of the federal policies, we'll have to, individuals will have to pay more to go to community college. That is just a fact of life. They will have to raise the fees for young people to go to community college, barring some from being able to do that. If all these jobs - I agree with you Chris, that small business is a generator of jobs and growth in the economy and creation of capital - but that can't happen unless we have an educated workforce. Unless the public sector plays its role in a safe society, with educated workforce with a protected environment and all that goes into job creation and the success of business.

And I think in this rampage that the Administration is on to cut taxes, but not within the context of tax reform, we are missing what the relationship is between the public sector and the private sector, and how our mutual success is tied. The success of business and individuals in attaining their livelihood fills the public coffers. Our treasury then turns around and educates the American people and provides the services that governments must do in order for businesses and individuals to reach their fulfillment. And, of course, the place where all this happens largely is at the state and local level. So I would like to return to the issue of what the impact of this Trojan Horse that the President has wheeled in, calling it stimulus, but again being sort of out of control without reform or disciplined tax cuts that disproportionately impact the high end.

We certainly want to reward success in our country. Let there be no mistake. The Democrats like tax cuts too, but we want them to be fair, we want them to be progressive, and we want them to stimulate the economy and create jobs. So I, again, go to the state where the impact is felt, where whatever subject that you can name - whether it's education, whether it's homeland security, whatever it is - the states and the localities play a critical role. Their tax bases are negatively impacted by the President's proposals, especially eliminating the so-called double taxation of dividends, but also negatively impacted by the cuts in discretionary domestic spending on which the states also depend to balance their budgets, as they are required to do, and provide the services needed for their people. Dr. Gale, would you speak to that?

GALE: Thank you. The Administration is increasingly tightening the vise on the states and it's doing it in several ways. The restrictions on discretionary spending, which you mentioned, have a first order impact. The proposed tax cut… well, first of all the 2001 tax cut, had a negative impact on state revenues. The current proposed tax cut would further reduce state revenues via the dividend exclusion, and by making equity more attractive it would presumably shift some resources from bonds to equity. That's the whole purpose; that's how the proposal is supposed to work. By doing that it would raise the cost of borrowing funds; it would raise the yield on municipal bonds, which would be another hit on the states. And the point, I think, to take away from this is the cumulative hit on the states is as large in a negative direction, and maybe larger in a negative direction, as any plausible, positive impact of the Administration's proposal on the economy in a direct sense. So, from my perspective it would be wise, for all sorts of reasons, for the federal government to pay attention to the plight of the states - not to ignore them or to try to starve them.

PELOSI: Thank you. Chris, would you speak to that?

EDWARDS: I guess I don't quite understand. Actually, it strikes me that increasing federal aid to the states will work against the policy of long-term discipline and work against the dealing with the long-term deficit we're going to face with Medicare, Medicaid and Social Security, which, you know, are, under current projections, expected to increase by about seven percentage points of GDP over the next thirty years. It strikes me that the federal government should be doing the opposite, that we should be ceding back to the states responsibility for programs like education that they have primary authority for because the federal government has got an increasing entitlement crisis to deal with when the Baby Boomers start retiring. So it strikes me that we'd be going in the opposite direction of solving our long-term problems.

SARBANES: What about…would you yield?

PELOSI: I am pleased to lead to the distinguished Senator.

SARBANES: What about the short-term problem? If we're trying to stimulate the economy, isn't what the states are doing to address their fiscal situation run directly counter to efforts to stimulate the economy?

EDWARDS: But it strikes me that, I mean, you're simply passing money from one pocket to another if the federal government is handing money over to the states. You're…

SARBANES: Except the federal government can run deficits and the states cannot. So the states are in a position where they're forced to take an anti-stimulative fiscal position. The federal government has more latitude in order to make that decision. And isn't what the states are doing directly contrary to any effort to stimulate the economy?

EDWARDS: I mean, I guess there's, you know, there's two basic…

SARBANES: I mean just answer my question. Isn't that the fact?

EDWARDS: No, I mean, the states are in, you know, a tough fiscal bind, for sure. But there are two conceptions about what causes economic growth. One is looking at the demand side and increasing aggregate demand, the

Keynesian sort of understanding of how the economy works. And the other is looking at the supply-side, lowering costs through the productive sector to businesses big and small. So that conception of the economy, you know, that I think is the correct one, you look at increasing business investment, increasing the supply side of the economy to generate economic growth.

PELOSI: Thank you, Chris. Peter?

ORAZG: Ah, yes, two, two points. First, on the states. It's important to remember that a significant component of the structural deficits facing the states comes from, basically, from mandates that the federal government has imposed on the states. In particular, Medicaid covers a lot of prescription drugs that are not covered by Medicare, and so the failure to have a prescription drug benefit in Medicare pushes costs onto the states. Let me just give you a couple numbers. Since, Ms. Pelosi, since you're from California you may be interested in a report that the California state treasurer released last week, which estimated that taxpayers across the nation would pay $155 billion more in increased interest costs on state and local bonds over the next ten years because of the types of effects that Dr. Gale indicated. In California alone, California taxpayers alone would pay $17 billion more in interest on bonds because of the increase in interest rates on state and local bonds that would arise from this plan. And that's not even taking into account the fact that the dividend exclusion would reduce revenue in an estimated 43 states by approximately four to five billion dollars a year, making the hole larger. And again, from a short run macroeconomic perspective, that is counterproductive. It will force states to undertake more tax increases and more spending cuts than they would otherwise have to do.

Let me just, very briefly, also turn back to the small business question, because this is something that the Administration has touted a lot. And, in fact, in the President's radio address last week again he used, this weekend, he used an average of about $2,000 in tax cuts for small business owners. Let's just look at those numbers for a second. Again, this is a 'averages can be deceiving' kind of thing. Roughly 80 percent of small businesses would receive tax cuts that are smaller than that average. So again, if you think you're going to receive that average, you'd better be in the top 20 percent. More than half, 51.6 percent, of tax returns with small business income would receive a tax cut of $500 or less under this proposal. So you are not delivering assistance to the vast majority of small businesses.

And finally, let's just look at the small businesses that are in the top tax rate. A lot of these aren't really small businesses. They're consultants, and lawyers, etc. that have some self-employment income that's flowing through the tax return and looks like it's a small business, even though it's really not. But even if you take them at face value, the Administration's own numbers suggest that there are about 500,000 returns in that top marginal tax bracket that have small business income. But the Administration also says that there are twenty-three million returns that have small business income at all. So we're talking about 500,000 out of twenty-three million. You do the math, that's, you know, only a couple percent. The primary problem facing most small businesses is not the top marginal tax bracket, because it doesn't affect most small businesses. And the harm that would be caused by the diversion of capital into the publicly traded corporate sector and the increase in interest rates would undoubtedly outweigh any benefit that most small businesses would receive from this plan.

PELOSI: Thank you, Peter. Thank you, Mr. Chairman.

DORGAN: Let me just say that we have five additional witnesses today as well so I am going to ask that we adhere to the five-minute rule on questions and we will try to finish this panel by 11:15. Senator Conrad.

CONRAD: First of all, thank all of you. I think you've been excellent witnesses. Obviously varying points of view, but that's a healthy thing and we appreciate your being here. First of all, let me ask each of you how much would be added to economic growth, in your judgment, by the proposal of the President. Mr. Orszag, what do you anticipate would be the increase in economic growth created by this proposal?

ORSZAG: Over the long term, because it's not paid for, I would think that the effect will be a negative number. So you had asked for what the increase would be, but it's of the wrong sign.

CONRAD: So you actually believe this would hurt long-term economic growth?

ORSZAG: If I were forced to choose one or the other, I would say that it would reduce economic growth. I think that the studies that have been done in the past, of what the benefits of a dividend exclusion are, assume that it's paid for, that it's revenue neutral. If it's not paid for, you're then reducing national saving. You have to more than overcome the drag from that reduced national saving in order to even get into positive territory, and it strikes me as plausible, especially given the fact that you wouldn't be shutting down corporate tax shelters, and such a large percentage of corporate income is not double-taxed currently. It seems plausible to me that any benefits would be smaller than the drag from reduced national saving, i.e. the overall effect would be negative.

CONRAD: Why does it make a difference to economic growth if national savings is reduced?

ORSZAG: Because if national saving is reduced, we have, we are investing less in this country or borrowing more from abroad - one of the two. It's necessarily the case. And that means that the capital owned by Americans in the future is reduced. And, in fact, one way of thinking about the net effect of this proposal is the dividend exclusion may allow us to allocate capital more efficiently across different sectors of the economy, but, because it's not paid for, we'd have less overall capital. And so you have to hope that the efficiency gains from allocating across different sectors more than offsets the reduction in capital, and it seems to me completely plausible that that would not be the case.

CONRAD: Mr. Edwards, how much do you think this would contribute to economic growth, if any?

EDWARDS: I think the Bush proposal would contribute quite a bit to long-term economic growth, but there is a difference between the type of proposal he has - in particular, the dividend tax cut - and a more straightforward tax cut, such as the thirty percent depreciation bonus last year, is much easier to plop into a macro-economic model and create and generate an accurate GDP forecast. The type of benefits that the dividend tax cut has, such as pushing American corporations to rely more on equity than debt, so that during economic downturns they… fewer of them become bankrupt, and creating an incentive for corporations to pay out dividends so that it gives less…

CONRAD: That's…but…the fact…

EDWARDS: So my point is macro-economic models are always, can give dueling results but I think the type of…

CONRAD: What does your model show?

EDWARDS: I do not have an economic model that we run at the Cato Institute. I rely on…

CONRAD: Do you have others' models and… The question that I've asked is very specific. How much would this plan add to economic growth, in your judgment? You make the assertion here that it's going to add to economic growth. Mr. Orszag said no, it's negative.

EDWARDS: Right.

CONRAD: What it your assertion?

EDWARDS: What I do know for sure is that it will reduce economic distortions. When you reduce economic distortions…

CONRAD: That's not my question.

EDWARDS: …you add to economic growth…

CONRAD: How much?

EDWARDS: I don't think any economist can tell you…

CONRAD: How much?

EDWARDS: …a precise number. Economists, as for example, as Mr. Corzine knows from Wall Street…

CONRAD: But what are the models that you rely on…

EDWARDS: …they're always changing their economic forecasts. It's very…

SARBANES: Well, give us an imprecise number.

CONRAD: Well, what does your model show? You are here asserting that this adds to economic growth. Now, I assume you base that on some analysis.

EDWARDS: Right.

CONRAD: And what does your analysis, or the analysis of others that you trust show this plan adds to economic growth? Does it add one percent? Does it add five percent? Does it add one-tenth of one percent? What does it add?

EDWARDS: I am telling you that no economist can give you precise answers but I do know...

CONRAD: I'm not asking you for a precise answer.

EDWARDS: But every economist will tell you that reducing tax rates will stimulate economic growth because it's those highest marginal rates create the largest, so-called deadweight losses on the economy…

CONRAD: And if they're not paid for…

EDWARDS: …the most inefficiencies…

CONRAD: If they're not paid for? If they add to deficits? That's positive?

EDWARDS: Well, you know, again, that's the type of effect that you can look at a macro-economic model to determine what the effect on national savings will be. But even there, looking at national savings, you got to make assumptions about what happens to federal spending. I think that reduced taxation will cause the government to spend less money in the long run, which in my view, is positive for economic growth. So…

CONRAD: Let me just say, the President's plan, his budget plan, as you indicated, you say is somewhat hypocritical about this because he's increasing spending. He is increasing spending on homeland security, which all of us support. He is increasing spending on national defense. He has a proposal for prescription drugs. He has increased spending for education. Now, he's got no cuts to offset those. No cuts that come anywhere close to offsetting those. So as overall spending goes up, the revenue goes down. Hhe is exploding the deficit, it's undeniable, and that's negative for economic growth in my judgment.

EDWARDS: I agree. And even, for example, in the Pentagon budget, we all agree that national security is of the highest importance. But, for example, the General Accounting Office routinely lambastes the Pentagon for wasting billion of dollars of money. We should have another round of base closings for example. There's all kinds of things even within the defense budget that we can do to save money on the spending side.

CONRAD: Let me go to Mr. Gale. Do you think this plan will contribute to economic growth and if so by how much?

GALE: Thank you. I want to agree with both of the previous two witnesses in a certain way. First, I want to agree with Chris Edwards *emphatically* that economists cannot give you a precise answer to this question, and that is precisely why dynamic scoring is a very bad idea. I also want to agree with Peter Orszag that if I had to take a point estimate in the long term, it would be negative. I would suggest a very modest short-term stimulus, a wash over a three to five year period, and ultimately a negative impact on economic growth.

CONRAD: And why?

GALE: Why - because the cumulative effect of increasing budget deficits is not any cataclysmic event, but it eats away at national saving, and it eats away at the capital stock owned by Americans, and therefore it reduces future national income in a continual persistent manner. I don't do macro forecast generally, but my sense, Dr. Orszag's sense, is perfectly consistent with the study that Macroeconomic Advisors put out, which shows deleterious long term effects because of this kind of insidious building effect of higher deficits over time.

CONRAD: I thank the Chairman.

DORGAN: Congressman Spratt.

SPRATT: Let me get something clear Chris, Mr. Edwards, Dr. Edwards. You do think that deficits are a problem?

EDWARDS: Oh absolutely, its always an issue, of course, of how high the deficits are as a percentage of GDP. Our deficits are lower than they were in the eighties for example. But obviously looking at the fiscal outlook now there could be a serious problem in the future if deficits keep rising.

SPRATT: Are you aware that the Administration's latest treatment of deficits as nothing to worry about, a sort of new disdain for deficits and debt?

EDWARDS: Well, there is an issue, and Bill touched on it a little bit. We haven't seen any negative effects so far, for example, on interest rates. We've swung from a large surplus to a substantial deficit, you know, and long-term interest rates are as low as they've been in decades. So we haven't seen a serious problem yet.

SPRATT: We are in a period of a slack economy with a very accommodating monetary policy. That's had enormous effect on interest rates, has it not?

EDWARDS: No, absolutely right, a lot of factors go into determining interest rates, but I'm saying we haven't seen a serious problem so far, and you know if deficits get up in the two and three hundred billion dollar range we may well see an effect down the road. Right now we don't see it.

SPRATT: So, in estimating the growth effects of this proposal, do you have to bear that in mind - that interest rates could be forced up as a result of the debt consequences of this proposal and that would have a deadweight effect on the economy, would it not?

EDWARDS: Well, you know deficits are of course are determined by two different sides, both the spending and the tax revenue. And if you look at spending in the last few years, as you well know, I looked at the numbers yesterday. In the last four years, taking out interest costs, total federal spending has gone up about a hundred billion dollars a year, four years in a row. Those are very big numbers, and so I would suggest, to deal with the long term deficit problem, we've got to deal with the entitlements - Medicaid, Medicare and Social Security - as well as pushing some of these programs, such as education, back to the states.

SPRATT: Well let me go to Dr. Orszag and ask him. He says, you say on the first page of your testimony that this proposal would actually lead to a decrease in jobs, and if you read the very complex footnote on page two you indicate that between 2005 and 2007, I believe there would actually be, per this proposal, a decrease of eighty five thousand jobs as a result of it?

ORSZAG: Let me emphasize these are not my numbers; these are the Administration's own numbers, so this is according to the Bush Administration itself. The Council of Economic Advisors put out an analysis on January 7 of what the effects of the President's plan would be. You often hear the Administration claim that there will be two million jobs created over the next three years, but if you actually look at what the effect is in 2003, see, according to their own numbers, it's only 190,000. Furthermore, they show you the average for 2003 through 2007 of 170,000. That means if you multiply by five, since there are five years between 2003 and 2007, there's a total of eight hundred and fifty thousand jobs created. The numbers 2003 and 2004 alone are more than eight hundred and fifty thousand. That necessarily means that if you are going to meet the average that they say, that there's reductions in employment in 2005 and thereafter, and we actually know from other things they've said that they're concentrated in 2006 and 2007.

So from an economic perspective, this is doing almost nothing to boost economic activity in 2003. According to their own analysis, it's harming economic activity in 2006 and 2007, but miraculously it's boosting growth in 2004. You could perhaps call this the Karl Rove plan instead of a economic stimulus plan. It's very strange that the peak of the activity occurs in 2004.

SPRATT: Now have you taken the House Democratic proposal and applied it to the same economic models, and in particular to the Council of Economic Advisors model?

ORSZAG: Again, this economic model, it's a little unclear what they did. But in previous analyses of economic stimulus plans, they have provided some indication of how they do their calculations. If you do the same calculations that the Council of Economic Advisors did, and also if you look at well known macro-econometric models... I have looked at the Democratic plan and it would produce between 850,000 and about 1.7 million jobs. So a number of about a million seems like a reasonable, middle of the park, estimate.

SPRATT: So it's several times, at least, what the Administration is proposing, for far less cost?

ORSZAG: And that's not surprising because it's delivering $136 billion in 2003 instead of…

SPRATT: What’s the difference in 2003 alone?

ORSZAG: In the number of jobs? Again, yours, the Democratic plan would be, I think, a rough order of magnitude that’s reasonable is a million jobs. According to the Administration’s own estimates, they’re at 190,000 jobs, so that’s more than five times as much under the Democratic plan.

SPRATT: Between the two plans…

ORSZAG: Correct.

SPRATT: So if you want jobs and growth, which is the label the Administration has put on their plan, clearly they should go to our plan and use it.

ORSZAG: Well, I’ll leave that judgment up to them, but I think the conclusion is a sound one.

SPRATT: Mr. Gale, you’ve been a long time advocate of tax reform. You’ve made certain proposals yourself. Can you see a case being made for doing something about the taxation of dividends, but in the context of wider corporate tax reform?

GALE: Sure.

SPRATT: Aren’t we giving up the big chip when we can make this concession and passing up an opportunity to clean out the closet, to get rid of a lot of deductions and credits and preferences and loopholes, shelters that have accumulated over the years and do something revenue neutral, a la 1986?

GALE: There are many problems in the taxation of corporate income, capital income, generally in this country, and I think a wide swath of observers, analysts, economists, politicians would like to see a comprehensive way of addressing that.

SPRATT: My point is simply if you did it should be in a tax reform package and not in a jobs and growth package.

GALE: Oh, that's exactly right. It should be in a package that actually solves the sheltering issues as well as the double taxation issues. It should be in a package that doesn’t cost the Treasury an arm and a leg. And it should be in a package, and it can be in a package, that is distributionally neutral. The notion that you have to have a big tax cut that disproportionately benefits high-income households in order to fix the corporate income tax problem is just completely misguided.

SPRATT: Thank you all for your testimony.

DORGAN: Senator Corzine.

CORZINE: Thank you, Mr. Chairman. I appreciate the witnesses' intelligent discussion on this proposal. I think, actually, we've gotten at the heart of this issue. Is this a growth package or an anti-growth package? And at least one individual who looked at a balance sheet for a while doesn't understand how anyone could argue taking cash off the balance sheet of a corporation, unless you're maybe Microsoft that happens to be carrying $40 billion, is going to promote growth. Most companies are running very limited amounts of cash on the balance sheet, and when you hire people there's this simple process that you have to pay them. Or if you're going to keep people on the payroll, you have to have cash to pay them. If you're going to invest in plant and equipment, when you go to the bank you have to have at least some margin to put down before you take out a loan to be able to invest in plant and equipment. So, the idea that it's going to not help stimulate the job growth in out years I think is, actually, relates pretty firmly to common sense and Corporate Finance 101.

But the national savings issue is even more important, as I wonder, and it actually gets at this interest rate issue we're talking about. I think long-term real rates are about, they're above average levels right now because we've got virtually zero inflation and, I don't know, the long-term bond is someplace like five percent. So I'm not sure that when you're talking with economists, that we're actually dealing with low real interest rates right now. So, we're having to compete for $2.5 billion a day to finance our trade deficit, which is a function of poor national savings. And the only way we do that over a long period of time is either raise interest rates or raise rates of return, and it is not obvious to me how this is going to accomplish that in any real sense for our corporations if it's anti-growth.

And you add in the whole discussion we've had about states. The critical weight of this could actually be far more devastating even if you believe in dynamic scoring - which I don't - in the sense that we have real tax burdens going up in every one of our states to offset any kind of marginal cuts in rates. So I don't understand why, and I want to go back to the question: if you have a temporary aid to the states, why that wouldn't be stimulative to our economy without undermining our long-term fiscal health? And I would love to hear why we think, and anyone talk about, why we think taking cash off a balance sheet is going to stimulate investment and growth in the economy. Peter?

ORSZAG: Let me address the state issue for a moment. Again, in the short run, I think it's very clear. The states are cutting spending, they're raising taxes, they're letting people out of prison because they can't afford to keep them in prison. They're taking drastic steps. Assistance to the states in the short run will prevent those tax increases and spending cuts, and thereby help the economy.

Now there is a legitimate issue to worry about if you're providing mammoth amounts of state fiscal relief in terms of the incentives for states to keep their fiscal house in order during the next business cycle. But I would say two things about that. First, that's a secondary concern right now - we should keep it in mind, but it's not the primary problem facing the economy or facing the nation right now. And secondly, the way you deal with that is you don't provide one hundred percent bail out. You try to limit the size of the state fiscal relief. In the House Democratic plan, for example, the number was about $30 billion. Given the scale of the deficits that have occurred over the last couple years in state budgets, and that are projected for this upcoming fiscal year, that seems to me to create a very… That is not going to alter their incentives to build up rainy day funds and keep their fiscal houses in order to any significant degree over the next business cycle.

CORZINE: So we should be debating the size of that?

ORSZAG: That's exactly right.

EDWARDS: I mean, looking at the states, I have a report coming out in a couple weeks where I've looked at the fifty state budgets over the last decade and the state and local spending has been, has far exceeded inflation plus population growth over the last decade. A lot of states, California and Virginia are good examples, had a real boom in the late '90s: capital gains tax revenues, in particular in California, high corporate profits taxes, high individual income taxes; and unfortunately the states used the money, and they expanded state spending pretty dramatically. So I think, just like when businesses big and small have to reassess their priorities during economic downturns, I think the states should use the current crisis as an opportunity to go through and rationalize their budgets. In Virginia, for example, the new Democratic Governor Warner is pursuing a lot of initiatives to go through and weed out excessive state spending, and so I think that's the most promising avenue at the state level.

With regard to dividend taxes it is... Senator, your question, how dividend tax cuts could create economic growth, it is true that economists have different views on the effect of dividend taxes and dividend double-taxation right now, but there is agreement that for investment funded by new share issues, cutting the dividend taxes will lower the cost of capital which will make more investment projects profitable and will lower the cost of financing, particularly for newer and smaller companies. So that's one avenue I think where there will be a direct and clear economic growth benefit.

CORZINE: Newer and smaller companies have the least access at cash flow that allows them to make reinvestments back into equipment. That's why we hear from the technology community, generally, that they are not in favor of this because they want to reinvest in the growth of their own companies. I truly don't understand the logic of taking cash off a balance sheet as the means to generate investments. Some long run context, as Mr. Orszag talked about, you can get a better distribution, although if you're borrowing it all from overseas, the dividends are going to go to offshore investors. I don't know how this drives growth in America on a, just a straightforward simple cash flow analysis of a corporation's business, balance sheet.

DORGAN: Senator Lautenburg?

LAUTENBURG: Thank you, Mr. Chairman. And I thank the witnesses for their testimony, their hard work in preparing. One of the things that puzzles me, I must tell you, is this appeal that we have based on the fact that there's double taxation. And I think that these are just catch words to try to make an argument where the logic seems to fail. And I was reading something put out by the Citizens for Tax Justice, and they make the comparison, well, if you had two taxes at ten percent, isn't that better off than one tax at forty percent? So the double taxation theme doesn't ring very well, especially, and here, Mr. Edwards, I don't quite understand what the relevance of the lowered taxes on dividends is to what America does in terms of our total tax burden. We are among the lowest in the OECD countries, the easiest ones to compare ourselves to. We're down twenty-seven out of thirty OECD countries as a share of GDP in 2001. So why is there a valid comparison between that which is paid on dividends, because it's all part of a whole system? I must tell you, I just don't get it.

EDWARDS: No, you're right. The United States does have one of the lowest overall tax burdens, total taxes - federal, state, local - as a percent of GDP of all the OECD countries. But there has been a long-term movement for about two decades now, particularly you see this in Europe, to move away from income taxes, particularly with high marginal rates, towards consumption-based taxation. And that, of course, a lot of people, such as Glenn Hubbard, support moving in that direction in this country. And part of those reforms, in my view, which I strongly support, is to move away from high corporate tax rates, to move away from high rates on individual capital income, dividends, capital gains, small business profits, towards a consumption-based system. We're going to have an increasing problem in this country trying to retain high capital income taxes when you've got massive flows, trillions of dollars a year, in direct and portfolio investment flowing across borders. It's going to get increasingly difficult to retain those high capital income tax rates, and, I think, sooner or later we're going to have to deal with that problem.

LAUTENBURG: Well, that may be sooner or later. Right now the sooner for us - I speak for, I think, most of us around this table - the sooner for us is to get this economy going. And that hardly looks like the kind of an approach that's going to do much for that. Are we not, have you seen what Senator Baucus - have we discussed that here yet, Mr. Chairman, before my arrival? - has proposed in terms of an economic stimulus package: $75 billion for the states; $4 billion for highway construction; income tax exemption, first $3,000 wages; $160 billion in upfront stimulus? The Administration plan, on the other hand, is looking at less than $100 billion upfront. Well, I think it's fairly easy, and I'd be interested in your point of view, Mr. Edwards, is that a better approach to our current need to the plea to get this economy rolling, than to be concerned about the taxes on dividends and permanantizing this tax package, these tax breaks for the guys who have done very well in this society, including my business career I had?

EDWARDS: Again, there's different conceptions about what creates economic growth and I think that lowering the cost of new investment for business big and small is the best way we can get the economy moving again. And that's why I strongly supported the President's thirty percent depreciation, or immediate expensing, from last year's stimulus bill, and I think the small business increasing expensing from $25 to $75,000 in the current bill is a very good step forward to get the economy moving and I'd like to see that even larger. So you know the dividends, I think, is probably more of a long-term return, or has long-term growth benefits. In a short immediate term benefits, increasing the big business expensing from thirty percent to perhaps fifty percent would be a way to jump-start the economy and certainly the small business expensing provision.

LAUTENBURG: The thing that Senator Corzine touched on and frankly puzzles me is that here, we have perhaps the lowest interest cost in our country, and small businesses in start-up situations cannot get capital. If you're GM or GE or whoever, yeah, you can get it. Or you want to mortgage your home and put up your assets, but otherwise it's impossible to get, so there's an anomaly out there. And frankly I've got to say this to you: I come out of the corporate world, as does my colleague from New Jersey, and when I see the misbehavior of corporate leadership, and you say, okay, if you get rid of dividends, with tax exemption, then that provides a choice. Do you invest in the business long term, to build the company, to build jobs, to build products, or do you say, listen let's get that stock price up here now because I ain't going to be here that long anyway, I got maybe a three-year hitch and I may as well get the stock price up? Not that we can rule corporate behavior from places like this but I'll tell you the response from the public, the disappointment that we've seen in this poor management and poor policy isn't, in my view, assisted in any way - especially since there is, Mr. Gale pointed out, that half of the dividends that are received now are received by non-taxables. So, I think that we're spinning wheels very frankly, and I hope that this tax package as it's constructed doesn't rely on no tax dividends. I don't think it does anybody any good, except people who need another yacht or something like that.

DORGAN: Senator Lautenberg, thank you very much. We have two additional senators to question, Senator Sarbanes and Senator Pryor, and let me indicate to the witness waiting to testify, that we will combine panel two and panel three and have all five witness, in about ten minutes, following the inquiry by the Senator from Maryland and the Senator from Arkansas. So let me now call on Senator Sarbanes

SARBANES: Well, thank you very much, Senator Dorgan. First I would like to commend you for organizing and holding this hearing. I think it is a very important contribution to the national debate on this very important issue, and to the process of education, which I think must take place, because some of these issues are indeed quite complex. I think engaging in this dialogue hopefully will shed some light.

I also would like to thank our House colleagues for joining with us - the House Democratic leader, Congresswoman Pelosi, and Congressman Spratt - and also to commend them for the economic plan which they put together on the House side, which I think has been very carefully designed to provide a short-term fiscal stimulus to the economy, focusing on working and middle-income Americans, while seeking to preserve our long-term fiscal strength. It is very careful in that regard. In fact, it provides far more stimulus in the first couple of years, at far less cost, then the President's much longer projected economic proposal, and I think that needs to be understood. The Pelosi-Spratt plan actually gives us more bang for the buck in terms of stimulus, without any doubt, and I commend them for putting it together.

I also want to express a broader concern about the President's proposal. I have to say that I regard it as reckless and irresponsible. To propose, and seek to adopt, large, long-term tax cuts in the face of the very severe national security threats that we confront at home and abroad, seems to be reckless. The war on terrorism, Al-Qaeda, the need to strengthen our homeland defense, the President seems to be moving towards war with Iraq, a potential crisis with North Korea, other possibilities, all will make uncertain but substantial demands on our public resources. In this context, it seems to me, seeking to put in place a set of tax proposals that will cost over one trillion dollars over the next ten years, counting interest costs as well, I find it very hard to comprehend the logic for that. It is just throwing prudence to the wind, and I think it reflects the triumph of ideology over reality.

I would like first of all to ask the people of the panel, if they would compare the growth of the U.S. economy with the European economy. I am under the impression that our performance has substantially exceeded that of the European economies over a sustained period of time. And even now, with the sluggishness of the economy, it is still outperforming. Is that impression correct?

EDWARDS: That is absolutely right. Of course, the U.S. population is growing a lot faster than Europe, so you always have to adjust for that, but that is absolutely right. Europe has a lot of problems, the overall large tax burden was mentioned earlier, but talking about job markets, I think that the standard conclusion is that their heavily regulated labor markets caused higher unemployment. So, I think there are good policy lessons and bad policy lessons to take from Europe.

SARBANES: I find it intriguing that when our economy is doing relatively well, I mean it's not where it ought to be, and I want to address that in a minute, that everyone comes in and says that we have to make these radical changes. We really have to make these far reaching changes in tax policy, in respect to an economy that has done pretty well under those tax policies. It is not as though someone comes along and says, "Well now look, the U.S. economy is lagging behind Japan, it is lagging behind Germany," etc., on down the list over a sustained period of time. We really have to make some very fundamental, far-reaching and, indeed, radical changes. That is not the case. The economy, in that context, has done pretty well. And yet, we are now confronting proposals, that I regard as radical, and of course whose implications, as Senator Conrad has repeatedly pointed out for the long-term deficit situation, are indeed far-reaching. Let me ask, is there anyone on the panel who, turning now to a more inner-focused view, who does not think that our economy now is soft, or that we run the risk of limping along or perhaps having a further downturn? Does any one disagree with that worry?

PANEL: (No response)

SARBANES: All right, well now are all agreed on that. Does that lead us then, to the conclusion, that at least in the short-run, we need some form of stimulus to try to boost the economy? Does anyone differ with that proposition?

ORSZAG: As long as it is truly stimulus. I think you can design many things that are called stimulus.

SARBANES: Oh, that is certainly happening now. Things are being put forward and it is asserted that they constitute stimulus, and as soon as you analyze them you find that there is not stimulus.

ORSZAG: The only second thing that I would say is that the farther out you go, the more that stimulus is delivered in late in 2003, or in early 2004, the much more substantial danger there is that you will just be stimulating the economy when it does not need it. So, something that is truly stimulative, but I think in the words of Ms. Pelosi, is "fast acting," that takes effect as soon as possible, will be much more beneficial than something that is out further in the future.

SARBANES: Mr. Chairman, I just want to close by touching on one other point on what ought to be included in a stimulus package, which I'm not sure has been brought up yet this morning. We have structured a system of unemployment insurance in this country. Taxes are paid in to an unemployment trust fund, in relatively good times, in order to build up a fund to be used when we run into unemployment problems. The unemployment rate is now at six percent. That is the highest in eight years. The long-term unemployed, those unemployed for six months or more, is now at almost twenty-five percent of the total of unemployed, which is a very high figure. In other words, there has been a substantial boost in the number of long-term unemployed. People are out of work and they have not been able to find work. The President finally gave his support to a limited extension of unemployment insurance, after months of urging him to do so. The plan passed by the Congress will cost about, somewhat less than seven billion dollars. The trust fund has close to twenty-five billion dollars in the trust fund, built up over time for the express purpose of paying unemployment insurance when we run into a difficult situation.

Now it seems to me - and I know this is part of the plan put together by Congresswoman Pelosi and Congressman Spratt, and it is also being advanced on this side by some of my colleagues - in past recessions we have extended this unemployment insurance, and we have been very reluctant to do it, the Administration has been very reluctant to do it in this economic downturn, but the fact of the matter is that there are more and more people out that have exhausted their unemployment benefits, have been unable to find a job because the labor market continues to contract, and they need support. It seems to me, that one of the critical items, and this obviously immediately feeds right into the economy, because almost by definition, those receiving unemployment insurance are only receiving a fraction of their previous income, and of course they are confronted with meeting their family expenses. So I think it is imperative that we include this as part of the stimulus package.

DORGAN: Senator Sarbanes, thank you very much. Finally we will call on Senator

Pryor, and following Senator Pryor's inquiry I will ask that the panel be excused and we will call up the other five witnesses, and I will recognize Senator Carper for the first inquiry of the next witnesses. Senator Pryor.

PRYOR: Mr. Chairman, thank you. I actually do not have any questions. My colleagues have done such a great job I do not think I could add anything this morning. Thank you.

DORGAN: Senator Pryor, thank you for joining us.

SARBANES: Senator Pryor is going to go a long way in the Senate, no question about that.

DORGAN: We should note that one member of the audience applauded. Anyway, we appreciate you being with us, Senator Pryor. To the three witnesses, you have distinguished careers, you are interesting thinkers in a very difficult and challenging field, and we appreciate you presenting your views today to this hearing, and we would excuse the witnesses. Next let me ask the following five witnesses on the following two panels to come forward.

We will be hearing from Frank Green and Kevin Douville, also from Robert McIntyre, Citizens for Tax Justice, Nancy Farmer, treasurer of the state of Missouri, and Iris Lav, the Center on Budget and Policy Priorities. Now if you would all come forward and take your seat at the table.

Let me say to all of you, thank you for your patience this morning. We have taken longer than we expected with the first panel, but it's obvious, I'm sure, to anyone participating in this hearing, that these are difficult and challenging issues dealing with the American economy, and so we've spent a fair amount of time on the first panel. But the second panel is equally interesting and we deeply appreciate your being willing to be with us today.

Let me begin with you Mr. Greene. I understand you are from Seaside Heights, New Jersey. I don't know where that is, but perhaps we have a couple of colleagues on this panel who can help us?

CORZINE: You're fortunate. It's one of the nicest places in the United States, and we encourage you to come and visit us regularly, right Mr. Greene?

GREENE: Yes sir.

DORGAN: Well, Mr. Greene, thank you for traveling from New Jersey today to be with us. We will include, as we will for all witnesses, your entire statement as part of the permanent record of this hearing. We would ask that you summarize. And let me ask you to proceed, Mr. Greene. And if you pull the microphone closer to you.

GREENE: Hello, my name is Frank Greene. I am 33 years old, and, I just said, live in Seaside Heights, New Jersey, the Garden State. I've been a New Jersey resident my whole life – born and raised there. I'm a member of the Service Employees International Union, Local 1199. I've worked for the past ten years as a Certified Nurse's Aide at Leisure Chateau nursing home. I'm currently making $9.05 an hour. I also work a second job at an agency that places me in different nursing homes temporarily, where there I make $13 and $14 an hour for the agency, but I receive no benefits. I'm a single man, and I have a 12-year-old child who lives with his mother in Oklahoma.

I'm hoping to buy a home if I could get a mortgage, but with my income level it's hard. I've had difficulty making ends meet. When your take home pay can be as little as $1,100 a month and your bills are as much as $1,600 a month, no matter how you do the math, you come up short. There's no upward mobility in this job. In any other job – such as McDonald's or Burger King – even after ten years, I would be making over $9.05 an hour.

The tax cut President Bush is proposing would put only $50 in my pocket for the entire year. That's less than one dollar a week. I think the federal government should send more money out to help the working class individuals who need the money and would use it to pay for everyday expenses.

Because of my work, I also think more money should be spent on the Medicare and Medicaid system. The money to make a nursing home run comes almost entirely from the government. We're extremely short-staffed at my job. Every year there are high turnover rates. When we're short-staffed, the residents don't get the care they deserve and need. If there aren't enough hands, they may have to wait up to 40 minutes for someone to respond to them. You can't stop caring for one person to go care for another person.

And most of the nurse's aides feel upset because the state has recognized how important our work is. It's one of the few jobs where we're required to be fingerprinted, with an FBI background check every two years in order to maintain our service. That's how important our work is.

If there were more Medicaid and Medicare dollars, it would help bring more people into this field, and people wouldn't leave because they can't afford to take care of themselves and their families. We don't work at these jobs for the money; we do it because we care about the residents. But we can't continue if we can't afford to live on the salaries we make.

Thank you for the chance to speak to you today.

DORGAN: Mr. Greene, thank you very much for being with us and offering your testimony. Next we will hear from Kevin Douville, I hope I pronounced that correctly, and Kevin is from Northern Virginia, I understand. And we are pleased for you to share with us, and why don't you proceed?

DOUVILLE: Thank you. My name is Kevin Douville, and I am here today to offer my perspectives as an ordinary taxpayer on the President's economic stimulus plan.

Like so many others, the economic downturn has had a negative impact on my life. Last November I was laid off from my job as a web designer and programmer for High Technology Solutions. With my company—which contracted with the military to provide technological services—I worked on a web site that helped army personnel find new housing when they are reassigned. My company lost the contract and I was let go.

Since then I have been sending out resumes and looking for a new job, but the high tech sector has been particularly hard hit, both in Northern Virginia where I live and nationally.

When I moved to the area three years ago and was looking for a job, I spoke with many potential employers and temp agencies. In my current job search, I am lucky to get a postcard back letting me know that they received my resume. It has even been difficult to get an interview with a temp agency. Of the ten or more I contacted, only two would speak to me in person. And I am someone with five years' experience working on web sites and the Internet, with a proven track record in both the public and private sectors. So I'm the kind of person employers are looking for. This sector is so hard hit that even my former manager, whose job includes finding new work for the company, is in danger of losing his job.

In order to meet my financial obligations, I have been working for a temp agency and receiving unemployment benefits. The $368 that I receive for the weeks when I cannot find temp work represents a dramatic cut in my pay compared to my previous salary, which was about $70,000 a year. I own a condo in Arlington, Virginia and my mortgage payment and fees alone run me around $1,300 a month. And this is for a small, one bedroom apartment, with only 800 square feet.

The tax cut that President Bush is proposing this year would not do much for me. I am not one of the right people to receive any special tax breaks.

Under the Bush plan, single people like myself do not get special consideration, despite the fact that we have to bear our own expenses and, when laid off, have no one to turn to for support.

If I have to finish out the year temping—and receiving unemployment until it runs out—I can expect to earn about $40,000. At this income level, my tax savings under the Bush plan would only be about $50.

If I succeed in my job search and find work that pays me as much as I earned last year, the Bush plan would provide me with a tax reduction of about $500. This wouldn't make much of a difference in my life. When I learn that millionaires will receive tax cuts of $90,000 under President Bush's plan, I know that the plan wasn't designed for a middle-income person like myself.

From my point of view, what I really need from Congress is not changes in my tax status. What I need is a growing economy that would help me find a job now. While Congress is debating various plans, the clock is ticking on my unemployment benefits. I say this even though I hate being in a situation where I have to receive unemployment checks. I would prefer to be out there earning my money, supporting myself on my own and contributing to the economy.

Looking down the road, I am alarmed by the almost overnight return to deficit spending. I'm no fan of taxes, but I am less of a fan of government borrowing. I think that large deficits would do more harm to the economy. We need an economic stimulus right now, but not one that will just create a worse problem down the road.

For years I've heard about the coming crisis in Social Security and Medicare, and I don't want the government to do anything that would worsen that situation. As a member of the generation after the Baby Boomers, I'm concerned about what will be left of Social Security for me and my generation when we retire. I don't want Congress to do anything that would jeopardize us even further.

In closing I would like to thank the Senators and representatives serving on this panel for the opportunity to speak with you.

DORGAN: Mr. Douville, thank you very much for your testimony. Let me next call on Nancy Farmer. She was elected November 7 in the year 2000 to be Missouri's state treasurer, the first woman to serve as the chief financial officer of that state in its 180-year history. She has a long record of public service in Missouri, serving in the state legislature. She chaired the Ways and Means Committee, served on both Budget, Operation and Finance committees. So Ms. Farmer comes to us with very substantial credentials.

Ms. Farmer, why don’t you proceed?

FARMER: Thank you, Mr. Chairman, and Leader Pelosi, and members of the Committee. I really appreciate the opportunity to be here today to comment on the potential impact the President’s proposal would have on states. Clearly from your opening statements, the first panel, and your follow-up questions, you’ve heard most of my testimony, so I’m going to proceed very quickly. And, you’ve all stated this in your questions and your opening statements, you’re well aware that nearly every state is in fiscal crisis. Nine states are facing deficits of twenty percent or more in their deficits for the following year.

You are well aware that the sluggish economy and the tax cut policies of this Administration in 2001 and '02 have reduced state revenues.

At the same time revenues are down, spending pressures, much of which we consider mandatory spending - Medicaid, Corrections spending – have increased dramatically.

The President’s 2001 tax law is contributing to the pain we’re experiencing today. His proposal to accelerate that plan and add additional cuts turns our bloodletting into a hemorrhage.

I want to give you a quick snapshot of what’s happening in Missouri and other states today. Medicaid spending grew 13.2 percent in FY 2002 alone – that was the fastest growth rate in a decade. As a result, thirty-seven states were forced to reduce their ‘02 enacted budgets by more than $12.8 billion. My state was no exception. Last year, Missouri government took in less money than in the previous year. The state’s net general revenue receipts declined three and a half percent. That’s the first year-to-year decline since 1955.

Over the past two fiscal years, we have cut nearly $1 billion from Missouri’s $19 billion budget. Among the cuts was a 15 percent reduction in funding for higher education and the elimination of about a thousand jobs.

We are not alone. According to the National Governor’s Association, school districts in seven states are now shutting down their public schools one day a week. In California, the governor has called for reduction in health care spending that will deny service to at least 200,000 needy people. And Kentucky, as you’ve already heard this morning, has released several hundred prison inmates to cut corrections costs.

Today, even with the cuts we’ve made, Missouri faces a projected $1 billion shortfall for FY04. Nationally, state governments are reporting $60 to $70 billion in potential budget shortfalls. And a $1 billion shortfall out of a $19 billion budget may not sound that drastic, but Missouri, like most states, has limited discretionary general revenue dollars. Only 6.8 billion of our budget is general revenue. The lion's share of our dollars is restricted: we have fuel taxes for highways, sales taxes for parks and conservation, and, of course, we receive federal money which, we are grateful for, even though it is earmarked for specific purposes. Of our general revenue, one-half, or over 49%, is spent on education – 2.5 billion on K through 12 and over $900,000 on higher ed.

The balance of our general revenue, about $3.5 billion, pays for everything else: the highway patrol, economic development, debt service, environmental protection, corrections, services for the mentally ill and the disadvantaged, among other things. So our one billion dollar shortfall is extremely painful. Missouri, like most other states, is wounded right now, and what we need from you here in Washington is aid, not another slash like the President is proposing.

And quickly, to the impact of the current proposal. Missouri – like thirty-six other states – ties its tax system to the federal tax system. Where the President proposes changes in federal tax rates or increases to tax credits, it has very little impact on us. It's the accelerated changes in deductions and exclusion of dividends from individual income taxes that have a substantial impact on our budget. Every dollar reduction in Federal Adjusted Gross Income results in a dollar reduction in Missouri income taxes.

Under the current tax relief act, Missouri would lose $23 million beginning in FY06, increasing to over 90 million in '08 with a phased-in reduction of the marriage penalty. The President's proposal to accelerate that reduction will cost Missouri $90 million next year.

We estimate that the impact of eliminating individual income taxes on dividends will cost Missouri in the neighborhood of $100 million. The National Governors' Association projects this provision would cost state governments collectively $4 billion this year and $45 to $50 billion over the next decade.

Also of concern on this provision, and the first panel discussed this, is the potential to increase interest rates for public debt. Because dividends would be tax-exempt, tax-exempt stocks would compete with tax-exempt bonds for investors' dollars. We're not projecting a specific increase, but any increase in interest rates will drive up the costs of building schools, roads, airports, and other capital improvement.

Missouri is a low-debt state. What I'm concerned about for us at home with potential higher interest rates is the impact it would have on our state housing agency. Our mortgage revenue bond program uses bond proceeds to assist low- to moderate-income first time homebuyers. Higher interest rates, obviously, would mean that we would be able to assist fewer potential buyers with attaining the dream of owning their own home. Not including the potential impact for higher interest rate on debt, the President's proposal will cost Missouri $100 to $150 million. That increases our budget shortfall by 10 to 15 percent.

I have not addressed the accelerated depreciation for businesses. Last year, Missouri along with twenty-nine other states, decoupled from the feds so this bonus would not impact our revenues. In Missouri, we decoupled for just one year. So if our legislature does not act to decouple again this year, it would reduce our revenue by another $70 million.

So in total, President Bush's attempts to stimulate the economy at the national level could undercut Missouri by nearly a quarter of a billion dollars.

And to add insult to our life-threatening injuries, there is no relief for states in this package. I've already mentioned skyrocketing Medicaid costs, but we've also increased spending with homeland security and the "No Child Left Behind" programs. From my perspective in Missouri, and I think most other states, the proposal is a lose/lose/lose.

First, the proposal will diminish states' ability to provide services to those citizens who need them the most; then, those same citizens, with the greatest needs, get the least in direct relief. And third, states are already struggling to balance their budgets, and this proposal exacerbates the problems.

The actions that we must take, from cutting education to layoffs and furloughs to reducing capital improvements, will contract the economy and negate any stimulus impact this proposal might have.

Thank you very much.

DORGAN: Ms. Farmer, thank you very much. You indicated that this was your first opportunity to appear before the Congress.

FARMER: And I couldn't be happier that it's before this committee.

DORGAN: Well, we appreciate your being here. And the person to your right is a veteran appearing before the Congress, Mr. McIntyre. Robert McIntyre is the director of Citizens for Tax Justice, a nonprofit, nonpartisan public interest and advocacy organization. They focus on federal, state and local tax policies. Mr. McIntyre, you have testified previously before the Policy Committee. We welcome you today, and why don't you proceed?

McINTYRE: Thank you, Mr. Chairman, and thanks to all of you for being here to listen to us little people. You asked me to come here today to talk about the fairness, or lack thereof, of the President's tax proposals.

I was glad to hear I didn't have to beat that horse any harder on whether this is a stimulus bill. You seem to have determined that pretty clearly that we can now officially call this, "the President's 'not-a-stimulus' bill," because that's not its purpose. Its purpose is a little different. They have two parts, as you know, one is speed up those income tax rate cuts and other provisions that aren't supposed to take effect until 2006 into the current year. The purpose there is to hopefully, they think, get them in place before it becomes even more obvious we can't afford them.

Their second proposal is to exempt dividends, corporate stock dividends and a lot of corporate stock capital gains from tax. Their purpose there is, as always, to shift more of the tax burden away from the wealthier people and ultimately to raise it on the poor and the middle-income people. They're even starting to admit that in press stories.

So how does this thing stack up? Well, the total package, including the accelerations and the dividends, about a third of it would go to the best-off one percent of the population. The average tax cut for that group would be about thirty thousand dollars a year. For the typical middle-income family the average tax cut would be $289. So there's a ratio of 100 to 1. If you're poor, you get an astounding six dollars a year from the Administration's plan. That's one five-thousandth of what the wealthiest get. The Administration, however, says that's not a fair comparison; you really should look at things as a percentage of the taxes that people are paying out. Well, I don't happen to agree with that, but I'm happy to do it. And if you want to look at all the taxes, not just the taxes the Administration does not like, well, the tax cut, as a percentage of taxes, is about nine percent for the richest one percent of the population, about four percent for the middle and less than one percent for the low income families. So we have a ratio of ten-to-one in the rich's favor compared to the poor, and two-to-one, compared to the middle-class. So no matter how you slice it, dice it, purée it, this thing is horrible.

Let's focus in on the dividends piece; that's their new innovation. I can tell you confidently that for four out of five Americans, the average tax cut from the dividend exemption is zero - a nice round number. That's because fewer than one in five Americans gets a taxable dividend in a year. A lot of Americans get dividends; they're in tax-exempt accounts. They don't care about this proposal.

Now, the Administration's argument, which they make with tongue in cheek, is that dividends are double taxed; profits, they mean, are double taxed. Now they know that's not true. In fact they write at great length that it's not true in some of their papers. But those are the papers that most people don't read; they aren't the Washington Post – they're the "Issues in Integration of the Corporate Income Tax…" etc. Well, how much of corporate profits are taxed? Well, at the corporate level, less than half of profits are taxed theses days. Most of the profits are sheltered, loop-holed, evaded, avoided, moved. They aren't taxed. The little bit that dribbles out in dividends, most of that isn't taxed. You add it up and we do not have a double tax on profits. We have, approximately, a half tax on profits. If the Congress in its wisdom would like to solve the problem here, you could double the corporate income tax and we would have a tax that only taxed profits once. If you get that far, I will be willing to come back and make the case for a double tax, which has its own merits, but since we're so far away from it, I'll just stick with tax it once for this hearing's purposes.

You had a witness here from the Cato Institute who told you that we had the highest corporate taxes, I believe, in the universe. I think he had a chart showing Uranus, Mars and some of the other places. We don't. We have almost the lowest corporate taxes, at least on this planet. And how do we know that? The easy measure is we look at corporate taxes as a share of the economy. And ours are lower than almost every country in the OECD, which is the countries that have corporate income taxes. So, how do these people say the opposite of that? Well, I'm not going to talk about morality here except in terms of fairness. And they're not fair when it comes to numbers, that's for sure.

Now finally, there's one final more unfairness here. We're giving money to the wrong people - there is no double tax, they made that thing up. There's one other unfairness you shouldn't forget. In 2001, the Administration passed its big tax cut, $1.6 trillion over ten years, counting interest. Now they want to increase that by more than half, about $900 billion more, counting interest. Who's going to pay for this thing down the road as interest payments get bigger and bigger and bigger? Well, they are people who are currently known as children, who will become taxpayers eventually. And I think it's just hopelessly unfair to them, immoral really, for us to be putting those burdens on them now so we, or at least a few of us, can have a good time these days. So don't ever forget that one. When we spend the kids' money now, they won't have it later. They won't have the programs. They'll be paying taxes that are too high. This Administration has a slogan, and I'll close on that, it seems to be to leave no child without a giant national debt. I hope you're resistant. I'm done.

DORGAN: Thank you very much, Mr. McIntyre. We appreciate your being here. Finally, we will hear finally from Iris Lav, from the Center on Budget and Policy Priorities. She's the founder of the Center's state fiscal project and received the Steven Gold award for contributions to state and local fiscal policy. Thank you Iris for being with us, and why don't you proceed?

LAV: Thank you, and thank you for having me this morning. Today, I'm going to talk about states, and talk about, as you've mentioned several times, what isn't in the President's plan, and that is fiscal relief for the states. And fiscal relief is critical because states are in very deep budget trouble. We've done some work to estimate just how much trouble they're in, and for the fiscal year that begins in most states in July, we estimate that state deficits will be in the range of $60 billion to $85 billion. That is just a huge gap - that's thirteen to eighteen percent of total general fund spending. In other words, states are missing about one dollar out of every six or seven dollars of revenue they need to maintain their programs and services. And of course unlike the federal government, states have requirements, and most of them are constitutional, to balance their budgets. So this huge budget gap has consequences.

However, this will be the third year of budget problems in many states, so the less damaging ways of making budgets balance - such as drawing down reserve funds, or putting on hiring freezes or things like that - have already been used up. In the coming year, the vast majority of these huge state deficits will have to be closed by cutting expenditures or by raising taxes. Thus, these actions will have a gross effect on the economy, as Bill Gale already mentioned. When states must cut programs to balance their budgets, what do they do? They lay off workers, they reduce payments to contractors and providers, or they lower benefit payments to individuals. This reduces the money that people have to spend and increases demand for private sector goods and services. And of course tax increases have a slightly lesser, but still similar effect. The only way to prevent the reduction in demand is for the federal government, which has the more flexible fiscal system, to provide some aid to the states to help them avoid deep cuts in services and sharp tax increases.

But clearly that's not what the President's plan does. And of course, beyond failing to help states avoid these damaging actions, the President's proposal actually makes the situation worse in most states. The proposals would directly reduce state revenues in most of the thirty-nine states and DC, that link their tax systems to the federal taxation of dividends and capital gains income, and it might also reduce revenues in some of the other states as well. Preliminary estimates that we've made suggest that these changes alone will cost states between four billion and 4.3 billion dollars per year for the next couple years, and even larger amounts after that as the capital gains portion of this proposal grows in cost. In other words, the Administration's proposals would add at least four billion dollars to the deficits states are facing in the upcoming fiscal year.

And the Administration's proposal, by sheer size and shape, would have other adverse effects on state and local governments. It's likely to lead to increased interest rates as the deficits expand and as the dividend exemptions make stocks marginally more attractive than bonds. Competitions from stocks with tax free dividends will be a particular problem for state and local government which depend on tax exempt bonds to finance their infrastructure needs, ranging from schools to transportation to clean water, and, as the Missouri treasurer mentioned also, housing for their residents as well.

Peter Orszag mentioned the California state treasurer's office study, and that looked at what would happen in the likely event that the interest rate on tax exempt bonds increased by twenty-five or fifty basis points, a quarter to half of a percentage point. If the interest costs increased by fifty basis points, the report finds that the total increased interest payments over the life of the state and local bonds projected to be issued over the next ten years, the extra cost would equal nearly a $155 billion dollars in extra interest costs. So far from promoting economic growth and job creation, from failing to aid states and further increasing state deficits is likely to be economic contraction and reduction in employment.

I mean, you would think at the bare minimum, no federal proposal would make the state's situation worse. And arguably, the best policy at this time would be for the federal government to aid the states – to help them avoid the contractionary budget cuts and tax increases. Now, fortunately, there are a number of Congressional proposals that would provide significant aid to the states. Last year in the Senate, a bipartisan proposal to provide funding in the states passed by seventy-four votes, although the bill to which it was attached died. This year, that bipartisan proposal has been expanded, as have the number of bipartisan sponsors. And of course there are also very important Democratic proposals in the House, that Leader Pelosi and Mr. Spratt put together, and in the Senate, Mr. Baucus, and the enactment of proposals of that nature should be a very, very high priority for this body. Thank you.

DORGAN: Ms. Lav, thank you very much. I appreciate the testimony from all of the witnesses on this panel. I indicated I would call on Senator Carper first, but then Leader Pelosi is going to have to leave, so I'll recognize Leader Pelosi following you, Senator Carper.

CARPER: Thank you very much, Senator Dorgan. To our witnesses, thank you very much for joining us, and your input today and on previous occasions, in some cases. Let's say to Leader Pelosi, I remember very well the day you came to the House of Representatives. I want to say fifteen years ago, you joined us on the House Banking Committee. I never thought I would go on to be a governor or a senator, but I knew you were marked for greatness. And I congratulate you for your accomplishments and the leadership opportunity that has been bestowed upon you by your colleagues. I want to say to Congressman Spratt of South Carolina, thank you for my wife. Not many of you know this, but his wife and my wife are first cousins. His wife introduced me to my wife some eighteen years ago, and now we have two children. So I regard John Spratt as a cousin-in-law and regard him fondly.

DORGAN: Are you just going to circle the subject, or are you going to talk about the economy?

CARPER: I'm always just delighted to be in the company of these two. To our witnesses, let me just say that sometimes we are criticized as Democrats for attacking tax cuts proposed by this Administration and by others, because we say that the tax cuts go inordinately to the wealthy and not to those who are most needy, and I would have us be careful not to have us always fall in to those arguments. Wealthy people do pay considerable taxes, at least they do in my state, and to the extent that we do cut taxes, I think it's appropriate that they realize some benefits from those tax cuts – not inordinate, but some reasonable benefit.

I'd also say that I believe dividends are tax cuts - not everyone agrees with that. If you look at the way companies expense for their debt service payments. They can't expense the cost of dividends payments. It sort of skews their propensity to issue debt, as opposed to issuing stock. I don't think that's necessarily a healthy thing for them, or for our country.

The approach that the Administration has taken though, is not to go at it that way. Not to say to companies, you can expense your dividend payments just as you expense your interest payments; instead they go a different way, a more convoluted, and I think, ultimately not a treacherous approach, but certainly a complex approach to try to correct what I think is not especially good policy.

The thing that troubles me most about the Administration's policy is the fact that we don't have the money to pay for it. Just at a time when we're preparing to send tens of thousands of young men and women maybe off marching into a war in the Middle East, while we're set to do that with substantial cost, for the war and for the occupation, their parents and grandparents, tens of millions of their parents and grandparents, are on a march of their own. And that is a march toward retirement, and my generation is going to be there within the next ten years, actually less than ten years, and the costs that will be felt there by Medicare and Social Security are substantial. For me, the Administration's proposal is most dangerous because of what it does to the long-term budget deficits, and it doesn't really attempt to offset them in my judgment.

State Treasurer Farmer? I used to be a state treasurer. Mel Carnahan was state treasurer when I was state treasurer, and he was one of my favorite colleagues in a number of capacities. Jack Markell, our state treasurer, sends his regards from Delaware. I just want to follow up on terms of what we need to be doing to help the states. You mentioned a couple things. You mentioned piggybacking; many states, including ours, piggyback on federal tax structure, and we're looking now at decoupling in Delaware. Are you looking now at possibility of decoupling in Missouri?

FARMER: We decoupled on the accelerated depreciation. We have not looked at a total decoupling, and I think that many states that do have their systems tied to the federal system, it would be a huge investment for us. We use the same definitions you use, we use your auditing practices, so for us to decouple completely would just require a huge investment in our own department of revenue, so it's not very practical at this time.

CARPER: You mentioned, and so did Ms. Lav, mention the possibility of the adverse impact of making the dividends tax-free will have on the cost of issuing tax exempt (*unintelligible*) on the part of the states. I certainly acknowledge that that's a threat, and a potentially expensive one. You talked a little bit about Medicaid costs spiraling out of control, especially as more people end up on unemployment, and don't have their health care from their employers. We have something called the FMAP formula, which determines what percentage the federal government pays out of Medicaid costs, and what percentage the states pay. Some of us have felt it makes sense for the feds to pay a little more on the FMAP Medicaid formula for a while, not forever, but for a while, and for the states to pay a little less. I think Senator Baucus has proposed actually giving the states money, just a grant, basically no strings attached. My own view is actually, what we ought to do, is pick out things it makes sense for us to fund - greater portions of Medicaid costs, fully fund No Child Left Behind, fully fund homeland defense - as opposed to just giving states money to just say do with this what you will. Your thoughts on that?

FARMER: Couldn't agree with you more. I mean, frankly, if you would assist us just in those three areas - I'm trying to do some quick mental calculations - I think that relieves our budget problem

CARPER: Two more points, then I'm done. We've been working with welfare reform, trying to reauthorize welfare reform for the last year or two to get an agreement; we're going to try it again this year. If you look at a bunch of states around the country, they have huge waiting lists for child care. Huge waiting lists for child care. The Administration tried increasing the work requirements. And I don't know if you have waiting lists for child care in Missouri, but I would have us be careful as we prepare to raise the hours that people have to work while they're on welfare, at a certain point in time, if we don't provide child care, we're going to provide another unfunded mandate. Any thoughts on that?

FARMER: I can't give you the exact numbers from Missouri. I know we do have waiting lists in many areas of the state. Child care, transportation is another big issue for us as we deal with welfare reform.

CARPER: Senator Dorgan has been pushing for something that I pushed for as governor. I'm troubled by the notion that if I live in a state that had a sales tax - Delaware is one of six states that have no sales tax - but if I lived in a state that had a sales tax, and I went to my local merchant in my state and bought something, I'd pay the sales tax. On the other hand, if I bought it over the Internet, from a remote vendor, there's a pretty good chance, if I use my computer, and access to the Internet, there's a pretty good chance that I could avoid a sales tax obligation. If I happen to be wealthier and more affluent in my state, and have a computer and access to the Internet, I end up maybe not paying my share of the sales tax burden. Meanwhile, if I'm not as affluent, I don't have access to a computer, I don't have access to the Internet, and I go to a local merchant and I buy a particular good or service, and I end up paying a sales tax supporting the services in my state even though I'm less well off. To me, that seems wrong. Do you all have sales tax in your state?

FARMER: We do. We have a sales tax in Missouri. We also have a use tax, so individuals or companies that are making purchases from out of state that would be taxable if purchased in Missouri, over $2,000, they are supposed to be remitting an equivalent use tax to state and local governments. Is there one hundred percent compliance? I sincerely doubt it.

LAV: I think actually use tax compliance around the country is around one percent, not one hundred percent. Almost nobody pays use tax. And so even though you're supposed to file a return for what you buy from mail order, and over the Internet, businesses do, because they're audited, but individuals very, very rarely pay use tax. So this is a major problem, and ultimately it may take Congressional action to fix it. The states are taking actions themselves to try to get some voluntary compliance now from retailers.

CARPER: Well, states need to simplify what they do. A lot of states have not just a state sales tax, but a county and a municipal sales tax. They need to simplify what they're doing, but we in turn should, and I say to Senator Dorgan, how much I support what you try to do, and if you think of ways to try to help the states, and by golly…particularly in light of the dramatic increases of purchases that have been going on over the Internet from remote vendors.

DORGAN: Well, Senator Carper, thank you very much. On that point, there is somewhere in the neighborhood of twenty to twenty-five billion dollars owed to the states, but not paid to the states in use taxes that have never been reported as a result of these remote sales. So it is a significant part of the revenue problem these states have.

Ms. Lav, I was told that you have to leave by 12 o'clock; it's a few minutes afterward. Why don't you depart, and let us thank you for your contribution at this hearing. I don't want to delay you. And let me then call on Leader Pelosi and thank her for being a part of this hearing and thank her for her leadership in the U.S. House.

PELOSI: Thank you very much, Ms. Chairman. I want to commend you once again for holding this hearing. I want to thank Ms. Lav as she leaves for her excellent testimony. And I want to join you in welcoming Mr. Carper here. He distinguished himself greatly when he served in the House, we were overjoyed when he became the governor, and now it's a pleasure that he's back in the Senate, now with some seniority after a new class is in, and I want to associate myself with one of his remarks.

Everything that we're talking about for tax breaks for the wealthy doesn't mean that we don't want to reward those who have worked hard and been successful. What we're talking about here is disproportionate advantage going to the high end at the expense of working families in America who really do need additional relief which helps the economy, puts purchasing power and money in their pockets, stimulates the economy and helps to grow it to increase our capacity. So it's nothing about being resentful of anyone's success; in fact, we applaud it. In fact, many of the those people say they'd rather see our budget in balance, they'd rather see our children educated, our environment protected, our streets secure, our country safe, than to have another tax break at that end.

Hearing the testimony of our witnesses here, and I want to thank each and every one of you for your clear message. Mr. Greene, for making it clear what it meant to you in your life as a worker having two jobs, but also the people you care for in the nursing home. And Mr. Douville, your own situation, but also indicating that the person who generates new business in the firm you worked for might lose his job - how does that make sense? And of course, the very distinguished testimony of the treasurer, making very clear the impact on the states, as well as Mr. McIntyre and Ms. Lav, reinforcing those points.

While I understand that this Administration is wedded first and foremost to tax cuts that disproportionately prefer the high end, I for the life of me cannot figure out how they forgot the states in what they consider to be a stimulus package - which is not. But how they could not even make a pass at increased funding immediately to the states for homeland security, for infrastructure, which also relates to homeland security. For the Medicare percentage that Mr. Carper talked about, the FMAP issue that the Senate overwhelmingly passed as part of a bill that did not succeed.

DORGAN: Leader Pelosi, may I interrupt you one moment. I understand that Mr. Greene has to catch a train to New Jersey, and the trains don't wait for anyone. So, Mr. Greene, why don't you depart, and again, depart with thanks for being with us today.

PELOSI: Thank you Mr. Greene, please make that train. I want to express my appreciation for those who referenced the California treasurer, Phil Angelides, whose work has been a tremendous resource in the consideration of state budgets and anything that impacts them - for example, a tax cut. I just make these comments to say I would like an explanation that this panel cannot give us but that the Administration owes us, as to why they completely forgot about the states when they were putting out a stimulus package.

And with that, I thank you again, Mr. Chairman, I thank you again, acknowledge the excellent contributions of all of our witnesses today, and say how much that we will use the documentation that you have given us. Hopefully, we will end up at the end of the day with a package that is better than what the President has proposed. The future budget condition of our country demands that. Thank you.

DORGAN: Thank you very much, Leader Pelosi. Congressman Spratt.

SPRATT: Thank you very much. Let me thank our witnesses, particularly you, Mr. Douville. As we said with respect to both you and Mr. Greene, you put a human face on what we're talking about, and that, in the final analysis, is where our real concern is: what's happening to Americans from coast to coast. Ms. Farmer, you sounded a message that we're all hearing from our respective states. Like Senator Carper he - he anticipated some of my questions very well, he apprenticed very well when he was in the House - we trained him well. One of the questions was about whether or not the aid to the states should be categorical or unlimited. Our preference, my preference would be to make it somewhat categorical. In respect to Medicaid in particular, has Missouri experienced a rise in the cost of Medicaid as a result of recession?

FARMER: Yes we have. I believe that that national average reflects roughly the increase we have experienced in Missouri. I have to say, Congressman, that certainly we in the states would like to have the least restriction on federal dollars as possible, but certainly categorical relief in those areas is needed, and certainly we'd be appreciative.

SPRATT: If we were to increase the FMAP for all states by 2.5 percent, what would it do, on a one time basis, for a state like Missouri?

FARMER: I can't answer that. I don't want to give you an incorrect number; I'd be happy to get that number for you.

SPRATT: Well, if you could. I'm sure you've got lots of other things to worry about with the issues you've got, so it would just be interesting for us to know. I take it though, however, that an increase in the federal share in the FMAP program, even on a one-time basis, would be welcome in the state of Missouri?

FARMER: I think in forty-nine other states as well.

SPRATT: Do you have any homeland security costs that you're finding it difficult to meet? Airport improvements?

FARMER: That clearly is contributing to the budget problems we've had. I apologize I don't have numbers on that, but clearly those expenses in the last couple of years are part of the spending pressures I referenced. And frankly, we consider those mandatory spending.

SPRATT: Mr. McIntyre, in talking about the dividend exclusion proposal, you indicated that only about fifty percent of all corporate earnings are effectively taxed.

McINTYRE: That's right, when you count dividend taxes and corporate profits taxes together. So most of the time - about half the time they're taxable, the other half they're not. So that's about a half tax. Like I said, if you want it to get to one, I'd be on your side. But the Bush Administration wants to take us down to way below half, which is the opposite.

SPRATT: What is the effective corporate tax rate?

McINTYRE: Right now, at the corporate level, it's about fifteen percent instead of the thirty-five you have in the statute. When you add in the personal taxes on dividends, you get up to about eighteen percent total.

SPRATT: If we had a tax reform bill, of which this particular proposal was a part, are there enough loopholes - shelters, deductions, credits, and other things in the corporate tax code - that we could change as we did in 1986 to make this a revenue neutral change in corporate taxation?

McINTYRE: I think you could go way beyond revenue neutral. If your goal was to tax corporate profits once and only once, then you would bring the effective rate back up to thirty-five. So, I guess, you'd be roughly doubling the revenues from corporate and dividend taxes, compared to what we'd get now. Yeah, you'd have a lot of money left over. You could use some of it to send to the states.

SPRATT: What is the corporate tax rate as a percentage of GDP in the United States?

McINTYRE: We're down now, counting state and local to 1.5 percent, the federal was 1.1, and that ranks us, there's some country behind us but… Iceland, that's it, everybody else is ahead of us. And the interesting thing here is the trend. We used to have higher corporate taxes than other countries back in the sixties. Ours have been steadily going down as a percentage of GDP, and theirs have been steadily going up, and now they have much higher ones than we do on average. I don't know if we're better off or worse off. The sixties weren't that bad, at least economically. The music was better.

SPRATT: Thank you all for your testimony. We appreciate you coming, and we appreciate your patience too.

DORGAN: Senator Lautenberg.

LAUTENBERG: Thank you Mr. Chairman. Very briefly, I was curious as to what Frank Greene, my constituent, where he might spend his tax cut. I was just wondering whether he'd blow it all in a week, or a month, or something like that. Kevin Douville said something kind of similar, he says that a $500 tax cut, at his old annual income of $70,000, wouldn't make much of a difference in my life.

I want to say, Mr. Chairman, I'm one of those people who have really struck it lucky in America. I helped create a giant company, and I'd be in the upper 1% of those who would get a tax break. And I would feel a hell of a lot better about the safety and well being of my country if that $70,000 or $80,000 that I might get would be distributed among people who really need that money and who will spend it because they need to eat. They need to clothe their children. They need to provide heat for their families, and decent clothing. And that's the way I think America ought to be investing in its plan. Thank you very much for doing this, and thank you all for your testimony.

DORGAN: Senator Lautenberg, thank you very much. Let me make a final comment. First of all, I think the consensus today among all who testified is that things aren't well with this economy. None of us take glee in that; all of us wished that we had a robust, growing economy that produced new jobs and jobs with good income, but that has not been the case, and there are many reasons for it. I cited at the front of this hearing: September 11th, the terrorist attack, the bursting of the tech bubble, the gyrations of the stock market as a result of that, the corporate scandals almost unprecedented in history. Just so many different – a recession of course, first and foremost – and so our economy has been trying to navigate its way through all of these unusual circumstances, and I think we are finally at the point where the question is not whether we do something to try to stimulate, and to give lift to this economy, but rather the question is how do we do that. For some many months, as you know, the President's economic team has said, "There's no problem. It's a sound economy, stay the course." It's now clear that the Administration says there's a problem and let's do something about it.

The problem is, at the moment, their proposal, in my judgment, will exacerbate the economic trouble that we have by dramatically increasing the deficits in the out term and do nothing to stimulate the economy in the short term. There is not, in my judgment, a right or a wrong way to do this that one party has captured. I mean, I think there are some ideas on all sides of the spectrum that can be contributing to a good solution. But I would just say that the President's proposal is not among them at this point because it is not stimulative, it is not short term, it is not temporary, and it will not control the out-year deficits. I think that adopting that would give us the worst of all worlds. I hope that we can find, with Republicans and Democrats thinking clearly about this, a solution in the short term that is temporary, stimulative, and will ignite this economy once again.

A couple of other quick points. One, this President is proposing very large defense spending increases, and for an important reason. We face some very uncertain and perilous times internationally. So the Congress is appropriating substantially more money, $45 billion, just in this last year for defense – increased funding for homeland security. But nowhere, nowhere at any time do we hear this President say, "And by the way, let's pay for this." He just doesn't say that. So, the question remains, How do we reconcile this? How do you put all this together so that it really works? I was here, elected to the U.S. House some years ago, when a previous president said we can do all this. We can have very large tax cuts, aimed largely at the upper income folks, and double our defense spending, and really it will all add up. It didn't all add up; and we embarked on a burst of increased federal indebtedness, saddling our children with these obligations. And so, we've been through this and I think hopefully have learned from it that this is not the right thing to do.

There are those who maintain that the proper way to deal with the American economy is to understand that it works at the top – and you pour something in at the top and it filters down. That's called trickle down. Hubert Humphrey, when he was here, said he preferred the percolate up theory: that you give the American workers something to work with and things percolate up and make this ship of state work. In fact, he said it's kind of like feeding the horses, giving the horses some hay, and eventually the birds will have something to eat. That's trickle down economics, he said. Percolate up is a much more apt description of how our economy really works.

Well, there's a lot to say, and we've covered much of it today. I expect in the next month or two months, this will be a very critical time in our nation, and particularly the Congress, choosing the methods and formulas by which we hope we can resurrect and stimulate this country's economy. Mr. Douville, I hope that someone might well be watching this program, and decide they have a job opening. If nothing else, your testimony today would be helpful in that respect. But I think your ability today to tell us your perspective, as someone who has lost a job in this economy, of how we ought to address these issues is very helpful to us. Ms. Farmer, as state treasurer of Missouri, I was struck by the substantial financial problems your state has, that is the shortfall. And I was especially struck by the fact that you said the state was actually going to have 3.6 percent, I believe, or 3.4 percent, less revenue in your revenue stream coming in this year versus the last. And that's a pretty significant problem for the state to grapple with, and we have to try to help. And Mr. McIntyre, as always, your information from the Center for Tax Justice is very helpful for the Congress as it grapples with these issues. Again, thank you very much and this hearing is adjourned.