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Hearing on Administration's Economic Policies
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Good morning Chairman Enzi and Ranking Member Sanders, and other members of the committee. To return here today to testify before the Senate Budget Committee is a privilege that I appreciate. I first began work on the House Budget Committee as a Democrat in 1979 and concluded my work on the Senate Budget Committee as a Republican in 2002. From my first day to my last, I never forgot that behind all the numbers, followed by a train of zeroes, were critically important policies that reflected our vision for America's future.

Since the 1974 Budget Act, every new president has had to present his legislative agenda first to this committee to secure the budget allocation and the privileges and protections provided by this committee's budget resolutions. My purpose today is to explain why I'm confident this committee can help reignite economic growth and to discuss the challenges the nation faces in starting and sustaining a full blown economic expansion.

America's economic exceptionalism has always been the product of freedom and opportunity, secured through limited government. When government policies have strengthened or impeded these sources of American exceptionalism, they have yielded quantifiably different results.

America's postwar economic experience spans 11 recessions and 11 recoveries. Ten of those recoveries were similar, but one was quite different. The economic policies implemented by Presidents Reagan and Obama were the polar extremes of postwar policies. The economic consequences of those policies defined the highs and lows of America's postwar economic experience. These extremes help define what might be expected if this Administration and Congress are successful in reversing the Obama program and moving toward a more Reagan-type policy of tax reform and regulatory relief.

Under President Obama, individual marginal tax rates soared and corporate tax rates became the highest in the developed world. Federal spending spiraled with a nearly trillion-dollar stimulus; Social Security Disability and food-stamp qualifications were eased; work requirements in welfare programs were suspended; Medicare and Medicaid were expanded and a significant portion of US healthcare was nationalized. Federal debt doubled, and public and private debt held by the Federal Reserve Bank quadrupled. New legislation, an unprecedented number of new regulations, and a torrent of executive orders transformed the role of government in American life.

From this uncompromised vision, fully implemented, an astonishingly low 1.47% GDP growth rate resulted – just 43% of the average growth rate in the postwar era through 2008. The economic failure came not from the deepest postwar recession, which ended six months into the first year of the Administration, but from the weakest postwar recovery, where real growth in gross domestic product averaged just 2.1% per year, less than half the 4.5% average during previous postwar recoveries of similar duration.

Naturally, proponents of the policies implemented over the last eight years now say the policies had nothing to do with the weak recovery, and that we are experiencing secular stagnation. We heard the same arguments back in 1979 when I first came to Congress. The claim then was that the general malaise and resource shortages severely limited America's future. Between 1974 and 1980, GDP growth averaged 2.5%, inflation reached 13.5% and the prime rate hit 18.9%.

When policy changed dramatically, results were dramatically changed as well. President Reagan in 1981 dramatically cut marginal tax rates, cut nondefense and entitlement spending, and reduced the regulatory burden. Once those policies were in place, inflation hit a 22-year low, the prime rate fell to a 14-year low and economic growth averaged 4.6% during the remainder of the Reagan presidency.

If the empirical evidence of America's postwar economic experience through 11 recessions and 11 recoveries demonstrates anything, it is that policy matters. Dramatically different policies will deliver dramatically different results. After averaging 3.4% growth per year through 10 recessions and 10 recoveries from 1948 through 2008, economic growth averaged just 1.47% for the last eight years. The Congressional Budget Office (CBO) now projects economic growth will average 1.9% over the next decade. If economic growth returned to the postwar average, federal revenues would rise by a whopping $4.7 trillion over the next ten-year period. Even if we closed only half the gap between the currently projected 1.9% GDP growth rate and the 3.4% GDP growth rate that the economy averaged for the previous 64 years, that alone would deliver $2.3 trillion in new revenues due to higher growth over the next 10 years.

The official CBO estimates originally saw no economic benefit in the 1986 tax reform. In fact, during the three years when the tax reform was fully in effect -- before the 1990 tax increase -- CBO actually lowered its average real GNP projections to 2.9% in January of 1987 but the economy during that period actually grew by 3.8%.

The CBO projected that the 1997 Balanced Budget Act would produce a $77 billion fiscal dividend over seven years, of which $33 billion would come from additional revenue growth. But in 2000, CBO actually found that revenues in that single year were "$303 billion more than estimated in 1997" due to "the strength of the economy and changes in characteristics of income." By January of 2001, CBO reported that an additional $1.34 trillion in revenues had flowed to the federal government than had been projected at the time the Balanced Budget Act of 1997 was enacted.

Together the 1986 tax reform and the Balanced Budget Act of 1997 helped produce a quarter-century of rapid growth, surging federal revenues and a balanced budget.

Economic growth is far and away the dominant factor in generating federal revenues. The 1990 Budget Summit agreement between President George HW Bush and Congress attempted to raise $159 billion in taxes over five years, but two months later, CBO reported that slower projected growth would cost $206 billion in revenues over the same five years – slow growth from an economy slipping into recession wiping out one of the biggest tax increases of modern times. The 2013 tax increase was supposed to increase federal revenues by $650 billion over the following decade but since then, CBO and JCT have revised down their ten-year revenue projections by almost five times that amount not because of a recession but because of weak economic growth.

Since its models cannot distinguish between failed and successful economic policies, the CBO and JCT are likely to miss or dramatically underestimate the economic growth and federal revenue coming from improved economic policy. But, this committee has every right to assume that a full blown pro-growth program of tax reform, a lifting of regulatory burden and a wholesale reduction of the degree to which government dominates the economy will allow us to escape this policy-induced stagnation and approach growth rates that defined postwar America. While some of the tax reform may have to be temporary due to JCT scoring and the limits of reconciliation, if the economy returns to its postwar norm, the tax reform will prove to be revenue neutral and pressure will build to make it permanent.

Critics will denounce the idea that good policies have anything to do with economic growth. But is America not itself proof that policies matter? After all, policies of freedom and opportunity are what allowed America to take the world's "huddled masses" and produce the most impressive empirical evidence the world has ever seen.

Not only do we need strong medicine to ignite a full blown economic recovery, sustaining that recovery will be more difficult than it has been in any of the previous postwar recoveries. The driving force behind every significant postwar recovery has been a sustained rise in private investment and new homebuilding, which has increased borrowing and driven up interest rates. Most postwar recoveries enjoyed sufficient momentum to overcome those rising interest rates. However due to the unparalleled borrowing and monetary stimulus which has occurred in the last decade, rising interest rates in a full-blown recovery would require the Treasury and the Federal Reserve Bank to compete with the private sector for available credit at unprecedented levels.

The recent debt surge was largely hidden by ultra-low interest rates and Fed purchases of government securities. So massive were Fed purchases of Treasury debt and mortgage-backed securities that the Fed effectively funded 55% of the Treasury debt issued during the last years as compared to only 12% of the debt issued during World War II. Despite doubling the publicly-held national debt as a share of GDP, debt servicing cost amazingly dropped to 1.3% of GDP in 2016 from 1.7% in 2008.

During the current recovery, private investment has averaged only 88% of the postwar norm and housing starts remained at recession levels. If a robust economic recovery were ignited now, private investment and housing starts would surge and competition for credit would intensify. Real interest rates would begin to rise as they have in other postwar recoveries. If interest costs simply returned to their postwar norms, government debt servicing costs would skyrocket, adding an extra $4.4 trillion of costs over the next decade. If those costs were simply borrowed, debt servicing costs would rise by another $1.3 trillion. By 2027, Federal interest cost as a share of GDP would more than triple to 4.9%, exceeding $1.4 trillion– roughly equal to that year's projected Medicare spending.

During previous postwar recoveries, annual gross private domestic investment averaged 17.6% of GDP. Increased annual Treasury borrowing during previous postwar recoveries averaged only 1.7% of GDP. If interest rates returned to their historic norms, debt servicing costs in the fifth year of a recovery would cause Treasury borrowing to spiral to 6.6% of GDP – almost 4 times the average competition for credit caused by Federal borrowing during previous postwar recoveries.

In addition to the headwinds produced by Federal borrowing, a full-blown recovery and a return of normal interest rates will force the Fed to sell assets, competing with the private sector for available credit. Since the bloated Fed balance sheet is the mirror image of bank reserves, the Fed's purchases of $3.4 trillion in Treasury bonds and mortgage-backed securities in its various monetary easing programs has swollen bank reserves to $12.31 of reserves for every dollar they are required to hold. These massive excess reserves have not produced an explosion in bank lending and the money supply because the Fed now pays interest on excess reserves – sterilizing those excess bank reserves by in essence converting them into interest bearing Fed securities.

Once a powerful recovery is underway loan demand will swell, increasing interest rates and incentivizing banks to expand lending. To stop the money supply from exploding, the Fed will have to reduce its balance sheet to soak up the excess liquidity in the banking system. Whether the Fed sells securities, lets securities it holds mature, pays higher interest rates on excess reserves to stop banks from lending or borrows against the value of its balance sheet with reverse repos all these options will have the same effect – competing directly with the private sector for credit.

Even if the Fed had five years to absorb excess reserves during a full-blown recovery, it would still have to dump $590 billion of Treasury bonds and mortgage-backed securities into the markets each year. The combined effect of Fed asset sales and new Treasury borrowing would generate a massive headwind for the recovery driving up interest rates faster and to higher levels than has been the postwar norm.

In the six decades before 2007, the Treasury borrowed on average an extra 1.7% of GDP per year. The Fed offset part of the Treasury's borrowing by buying some 0.3% worth of

Federal debt per year, reducing net new public borrowing to 1.4% of GDP per year. But by the fifth year of a full-blown recovery, with normal interest rates, the Treasury would have to borrow some 6.6% of GDP as the Fed shifts from being a buyer to a seller of financial assets absorbing another 2.8% of GDP. Treasury borrowing and Fed asset sales would absorb 9.1% of GDP in new borrowing, 6.5 times the postwar average – a crippling level of crowding out of private investment never before remotely approached in a postwar era recovery.

Igniting and sustaining a strong recovery will not only entail overcoming the current stagnation but overpowering the extraordinary headwinds posed by the explosion of Federal debt and the balance sheet of the Fed. As long as the economy has no pulse the fever of rising interest rates will not be felt, but in a full-blown recovery the extraordinary nature of the challenge we face will become all too clear.

To meet this challenge, I believe Congress needs to adopt a dramatic tax reform that reduces marginal rates, repeals subsidies in the tax code, grants territorial tax treatment for foreign earning and repeals the gift and estate taxes to promote strong, sustained levels of private investment.

The lifting of regulatory burden should be pursued relentlessly through legislation, agency rule making and executive action. Spending limits and entitlement reforms will be critical to sustaining the recovery once it is ignited, and with Medicaid metastasizing and Medicare and Social Security careening toward insolvency by 2028 and 2034, respectively, comprehensive entitlement reform should not be delayed. Failing to ignite a strong recovery in the private sector and failing to dramatically reduce the growth of government during the ensuing recovery will risk making our current government-induced stagnation a permanent part of American life.