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THE 1990 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

JANUARY 24 AND 30, FEBRUARY 2 AND 8, AND MARCH 15, 1990

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THE 1990 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 24, 1990

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

The committee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Obey, Snowe, and Upton; and Senator Mack.

Also present: William Buechner, Chris Frenze, Susan Lepper, and Chad Stone, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order this morning. The Joint Economic Committee today begins its review of the economy and economic policy for 1990 and fiscal year 1991.

Next week, President Bush will present his economic forecast for this year and next when he transmits the U.S. Government budget for fiscal year 1991.

Gramm-Rudman-Hollings requires that these economic assumptions be used to calculate a budget deficit for sequestration purposes, so they have serious consequences for fiscal policy and hence, serious consequences for the performance of the economy in both the short and long term.

The administration's forecast for 1989, which was released in conjuction with the midsession review of the budget in July, proved to be quite reasonable, although its long-term forecast for the first half of the 1990's was highly optimistic.

To help evaluate the economic forecast that President Bush will issue next week, I am pleased to welcome three distinguished economists this morning to testify on the economic outlook:

Mr. Lawrence Kudlow, senior managing director and chief economist, Bear, Stearns & Co., and former chief economist for the Office of Management and Budget.

Mrs. Nancy Teeters, vice president and chief economist, IBM Corp., and former member, Federal Reserve Board.

And, Mr. David Wyss, senior vice president and chief financial economist, DRI/McGraw-Hill.

We are very pleased to have each of you here this morning. Your prepared statements, of course, will be entered into the record in full.

We'll begin with you, Mr. Kudlow, and just move across.

STATEMENT OF LAWRENCE A. KUDLOW, SENIOR MANAGING DIRECTOR AND CHIEF ECONOMIST, BEAR, STEARNS & CO., AND FORMER CHIEF ECONOMIST, OFFICE OF MANAGEMENT AND BUDGET

Mr. KUDLOW. Thank you. I will be brief. You've had my prepared statement, which covers plenty of ground you may or may not want to go into.

Essentially, my overview is rather optimistic, both with respect to the next year and also with respect to more general prospects in the 1990's.

I think overall economic performance in the current cycle, which started in 1982—started in early 1983—has been really quite good.

The economy has proven to be more resilient, more durable and more flexible in many respects, more entrepreneurial. And, I dare say, performance in the last 7 years has surprised a lot of people, even including some of the strongest backers and advocates, among whom I count myself.

Nothing is perfect, and I have no doubt that we can always design a better economic mousetrap to solve various problems which are ongoing. So I do not make the claim that we have ended business cycles or we have nothing to concern ourselves or nothing to fear, because I think we do. And I think we have to remain watchful and vigilant.

But, on the whole, I have been optimistic. I think the performance is quite good. And I remain optimistic as far as looking at the nearer term with respect to the administration's upcoming economic and budget estimates, of the Congressional Budget Office, and so forth.

My own view is that, right now, the economy is rather soft. There's no question in the aftermath of a year or two of rather tight Federal Reserve policy we are suffering some of the aftereffects of that disinflationary effort.

We have gone through soft patches before, most notably in 1985 and 1986, which followed a period of Fed tightness during the cycle.

I cannot in all honesty rule out the possibility of a recession. I think at the moment we are probably going to record very low economic growth in the fourth quarter, a number which is due out Friday, the first quarter GNP report. It is possible that the first quarter might similarly be very soft, probably around maybe zero to plus a half a percent, plus a percent.

And when you get that close, I think honesty would admit that a swing in one factor or another statistically could give you a minus number. So I can't rule it out.

But, at the same time, I think, if we do have a recession—and that is not my forecast, but if we do have one, it will prove to be rather mild and quite short.

I certainly don't think we face economic hardships such as we had in 1981 or 1982, or 1974 and 1975, which were the worst of the postwar business cycle downturns.

I say that because I don't see major imbalances in the economy which might prove to be extremely painful. I don't see a skyrocketing inflation rate.

Indeed, the evidence suggests to me that inflation trends have moderated and will continue to do so over the next year.

Similarly, although interest rates in the open market bounce around, I think the trend is toward lower interest rates. And my expectation is the remainder of 1990 interest rates will over time continue decline.

Basically, I think the biggest problem the economy has right now is a profit squeeze. We are in a bit of a profits recession. This has been unfolding since the very beginning of the year, when so-called Economic Profits, published by the Commerce Department on the National Income and Product Account basis, have been declining.

My guess is, when we get the final numbers for the fourth quarter, these operating profits for current production will be down some 15 percent from the end of 1988 to the end of 1989.

I think, largely, the profit squeeze is a function of the Fed's tightening of policy, which has slowed down the rate of increase in prices, and now the job for business is to bring their cost structures into line with the lower price levels in many cases.

This requires some correcting. As a result, you see industrial production has slowed considerably, particularly in the last 6 months. The rate of employment growth, which has been quite robust in this cycle, is now slowing.

Indeed, in the manufacturing and goods producing areas, jobs have actually fallen in the last 4, 5, or 6 months. Inventories are being pared down, particularly in the manufacturing sector. Inventories were very low in other areas, such as retail and wholesale. Inventories are a bit higher but they are not troublesome; they are not out of line with the sales figures, possibly excepting the automobile industry, which I think probably has the worst inventory sales story.

But I think, in a broader sense, if we look at inventories with respect to past economic downturns, we simply don't have the excesses here that might lead us to a severe correction and a more prolonged recession.

This is one of the reasons, this relative inventory balance, that I don't fret over any really serious economic damage.

Last, we have not had a real, what I would call an old-fashioned credit crunch, even though monetary policy has tightened. Credit generally has been available. We've not had the kind of disintermediation which has sometimes characterized past cycles.

Some of this, of course, is a function of congressional reforms with respect to deregulation. And, by and large, although certain parts of the corporate sector in my judgment are unbalanced, certain parts of the corporate sector have too much debt for their own good, on the whole, looking at the aggregate economy, I do not think we have a serious debt imbalance on the whole.

And what I find in my own experience coming from Wall Street is that with respect to credit provisions, lenders do have liquidity but they are parceling out their credits in a very careful, credit-conscious way.

What we call collateral asset quality has become one of the major financial market themes in the latter part of 1989, and it is a theme which I think will predominate in the early 1990's. Banks and other lenders are putting a much sharper pencil to the balance sheet of P&L-type analysis.

So there is a form of credit rationing, but it is different than an old-fashioned credit liquidity type credit crunch.

So I distinguish this from other cycles.

Let me add that on the consumer side, the good news is that the key measure of real disposable income, which is to say income adjusted for inflation on an aftertax basis, which is the key measure for economic analysis, real disposable income continues to rise at an excellent pace running well into its 3 to 4 percent average annual growth rate.

And this is a good sign and it reflects the overall strength of the economy, and it does not suggest that we are headed for a prolonged downturn or particularly difficult times.

It also so happens that the disposition of this real disposable income has shifted in the last year or two. There's no question now that, on the margin, consumer propensities to save are rising and consumer spending propensities are declining, and this seems to be a classic market choice on the part of the consumer sector, reflecting a number of factors.

I think this is a welcome choice on the part of consumers. It is a voluntary decision. It is already helping to correct their balance sheets with respect to lending and repaying. And I think, on the whole, even though this swing from spending to saving will actually show up as a negative in the GNP accounts, it's going to depress personal consumption in the fourth quarter quite a bit actually, and will probably cause us to flirt with recession because of that.

It has good, long-term effects; a pickup in consumer saving is, in my judgment, generally a good thing. And I might note that personal saving as measured by the Commerce Department has shown a substantial increase in the past four or five quarters.

So that for the first time in a long while beginning in early 1989, personal saving is now running ahead of the Federal budget deficit. And, therefore, that's a pretty good move toward a more balanced saving position.

So this is one of those odd issues in that even though we are getting more saving out of consumers, it's being done on a voluntary basis. It has positive, longer term effects, in my judgment. It will, nonetheless, paradoxically show up as a negative for the economy. It's going to depress GNP and that crucial category of personal consumption expenditures is going to be very weak in the fourth quarter. It might even be negative, which is quite unusual for consumption.

But, again, with respect to inventories, with respect to investment, inflation, interest rates and the like, I, myself, think if we do have a recession, it will be very mild and it may be discernible more to statisticians and economists than to the general public at large.

And I note that the unemployment rate at 5.3 percent still is quite low. And although we may have some modest upward movement in unemployment, I do not expect a serious problem there.

So, on the whole, I think the next quarter or two can be a little dicey from a statistical standpoint, but I don't see it as a disaster. I think some good corrections are occurring underneath these numbers.

My judgment is it is possible to get as much as 2 percent real GNP growth from the fourth quarter of 1989 to the fourth quarter of 1990. It may come in a little lower than that, but I think that is possible.

How that stacks up, Mr. Chairman, with the OMB forecast, I don't know. I've read some interesting things in the paper. Once in a while, one of those fellows talks to me and I think I might be a little under their growth rate, which I think is going to be closer to 2.5 percent or so. But these are differences which are not worth major quarrels.

And as I like to do from time to time, I commend the Office of Management and Budget because its forecast last year was rather closer to the track than many people thought.

A last point. Looking forward in the 1990's from a policy standpoint, I have a lot of views about a lot of issues. And maybe we can visit them in the course of your process this morning. Let me note two points which stand out in my judgment.

No. 1, I hope that we maintain the improved incentive structure which was established by various administrations and Congresses in the last 10 to 12 years.

By that, I mean the reduction in marginal tax rates. The general course of economic deregulation, the general restraint on Federal spending—none of this is perfect. Some of this is quite controversial. But, my own judgment is this policy shift has served the country and the economy very well. And I think, in particular, the improved reward structure with respect to working and investment has really helped create a more vigorous, more efficient work force and more efficient, more economical business structure.

And I think, frankly, the supply-side reforms have done very well, even though they're not perfect. And I think reasonable people can disagree about specific issues, but on the whole, I attribute the unexpectedly good and durable economic performance over the last 7, or almost 8 years in large part to the change in our tax and regulatory and fiscal policies.

And I think it's not surprising that many countries around the world—in West Europe and South America, the Pacific Basin, now in Eastern Europe—are borrowing and replicating the thrust of these policies. Imitation is the sincerest form of flattery. And I think we should take this flattery and work on it and try in the 1990's to move ahead by using the best parts of this policy and expanding on them, while at the same time dealing with some of the less good parts in the reform sense.

I've never painted a perfect picture. It is true I am an alumnus of Reagan's first term. It is true I was there at the beginning of those policies, working with Members of Congress. And it is true I've been an advocate of it all down through the years.

It's also true that I see it for what it is. There are a lot of pluses, but there are also some minuses.

My feeling is, however, in the main, we are on the right track and we ought to stay on that track.

Incentives really do matter and I think the entire economics profession has really changed its view with regard to tax policy, incentivization, aftertax rewards and the benefits thereof, I think there's been a major shift in mainstream economic thinking on all of these points. And I think that's to the good.

Finally, our monetary policy, which plays a big role in all this. On the whole, I don't have any particular quibble with monetary policy right now. And, on the whole, I think the lower inflation performance of the 1980's speaks for itself. It was a big plus.

When I was a private sector economist in the late seventies, it looked like the world was in fact going to hell in a handbag, unless we conquered inflation. And, we did. There was some pain.

I hope that pain serves as a lesson that we need not reinflate or experiment with reinflation ever again.

But, the fact is that the United States and all the Western countries—Europe, Japan, the United States—showed it had more discipline and more moral and political willpower on the inflation question that a lot of the skeptics thought.

And I think, along with the incentivizing of fiscal policy, the low inflation monetary policy has been a crucial ingredient in the improved economic performance.

Looking ahead in the 1990's, I hope that the Congress and the White House encourages the Fed to maintain its strategy of long-term price stability and zero or near zero inflation.

I think this is exactly the right strategy.

I think it would behoove the Congress to examine the Fed's ways and means in implementing the strategy. We are all taxpayers and citizens. Therefore, we are entitled to our monetary views.

I hold no agreement with those who say you should never criticize the Fed. I think they're human just like we are. A good monetary discussion is a good thing for the country, and no Fed Governor, even the most enlightened, will always get the story right.

And I would like to see the Fed stay just on this track. And I will close this point with the hope that we can pick it up later.

Controlling the money supply, although that is itself not perfect, nonetheless, is one of the key levers the Fed has. And I think that's appropriate to keep good control of the money supply.

And, second, complimenting the monetary view, I, myself, wish to publicly endorse the view of some of the Governors of the Fed, the present Governors, who have made greater use of financial markets and market prices to tell them whether the markets are lowering their inflation expectations or raising their inflation expectations.

To me, inflation is a function of money supply and money demand. I don't think the monetarists have it completely right. It's not just the money supply; money demand is very important. That's a function of many, many business and investment decisions.

But, ultimately, it's a function of confidence and psychology, whether people believe inflation is going up or down. And they change their plans accordingly; because I think markets possess more information than even the brightest government official, I think it's completely right for the Fed to take a look at bonds and commodities, at gold, at currencies and other market indicators to tell them whether their policy is inflating or deflating, or whether it's just about right.

I think what we are seeing is a very intelligent merger of monetary thinking where the Fed is no longer rigidly, dogmatically monetarist, nor will the Fed ignore money supply. And the Fed is bringing in the commodity picture, which has a large role in classical economic theory and which has been a great help in past years—most particularly, the fifties and sixties when we were operating under Bretton Woods.

So I want to encourage those monetary reforms to move ahead.

I also want to encourage us to stay on the incentivizing fiscal track with respect to tax and regulatory policies. And I think, if we can keep these policies up in general terms, the outlook for the U.S. economy in the 1990's is going to be an excellent outlook.

And, indeed, my optimism stretches beyond our borders because I see many other nations and large trading blocks moving along the same path. And I think the potential for this coming decade is virtually unprecedented.

Thank you.

[The prepared statement of Mr. Kudlow follows:]

PREPARED STATEMENT OF LAWRENCE A. KUDLOW

Following the 1988-1989 period of disinflationary Fed restraint, there's no question that the economy has slowed substantially. The fourth quarter of 1989 will be just about flat. However, while there is a risk of recession, the overall trend still looks more like slow growth than outright recession.

There is an important difference between the two. Certainly the current weakness is not likely to turn into deep recession such as in 1974-1975 or 1981-1982. Even if real GNP were to decline for two consecutive quarters, it would be a very mild recession, probably discernible only to statisticians and economists. More likely, the current weakness will give way to improved economic growth over the course of 1990. Real after-tax income levels and living standards are rising at excellent rates; capital gains and wealth creation continue to accumulate nicely; the housing sector is showing some improvement after a sizable drop in mortgage rates; commodity prices are holding a relatively high level; consumer confidence remains quite high; certain leading indicators of business investment are solid; Christmas spending turned out better than expected; inventory levels are low and balanced; inflation and interest rates are trending gradually lower; exports are strong; and the profits squeeze may be ending.

When the adjustment is completed, business will be leaner, more balanced and more competitive, while both consumers and businesses will retain their new found caution over debt and leverage. Incentivizing economic policies in the 1980's have rejuvenated prospects for business enterprise and economic growth. Policies in the 1990's are likely to continue this thrust.

Therefore, I approach the new year with a sense of optimism. I will leave the Cassandra-like forecasts to others. While the economy could stumble in the next few months, it could also display the same sort of resilience, flexibility, diversity and entrepreneurship which has been its principal characteristic for nearly a decade. While the long expansion could be coming to a momentary pause, it also could be gearing up for the next round of growth which could extend the cycle to 10 or 15 years. Given a choice, I continue to favor prospects for the growth scenario.

Highlights

1) *Profits* are always the heart of business conditions. Although the post-disinflationary squeeze on profit margins has been the key source of economic weakness, profits are still holding a relatively high level. Importantly, there is no recurring price deflation, and diminished cost pressures should soon accrue from lower interest rates, moderate wages, steady raw material prices and improving productivity.

2) *Inventories* are generally low and well balanced with sales. Computerized inventory controls and intense price sensitivity have prevented major imbalances from occurring. Unlike prior cycles, inventory swings in the 1982-89 expansion have been relatively mild.

3) *Housing* is stabilizing and perhaps turning up a bit. Lumber and plywood prices are firm, a good leading indicator. Nationwide, median home prices continue to hold the high ground. Accumulated capital gains from this sector are a source of household comfort. Sensationalized news reports of pervasive deflation and bankruptcy - drawn from isolated sources - are completely false.

4) *Retail Sales* outside of autos are rising moderately; Christmas exceeded expectations; real after-tax income still is plentiful. Since 1986, consumer spending has been adjusting to the tax reform shock of nondeductible borrowing expense. But the adjustment has been reasonably smooth.

5) *Autos* are probably bottoming as the correctives for rebates, production and inventories are running their course. Apart from last year's interest rate surge, most of this industry's problems can

be traced to mismanaged pricing, production and inventory strategies, not the macroeconomy (or imports).

6) The survey of ***purchasing agents***, which is probably the best economic indicator, indicate a bottoming pattern of slow growth. The production and new orders components are both above 50%.

7) ***Manufacturing employment***, industrial production and unemployment insurance claims look weak, and must be watched closely. These are the weakest part of the story, reflecting the squeeze on profits. However, nondefense capital spending indicators are still pointing upward, and at 5.3%, overall unemployment is low.

8) ***Inflation*** is trending gradually lower, as are interest rates. No major shock from these factors, such as in the early 'Eighties, has occurred. In the absence of Fed blunders, both inflation and interest rates can gradually decline over the next year.

9) ***Debt ratios*** show a steadily declining trend in nearly all areas. American households and businesses are gradually deleveraging. Internationally, U.S. businesses are less leveraged than those in Germany or Japan.

10) ***Federal budget deficits*** are likely to gradually evaporate in the 1990's, owing to a combination of Grambo spending restraint, military baseline reductions, Social Security surpluses, lower interest expense and steady economic-based revenue expansion.

11) ***Trade deficits*** should also descend in the years ahead, maintaining the progress of the late 'Eighties. With enlarged business-export markets opening up in Eastern Europe and Latin America,

cost conscious U.S. industry is increasingly competitive and well positioned to post surpluses by the second half of the new decade.

12) *Monetary policy* already has turned sufficiently stimulative to supply adequate liquidity. Hopefully from here, the Fed will keep a careful eye on gold, broad commodity indexes and the dollar exchange rate to guide policy and to insure stable monetary value, low inflation and low interest rates in the period ahead. Monetary policy is the key to price stability, not GNP pump-priming.

<u>1982-89 Recovery Cycle</u>

To assess the 1990's in economic and policy terms, it is instructive to review the current expansion, which has now run for 7 years. Contrary to a continuous chorus of pessimism, economic policies put into place in the early 1980's generated an expansion which turned out to be far longer and much better balanced than initially predicted by economic forecasters in or outside government.

In particular, the controversial supply-side program of significant marginal tax-rate reduction on income derived from individuals, corporations and capital has proved to be a major success in rejuvenating economic growth. In the 1970's, a combination of rising inflation and high marginal tax-rates discouraged individuals from working, saving and investing, and thus created the dilemma of stagflation.

In the 1980's, however, reduced tax-rates helped to restore economic incentives and efficiency, thereby providing a booster rocket to the economy. By restoring behavioral incentives in response to a higher after-tax return on work effort and business output, a flood of entrepreneurs took risks to form new businesses and create new jobs. This is why new businesses were formed at a 664,000 record yearly rate, while the labor force participation rate soared to a record 66.8% and 18.8 million new private jobs were created.

The supply-side, classical economic policy revival represents a return to microeconomic principles, where price theory explains individual behavior. If the price of leisure and the return of work are raised, then individuals on the margin choose work over leisure. If the after-tax return on investment is raised, then the capital cost of financing business is reduced and investment flourishes . These are key reasons behind the rise of stock market prices, where the broad Dow-Jones index rose from around 800 to nearly 2700 over 7 years, creating an estimated $2 trillion of new wealth to bolster the economy and the value of its productive resources. Indeed, including stocks, bonds and real estate, net asset values rose by more then $5 trillion, an increase of roughly 50%.

What's more, contrary to numerous predictions in the early 1980's, large scale tax-rate reduction did not generate more rapid inflation. With the Federal Reserve pursuing a relatively tight monetary policy, consumer price inflation averaged only 3.6% per year, compared to 8.5% in the prior 1975-80 expansion cycle. In qualitative terms, less money chasing more goods led to lower inflation and interest rates. In other words, the unorthodox monetary-fiscal policy mix of tight money and lower tax-rates turned the declining 1970's economy of stagflation into the rising 1980's economy of broadbased wealth creation.

<u>Additional policy-related issues from the 1980's</u>:

o Lower tax-rates did not launch an excessive consumer boom. Real consumer spending expanded at a 3.7% annual rate during the 1982-87 cycle, the same as the 1975-80 expansion and lower than the 4.4% rate of the 1961-69 cycle.

o Real business investment spending expanded at a strong 5.7% average yearly rate in the 'Eighties, although this was somewhat slower than the 6.9% and 6.6% growth rate of the prior two expansions.

o However, adjusting for better inventory control and lower energy prices, real business equipment spending in the 'Eighties grew at 9.1% rate, compared to 7.4% and 8.4% in the prior two expansions.

o Only in the narrowest sense has saving declined in the 1980's. That is, while the personal saving rate has fallen to a 4.7% average rate from 7.4% in the 1970's and 6.8% in the 1960's, broader saving measures have held steady. When gross durables in consumption and capital gains (less liabilities) are included, the gross personal saving rate and the net asset saving rate have been steady for 30 years, hovering around 22% for the former and 12 1/2% for the latter.

o As a share of GNP, U.S. Federal debt remains historically modest. At 41% currently, we are higher than the 25% of the early 1970's, but much lower than the 127% peak after WWII. Presently national income is growing faster than debt, and this will bring the ratio down in the 1990's.

o In an international context, the combined U.S. debt position (Federal, State and local) is not out of line with the G-7 countries. At 52% of GNP, the U.S. compares favorably with 76% in Japan, 84% in Canada and 44% in W. Germany.

o As for corporate debt, G-3 comparisons also show that the U.S. is not overburdened. As a share of GNP, U.S. corporate debt is 53%, Germany's is 60% and Japan's is 189%. On a debt/equity basis, the U.S. stands at 68%, while Germany is 149% and Japan is 422%.

o On borrowing from foreigners, the proportion of the U.S. national debt held by foreigners has dropped from 22% in the mid 1970's to 15% currently. W. Germany has 21% of its debt held by foreigners, while Canada has about 15%.

o As for the so-called twin budget and trade deficits, the analytical linkage is highly suspect. To be sure, the U.S. is running historically high budget and trade deficits. But are they related? The UK is running a record budget surplus and a record trade deficit simultaneously. Germany has a budget deficit and a trade surplus.

Taking a longer view of the trade issue, I continue to believe that the U.S. trade deficit is essentially capital driven, a sign of strength rather than weakness. Indeed, the trade deficit is one of our most overrated problems. With low tax rates, low inflation, low interest rates and more of a hands-off government attitude, global capital and savings voluntarily flowed to the best investment environment in the world. The massive amount of foreign money voluntarily moving into our economy has created a higher standard of living and a surge in U.S. demand, both for domestic goods and imported foreign goods.

Critics argue that we have squandered this capital, mainly because we have not invested in traditional bricks and mortar, factories and steel mills. But the foreign capital has been wisely invested in the hi-tech, computer-automation, robotics, telecommunications and information revolution areas, raising U.S. productivity and competitiveness at low cost. Using deregulated financial markets, linked worldwide, U.S. business has been completely restructured, recapitalized and streamlined in the 1980's.

Sophisticated investment strategies employing mergers, acquisitions, take-overs, leveraged buy-outs and so forth have created a whole new class of owner-managers to replace discredited bureaucratmanagers and improve products and profitability. Suddenly, as the dust clears, newly competitive American exports are booming and newly redirected American companies are in great demand worldwide. The resultant surge of exports may carry the U.S. economy forward for many years to come. In the 1980's, the U.S. export share of GNP rose to a record 11.6% average.

Finally, on the budget, despite the usual chorus of doom and gloom, a number of favorable trends are developing.

o Federal outlays as a share of GNP, which is the truest measure of the government's overall tax burden, have dropped from 26% in 1982 to 22.4% currently. This is largely a function of Gramm-Rudman spending restraint which, for all its imperfections, has served to discipline spending. 35 years ago, the budget share of GNP stood at 17%.

o Meanwhile, Federal revenues are holding at around 19.5% of GNP, which is actually a bit higher than average over the past 20 years.

o During the current economic recovery, budget revenues have exceeded the growth of national income in both real and nominal terms. This occurred despite significant tax-rate reduction for individuals and businesses. Indeed, the strength of revenues over the past seven years may well have occurred because of lower tax-rates, which completely reinvigorated economic growth by creating enlarged after-tax rewards and incentives for work effort and individual initiative.

o What is particularly interesting during the recovery cycle is the divergence of average tax-rates and marginal tax-rates. While marginal rates declined from 70% to 28-33% for individuals, and from 46% to 34% for corporations, the average rate has increased from 19% to 20% as a share of GNP. This is a forgotten lesson of classical economics. Low marginal tax-rates are necessary for improved economic incentives, efficiency and growth. But higher average tax-rates are desirable to finance the budget, reduce deficits and, over time, to generate surpluses and pay down outstanding debt. In fact, it theoretically can be argued that the growth-producing effects of low marginal tax-rates generate the deficit-reducing effect of higher average tax-rates.

No one can deny that the build-up of deficits and debt in the 1980's has had a cost. Undoubtedly, the economy has not reached its fullest potential, in part because the government continues to spend and borrow too much. But there are also benefits associated with the rise in debt:

o The rapid disinflation of the early 1980's, when nominal GNP growth dropped from 12% to 4%, and the CPI fell from 13% to 4%, caused a huge loss of income and receipts. But low inflation and declining interest rates created the foundation for long-term economic growth.

o Lower tax-rates in the short-run caused the deficit to rise, but the restoration of proper incentives and rewards has revitalized the economy and is now generating a surge of tax revenues. Importantly, new academic studies show that by reducing the top income tax-rates, the wealthiest taxpayers substantially increased tax payments.

o Higher defense spending also temporarily raised the deficit, but a stronger U.S. national security position restored balance with the Soviet Union. Now from a position of strength, prospects for mutual arms reduction have improved, regional conflicts are moderating and the cause of democratic capitalism is on the rise worldwide.

o Politically, budget deficits have frustrated Congressional spending expansion. High deficits led to the passage of Gramm-Rudman, and a new fiscal era of spending control is taking shape.

No one wanted high deficits in the early 1980's. No one correctly projected a sharp disinflation and a deep recession. Not president Reagan, not the CBO, not private forecasters. But it happened. But if high deficits were the price we paid in the transition from stagflation to long-term growth, then so be it. There are benefits to this story, along with the costs. If economic policy stays on the right track, then the temporary costs will be more than offset by permanent benefits. (See attached appendix)

Policy for the 1990's

In terms of economic policy recommendations, I see no reason for any major changes to the basic direction set in the 1980's. The combination of disinflation, reduced tax-rates, deregulation and budget restraint has worked well. Indeed, in economic performance terms, it has probably worked even better than many of its advocates dared hope. Precisely because U.S. economic performance has continually exceeded expectations, the free-market supply side model has been replicated in Western Europe, Canada, Britain, the Pacific Rim, South America, and now in Eastern Europe. Imitation is the sincerest form of flattery.

In broad macroeconomic terms, I suggest attention to four areas.

1) Monetary Policy

The Federal Reserve should be encouraged to maintain its strategic goal of price stability and zero inflation. Having brought inflation down from above 10% to around 4%, we have a unique opportunity to eliminate inflation in the 1990's.

Fed policy should keep its eye on this long-term objective. Short-run efforts to fine-tune GNP should be avoided. Instead, the Fed should seek price stability through strict control of the monetary base, which is the only money supply measure under direct Fed control.

At the same time, the Fed should keep a careful eye on inflation-sensitive market indicators such as gold, bonds, broad commodity indexes and currencies. These indicators will guide policymakers toward the proper balance between money supply and money demand. This balance is necessary to maintain steady monetary value, which translates to zero inflation over time.

As a rough approximation, a gold price ranging between $350-$400, and monetary base growth between 2% and 4% seems consistent with price stability. If this course is followed, then interest rates in the next few years can descend to something around 3%-5%, as was the case in the 1960's.

Internationally, G-7 efforts should be directed toward the same principles of monetary scarcity anchored by gold and commodities. An international commodity anchor will generate currency stability accompanied by converging inflation and interest rates.

2) Tax Policy

International competitiveness can be enhanced by bringing down the U.S. capital gains tax-rate. Gemany has no capital gains tax, while Japan's is 1% to 5%. If the U.S. wishes to improve saving and investment, tax-rates on saving and investment must be reduced. Investors will take risks if the after-tax returns are sufficiently rewarding. The U.S. has done a good job on personal tax-rates, but corporate and capital tax-rates are still too high.

Additionally, to remedy debt-equity imbalances in parts of the corporate sector, the double taxation of corporate dividends should be eliminated. Debt-related interest expenses should be equalized with equity-related dividend expense. This too will improve international competitiveness.

Considerable thought should also be given to reducing the growing payroll tax burden, which itself is a barrier to saving. FICA tax relief should be designed to complement budget restraint and deficit reduction. Reform on the benefit side should also be addressed, particularly with respect to maximizing benefit rates of return through investment in private non-Treasury vehicles such as stocks, corporate bonds, mutual funds and so forth.

3) Budget Policy

Continued spending restraint through an improved Gramm-Rudman mechanism is the key. Gramm-Rudman has worked to limit spending growth. G-R-H can be improved by tighter intra-year guidelines, such as most states and cities have.

Additionally, Congressional reform to centralize and limit the authorizing and appropriating committees would greatly assist G-R-H. Moreover, recission and deferral rules should be amended to force public votes on items sent back by the President.

4) Trade Policy

Protectionism should be opposed in any form. So should currency devaluation as a form of monetary protectionism. If these policies worked, then Argentina would be the center of the world economy.

Market-opening free trade agreements, such as the Canada-U.S. FTA, are a more constructive approach to existing trade barriers or inequities. Bi-lateral trade measures can occur within the overall context of the multi-lateral GATT.

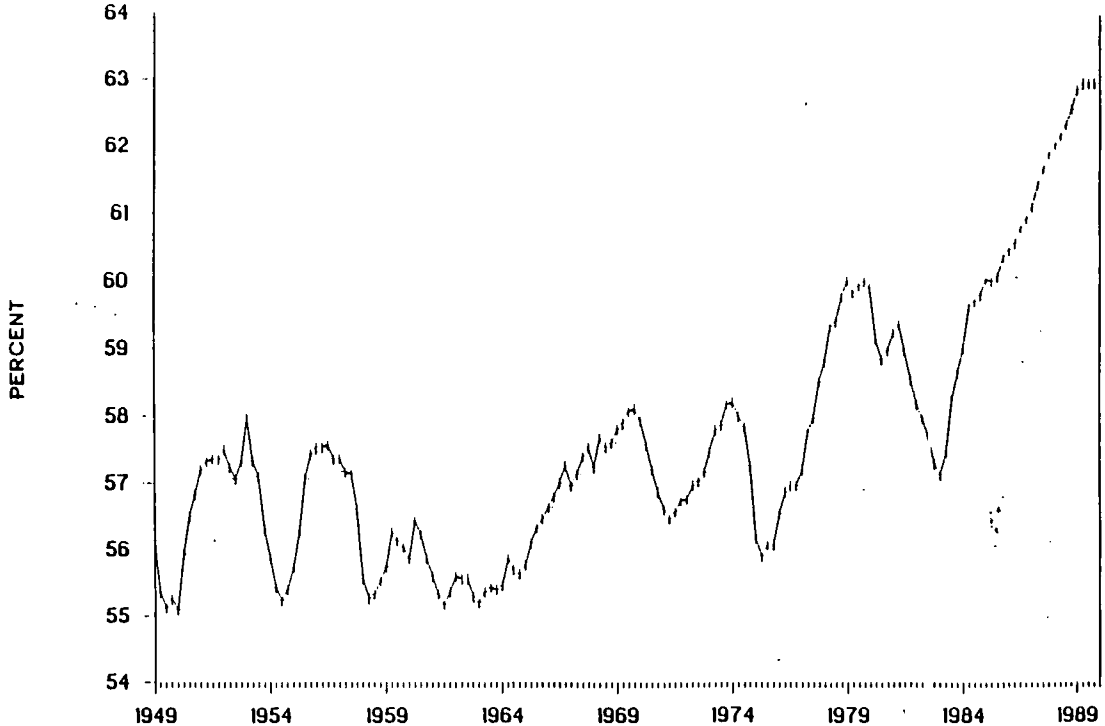
COMPARISON OF CYCLICAL EXPANSIONS: 1960's, 1970's & 1980's

	1961-69 EXPANSION		1975-80 EXPANSION		1982-89 EXPANSION	
	TOTAL	ANN. AVG.	TOTAL	ANN. AVG.	TOTAL	ANN. AVG.
GROSS NATIONAL PRODUCT	45.0%	4.3%	22.4%	4.1%	31.9%	4.0%
INDUSTRIAL PRODUCTION	75.3%	6.6%	33.5%	5.9%	41.5%	5.1%
TOTAL PAYROLL EMPLOYMENT	32.8%	3.3%	18.4%	3.4%	23.3%	3.0%
PRIVATE PAYROLL EMPLOYMENT	30.4%	3.1%	20.1%	3.7%	25.6%	3.3%
REAL CONSUMER SPENDING	45.8%	4.4%	20.2%	3.7%	29.1%	3.7%
REAL BUS. FIXED INVESTMENT	74.6%	6.6%	39.3%	6.9%	47.2%	5.7%
REAL EQUIPMENT INVESTMENT	103.1%	8.4%	42.7%	7.4%	83.8%	9.1%
REAL HOUSING INVESTMENT	19.2%	2.0%	44.9%	7.7%	58.0%	6.7%
REAL EXPORTS	69.7%	6.2%	53.4%	8.9%	77.7%	8.6%
REAL IMPORTS	111.3%	8.9%	46.5%	7.9%	101.7%	10.5%
REAL GOVT. PURCHASES	39.5%	3.9%	7.0%	1.4%	22.9%	3.0%
REAL FEDERAL GOVT PURCHASES	27.6%	2.8%	7.5%	1.5%	17.2%	2.3%
MEMO: SHARES OF GNP						
CONSUMER SPENDING		59.4%		63.3%		65.0%
BUSINESS FIXED INVEST.		10.3%		11.2%		12.0%
EQUIPMENT INVESTMENT		5.7%		7.3%		8.4%
HOUSING		5.3%		5.2%		4.8%
EXPORTS	(AVERAGE)	6.3%		10.1%		11.6%
IMPORTS		6.8%		10.4%		13.7%
GOVT PURCHASES		24.5%		20.0%		19.9%
FEDERAL PURCHASES		12.9%		7.8%		8.6%
REAL DISP. INCOME	48.1%	4.6%	18.8%	3.5%	29.0%	3.7%
GROSS PERS. SAVING RATE		22.6%		24.1%		22.3%
NET ASSET SAVING RATE	(AVERAGE)	12.2%		2.7%		12.6%
COMMERCE SAVING RATE		6.8%		7.4%		4.7%
CPI	25.8%	2.7%	50.3%	8.5%	28.5%	3.6%
NON-FARM UNIT LABOR COSTS	25.5%	2.6%	44.0%	7.6%	19.0%	2.5%
MANUFACTURING UNIT LABOR COST	13.6%	1.5%	36.0%	6.3%	-1.9%	-0.3%
MANUFACTURING PRODUCTIVITY	32.7%	3.3%	13.0%	2.5%	30.8%	3.9%
MANUFACTURING GNP SHARE	(AVERAGE)	21.4%		21.2%		21.5%
PARTICITPATION RATE	(AVERAGE)	59.8%		62.8%		65.5%
BLACK EMPLOYMENT		NA	19.2%	3.6%	30.3%	3.9%
HISPANIC EMPLOYMENT		NA	50.2%	8.5%	49.6%	5.9%

SOURCE: BEAR STEARNS, COMMERCE DEPT., FEDERAL RESERVE & LABOR DEPT.

CIVILIAN EMPLOYMENT POPULATION RATIO

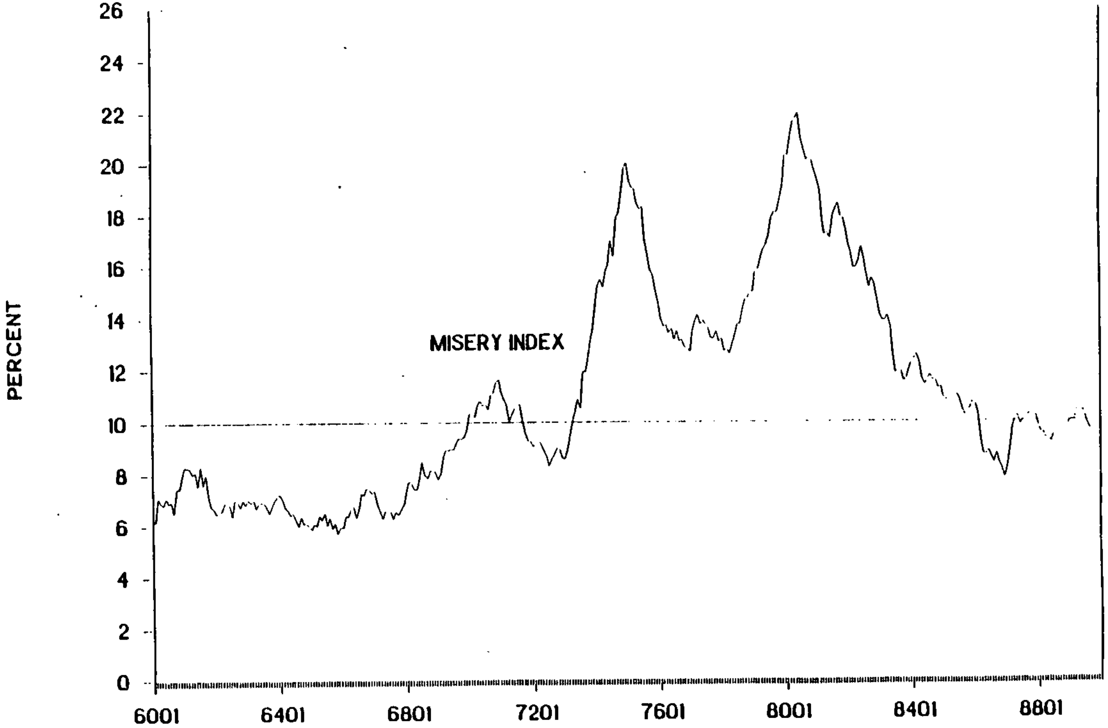
QUARTERLY LEVEL, S.A.



SOURCE: COMMERCE DEPARTMENT

MISERY INDEX

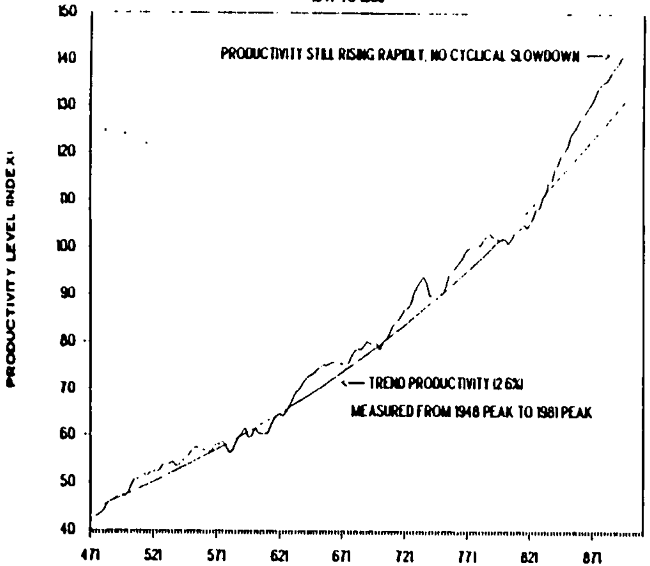
UNEMPLOYMENT RATE + CPI INFLATION



SOURCE: LABOR DEPARTMENT & BEAR STEARNS

PRODUCTIVITY IN MANUFACTURING: STRONG

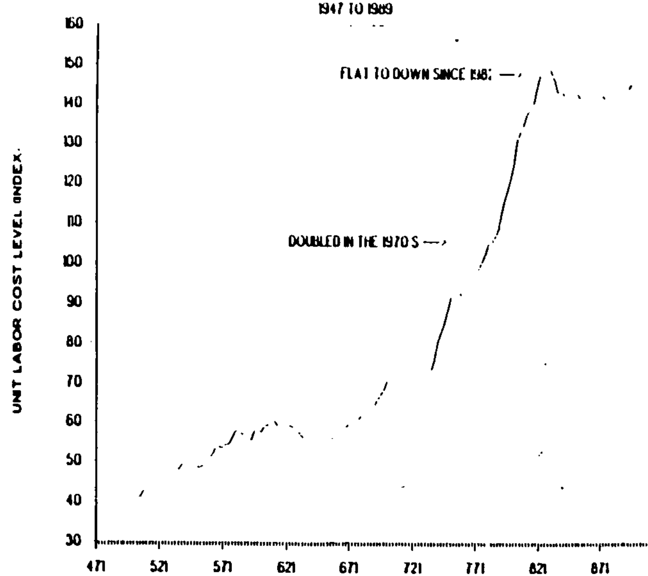
1947 TO 1989



SOURCE: DEPARTMENT OF LABOR

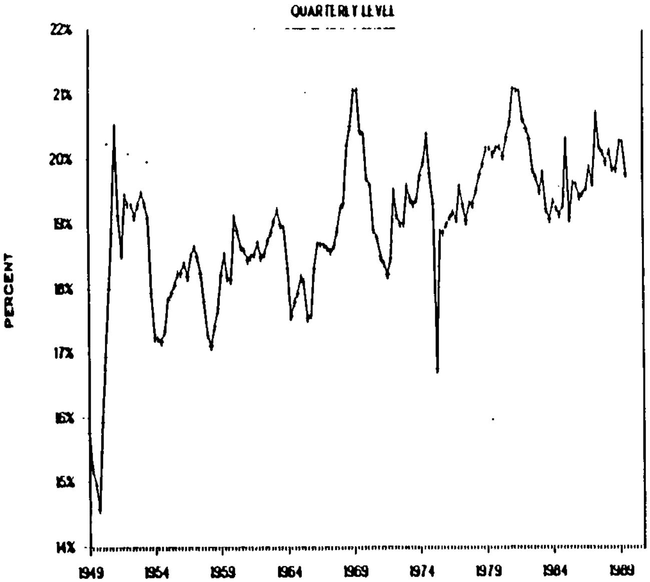
UNIT LABOR COSTS IN MANUFACTURING

1947 TO 1989



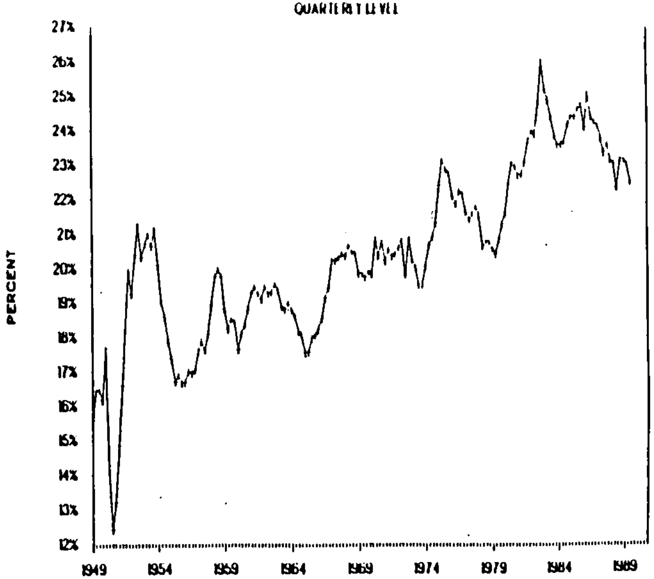
SOURCE: DEPARTMENT OF LABOR

FEDERAL RECEIPTS AS PERCENT OF GNP



SOURCE: COMMERCE DEPARTMENT

FEDERAL OUTLAYS AS PERCENT OF GNP



SOURCE: COMMERCE DEPARTMENT

THE GLOBAL SPECTATOR

December 15, 1989

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GRAMM-RUDMAN-GORBACHEV

G-R-G is now the driving force behind U.S. budget policy. It is a policy driven by the Gramm-Rudman-Hollings deficit targets ($100b in FY 1990; $64b in 1991; $28b in 1992; and budget balance in 1993) and by the prospect of sizable conventional force reductions in response to improved relations with the Soviet Union and far-reaching political and economic reforms in the Soviet East Bloc countries.

It's a policy that comes none too soon for the Bush Administration. Since the President is properly keeping to his no-tax pledge in order to maintain the incentives necessary for continued economic efficiency and growth, political logic points to defense as the only remaining realistic category capable of generating sizable budget savings.

This is especially the case since the Administration chose not to enforce a permanent Grambo sequester in FY 1990, an action which would have generated $10 billion in real nondefense spending restraint this year, about $18 billion in 1991 and even larger savings in the out years. Looking at these numbers, the recent flip-flop on this is discouraging. What's more, sizable reductions in entitlements are not likely. Although OMB is cooking up a major Medicare reform proposal which would slow spending by $9 billion in 1991, the reality is that a heavily Democratic Congress will not permit radical surgery in health care.

Hence the significance of the Gorbachev-East Europe phenomenon. All year we have believed that Bush's unspoken budget agenda included large reductions in defense. Now the fading of the Cold War provides a very handy rationale. As NATO shifts its primary focus from military enforcement to political coordination (and perhaps arms treaty verification, according to Secretary of State Baker), defense budgets on both sides of the Iron Curtain will shrink substantially.

First blood was drawn last week, when the President set his defense mark for 1991 at $292 billion. This, by the way, represents a $22 billion reduction from President Reagan's 1991 estimate of $314 billion put forth last January, and a $17 billion drop from Bush's $309 billion February budget revision. Of course, Bush's $5 billion defense cut of last winter occurred well before anyone in Washington ever dreamed of freedom and democracy behind the Iron Curtain.

Going forward, we assume that defense spending will be reduced by $15 billion from the current services baseline in each of the next several years. Indeed, this may turn out to be a cautious estimate. Because the 1991 Grambo deficit target is $64 billion, with a $10 billion error factor, a very difficult $40 billion in deficit savings will be required. More than likely, Congress will again wait until the end of calender 1990 before completing action. Undoubtedly they will hope for a final agreement in the Vienna conventional force reduction talks, which may provide additional leverage for deeper defense cuts in 1991 and the outyears.

Since the new Presidential baseline for 1991 is not yet available, we take the OMB July Mid-Session Review as the basis of comparison between prior defense budget policy and the new Gramm-Rudman-Gorbachev projections. Again, we assume Bush's mark of $292 billion for 1991, and then a series of $15 billion annual reductions which we expect for each yearly budget thereafter.

Defense Spending

	'90	'91	'92	'93	'94
July Mid-Session	296	308	318	329	341
G-R-G Policy Cuts	—	−16	−31	−46	−61
New Policy Baseline	296	292	287	283	280

By 1994, the annual decline in defense spending is $61 billion from the July OMB baseline. In nominal terms, the projected $280 billion level would be a $24 billion reduction from the $304 billion level actually reached in 1989. In inflation adjusted real terms, this would represent a 20% decline, bringing it down to the level of 1983. As a share of GNP, nominal defense spending would drop to 3.8% in 1994 from a peak of 6.7% in 1986.

Of course, this sort of defense restraint will radically alter the budget outlook in the 1990's. Indeed, using conservative estimates, our projections show a $33 billion surplus at the completion of FY 1994, rather than the $128 billion deficit estimated by the Congressional Budget Office last August.

Projected Budget Totals

	'90	'91	'92	'93	'94
G-R-G Defense 1/	296	292	287	283	280
Nondefense ex. Interest 2/	707	746	787	830	876
Interest Expense 3/	178	181	181	183	183
Total Outlays	1181	1219	1255	1296	1339
Total Revenues 4/	1071	1138	1207	1287	1372
Deficit	-110	-81	-48	-9	33

1/ Gramm-Rudman-Gorbachev defense budget assumes $15 billion in annual reductions from the current services baseline estimated by OMB in July 1989 Mid-Session Review.

2/ Assumes 5.5% growth from 1990 to 1994, which matches the average actual growth from 1985 to 1989.

3/ Split the difference between OMB and CBO mid-year 1989 interest rate assumptions

3-month bill rate	6.9	6.0	5.7	5.5	5.2
10-year bond yield	7.9	7.4	6.9	6.7	6.5

4/ CBO current services revenue baseline, which does not adjust for any capital gains tax reduction.

This new set of deficit estimates for the period 1991-94 could turn out to be even lower if there is any serious policy restraint in the nondefense category, which by 1994 is projected to be 65% (excluding interest) of total outlays. What we cannot yet calculate is the long-term effect of the partial Gramm-Rudman sequester put in place in the current fiscal year 1990. This will have the effect of lowering both the defense and nondefense baselines. These numbers will become available when the President's new budget is published in late January.

Some are fearful that the so-called "peace dividend" will be dissipated on social programs and the like. But this is unlikely. First, the actual deficit is still very large, and very few people will actually believe the Gramm-Rudman-Gorbachev forecast published above. Indeed, the very presence of the large deficit in the 1980's has helped to curb the growth rate of overall Federal spending.

Second, the Gramm-Rudman-Hollings deficit targets and across-the-board sequestration threat have been and will continue to be a reasonably effective discipline on the budget, even with their many imperfections. While our G-R-G deficit forecast declines rapidly, so do the G-R-H deficit targets. Hence there will never really be a "peace dividend," at least not for the next four or five years.

But there will be substantially lower deficits, and a vastly improved fiscal position in the U.S. This enhanced fiscal position improves the outlook for capital gains tax relief (which will generate higher revenues) and for relief on the double taxation of corporate income. Both of these reforms could increase U.S. saving and investment in the 1990's. And of course the elimination of the budget deficit through spending restraint will also increase national savings while at the same time it will reduce the government claim on the national resources.

Representative HAMILTON. Thank you very much, Mr. Kudlow.
Mrs. Teeters, please proceed.

STATEMENT OF NANCY H. TEETERS, VICE PRESIDENT AND CHIEF ECONOMIST, IBM CORP., AND FORMER MEMBER, FEDERAL RESERVE BOARD

Mrs. TEETERS. We appreciate the invitation to appear before the Joint Economic Committee and discuss our forecast for the coming year. Before covering our forecast for the United States, I would like to share with you the forecasts of our economists in various countries in the world.

On a worldwide basis, we expect economic activity to be somewhat slower in 1990 than in 1989. The rather remarkable burst of economic activity in 1988 following the stock market crash has declined, we estimate, to just over 3 percent in 1989. And we expect a modest further decline in 1990.

The United Kingdom, Canada, Denmark, and Australia are all growing below the worldwide averages. If you look at the table closely in the prepared statement, you can see we have a rather remarkable rate of growth for Latin America in 1991.

That assumes that there is some form of political reform in the major countries in Latin America. In our opinion, the worldwide economic environment continues to look favorable. The tapering off in growth has been the result of monetary policy restraint among the G–7 countries, and the more modest 3 percent growth that has resulted appears to be sustainable without inflation.

The most important source of worldwide growth has been the increase in international trade. World export growth is running twice as fast as GNP both in real and nominal terms. However, trade imbalances are showing only slight improvements as yet.

In addition, there has been a worldwide capital boom. Underlying our forecast is the assumption of very little further change in the trade-weighted value of the dollar. Of all the assumptions underlying the forecasts, this is the most tenuous.

In recent years, a forecast of moderate changes has been more accurate as the monitoring of the international values of the currencies by the G–7 countries has introduced increased stability.

Turning now to our forecast for the United States, we are expecting real growth of about 2.5 percent in both 1990 and 1991. We are in the upper reaches of the Blue Chip forecasters range.

One of the reasons we are somewhat more optimistic than the average is that we and most others have rather consistently underestimated the strength of the U.S. economy.

The incoming data for the fourth quarter of 1989, as Mr. Kudlow says, is still incomplete. But it indicates that the economic growth in that period was really quite weak. It looks as if it's well under 1 percent. And if you get below 1 percent, the changes, as Mr. Kudlow says, of tipping it over are quite high.

In addition, we expect the Federal Reserve to continue to respond promptly to incoming economic information. In my opinion, the management of monetary policy in the past several years has been excellent. If the slow growth of the fourth quarter continues into early 1990, my expectation is that the Federal Reserve would ease further. How much they would ease depends on economic developments and possibly unfolding events in the international value of the dollar.

Finally, income growth, as I mentioned, has remained strong in the economy for the 1990's. Our longer term forecast uses the now traditional method of forecasting the growth in the labor force, increase in output per man-hour and minor modifications for changes in the hours worked.

First, now that the baby boomers are grown, the rate of growth of the labor force has declined markedly from just over 2 percent per annum increase in the decade of the 1970's to about 1.2 percent currently. That's approximately the rate of growth of the labor force in the 1950's. The young people who will be entering the labor force in the decade of the 1990's were born between 1965 and 1985. The number of live births during that period is almost 10 million less than during the period 1945 to 1965.

It is quite possible that we will have a labor shortage develop during the decade of the nineties. There are both costs and opportunities to this. It might put upward pressure on wages. On the other hand, it presents an opportunity to reduce unemployment rates, particularly for the young people and the minorities. Not only is the labor force growing more slowly but the mix of jobs is changing markedly. We think the workplace will continue to become more computerized; if that happens, persons without basic computer skills could become disadvantaged. In our opinion, improving the educational skills of not only today's student population but also the adult members of the labor force has a very high priority.

An interesting demographic development is that the baby boomers are finally having babies. And there are now so many women in child-bearing ages that even though the completed fertility of each woman will be relatively low, another baby boom may be developing. You can already see it in the schools—the school population is rising—a repeat of the baby boom could help to solve the anticipated labor shortage in the second quartile of the next century when the first baby boom, their parents, are beginning to retire. On the other hand, the second baby boom could create a major, even longer term problem of alternating large and small generations. For example, think what it would do to the educational system if we were faced every 20 years with excess capacity followed by inadequate capacity. That's essentially what has happened over the past 40 years. We just got the schools closed and we had to open them again.

We have not solved the puzzle of why the output per man-hour or productivity has dropped so far. And nobody else has either. We have searched the literature very carefully for that. There are many reasons advanced to the slowing in productivity, but our research, thus far, has not produced convincing evidence that these possibilities that have been suggested, alone or in combination, can account for it.

We have rather somewhat arbitrarily assumed that the labor productivity would increase about 1.5 percent a year, somewhat above our recent record but below the first 20 years after World War II. The combination of 1.2 percent growth in the labor force

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and 1.5 percent increase in productivity gives us a longer term growth rate for real GNP in the neighborhood of 2.7 percent.

Finally, as a consumer of economic data, we are seriously concerned about the reduced resources being provided to the Government statistical agencies. Changes in both the structure and complexity of the economy make it difficult to measure economic performance. This makes us less able to answer even the most basic questions about the economy and its status.

In short, this is a time when we should be enhancing rather than diminishing the base of our system of economic intelligence.

Thank you.

[The prepared statement of Mrs. Teeters follows:]

PREPARED STATEMENT OF NANCY H. TEETERS

We appreciate the invitation to appear before the Joint Economic Committee and to discuss our forecasts for the coming year. Before covering our forecast for the United States, I would like to share with you the forecasts of our economists in various countries of the world.

REAL GROSS NATIONAL PRODUCT

(Annual Average Percent Change)

	1988 act.	1989 est.	1990 forecast	1991 forecast
World	4.2	3.2	2.8	2.8
United States	4.4	2.9	2.5	2.5
Europe	3.4	3.3	2.7	2.5
Asia Pacific	5.8	4.7	4.0	4.1
Canada	5.0	2.6	1.4	2.0
Latin America	0.3	-1.3	2.1	5.2

Source: IBM economists in 18 countries.

On a worldwide basis, we expect economic activity to be somewhat slower in 1990 than in 1989. The rather remarkable burst of economic activity in 1988 (following the crash of the stock markets) has declined, we estimate, to just over 3 percent in 1989 and we expect a further modest decline to just under 3 percent in 1990.

The United Kingdom, Denmark, Canada, and Australia are experiencing slower growth than most other industrial countries. Their economic policies are more restrictive than others in an attempt to eliminate stronger inflationary momentum. As near as we can estimate, Latin America--overall--experienced a recession in 1989, but has a better outlook for the next two years. In our opinion, the worldwide economic environment continues to look favorable. The tapering off in growth has been the result of monetary policy restraint among the G-7 countries and the more modest 3 percent growth that has resulted appears to be sustainable, without increasing the threat of inflation. Of particular interest in the forecasts is that the Asian Pacific Area and Europe are continuing to grow somewhat faster than the United States. This should aid in correcting the imbalances in international trade. Among the industrial countries, faster economic growth tends to increase the demand for imports.

The most important source of worldwide growth is international trade. World export growth is running twice as fast as GNP, both in real and nominal terms. However, trade imbalances are showing only slight improvement, as yet. In addition, there has been a worldwide capital boom. A combination of tightening labor markets and relatively high capacity utilization levels offers considerable incentive for investment in machinery and equipment. It is being facilitated by increasingly liberalized flows of financial resources, deregulation and privatization of industry and commerce, and the continued integration of the European marketplace.

Underlying our forecasts is the assumption of very little further change in the trade-weighted value of the dollar. Of all the assumptions underlying the forecasts, this is the most tenuous. Our efforts to forecast the value of the dollar have not been anymore successful than others. In recent years, a forecast of moderate changes has been more accurate, as the monitoring of the international values of the currencies by the G-7 countries has introduced increased stability.

Turning now to our forecast for the United States, we are expecting real growth of about 2.5 percent in both 1990 and 1991. We are in the upper reaches of the Blue Chip forecasters' range. One of the reasons we are somewhat more optimistic than the average is that we and most others have rather consistently underestimated the strength of the U.S. economy. The incoming data for the fourth quarter of 1989 (which are still incomplete) indicate that economic growth in that period was quite weak. Numerous special factors adversely affected the fourth quarter... a hurricane, an earthquake, and several strikes. In addition, automobile production was cut sharply. Overproduction of automobiles in the fourth quarter is almost becoming an annual event.

U.S. Forecast

(percent change)	1988 act.	1989 est.	1990 forecast	1991 forecast
GNP (real)	4.4	2.9	2.5	2.5
CPI	4.4	4.8	4.0	4.2
Consumer Spending (real)	3.4	2.7	2.9	2.3
Capital Spending (real)	8.4	3.8	4.8	5.8
Unemployment rate (% of Civ. Labor Force)	5.5	5.3	5.6	5.6
3-Month T-Bill Rate (% per annum)	6.7	8.1	7.6	7.5
Federal Budget Balance (Billion of Dollars, F/Y)	-155	-152	-115	-70
Current Account Balance (Billions of Dollars)	-127	-124	-115	-118

In addition, we expect the Federal Reserve to continue to respond promptly to incoming economic information. In my opinion, management of monetary policy in the past several years has been excellent. As the rapid growth of economic activity in 1988 became apparent (remember it was not anticipated because of the stock market crash), monetary policy tightened and lasted through the middle of 1989. As slower growth appeared, the Federal Reserve has eased. If the slow growth of the fourth quarter continues into early 1990, my expectation is that the Federal Reserve would ease further. How much they would ease depends on economic developments and possibly unfolding events in the international value of the dollar.

Third, income growth has remained strong. Total personal income grew by 7.5 percent in 1988 and nearly 8 percent in 1989. With only a modest rise in the unemployment rate in 1990, growing personal income, and thus, consumer spending will continue to be a source of economic strength.

Any economic forecast is at risk. We routinely forecast a "risk scenario" and try to assess the probability of the risk occurring. Our current risk scenario is based on the assumption that interest rates could be higher overseas than in our base case. The threat of higher inflation could force foreign central banks to adopt more restrictive monetary policies. In the case of Japan, higher rates may be needed to bring the dollar-yen exchange rate into a mutually acceptable trading range, if currency intervention fails. Under this scenario, U.S. exports would suffer from reduced worldwide growth. A growth recession could develop, with little or no expansion over the first half of 1990. We have assigned a 35 percent probability to our downside scenario.

Our longer-term forecast uses the now traditional method of forecasting the growth in the labor force, increases in output per man hour, and minor modifications for changes in hours worked. Our most recent such forecast has some informative and puzzling aspects to it.

First, now that the baby boomers are grown, the rate of growth of the labor force has declined markedly, from over 2 percent per annum in the decade of the 1970's to 1.2 percent currently. The young people who will be entering the labor force in the decade of the 1990's were born between 1965 and 1985. The number of live births during that period is almost 10 million less than in the period 1945 to 1965. The drop in the number of native born young people is being partially offset by immigration, both legal and illegal. In spite of the immigration, it is quite possible that a labor shortage could develop. There are both costs and opportunities to such a situation. It might put upward pressure on wages. On the other hand, it presents an opportunity to reduce unemployment rates, particularly for young people and minorities. Not only is the labor force growing more slowly, but the mix of jobs is changing. In their 1986 study of the impact of automation, Leontief and Duchin[1] concluded that the changing mix of jobs would intensify the labor shortage. We think the work place will continue to become more and more computerized. If that happens persons without basic computer skills could become disadvantaged. In our opinion, improving the educational skills of not only today's student population, but also the adult members of the labor force, has a high priority.

Another interesting demographic development is that the baby boomers are finally having babies. There are now so many women in childbearing ages that even though the completed fertility of each woman will be relatively low, another baby boom may be developing. The school age population is already rising. A repeat of the baby boom could help to solve the anticipated labor shortage in the second quartile of the next century when the first baby boom (their parents) begin to retire. On the other hand, a second baby boom could create a major even longer-term problem of alternating large and small generations.

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[1]Leontief and Duchin, The Future Impact of Automation on Workers, Oxford University Press, New York, Oxford, 1986.

For example, think what it would do to the educational system, if it were faced every twenty years with excess capacity followed by inadequate capacity. That is essentially what has happened in the past forty years.

We have not solved the puzzle as to why output per-man hour (or productivity) has dropped. Nor has anyone else. We did an extensive search of the economic literature on this subject in the process of preparing a long-range projection for the Congressional Research Service last year[2]. Productivity growth is the driving force behind rising levels of real output (and thus income) per capita. Its importance is illustrated by the following calculations. When the long-term growth rate of productivity is 3.5 percent a year, material standards of living double every 20 years; at 2 percent, every 35 years. At 1 percent, it takes 70 years for living standards to double.

Average Annual Rates of Growth in U.S. Productivity

Period	Business Sector	Nonfarm Business Sector
1947-66	3.3	2.7
1966-73	2.1	1.8
1973-79	0.6	0.5
1979-87	1.3	1.1

Somewhat different growth rates can be obtained if different time periods are chosen, but the general picture doesn't change much.

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[2]Rosanne Cole, Brian P. O'Connor, and Nancy H. Teeters, Long-Term Economic Forecast, 1988 to 2000, submitted to the Congressional Research Service of the Library of Congress, January 1989.

There is no question that there was a major slowdown in the rate of productivity growth, at least as we currently measure it. Many reasons have been advanced for this slowing...energy price increases, slowing in the rate of growth of skills of the labor force, inadequate investment, shift of economic activity and resources to the production of services, and inefficiencies arising from the increased role of government in the economy. Research thus far, however, has not produced convincing evidence that these possibilities (alone or in combination) can account for it.

This unsatisfactory state of our understanding of secular trends in productivity surrounds the projection of future trends with uncertainty. We somewhat arbitrarily assumed that the labor productivity would average 1.5 percent per annum, somewhat above our recent record, but below the 20 years after WWII. The combination of 1.2 percent growth in the labor force and 1.5 percent increase in productivity gives us a longer-term growth rate for real GNP of 2.7 percent.

Finally, as a consumer of economic data, we are seriously concerned about the reduced resources being provided to the government statistical agencies. Changes in both structure and complexity of the economy have made it more difficult to measure economic performance. This makes us less able to answer even the most basic questions about our economy and its standing worldwide.[3] In short, this is a time when we should be enhancing, rather than diminishing, the base of our system of economic intelligence.

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[3]For example see "Statistical Needs for a Changing U.S. Economy," Background Paper, U.S. Congress, Office of Technology and Assessment, September 1989.

Representative HAMILTON. Thank you very much, Mrs. Teeters. Mr. Wyss, please proceed.

STATEMENT OF DAVID A. WYSS, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL ECONOMIST, DRI/McGRAW-HILL

Mr. WYSS. Thank you, Chairman Hamilton. We are very happy to be here to discuss our outlook for the economy with the committee.

This economic expansion is now entering its 8th year. It's the second oldest expansion in postwar history, but is beginning to show some signs of age, not surprisingly.

But, although it's showing some signs of age, we see no signs of imminent death. We think that we are going to avert a recession during 1990, and that this expansion has every possibility of becoming the longest in history.

There are two questions. No. 1, why do we expect the economy to slow down? And, No. 2, why don't we expect it to go into a recession?

The first point is fairly clear. We see a significant slowdown in the consumer sector. Consumer spending actually dropped in real terms in the fourth quarter of 1989. We think that there was a decline of close to 1 percent in consumer expenditures, primarily in the automotive sector. People stopped buying cars.

The 1990 models were much more expensive than the 1989's, and the various rebate programs that were put in last summer ended on October 1. People responded by fleeing car dealers' showrooms, and cars piled up on the lots.

The consumer generally seems to be becoming a little more cautious. He's leaving a little more money in his bank account and isn't quite so anxious to spend every dollar that the IRS leaves in his pocket.

He's still coming pretty close, only saving about a nickel out of each dollar. But that's a lot better than the 2.2 percent that he saved back in 1987, which was a postwar low for the saving rate.

The saving rate is still low by historic standards and extremely low by any international standards. I'm going to come back to that later because it is a problem for the long-term growth of this economy.

We do not expect the consumer to retrench completely, however. The rebounding auto sales in the last 20 days is some sign that they will respond to rebate programs when the manufacturers put them back in.

Car sales have bounced up on the last 20 days; the last 10 days of the year and the first 10 days of the new year are not necessarily the cleanest periods to look at automobile sales, but they are encouraging—both to us and more especially to the automobile manufacturers.

Housing has slowed down pretty dramatically in the first part of 1989. We are seeing a little bit of recovery from the very poor sales of the spring of 1989, as mortgage rates dropped during the summer months.

We are afraid, however, that that recovery may be terminated by the recent rise in bond yields. Mortgage rates are now back into double digits. And if we enter a new home buying season, which starts in March and April, with 10 percent mortgage rates, I think that's going to put more of a damper on housing sales.

But, with bond yields now up around 8⅓ percent, it's inevitable that we are going to see the mortgage rates up well above 10 percent.

And, of course, the other major sector of the domestic economy, business investment, is also showing some signs of slowing down. Business intentions surveys done by ourselves and by the Commerce Department both show that manufacturers expect to increase investment by less in 1990 than they did in 1989; in fact, by about half the amount.

We think they could slow down even more than the most recent Commerce Department surveys indicate as they see the impact of slower economic growth. However, the fact that they are still showing an increase in investment for 1990 shows that they aren't panicking, and that they are not expecting a recession.

When we put it together, we see a definite slowdown in domestic economic growth. All three of the major sectors of the economy—business investment, the consumer, and housing—have shown a significant slowdown in the last part of 1989, and will continue sluggish in the first part of 1990.

We think, however, that we are not headed for a recession. It's going to be close, but we think that the preemptive strike waged by the Federal Reserve on the recession has been sufficient to prevent it from occurring.

The Fed lowered interest rates very dramatically during most of 1989; after the peak of interest rates in the early spring, interest rates came down very sharply for the rest of the year. That's been enough, we feel, to prevent the slowdown from turning into an outright recession.

We have to give the Federal Reserve very high marks for its handling of this economic expansion. They have made no major mistakes.

We hope that that will continue. We fear that monetary policy at this point will have a more difficult time in controlling the economy—in walking the usual tightrope between excessive growth and resulting higher inflation. We fear that there will be a slight inflationary bias to monetary policy over the coming years.

Part of the reason for that inflationary bias is, frankly, coming from the dollar and international trade over the coming months. The slowdown that's occurring in the United States is a worldwide slowdown.

The world economy has been very robust in the last few years. But, as in the United States, the world economic expansion is showing signs of having peaked. Certainly, you can see that in Britain, where the Bank of England has been dramatically slowing the economy by pushing interest rates up to 15 percent. Interest rates essentially doubled in the United Kingdom in the course of the last year and a half, as the bank worried about the sharp acceleration in the British inflation rate.

With the U.K. Ford workers now under a contract with double-digit wage increases in the next 2 years, those inflationary worries are going to worsen, and Britain is very likely to move into recession.

Both the Bundesbank and the Bank of Japan have also been hitting the brakes in recent months. Interest rates are up sharply in both those countries, and we expect them to rise further as they try to slow down their economies.

Despite that, the dollar remains relatively strong. It has dropped against the mark, but we are now at a 4-month high against the Japanese yen, back over 146 yen.

With that kind of exchange rate, it's hard to see much improvement in our share of world trade, and that means not much improvement in our international trade deficit.

Exports have slowed down very dramatically. Export growth was 20 percent in 1988, under 10 percent in 1989, and an estimated 5 percent in 1990. It has been cut in half every year.

Five percent export growth is simply not enough to offset the increase in import prices that we expect over the coming year. We think that the trade deficit could actually worsen in 1990 after the sharp improvement that we saw in 1988.

But the biggest worry is and remains inflation. I'm considerably more pessimistic about inflation than Larry Kudlow is. We think there are clear signs of acceleration in inflation.

That has been hidden a bit at the consumer price level. The CPI, once you take out the volatile food and energy components, has been essentially stable, in the 4 to 4.5 percent range, since 1984, and we expect it to remain stable in 1990. In fact, the overall CPI is expected to rise only 4.2 percent this year, slightly less than it did last year.

But that hides what is going on under the surface. We are seeing an acceleration in domestic costs, which is being offset by a slowdown in import prices. If we look at the Producer Price Index, and more especially if we look at wage increases, there is a clear acceleration. Wage increases set a postwar record low in 1987, and they've been rising essentially half a percent a year ever since.

Fringe benefits are rising even more rapidly. Fringe benefits are rising at double the pace of wage increases, creating the worst of both worlds for people engaged in wage bargaining.

The worker looks at his paycheck and says:

"My paycheck isn't going up as fast as inflation. Last year, my wages were up 3.9 percent. The cost of living was up 4.6 percent. I am losing ground."

The employer looks and says:

"My costs of employing you went up 5.4 percent last year. That's more than I can possibly pass on when I'm faced with this foreign competition and competition from other manufacturers."

We end up with an impasse. I think that fringe benefits, particularly health insurance costs, are going to become an increasing factor in wage negotiations over the course of next year. The telephone workers strike was only the first case that we are going to face. The Federal Reserve is going to have a hard time controlling this acceleration in inflation because they do not want to see a recession in the near term, but they do not feel that the political will exists to put the economy through a wringer at a 4.5-percent inflation rate.

We are not in the same world that we were in 1979 and 1980, when double-digit inflation gave the Fed adequate political justification for creating the 1980–82 recession.

The Fed does not feel that it has that go-ahead right now.

As a result, I think that they are going to allow the inflation rate, not deliberately but effectively, to accelerate over the next couple of years. The situation is going to look very much like the late 1960's, when we were at a similar point in the economic cycle, with the economy near capacity. There was a slowdown in 1967 much like the slowdown we expect to see currently, and then a period of about 2 years of sluggish growth and slightly rising inflation, culminating in the 1970 recession.

I expect to see that same pattern repeated over the next 2 to 4 years.

Fiscal policy continues to give problems for monetary policy and for the economy. The basic problem is the continued large Federal deficit.

There's a common misconception among economists and the economic press that deficits are bad for you. Borrowing money doesn't hurt. Borrowing money feels great. It feels great when you're running up a balance on your charge card.

What hurts is when people want the money back. We are paying in the long run for the deficits that we ran during the 1980's. That's seen in the trade deficit, and in the fact that the 1980's, a period of almost unprecedented economic expansion, was also a period of the lowest net addition to the capital stock of any decade in our history.

We also are paying for the deficit in the form of an increased reliance on foreign capital markets. I think we have seen that very clearly in the bond market in the last month.

Long-term bond yields have increased by over half a percentage point since mid-December. Most of the reason for that is the sharp increase in Japanese bond yields, caused in part by a tightening by the Bank of Japan and in part by nervousness about the forthcoming Japanese election.

That has been echoed in a rise in U.S. bond yields. We have become reliant on the Japanese financial market for funds to finance the imbalance between saving and investment in the U.S. economy.

In the long run, that problem has to be addressed. There are essentially two ways to address that. The first way is to reduce the amount of money that we are borrowing.

The second is to increase the amount of money that we are saving. Many of the issues that fiscal policy will be addressing concern this dual goal over the course of the next year.

The introduction of various savings plans, and a lower rate for the capital gains tax are all in some measure aimed at increasing the amount of money this economy is saving.

And, of course, the continued pressure to reduce the budget deficit will address the goal of trying to reduce the amount of money that this economy is borrowing.

Our feeling is that we will probably have more success in reducing borrowing than increasing savings.

The American consumer has shown himself very reluctant to increase his saving rates, even with significant tax incentives.

Overall, we remain relatively optimistic about this economy. We think that we will avoid a recession this year. Economic growth will slow in the first half of 1990, but gradually gather speed in the second half of the year.

For the year as a whole, we are looking for growth near 2 percent. I think that's probably a little more pessimistic than the Office of Management and Budget is likely to be. But, the Office of Management and Budget is traditionally more optimistic than most private forecasters.

Having worked on that forecasting team, I was more optimistic than most private forecasters when I was doing it.

The last time I addressed this committee, I said that for the first time in recent memory, our forecast was actually more optimistic than the OMB forecast. I suspect that will be the last time I will be able to say that for a few years.

But, although it's going to be a poorish year, it's by no means a disaster. And we think that a slowdown this year will set the stage for another couple of years of moderate economic growth.

Thank you.

[The prepared statement of Mr. Wyss follows:]

PREPARED STATEMENT OF DAVID A. WYSS

THE ECONOMIC OUTLOOK: A CLOSE CALL

Chairman Hamilton, Members of the Committee

I am very pleased to be here to discuss the outlook for the economy.

As it enters its eighth year, the economic expansion is showing signs of age. The slowdown that began in the fourth quarter of 1989 is likely to persist through the first half of 1990. But there is little sign that the slowdown will turn into a downturn.

The slowdown is broad, but shallow. Almost every major sector of the economy has seen weaker demand in recent months, but nowhere has the softness been severe enough to suggest recession. In most sectors, the weakness seems temporary, with special factors accounting for much of the swing.

The most disturbing factor has been the drop in the bond market. Investors have become more worried about inflation, even before the December producer price data were released. Bond yields are moving up in spite of the looser Federal Reserve policy and lower short-term interest rates. In these conditions, further loosening will become difficult, and could be counter-productive.

Even without further loosening, the economy will start to accelerate in late 1990. By next year, we expect growth to be back near trend. A slowdown at this stage of the business cycle creates worries about recession, but is necessary to provide room for future growth.

THE CONSUMER DRAWS BACK

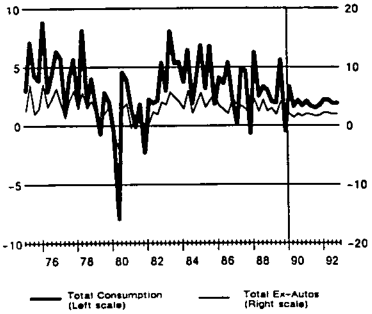
Consumer spending has slowed. Auto sales dropped sharply in the fourth quarter; after the end-of-model-year incentives had attracted heavy buying in August and September, higher new car prices and lower rebates kept buyers out of the market. Manufacturers have sweetened incentives in order to get buyers back into showrooms. The Chrysler "guaranteed rebate" seems an effective defense against the recent buyer mentality, which is that prices will come down when sales drop. The resurgence of sales in late December and early January is an encouraging sign, but 1990 sales are expected to be softer than for the last few model years, at 10.3 million units.

The softness is not confined to cars. Christmas buying was mildly disappointing for retailers. Sales at general merchandise stores fell 0.4% in December, and apparel sales were up only 0.1%. Still, the saving rate remains stable, at a low 5.4%, and consumer confidence remains high.

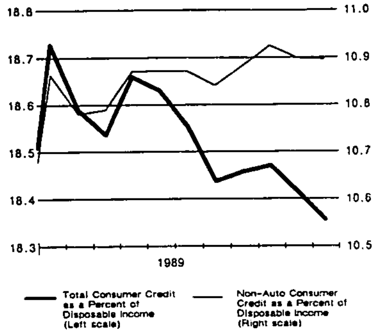
The softness reflects caution, but not a major retrenchment by consumers. The high heating oil and utility expenditures in December may have induced more caution during the Christmas season, and the bad weather also may have discouraged some retail trade.

The lower borrowing by consumers reflects the more cautious attitude. Consumer credit outstanding has dropped from 18.7% of disposable income in January, 1989 to 18.4% in Novem-

Consumer Spending is Slowing
(Percent change annual rate, billions of 1982 dollars)



Along with Consumer Borrowing



ber. The decline was concentrated in automobile loans, which fell from 7.9% to 7.5% of disposable income over the period. Excluding car loans, credit was a stable share of income.

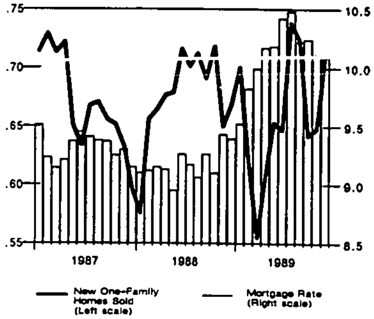
Consumer spending is expected to remain in line with incomes this year. Spending will not be able to lead the economy, but should not be a major drag either. As incomes accelerate late this year, spending will follow.

HOUSING RESPONDS TO LOWER INTEREST RATES

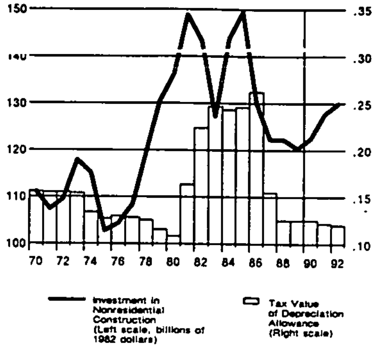
The Federal Reserve's preemptive strike on the slowdown has already helped housing recover from its lows of last spring. Home sales have responded to the lower mortgage rates, and will improve further when the 1990 buying season begins. Housing starts have lagged sales, hurt by the heavy inventory of unsold homes in early 1989, but much of this inventory should be run off by spring. 1989's natural disasters (Hurricane Hugo and the San Francisco earthquake) also will spur construction activity to repair and replace damaged homes.

The recovery will be concentrated in single-family housing. The multi-family sector remains depressed by the 1986 tax law changes and the overbuilding of the mid-1980s. Demographics are also moving against multi-family housing. Little improvement in this sector is likely in the foreseeable future.

Housing Sales are Recovering as Mortgage Rates Drop



The 1986 Tax Changes Continue to Hold Down Nonresidential Construction



BUSINESS INVESTMENT SLOWS

Business investment has led the economic expansion for the last two years, but is slowing down. Corrected for inflation, business fixed investment rose 8.4% in 1988, 3.3% in 1989, and a projected 2% in 1990. The recent surveys suggest slightly stronger growth, but we expect some downward revision of plans as the weak economic growth becomes more evident.

Aircraft orders remain the strongest component of investment. The continued replacement of the aging fleet will keep investment strong in this sector for the coming few years. Capacity is the major constraint on increased investment, with Boeing currently operating with a three-year backlog of orders.

Excluding aircraft, the picture is less bright. Computer sales have slowed sharply in recent months. This sector has tended to lead total investment. Some drop off in motor vehicle investment is also clear. The worst seems to be nearly over, however, and by late this year orders should accelerate.

Construction spending is soft, but the worst is over. After dropping for two consecutive years, real spending on nonresidential structures is expected to rebound 7% in 1990, helped by a revival of oil drilling. Office and commercial construction will remain weak, however, because of the massive oversupply in most areas.

THE TRADE GAP REMAINS WIDE

Export growth has slowed in response to the weaker world economy and the strengthening of the dollar since its December 1987 low. Export volume rose 17.6% in 1988, 10.7% in 1989, and a projected 5.0% in 1990. The dollar has now begun to drop, however, and exports should accelerate in 1991.

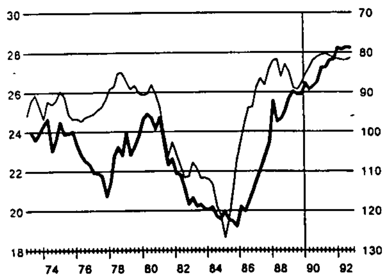
The rapid increase in U.S. exports since 1986 has been caused by the more competitive level of the dollar. Since early 1986, our share of industrial country exports has risen from 19.5% to 26%. This share has leveled off since the dollar rebounded, but is expected to rise again later this year and in 1991.

Unfortunately, import growth remains robust. Strong U.S. domestic demand continues to attract foreign manufactures, especially in consumer goods. The slower economic growth has slowed import growth, but not enough to offset the deterioration of the terms of trade.

The drop in the dollar, while it has helped to raise exports, has also raised import prices. The higher prices have offset the improvements in volume, in the traditional manner of the "J-curve." When the dollar rebounded in 1988, the trade deficit narrowed sharply, but now that the dollar is dropping again we expect the deficit to stabilize near $115 billion.

Our Share of World Trade has Stopped Improving

U.S. Export Volume as Percent of Seven Industrial Countries* and Real Exchange Rate

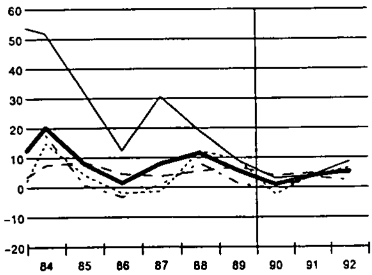


*Canada, France, Germany, Italy, Japan, United Kingdom, and United States.

Trade Share (Left scale) — Real Exchange Rate (Inverted, right scale)

Computer Sales are Leading the Slowdown

Investment in Producers' Durable Equipment
(1982 prices, percent change)



Total — Office Equipment — Comm Equip & Instr — Industrial — Other

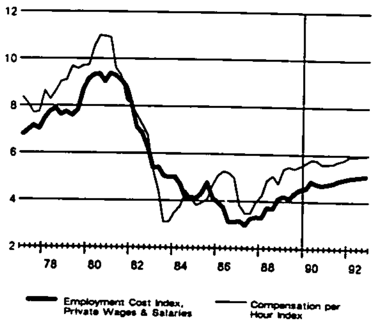
INFLATION EDGES HIGHER

The inflation rate has been edging higher in the last two years. The pattern is seen most clearly in the wage data. Hourly earnings increases were at a post-war low in 1987, but since then have been accelerating about half a percentage point per year. Compensation per hour is rising much faster than earnings, because fringe benefit costs are climbing at twice the rate of hourly earnings. The divergence is caused by two factors: the sharp rise in health insurance premiums and the increases in social insurance taxes.

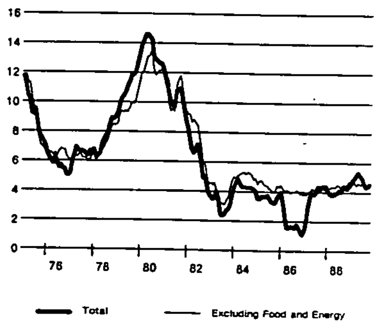
The divergence creates the worst of both worlds for wage bargaining. Looking at 1989, the employee sees that his pay has risen only 4.3%, less than the consumer price inflation of 4.6%. The employer, on the other hand, sees an increase in compensation per hour of 5.4%, significantly more than inflation and more than competitive pressures allow him to pass on. It is no accident that wage negotiations are increasingly revolving around fringe benefits, and especially health care.

Producer price inflation, even excluding the late surge in energy and food costs, has been rising in recent months. The higher labor costs have translated into higher prices at the producer level. In contrast, consumer price inflation, excluding the volatile food and energy components, has been at 4.2% in 1989. Lower import inflation, helped by the turn-around in the dollar, has offset the higher domestic cost increases.

Fringe Benefits are Rising Faster than Wages
(Year-over-year percent change)



Consumer Price Inflation is Stable
(Year-over-year percent change)



Lower food and energy prices will lead to a lower CPI rise in 1990 than in 1989 (4.2% vs. 4.6%), but wage increases will remain high. The economic slowdown will stop a further acceleration in wages, but will not slow the advance significantly. When the economy accelerates again in 1991, so will wages.

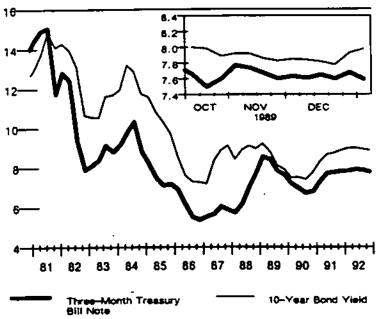
In the long term, the inflation rate will be dominated by domestic costs, and particularly by labor costs. The financial markets are already concerned by this upward creep, and the Federal Reserve must take more notice once the weakness of early 1990 is past. The higher inflation limits the possibility of further interest rate declines.

MONETARY POLICY WILL EASE FURTHER

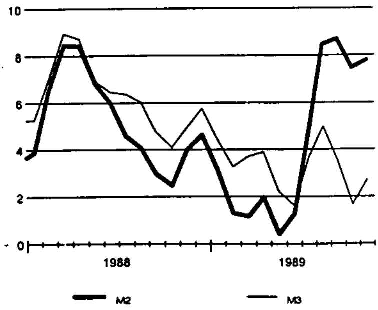
The Federal Reserve has been loosening monetary policy steadily since last spring. The federal funds rate has fallen from 9.84% in April to 8.25%, and is likely to drop another 75 basis points by the summer as the economy slows. The recent surge in food and energy prices will put that easing on hold, but when prices ease in the spring, so will interest rates. As the economy accelerates later in the year, the Federal Reserve will push interest rates back upward.

The Fed is acting to avert a recession. In spite of the brave talk of zero inflation, the Fed seems willing to accept a stable inflation rate if the alternative is a downturn in the economy. If the Fed were serious about zero inflation, it would be tightening, not loosening. Inflation, excluding the volatile food and energy components, has been essentially stable.

The Fed Will Ease Further In the Spring
(Percent)



M2 Growth has Accelerated
(Three-month percent change, annual rate)



Financial markets are now becoming concerned that the Fed is too easy. The surge in inflation has focused fears on inflation again, and bond yields have surged. The drop in bond prices has been exacerbated by the thrift crisis. Reports suggest that thrifts have become major sellers of Treasury securities, since these are the easiest assets to dispose of as they downsize. The jump in Japanese bond yields has added to the pressure on the U.S. bond market. Japanese investors are afraid of the coming election, as refelcted in the weakness of the yen as well as the fall in yen bonds. The yield curve has steepened as a result. Even if short-term interest rates drop as expected, bond yields are unlikely to fall below their December low.

I share the market fear that the Fed is going to ease too quickly. There is always a bias toward inflation in monetary policy, since the real effects of tight money are felt quickly, while the inflationary impact of loose money appears only with a long lag. The current situation resembles the late 1960s, when the Fed was trying, with the aid of military spending, to keep the economy out of recession. The cost was a gradual upward creep in inflation, culminating in the 1970 recession. Over the next few years, I expect to see a similar pattern of creeping inflation, with a recession coming when the Fed eventually cracks down.

FISCAL POLICY REMAINS FROZEN

Fiscal policy has changed little since 1985. Since the passage of the Gramm–Rudman–Hollings amendment, Congress and the Administration have concentrated on cutting the deficit. The deficit has been reduced from its peak of $198 billion in fiscal 1985 to $152 billion in fiscal 1989. Although this is only half the reduction required in the original schedule, at least the direction has been correct.

Despite the reduction, the deficit remains a drag on U.S. and world capital markets. Because the United States is, on net, borrowing more than it is saving, it must rely on a capital inflow from abroad to finance the deficit. Although this inflow has permitted some net additions to the capital stock, the ratio of net investment to GNP has been lower in the 1980s than in any post-war decade.

Continued reductions in the deficit are needed if the United States is to continue to grow at an acceptable pace. The promised cut-backs in military spending must be used to cut the deficit, not to increase spending on other programs. If Defense Department spending can be held stable at a nominal $300 billion, as Secretary Cheney has suggested, reducing the deficit would be much easier.

Revenue increases may be needed if further program reductions are not possible. Continued progress on reducing the deficit is essential if the confidence of international capital markets is to be maintained. In general, spending cuts are better for the economy than tax hikes, but social goals must be weighed against economics.

Financial Flows

**	Net Personal Saving	Net Business Saving	State and Local Surplus or Deficit	Federal Surplus or Deficit	Net National Saving *	Capital Outflow (–) or Inflow (+) from Abroad	Net Domestic Investment
1976	5.4	2.6	0.9	–3.0	5.8	–0.5	5.4
1977	4.6	3.1	1.4	–2.3	6.7	0.4	7.3
1978	4.9	3.1	1.3	–1.3	7.9	0.4	8.5
1979	4.7	2.5	1.1	–0.6	7.6	–0.1	7.7
1980	5.0	1.4	1.0	–2.2	5.1	–0.4	4.7
1981	5.2	1.4	1.1	–2.1	5.7	–0.3	5.2
1982	4.9	0.6	1.1	–4.6	2.0	0.0	2.0
1983	3.8	1.9	1.4	–5.2	2.0	1.0	3.0
1984	4.4	2.5	1.7	–4.5	4.1	2.4	6.5
1985	3.1	2.6	1.6	–4.9	2.4	2.8	5.2
1986	3.0	2.0	1.5	–4.9	1.5	3.2	4.8
1987	2.3	1.7	1.1	–3.6	1.5	3.3	4.8
1988	3.0	1.6	1.0	–3.0	2.6	2.4	5.0
1989	3.9	0.9	0.9	–2.9	2.9	1.9	4.8
1990	3.4	0.5	1.2	–2.2	2.8	2.0	4.8
1991	3.3	0.3	1.5	–1.6	3.5	1.9	5.4
1992	3.3	0.3	1.7	–1.6	3.7	1.6	5.3
1950–54	4.7	2.6	–0.2	0.1	7.3	0.1	7.6
1955–59	4.7	2.9	–0.3	0.1	7.5	–0.4	7.3
1960–64	4.4	3.3	0.1	–0.3	7.5	–0.8	6.7
1965–69	4.8	3.7	0.0	–0.3	8.2	–0.4	7.8
1970–74	6.0	2.2	0.6	–1.2	7.6	–0.3	7.5
1975–79	5.2	2.7	1.0	–2.3	6.6	–0.2	6.5
1980–84	4.7	1.6	1.3	–3.7	3.8	0.5	4.3
1985–89	3.0	1.8	1.2	–3.8	2.2	2.7	4.9
1990–94	3.3	0.4	1.5	–1.7	3.6	1.7	5.3
1995–99	3.4	0.5	1.4	–0.6	4.6	1.4	6.1
2000	3.5	0.4	1.2	0.0	5.1	1.2	6.3

* Net national saving is the sum of columns 1 through 4.
** A statistical discrepancy is omitted from this table.

If taxes are to be raised, general taxes such as the income tax do less damage than targeted taxes such as energy. Excise taxes should be used only when the allocative impacts are desired, and outweigh the losses caused, including the inflationary and financial market impacts.

CAN THE SAVING RATE BE INCREASED?

The need for foreign funds depends not on the federal deficit alone, but on the overall balance between saving and investment in the U.S. economy. An increase in the personal saving rate could help the external balance as much as a reduction in the federal deficit. Several tax proposals have been made that attempt to address this possibility.

A cut in the capital gains tax would encourage saving by increasing the after-tax return to earnings. The impact on the saving rate is probably less than the effect on the distribution of assets, however. A capital gains cut encourages more risky, longer-term investment over fixed-income securities.

Our studies suggest that the capital gains tax is nearly revenue-neutral in the long run; that is, a tax rate cut generates just about enough extra growth to offset itself. Lowering the tax rate generates a one-time jump in revenue, as investors take capital gains early, but then lower revenue in the next few years. Eventually, the higher resulting investment generates enough extra real growth to bring tax revenues back to the level they would otherwise have attained.

Note that this argument cannot be made for a temporary tax cut. Such a cut provides a windfall for those who have unrealized capital gains, but by its nature does not change long-term decisions, since investors expect it to revert at the expiration of the law. Such a cut presents the worst of both worlds, providing a temporary boost in taxes but at the cost of lower future collections.

Direct savings incentives plans are again being proposed. Experience with individual retirement accounts was not encouraging as to the effect of these plans on the saving rate. After the passage of the IRA legislation, the saving rate slid for five years, to its lowest level in post-war history. Since the restriction of the IRA in the 1986 tax law, the saving rate has risen.

Our analysis suggests that the movements in the saving rate were not caused by the IRAs, but the saving rate behavior certainly suggests that they cannot have had a very big positive influence. We can find little evidence that the act had any significant impact on the saving rate. The money that went into IRA accounts was mostly diverted from other assets or offset by additional borrowing.

The newer proposals may be more effective than the IRA. For one thing, the incentive to offset saving with borrowing is less, since personal interest payments are no longer deductible. For another, the IRA attracted savers thinking about retirement, who were generally the households already saving substantial sums. Younger households saw less advantage in locking up funds until age 60. A more flexible plan would attract younger families, for whom the plan would add to savings rather than merely divert funds.

On net, however, the plan seems unlikely to increase the saving rate significantly. Most households save for specific goals, and take little account of tax advantages. The historic evidence suggests that the long-term saving rate is primarily determined by sociology, and only secondarily by tax breaks.

SUMMARY

1990 is expected to be a below-average year. The Federal Reserve has eased before the weakness was established, and thus successfully avoided a recession. The cost, however, has been an acceleration in the underlying inflation rate. Eventually, the upward creep in inflation will force the Fed to hit the brakes, triggering the next recession. The current slowdown, however, is likely to postpone that event for at least two years.

Representative HAMILTON. Thank you, Mr. Wyss. We will begin questions with Congressman Obey.

Representative OBEY. Thank you, Mr. Chairman. I appreciate that. I am due at a meeting in about 3 minutes.

There are a number of questions that I would like to ask, but let me simply ask:

On trade, what are all of your expectations in terms of the trade situation and the size and trend of the trade deficits in nonenergy components and in high tech?

Mr. WYSS. If I can address that, it depends to some extent on what you define as high tech. Overall, we expect the trade deficit to be essentially flat for the next year. It's been stalled out at about $9.5 billion a month since the middle of 1988, plus or minus a billion dollars.

The last couple of months, we had some abnormally large trade deficits. Those were caused primarily by the Boeing strike and the loss of aircraft exports. With aircraft exports coming back at the end of the Boeing strike, we will see some better numbers at the beginning of 1990.

High-tech exports are improving. We do expect that the balance on the general high-tech category to be improving over the course of the year. But, unfortunately, that's going to be offset by some continued worsening on the consumer goods side. And we don't expect to see a lot of improvement on the high-tech side.

One advantage we have in high tech is that, contrary to popular belief, most of our competition is European and the dollar has depreciated very dramatically against the European Community currencies. That should allow us to claw back some of our market share in those high-tech categories, particularly in areas like machine tools and heavy equipment over the course of the next year or two.

Mrs. TEETERS. In the case of computers, the competition is not European. Almost all of our competition is Japanese. In many cases, except for the smaller machines, all the European computers are Japanese, too, with European names on them.

We are one of the few industries that never went into deficit on the U.S. trade accounts. What we are seeing is an increase in the flow of trade as the economies, particularly, of Europe, Japan, and the Asian countries continue to grow more rapidly than the United States. Our flow of product back and fourth in those areas is rising somewhat.

We also don't see much improvement in the trade imbalance, unless we get some downward shift in the value of the yen.

Mr. KUDLOW. Well, in the very short run, I don't disagree. I don't think there's going to be much of a swing in trade. My reasoning might be somewhat different. What you have here is a case where you have the general softness of the U.S. economy as exemplified by the slowdown of industrial production. It simply means we're not producing the goods right now to export.

If you don't produce, you can't export.

Exports have done very, very well over the course of this cycle. One of the tables that I submitted in my prepared statement showed that export growth in the eighties cycle has actually been at a faster pace than either the sixties cycle or the seventies cycle.

However, the issue with respect to trade is whether our industrial production and, therefore, our exports are going to pick up. I think that's a function of the overall economy, since I think the economy is going to gradually improve this year, and will certainly be in better shape next year. And I think we are going to get a good rebound in exports.

The second point on this, growth rates around the world are going to play a major role. One of the important trends that I see is the distinct possibility that economic growth in Western Europe—we may wish to redefine Western Europe to include some of the improvements now underway in East Europe, that will take time—but that whole trading block may find itself as the fastest growing sphere in the world in the 1990's.

If that is the case, it would reverse the trends of the eighties. In the eighties, the U.S. economy grew substantially faster than the European economy and at about the same pace as the Japanese economy. In the nineties, I think our growth is going to be pretty good. I would say we could do 3 to 3.5 percent average real GNP. But I think West European growth, European Community growth, could be above 4 percent real GNP.

That's going to open up a lot of business marketing opportunities for American companies. That could be reflected in a major improvement in our trade position.

Similarly, another important trading sphere, which doesn't seem to get much discussion, is the South American position. We are seeing very positive economic reforms in a number of countries in South America. Not all, I hasten to add, but in some important countries, most notably, Mexico.

And if these economic improvements continue, I think America's trade with South America is going to increase. It has been largely dormant in the last decade.

This could also help to improve our position, provided, of course, we remain competitive. That's a function of a number of issues. One of them is cost control.

I noted in my opening remarks the importance of businesses holding down costs. That's the key to profits. That's the key to exports. I think America has done a pretty good job on that, but I think the numbers, particularly in the manufacturing industry areas, are quite good.

As far as high tech, I would distinguish two parts of high tech—the hardware part and the software part. I think what Nancy Teeters mentioned about hardware is correct; she would know that better than anybody around here. But we also have a lot of value added in the software area, America's tremendous world share of software production and exports and design.

We are the leaders in software and I think we are going to get a large share of that exporting to both Europe and South America and, frankly, even to the Pacific Basin.

So I'm not pessimistic. I hope, as a matter of economic policy, we can help American businesses to export in the nineties by keeping our capital costs as low as possible. This issue of capital costs I find to be among the most important fiscal-related issues in the 1990's.

One of the reasons Japan has done a better job than we have in many parts of the trade discussion is they have very low capital costs. Until recently, their interest rates have always been lower than ours, going back 20 years, until recently. This is now changing a bit.

Second, with respect to tax policy, Japan has virtually no capital gains tax. Most of the European countries have no capital gains tax. Germany, for example, has none. This is an important business cost. It reflects the cost of financing, which, in turn, has to be built into the overall cost of the price structure.

With respect to dividends and equity, for example, I hope that Congress will take up the question of possible tax reform to equalize dividend and interest expense, which would, therefore, swing us back to an incentive to generate more equity financing at lower cost with improved balance sheets.

This would go a long way toward helping American business to be internationally competitive.

Representative OBEY. I really do have to leave.

One comment and two very short questions.

My main concern about high tech is simply that 5 to 7 years ago, we were told that that was going to be our salvation in terms of the trade deficits. And now we find out that, just like everything else, it sank into a quite different position. It's tough to find some loss leaders around today to drag us in the other direction.

I'd like to hear you expand a little more on your justifications for arriving at the somewhat different conclusions you do with respect to your future expectations for interest rates.

Mr. WYSS. Well, I'm not sure that we're completely different, but my viewpoint is that this economy is now operating very close to capacity. As the economy expands in the second half of this year, the Fed is going to have to touch the brakes once more.

I think a lot of our difference on the interest rate outlook is based on the inflation outlook. I feel that inflation is accelerating. That can be seen very clearly in the recent wage settlements and the wage data. And that acceleration of inflation is going to force the Federal Reserve to maintain a relatively tight monetary policy, and it's going to push up both the Federal Reserve determined interests rates and the market determined bond yields, as the markets get scared of inflation, as I think they have in the last month.

Mr. KUDLOW. I have a much different view of this. Sometimes, economists can look at the same data and give different interpretations.

No. 1, I disagree with the data. Maybe prospectively, but I disagree. My reading is that, if you look at the Producer Price Index, which is really the underlying price structure, we seem to have excellent progress over the last 6 months.

The PPI has grown only 2.5 percent over the past 6 months, versus nearly 9 percent last May. In particular, the next level down—not just the PPI but the intermediate level, intermediate materials, which is really the closest thing to a commodity measure we have officially, and which then bucks up into finished producer prices, and finally into consumer prices—we have seen terrific progress there.

Intermediate materials have actually declined by sixth-tenths of a percent at an annual rate in the last 6 months. The peak was at 7 percent last April.

The PPI, excluding energy, has been almost identical. The decline has been nine-tenths of a percent compared to a rise of 7 percent at the peak last January.

I think monetary policy has been conducted in a very responsible way and I think we have not yet seen the full disinflationary effects of prior Federal Reserve tightening.

I believe we should be vigilant on the wage and benefits front, but my reading of the wage situation is not as alarming, particulary in the manufacturing hard goods sector. The year-to-year change in wages is below 4 percent. Productivity has been a little slower this year, 1.5 percent. But the average has been 4 percent during the cycle.

Unit labor costs are well in hand. As far as so-called service inflation was concerned, I believe the data suggests we saw a peak in late 1988 and early 1989, though I have no doubt service inflation will come down more slowly than manufacturing or goods producing inflation.

Notwithstanding those caveats, I think the inflationary trend has moderated. And I think that's a very good thing indeed for the economy. And I think probably we're not going to see an actual bottoming of inflation for another four to six quarters.

And if the Fed stays on the counterinflation path, which is my expectation, judging from their statements, I think we have a unique opportunity, having brought inflation down from 10 percent or thereabouts to 4 percent in the eighties, we have the unique opportunity to virtually eliminate inflation.

And I think we are on that path right now. So I'm really quite optimistic on this front.

Representative OBEY. Well, not hearing any other comments, let me simply make the point on statistics and then get to my other meeting.

I think you'll find every member of this committee agrees with you in terms of the erosion of the quality of our statistical base. We move billions of dollars around in the budget and the economy on the basis of those numbers and don't really know what we're doing.

I would simply say that there's only one way you're going to get attention paid to that, and that is:

If people with your reputations and a lot of others simply go to the leaders of both parties and say, hey, we need your help on this problem.

I sit on one of the subcommittees that funds the BLS, for instance. And I tell you, there are lots of political sex behind lots of programs. There's no political sex behind statistics, unless you can cut through that and simply say:

Look before you start getting these other things, you just have to do this and get the committee to do it.

It just isn't going to happen.

Mrs. TEETERS. May I suggest that you take a look at what happened in Canada and the U.K.? In both cases, they let their statistical operations decay to the point they couldn't trust them. And then they had to spend a great deal of money to readjust and reconstitute the statistical bases.

May I just make one comment on the interest rate?

Representative OBEY. Sure.

Mrs. TEETERS. I get very amused by Fed watchers. I apologize to the others because we all do it. But the Federal Reserve does not act on the basis of forecasts. They act on the basis of information as it comes in. Consequently, any forecast of what the Fed is going to do is what people think the economy is going to do over the next period of time. What the Fed will actually do is react to what comes; what happens to us as we go along.

So, if you get a flareup of inflation as we did with the oil and the drought, they're going to react to it. If you get a calming down of the inflation and a drop in real growth, they're going to react to that.

Chairman Burns was once asked what the Federal Reserve was going to do in the fourth quarter of a particular year. His response to that was to pound on the table and say: "Only God knows what the Federal Reserve is going to do in the fourth quarter of this year."

I think that's absolutely correct. It is the unfolding of events to which the Fed reacts as they happen.

Representative OBEY. Thank you, Mr. Chairman.

Representative HAMILTON. Senator Mack.

Senator MACK. Thank you, Mr. Chairman, and I thank all of you for your testimony this morning.

Mr. Kudlow, I apologize for not getting here to hear all of your statement. But, from what I gather, you gave a fairly optimistic attitude about 1990.

I'd be interested in your reaction if the Congress were to pass capital gains reduction fairly early on in this legislative session.

Would that have an impact on your forecast? Or is that something you've already factored in?

In addition to that, we would be interested in talking about the idea of tying a reduction in the capital gains rate to an increase in the top tax rate.

And I'd be interested in your reaction to that as well as the indexation of taxable capital gains, whether you think that is a good idea.

And if you all want to hop in on that at some point, that's fine.

Mr. KUDLOW. Well, taking them one at a time, I've been a strong proponent of a capital gains reduction; I'd like it down to 20 percent, where we had it in most of the eighties.

Senator MACK. Let me just interrupt quickly and suggest that, since you mentioned the rate, it was 20 percent when other rates were considerably higher than they are today.

Would that mean that maybe if you want to keep the same relationships, that it should be lower than 20 percent?

Mr. KUDLOW. I was about to say I actually prefer optimally to settle in around 15 percent. How fast you got there or how slow is of less concern to me than that target. You're right, the first capital gains reduction we had was in the late seventies and the rate was dropped down to 28 percent.

If my memory serves me, the top rate on the personal income at the time was 50 percent, plus there was another 20 percent surcharge under so-called unearned income. And the spread was very wide. The top rate on all income was lowered to 50 percent, with a 20-percent capital gains.

Now we are roughly 28 and 28 percent with that 33 percent bump up.

My logic on capital gains is really twofold.

No. 1, the question of international capital cost competitiveness, which I raised in response to Congressman Obey's initial question, I think this is a very key point.

I really think—and we all talk about the international competitiveness of the economy—we need to compete. And I think we have to understand the basic capital cost of financing is a crucial ingredient. It's a crucial cost factor to any business. It affects the whole cost-price structure.

It generally affects their ability to profitably gain capital and put it to work in not only products to be exported or sold domestically, but research and development.

I noticed in yesterday's New York Times, there was a story on the front page worrying about R&D. I think that's a very legitimate worry.

I favor the R&D tax credit for that reason, but I think capital gains ought to do that.

No. 2, in terms of the basic financial investment decisions, the trick is to provide enough reward to unlock capital. I have always been amused by talk about whether we're helping the rich at the expense of other income categories.

As somebody who spent his career mostly on Wall Street except for a stint with the Fed and a couple of years at OMB, the wealthiest investors really don't live and die with capital gains because they have numerous investment outlets in tax-exempt securities, for example, where they can park their money and be assured of a virtually risk-free return over many years.

The trick is to try to take that capital and employ it at a sufficiently high rate of reward to unlock it and put it where it can do us the most good, creating new companies and creating new jobs.

That's the basic dynamic of an entrepreneurial free market risk reward type economy. That's really the crucial issue.

I don't like to get into the measurement battles. All I'll say is, in general, I think that the evidence of the past 10–12 years under a lower capital gains tax rate has been very good. In broad terms, the economy has shown that capital gains has been a big help.

I, myself, if I thought with certainty that there would be passage of this differential, I would be inclined to revise upward my growth forecast. I think the markets and businesses and individuals would respond immediately, literally in a nanosecond. When that information is available, you will get an immediate response and you'll get movement.

And given the softness of the economy, which in many respects is centered in the manufacturing hard goods area, this is exactly where they need the help.

And I also think, even though I confess this is a more speculative judgment, I think it would be a great help to our markets—to the stock market in particular—because by raising the rate of return on an aftertax basis, I believe stock prices will immediately revalue upwards to reflect this improvement in efficiency and asset yield.

That, in turn, will have positive spillover. It will make it cheaper for businesses to finance. And everyone's affected by it. Whatever happens at the top, everyone else is affected positively by it.

My third point on capital gains, in addition to the domestic effects and the international effects, really comes from my own work at the moment with respect to urban economies, especially New York City, which is an interesting topic of discussion. It's not easy for minorities to start a business; it's not an easy thing for them to get their hands on cash.

And in a very simple, basic way, somebody who wants to start a small company and has to raise a hundred thousand bucks—not much for a repair shop or a food store, or something like that—is asking people to make an investment which has no payoff the way a Treasury bill does, or even a corporate bond does.

It's just an investment in the future and the future value of the company. But, to make that investment, I think you really have to provide a tax break. You have to provide a higher reward.

And I think, if we are serious about new ideas to help the antipoverty program, the minority program with respect to immigration and all the rest, we have to make this linkage between tax-policy issues and the actual day-to-day operation.

I regard capital gains as essentially a minority enterprise stimulant. So, for those three reasons, I would be very much in favor of it. And, again, in the forecasting sense, I would be inclined to mark up my forecast right away.

Mr. WYSS. I am probably not quite as much of a proponent of capital gains as Larry Kudlow is, but I think the difference is only one of degree. I think the evidence shows very clearly that lower capital gains rates do, by reducing the effective cost of capital, increase the investment in the economy and increase long-term economic growth.

And I think that a lower capital gains tax is a very good idea. It worried me the original time it was taken out. Every time we've taken capital gains out, Congress 2 years later has passed it again.

I do have, however, one caveat. The worst way to lower the capital gains tax is a temporary bill. That accomplishes nothing and wipes out most of the goals for which you reduced the capital gains tax.

The whole idea of a differential capital gains rate is to convince people to invest, in the expectation that when they cash in the investment, they're going to get a higher aftertax return. If you put it in temporarily, you're telling people that they're allowed a windfall on what they've done in the past, but on what they're going to be doing now, they're going to be taxed at the higher rate. Then, of course, you get the tax loss with practically no incentive impact.

On the 1990 forecast: First, what does it do to government revenue forecasts? Second, what does it do to the economic forecasts?

I think it's good for the economy. I don't think I would make a major change in my 1990 forecast on the basis of passing the capital gains tax, but it would be good. I would certainly move up my stock market forecast and probably the economic forecast as well in the second half of the year.

There would be a windfall in revenue to the U.S. Government in the first year, because when you lower the rate, people are going to delay capital gains until the new rate comes into effect, and they're going to move up realized capital gains. But that's a temporary windfall impact. It lasts 1 year, and you pay for it in the future.

In the long run, our studies suggest that the capital gains tax is approximately revenue neutral, that the issues of economic growth and the increased turnover of capital assets that you get roughly offset the lower rate, so there is very little long-term impact on total tax revenue.

The other two questions were the question of bumping up the 28 percent rate, to eliminate that little notch that we have now between the 33 percent rate and then back down to 28 percent, and the question of indexation of capital gains. Both of those, to my mind, are equity issues rather than efficiency issues.

I think they're both probably good ideas. But, on the other hand, I'm not convinced that we ought both to index capital gains and have a lower rate. You have to consider what the net impact of doing both of them would be.

The argument for indexation is basically that you shouldn't have to pay a tax on inflation. If the value of your assets goes up only because prices go up, the gain should not be taxable. That's a very strong argument.

As for bumping up the 33 percent tax rate, let's face it, most people who have capital are rich. The rich have more money than the poor on the average. [Laughter.] As a result, most capital gains taxes are paid by the wealthy.

Senator MACK. Would you go back and say that again? [Laughter.]

Mr. WYSS. The rich pay most of the capital gains taxes. They're going to receive most of the breaks from the lower capital gains rate.

I think that if you asked the average person with wealth if he's willing to trade a 20-percent capital gains tax against bumping up a tax on his ordinary income to 33 percent, most of them would raise their hands.

Mrs. TEETERS. I'd like to comment. We are in the rather unique position of having economists stationed around the world. Last summer, we asked them to start submitting information on the cost of capital. Of the G–7 countries, it's the six against Japan. There is very little difference across Canada, the United States, and Europe in the cost of capital. What happens is that you get compensation within the laws of the countries; where you may have a higher tax rate here, a lower capital gains rate over there, these tend to even out so that you get a sort of common cost of capital.

In the case of Japan, you get widely different answers depending upon whether you use the book value of the capital or whether you use the market value of the capital. There are other differences. The Japanese corporations pay very low dividends. And the capital gains tax is only 1 percent. But, the main differences are the low interest rates in Japan and these are beginning to disappear. Since 1982, when the international financial system became electronic—both with CHIPS and with the new FRCS–80 system—we have had an international capital market that is capable of arbitraging differences in interest rates.

I think, eventually, what you're going to have is differences in the cost of capital which will reflect differentials in inflation and risk, because the capital is now flowing freely around the world.

Senator MACK. I saw a report recently that indicated that the cost of capital in the United States—I gather from what you say there are as many different ways to calculate the cost of capital. But I saw a report recently that indicated the cost of capital in the United States was about 11.2 to 11.4 percent; showing in Japan, 7.4 percent; in Germany, 7 percent.

Mrs. TEETERS. We still have a lot of work to do to clarify the comparisons.

But, the cost of capital in Europe, the United States, and Canada was somewhere between 7 and 10 percent. Depending on how you calculated it in Japan, it was about half that. Given the quality of the statistics that you have to use, the difference between 7 and 10 percent is peanuts as far as I'm concerned.

Mr. KUDLOW. That is the so-called market cost of capital. In other words, that's using bond and stock.

Senator MACK. The numbers that I used?

Mr. KUDLOW. Yes, bond and stock valuations grossed down to an aftertax basis. On that point, I would agree Japan is the lowest.

Then you have a whole cluster up around 8 to 12 percent. But, another way to look at that from just the businesses' standpoint and the corporations' standpoint and the the use of IMF numbers looking at the corporate tax rate across the G–7 countries, and looking at the capital gains tax rates for individuals and combining the two, which is, in effect, the cost of capital at present, using our top-rated 33 percent, the United States is at 55.8 percent. That's the highest.

The lowest is Italy, which is 36 percent. Italy does not have a high capital gains tax rate. However, Japan has a 40-percent corporate tax rate and a 5-percent capital gains tax rate, which is a tricky calculation because not many pay it. They're at 43 percent, so they're 12 points below us.

Germany, a 50-percent corporate tax rate, does not have a capital gains tax. So they are 50 percent, so they are 6 points below us.

So there's the spread there and I don't think that's an inconsequential spread. I agree you have to factor in interest rates and I also agree you do have measurement problems on taxable income.

But, nonetheless, I think most economists agree, we've made progress but not enough.

I wanted to address just one of the points on the top personal tax rates on indexation, and also the revenue question.

I indicated in my earlier remarks that I thought the incentivizing U.S. fiscal policy in the eighties was one of the great positives in the economic reforms. Raising aftertax rewards for all matter of investments was a tremendous cost. That's why it's being borrowed around the world. Imitation is the sincerest form of flattery.

I, myself, think it would be a great mistake for us to step back and start changing, start raising these top rates—for two reasons.

No. 1, it would damage incentives, an important point, in a measurable way.

No. 2, it would undermine the credibility of the policy. The minute you make that step, then people start forecasting and anticipating the next step: higher tax rates.

Credibility is very important. Permanent tax change is what we need for businesses and individuals.

So, I think from both an economic and a psychological standpoint, the change in the top rate would be an error. I favor indexation of capital gains; I always have. In fact, if you asked me, if you couldn't have a rate reduction, would you take indexation?

The answer is yes. In fact, in many respects, we had a temporary rate reduction. I would rather have indexation than a temporary rate reduction. I agree with Dave Wyss' point on that.

I think indexation is really important.

The third point, on revenues, the capital gains revenues argument is not going to be settled. I spent 6 years in Washington. We didn't settle it then, and my guess is, in the next 20 years, we are not going to settle it.

Reasonable people can disagree. I just want to note that important studies have shown though that when we first visited capital gains in the late seventies, revenue estimates were all negative.

That wasn't the case. The actual performance was positive. It was even slightly positive during the recession. We've done a couple of papers on this. And I admit, we are the optimists.

But, my sense is the initial effect of the capital gains differential would generate much more revenues than the Treasury's or the Joint Tax Committee's estimates. The so-called unlocking effect would be two to three times greater than the $4 or $5 billion number that was tossed around at the last session.

After that, we believe that the Government agencies have underrepresented the unrealized capital gains out there.

Therefore, we think over time you can actually get a positive revenue flow, though it will be lower than the initial unlocking revenue flow. Over time, I think it's going to be better and would actually wind up helping us on the deficit.

And I agree the rich are richer. And I agree that in a static sense, the upper income classes will benefit more in the first break. But, the fact is they are going to pay a lot more revenues.

And in that respect, you can put those mules to work. I think that's the key point.

Senator MACK. Thank you, Mr. Chairman.

Representative HAMILTON. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

It is clear—I guess maybe coming from the Northeast, I may have a skewed outlook—the economy is sputtering.

I was wondering if you can share with this committee, in terms of looking at it regionally—although there are more than 30 States I gather that are in the red right now and addressing some budgetary shortfalls, including my State and throughout all of the Northeast—whether or not that could be a precursor for an overall decline in the economy?

Mrs. TEETERS. We do regional forecasting, because marketing and sales are on a regional basis.

There are large differences between the regions—in fact, this is worldwide. In all of the major countries, the comment is that the regional rates of growth are more different than the differences that occur in the national rates of growth.

The New England area has obviously had a bad time. A good deal of it is coming from the fact that the Defense Establishment is basically flat and will probably decline. They have done a marvelous job of recovery from the loss of textiles and shoes after World War II, but then they went very heavily into high-tech defense. The flattening out in defense is beginning to hit them.

The other regions of the country are doing fairly well. The Middle West around the Lakes has come back very nicely and it is still holding up quite well. The Far West is doing very well.

The other place that is weak is basically around Texas. And even there, Texas is finally getting to the point where they are not going downhill any more.

You might be interested, six to eight times a year the regional Federal reserve banks make a report on the conditions in each of their regions. They do not forecast, but they do give a very nice roundup as to what is going on. There is very little oil activity in the Kansas-Texas area, and the drought is essentially over.

Representative SNOWE. You do not think it is related at all to the overall national economic circumstances?

Mrs. TEETERS. Of course, it is. As you slow down the national economy, as we have done since 1988, this reflects in each of the regional areas, also. But some of the regions are stronger than others. Some have more international trade.

One of the interesting things in New England is that exports are going to turn around. One of the largest exports out of Boston Harbor is fish which is flown to Japan. The amount of freight out of Boston by air is now larger than what is going out by rail.

Representative SNOWE. That is incredible.

Mrs. TEETERS. I agree.

One of the nice things about New England is that the experience they had after World War II caused the development of local councils on economic growth. The Federal Reserve Bank of Boston is deeply involved in them. Thus, you have in the New England area groups of very concerned people that include the financial institutions, the universities, and the industrial groups that monitor the economic health of the area. And so soon as the economy begins to turn down, the FSE groups revive at a rate that is really amazing. They simply come out of the woodwork, regroup, and start to work to recast New England.

Mr. WYSS. I should say, like IBM we do fairly extensive regional forecasting for each of our clients in our regional operations. We basically say the same thing that you've said, for a while now.

The study in Boston hits home very easily. New England is in a recession. Texas has not had much of a recovery. In this whole economic expansion certainly since 1985, Texas has been effectively in recession. But at the same time, that is being offset by a clear acceleration in the Southeast and continued strength on the West Coast.

The whole economic expansion since 1982 has looked like a reciprocating engine: every time one part of the country goes down, another part seems to pop up. I think we're seeing that now.

New England had been leading the expansion. A year ago, we were still talking about the "Massachusetts miracle." Now, it's New England's turn to go into a slide. It's going to be a temporary slide. I don't think it means the economy is heading toward a recession.

Representative SNOWE. We are facing an unprecedented situation in our own State—you know, historical performances—but it bothers me, because I see the concern. It even goes beyond some of the tangibles, like defense cuts and so on, which we haven't even faced yet. We have not even confronted that prospect, even in our own State and throughout New England. Those decisions have yet to be made.

You add that to an already difficult situation, and it's very difficult to comprehend what the situation will be for the future. But I see an overall lack of confidence in the economy right now. People are pulling in every direction. They are not spending, they lack confidence in their institutions, because they didn't make adequate decisions.

With developers, for example, I mean three out of the eight developers in the State of Maine probably will be insolvent at the end of this cycle. That is the same as is happening in Massachusetts and many other States. People are just not spending. They are showing their concern about their job security, and what the future portends for them.

So then we have some difficult decisions to make here concerning deficit reduction, which we really haven't pursued this morning. And I would like to have you address, exactly how do we approach deficit reduction this year? Is it very important to meet Gramm-Rudman targets? Should we go beyond that? Should we be expected to go beyond that? And how does that play into the overall circumstances of our economic problems?

Mr. KUDLOW. Before we get to the budget picture, I wanted to respond to your Northeast perspective, which I share. I think there is a fiscal policy problem that has developed in the Northeast which, if it is not corrected, is going to forebode probably a longer term underperformance.

And as much as I worry about the problem, I guess I am glad to say, at least for these purposes, it is a bipartisan problem. Frankly, both Republican and Democratic State executives have not done a good job of fiscal management over the past 5 years.

In almost every case when we look at this, from Maine on down, excellent economic growth in the first half of the 1980's created a tremendous surplus of revenues above expectations, but it was very badly mismanaged in the second half of the 1980's.

Every single one of those States suffers from this, and no matter how crusty and curmudgeonly. New Hamsphire, the same thing, large State spending. Maine, New Hampshire, Vermont, Massachusetts, New Jersey, New York, and Connecticut.

Representative SNOWE. Unlike the Federal Government?

Mr. KUDLOW. The odd thing is, though——

Representative SNOWE. At least they have to balance their budgets; right?

Mr. KUDLOW. Yes. But if you look at Federal spending, Federal spending trends in the last 5 years are much better than Northeast government spending trends.

Representative SNOWE. What about all the needs that the Federal Government has curtailed or terminated?

Mr. KUDLOW. Whatever the logic and the arguments are—and one can make arguments on all sides—the figures show State spending growth right up and down the Eastern Seaboard.

I just want to remind the Joint Economic Committee, there was some excellent work done in the 1980's by an Ohio University professor, Richard Vedder, who presented studies to the committee with respect to State and local spending and tax policies, and how incentive structures and other issues could affect regional growth, and how regional growth differentials can develop with respect to national growth.

At the moment, on the tax side particularly, the work done by the Intergovernmental Advisory Commission here in Washington shows that the tax structure of many of these Northeast States and as a region is not competitive with the rest of the United States, and is increasingly losing. That is an important issue.

Representative SNOWE. What do you mean, the tax structure?

Mr. KUDLOW. Measured in a variety of ways, measured as individual and corporate tax rates, measured as property tax rates, sales tax rates, measured as the incidence of taxation on a per capita basis and per $1,000.

Representative SNOWE. Are we a high tax or a low tax?

Mr. KUDLOW. Very high tax.

Representative SNOWE. That is right, because we have no choice.

Mr. KUDLOW. Again, I am not in a position to argue.

Representative SNOWE. I understand that. But it depends on the quality of life that you want for the people who live in that State. Those are some of the choices that we have to make.

Now, you look at the State of New Hampshire. The State of New Hampshire has a property tax. It does not have a sales tax, it does not have an income tax. And they are facing the same problems.

So to say that what the Federal Government does is entirely unrelated to the situation in the Northeast is ignoring reality. I am just telling you that the 1986 Tax Reform Act changed the whole tax code in the State of Maine, which required a return of almost $100 million to the taxpayers from overcollection.

Mr. KUDLOW. The fact remains that these States are making independent tax and spending policies, and their rates and incidence of taxation and spending are now increasingly out of line. When I say national, I do not mean just the Federal Government, I mean the national average, with respect to other regions of the country.

And the work that was shown to this committee by Richard Vedder in the early and mid-1980's, which has been corroborated by other academic work, shows that regional fiscal policies play a major role in regional economic performance. And I think this is a crucial point.

Because I think whatever is going to be done on the tax and spending side, the issue of regional competitiveness and regional fiscal policies is a crucial issue.

Representative SNOWE. I do not dispute that, whatsoever. But I do not know what you would suggest all of these States to have done, just out of curiosity. Because it is sort of separating what the Federal Government has done and what the U.S. Congress has done impacting these States.

You have to look back at the past decade. Many would suggest that it was the tax cuts in 1981 that contributed to the size of the deficit. The inference is that we have had to cut back on Federal spending. Now, the State government establishes a certain level of taxation, the revenues come in, and you can either choose to give it back as we did in our State, or you can also improve the social objectives of a given State.

Mr. KUDLOW. I can tell you the numbers on these State budgets show clearly that they have grown far beyond not only the rate of inflation, and far beyond the national average of all 50 States, but also they have grown well beyond any comparable redistribution of Federal funds.

In other words, you are talking about, in almost every case, 10, 12, or 13 percent annual growth in State budgets in the last 5 years. And I think it is very hard, even though I am not an expert on each State and I am not arguing the merits, the specifics for your State—I know more about New York and the others—it is very hard for me, in a macro sense, to suggest that mistakes have not been made here in the tax policies, of course, because of the strict budget balancing laws. Tax policies play right off the spending policies.

In terms of quality of life, that is a hard one to measure. We could probably have a whole long discussion about that. But certainly, one of the ways to measure quality of life is just basic economic indicators, income, job creation, per capita disposable income, and so forth.

My concern here is that the deteriorating Northeast performance, because of certain fiscal policy mistakes, is not going to be simply a function of the down part of the business cycle. It may go on.

Mrs. TEETERS. May I address your other question on the Federal budget?

Over the years, working in Washington, and now in the private sector, I have heard the forecast that if you go far enough out into the future the budget always balances and it never does. In the early years, we used to get fiscal surpluses; however, in the decade of the eighties you had a combination of very large tax decreases in the early part of the 1980's, and 4 years of increase in defense that averaged in nominal terms, 14 percent a year. Just arithmetic of that produces huge deficits.

In the last 4 years, a cap has been put on defense, basically with an adjustment for inflation and some real growth. If you cap defense at that particular level and if you don't lower the Social Security taxes so that the increasing Social Security surpluses are retained, we can get a balance in the Federal budget by about 1993 or 1994. It would also require that any new programs, such as catastrophic medical insurance, would have to be self-financed. That is apparently what the Senate Finance Committee has been doing.

I also pointed out earlier, we never got those budget surpluses, because they were spent for increased expenditures for another program or handed back as reduced taxes in some cases. A plan in which you bring the budget closer to balance is more realistic. To get a government sector which is balanced, State and local governments produce through their pension funds surpluses of about $65 billion a year. To get a balanced government sector, you need the Federal deficit below $65 billion. The Government sector in total would no longer be a net user of savings.

Mr. WYSS. Going back to the original question, which is, is it essential to maintain progress on Gramm-Rudman, I think the answer is, yes.

One of the reasons is that we have become very dependent on foreign capital markets, and to regain the confidence of those foreign investors I think we have to continue to show that we are getting our budgetary house in order.

I think that can only be done if the budget deficit continues to shrink. I think that if you cause a significant inflation in the budget deficit, you would see a significant outflow of Japanese money from this country, and a significant impact on bond yields and the value of the dollar.

I would like to point out to Larry Kudlow one thing. In the past 5 years, the average tax rate in New England has been dropping. From actually being well above the national average at the point that study was done, Massachusetts now ranks 37th in the percentage of State taxes taken out of income in the 50 States. I think it ranked 13th in 1985.

The fact of the matter is that politicians, when they see—and I hate to say this—revenue coming in, they have a tendency to spend it. They are always working on programs.

The money that came in was very much spent on projects which were not done, which did not contribute to the quality of life, but it was largely spent. Now, that money is not coming in any more, and making the adjustment is very difficult.

Representative SNOWE. Government cannot create enormous surpluses. There is no justification to having surpluses. Right? Either you lower the tax rates, or return the money to the people, or you spend it on projects.

Frankly, just looking at a recent national survey that indicated that people do not expect to have their tax rates lowered, they are not looking for that. They do not want to see their tax rates go any higher. They are willing to sacrifice, you know, their taxes for the greater good, to do certain things.

Recently, there was a poll in Maine. Ten years ago, people were not willing to give up their jobs to preserve the environment; today, they are willing to give up their jobs to preserve the environment. If it means a question between a job or doing something to enhance the environment, they would give it up. And I think that people are looking at the quality of life.

All of the things cannot be done at the Federal level. Just in cases of Medicaid, for example, those costs have gone up astronomically. Talking about the homeless, the uninsured—we could go on and on, an endless list of programs that the States are now having to absorb as a result of the Federal cutbacks.

Now, in addition to that, you are going to see obviously a restraint on defense expenditures. That has even yet to come certainly in our State, and certainly it varies in New England.

Mr. WYSS. It would be nice if the States could set up the funds that Connecticut has done, or you could store the surpluses. The problem is that you can hardly justify storing up enough of a surplus to make it through the bad years.

Representative SNOWE. With the State of New York, it is probably a couple of billion dollars, but it certainly wouldn't cover some of the losses of expenditures. It was unprecedented to have any years that you did not have growth over the previous year in the history of our State. So I think that is a very difficult circumstance.

Thank you.

Representative HAMILTON. Congressman Upton.

Representative UPTON. Thank you, Mr. Chairman.

I am now late for an 11:30 meeting. I do not intend to take long.

Mr. Kudlow, good to see you again, my former colleague. We spent a lot of time on capital gains this morning, and I do not intend to spend much more, but I do have a question in that area.

As you formulated your real growth rates, most political pundits, I would think, around the country, both Republicans and Democrats, would agree that capital gains are going to have to be tied to family savings. I think that the tea leaves show that it is going to happen.

I am surprised when you say, if it comes about, you are going to immediately revise your forecast upward. That is a little rosier than perhaps your colleagues at the table this morning. Are you really expecting to revise it if that happens? Aren't you sort of banking that that is going to happen?

We had the votes in the House last year, by a good margin, and a majority in the Senate. Only parliamentary procedure actually curtailed it.

Mr. KUDLOW. As I demonstrated over and over again, I am not very good at political forecasting. If I had had this conversation with you 2 weeks ago, I would probably—it would have had a higher probability for passage. I am still quite optimistic about it, but I sense that there is a new ingredient of uncertainty that has been thrust into the discussion, with respect to possible Social Security reform and related matters.

Representative UPTON. That was my next question.

Mr. KUDLOW. I do not want to coin any phrases about dropping handgrenades into the legislative process, but the fact remains. I said there is a little more uncertainty, but I hope you are right. I sincerely hope you are right.

As an economic forecaster, we start each year, we think of these things, what Federal changes will occur, in very qualitative terms. The capital gains tax, and depending on when the tax is implemented, grandfathering rate structure, permanent versus temporary, all of these factors and specific provisions—I would be inclined to raise my output really for the GNP by half a percentage point.

Representative UPTON. Let me go back to Representative Snowe's question on Gramm-Rudman. We have seen some gimmickry, certainly, in the past, offbudget, onbudget. Now there is a new one out there with the RTC. Perhaps Congress in legislation this year will allow them to purchase assets and sell them off, so it can be considered lower. This has already passed the deadline for fiscal year 1990-91.

One of the things the Moynihan proposal, which obviously would reduce revenues to the overall Treasury by some $50 billion, with no offset immediately, unless you take the Hollings proposal—how important is it to Wall Street and the private sector that Congress really tries to stick with the deficit target?

A CEO I know has pointed out a $138 billion deficit for next year. What caution flags would you raise? How do you all in New York and other places take Gramm-Rudman? With a grain of salt? Congress acting as usual? I am also interested in the Moynihan proposal.

Mrs. TEETERS. On the editorial page of the Washington Post this morning, Robert Samuelson, whom I view as an excellent commentator on economic development, gave what I think is the most clear explanation of what the social security problem is.

Representative UPTON. Herb Stein has another good one today.

Mrs. TEETERS. It is a tax and transfer program. The mythology that built up in the 1930's that it was an insurance program really was to get it passed 55 years ago. If you really look at the situation, the question is, what do you want the tax structure to be? The Social Security structure tax is the most regressive tax among the family of taxes that we have. In 1950, when it finally went on pay-as-you-go and also started paying the benefits—no benefits were paid basically between 1936 and 1950—the Social Security tax at that time was approximately 1.6 percent of GNP.

The individual income tax weighed in around 6 percent of GNP. The corporate taxes were about 4 percent of GNP, and the miscellaneous highway taxes and things of that sort were around 3.5 percent. It added up to close to about 15 percent of GNP in Federal taxes.

At the present time, Social Security is 7 percent of GNP. The individual income tax is 8½ percent. The miscellaneous is still about 1.5 percent. The corporate is only about 2.0 percent. So you had a major shift in where we have taken in our revenue. And we may want to do that, but we do not want to do it under this mythology that we have this insurance fund out there.

What you basically have is a transfer to the elderly from the working population. It is on the replacement ratios that the benefits will be counted: How much of the working wages are you going to replace? The surpluses in the Social Security funds strike me as being quite dangerous; not only because it is going to be misleading as to how the Government actually is financed, but also because the elderly are getting to be a larger proportion of our population. They can put a tremendous amount of political pressure on the Congress to raise their benefits. Then, when the "baby boom" hits us in 2020 and after, we will not have a comparable amount of resources to support them, since we will have a smaller working population.

I do not know how we even talk about the actuarial soundness of Social Security. In the 1988 report of the Social Security trustees, it is very interesting that there is almost a plea by the trustees to look at the system in a rational way and get away from the old actuarial assumptions which really do not apply to a public pension fund.

I think you have a crisis of a different sort coming along. The crisis of Social Security in the early 1980's was not because of population distribution. It was basically a situation in which the inflation went up faster than the wages, so the benefits went up faster than the revenues. Any such system will break down if the prices are rising faster than wages. But the solution enacted was based on the demographics of the baby boom coming up to retirement in the 2020's. I think it was a major mistake.

Representative UPTON. Mr. Wyss.

Mr. WYSS. I am a little concerned, because I think myths are important. I do not think there is much argument about the economics of the situation, but we really have a transfer program, because everything has to be financed out of current income in some ultimate sense.

Everything that is going to the elderly who are receiving Social Security comes out of the pockets, the goods available, of those who are not in the elderly population.

But the fact that there is an actuarial basis at least provides, No. 1, some reason for setting a specific tax rate; also, No. 2, I think some assurance that eventually the benefits will be paid. That is a political argument, that they have been paid for in the past.

I think this is really a political question, rather than an economic question. The economics concern the overall size of the budget deficit much more than they do whether the money is in the Social Security trust fund, or any other trust fund.

There is a longer term issue, though, which is that these benefits, when they come due for the baby boomers out in the 2010 and thereafter, are going to have to come out of current production. If there is not more investment being done now in order to increase the size of that future production, there is going to be a very serious problem once we hit that area with what it does to the aftertax available income of the working age population. And I think that is a bigger question, and that is why a lot of economists have wanted to use that surplus effectively, to add to the overall national savings rate.

That assumes that we can somehow get the rest of the deficit back to balance, however, and we are so far away from that I am not sure it is worth making that argument. That is adding to a depressing problem.

When Wall Street looks at the deficit, their worry is whether progress is being made. I do not think anybody on Wall Street expects the Federal Government to meet the Gramm-Rudman targets in fiscal 1991 or in fiscal 1990, for that matter. We know there is going to be slippage, we know there is going to be cheating, we know there is going to be smoke and mirrors.

What is important is that it be kept to an acceptable level of cheating. So far, I think it has been. But probably the key to that is to make sure that the deficit keeps going down; the speed at which it goes down is probably secondary.

Representative UPTON. Mr. Kudlow.

Mr. KUDLOW. I think, from a fiscal policy standpoint, maintaining the Gramm-Rudman targets is a very important priority. And I take the contrary view: that the Congress has actually done a pretty good job, even though it has been a very imperfect performance.

When you look at the overall spending trends, Federal spending trends, what you see is that since the inception of Gramm-Rudman-Hollings, which was passed in late 1985, the rate of growth of Federal spending has declined significantly. It is growing at just under 5 percent for the last 4 fiscal years.

In the first half of the decade, it ran 9, 10 percent, and was even higher in the late 1970's. So I basically feel that Congress has done a reasonably good job, and I think it has improved the Congress' credibility.

My own sense with respect to Gramm-Rudman's imperfections, is that it would be very useful to close some of these loopholes. In particular, the loophole that concerns me the most is the idea that if you make a forecast at the end of the fiscal year for the year ahead, then after the policy process is completed what is essentially a forecast becomes the Gramm-Rudman decision. That I think is where some mischief has been made and some mischief can be eliminated.

Most States we are talking about, most States have very tough intrayear reform processes. So that a forecasting process is not a nominating process, you have to look at it several times over the course of a year. That may not be so easy at the Federal level, but it is something that should be looked into.

As far as the accounting changes, you know, going from one unit to the other, I have heard about these things. I don't know if they can be stopped all the time, but I think the big loophole can be closed, and I think that would be an extremely useful thing to do.

And I think Gramm-Rudman on the whole has been an excellent disciplining influence, putting some rulemaking into the whole process—as imperfect as it is.

I also feel it might be useful, as a longer term project, to have a look at the large number of committees and subcommittees involved in the authorization and appropriation process.

Another colleague of ours, John Logan, has written extensively about this. John and I were down last year or the year before at the Ways and Means Committee retreat talking about this issue. It is awful hard to try to unify a centralized process, when the authorizations are so diverse. That would be another suggestion I would make to reform the process.

As far as the market impact of this goes, you know, I have looked at this so long. I do not think you make fiscal decisions just because of financial markets. I think you make it so that they reflect sound policy.

My basic view about this has always been a balanced budget is a good thing, it is a very good thing. I am not sure I can tell you in strict economic terms why it is a good thing; I just think it is a good thing.

I used to say this occasionally when I served in the Government in the early 1980's, and my pure ideological credentials suffered because I would say a balanced budget is a good thing.

Representative UPTON. You are still for the line-item veto, though, right?

Mr. KUDLOW. I am for some enhanced decision power, yes. I think it is important.

So I think it is a good thing. I don't know if I could give you a great economic answer as to why it is good.

In terms of the level of Federal spending, on that I feel I am on safer ground. I believe, if you can reduce or stabilize the GNP share of government spending, that that in effect is its tax limitation in action. In other words, whatever the Government spends, it absorbs from the private economy, either through taxing or borrowing.

And because of my own point of view, I think the more money left in the private hands, the more efficient and productive the economy is. Therefore, if we can find a way to limit or stabilize the Government's share of gross national product—and I think Gramm-Rudman does that—that is a very positive thing for economic growth.

We have seen progress on this on a national income and product account basis, from the Department of Commerce. The spending share of GNP peaked in the 1983–85 period at about almost 26 percent. For this country, that is very high. For other countries, that is not so high, but for the United States that was very high.

Through the end of 1989, the spending share, the budget share of gross national product has dropped to about 22½ percent of GNP. If we could keep it at that level or lower for ever more, I think that would be a very positive development that would promote economic activity, competitiveness, and so forth and so on.

So I would not hang on interest rates. We have never really proven conclusively that deficits have an effect on interest rates. People have tried, I have tried. Academic people have spent many years trying, numerous studies have been published.

Frankly, it is very inconclusive, even though my own bias is somewhere in this equation high deficits are not good for financial markets. That is my bias. Regrettably, I have never been able to prove it quantitatively. But I do not think you hang your hat on that. I do not think Members of Congress, members of the administration, should go to the public and say, "We must cut the deficit in order to get interest rates down." There are many other, better reasons to cut the deficit, to constrain Federal spending.

The odd part about this is that we know when the economic cycle turns down, whether it is soft or an actual recession, the fact remains that budget deficits rise and interest rates fall.

I hate to see people make the interest rate argument, only because some wise guy out there with a less constructive agenda will say, "See, it does not matter. Deficits do not matter. Why should we worry about this." So I think there are better reasons to serve and argue for deficit reduction.

I think Gramm-Rudman is something that should be institutionalized and codified in different form. I would like to see a Gramm-Rudman-like rule govern the budget process for the next 25 years.

Representative UPTON. Thank you

Representative HAMILTON. While you all have been at it for quite a while, I would like to get a few questions in here for a minute, if

I may. You have been testifying very articulately for a long while. So I will try to make my questions fairly brief.

I take it, all of you think that the risk of a recession is low in the 1990's. That is the impression I have.

Mrs. TEETERS. It depends. It is not in the formal forecast. I never make a forecast that has anything less than a 20-percent risk of recession in it, because so many things can go wrong. At the present time, we have the probability of a recession occurring in 1990 at about 35 percent.

Representative HAMILTON. And that is higher than it has been recently?

Mrs. TEETERS. Yes.

Representative HAMILTON. Mr. Wyss.

Mr. WYSS. I think we are slightly lower than that. But overall, I would agree. There is a significant danger of a recession, probably a very mild recession, in the first half of the year.

Representative HAMILTON. Mr. Kudlow.

Mr. KUDLOW. I basically agree.

Representative HAMILTON. You are not violently opposed to that, anyway. OK.

In the administration's long-term economic assumptions—I do not know if you have had a chance to see them—for 1990 they are talking about a real GNP growth of 2.6 percent, according to one newspaper report. Then, what they have is a 3-percent growth rate extended out—3.1 percent in 1991, 3.2 percent in 1992, 3.1 percent in 1993, and 3 percent in 1994.

At the same time, they have unemployment coming down modestly, they have inflation coming down steadily from 4.2 percent in 1990 to 3 percent in 1994. And they have declining interest rates; the interest rates on the 91-day Treasury bills going from 6.7 percent in 1990 to 4.4 percent in 1994.

So you have their long-term economic assumptions then of growth at about 3 percent over the next 5 years, with declining inflation and rather rapidly declining interest rates.

My question is, do you think that is a prudent, realistic path?

Mrs. TEETERS. It is standard. I mean, the real growth rate used to be 4 percent.

Representative HAMILTON. What do you mean, "standard"?

Mrs. TEETERS. It is just a standard forecast.

Representative HAMILTON. I did not ask whether it was standard. I asked whether it was prudent.

Mrs. TEETERS. It does not make much difference.

Representative HAMILTON. It makes a lot of difference.

Mrs. TEETERS. I do not think it does. Because they never turn to be exactly what they are forecast.

Representative HAMILTON. I understand that. But as economists, all of you highly professional, do those long-term economic assumptions make sense to you? Is that the kind of long-term assumptions you would make if you were putting down——

Mrs. TEETERS. They are almost identical. They have a slightly higher increase in output per man-hour. We are using 1.5 percent, they are using 1.8 percent. So we come out a little bit lower than they do. If you are going to do the long-term forecast——

Representative HAMILTON. What bothers me about it—and you all know a lot more about it than I do—is that you have a growth rate at 3 percent, declining inflation, and declining interest rates, all the way through this period. That is a 5-year period. Now, is that a prudent economic assumption?

Mrs. TEETERS. Remember that you are talking about the administration.

Representative HAMILTON. Right. I am using the administration figures.

Mrs. TEETERS. Basically, what they have in their real growth is approximately somewhere between 1.2 and 1.5 percent rate of growth in the labor force, which is what the demographics tell you. They have somewhere between 1.5 and 1.8 percent on productivity or output per man-hour.

Now, the next two assumptions are things that are just pure assumptions. It is to their interest to have declining interest rates, because it reduces the outlays for interest in the budget.

Representative HAMILTON. I have that much figured out. [Laughter.]

Mrs. TEETERS. And the declining inflation rate is also to their advantage, because it holds down Social Security expenses.

Representative HAMILTON. I have also that figured out. [Laughter.] All I am asking you is, you are a professional economist, are you comfortable with those kinds of assumptions?

Mrs. TEETERS. We have not made the assumption that there is going to be declining inflation in our long-term forecast and we have not made the assumption that there is going to be a major reduction in interest rates over that period of time.

Mr. WYSS. I think the projections that currently are leaked to the press are about as optimistic as one can get. And as far as I am concerned, it is off the range of likely outcomes.

We are looking for about 2¾ percent growth on trend over the next few years, assuming no major recession. Obviously, we could have one. We are likely to have one some time in the next 5 years. If you get growth anywhere above trend, inflation rates are going to be going up, not down. And if inflation rates are going up, interest rates are going to be going up with them.

Representative HAMILTON. Mr. Kudlow.

Mr. KUDLOW. I think the 1990 forecast is a bit optimistic. I think it is in the range of reasonableness, but I do feel it is a bit optimistic on real GNP. It is not going to be easy to get 2.6 percent, fourth quarter over fourth quarter, even though I would love to see it.

On the other hand, with respect to the long-range estimates, my answer is, yes, it is prudent. I think it is also internally consistent, and I do not think it is excessively optimistic. It may not happen, it may happen.

To me, if economic policies are steady, if Federal Reserve policy is steady, I believe that it will be possible to have even better economic growth. In other words, 3.1 percent over the next 5 years. I think you can get 3.5 percent over the next 5 years.

Representative HAMILTON. Let me ask another question.

I was interested, Mrs. Teeters, in the figures you gave with respect to percentage of revenues from various taxes. I think we have them roughly accurate here.

Social Security in the 1950's was 2 percent; now, it is 6 or 7 percent. Individual income was 6 to 8 percent; now it is 8 to 9 percent.

Mrs. TEETERS. Yes.

Representative HAMILTON. OK. The corporate rate is down: 4 to 6 percent in the 1950's; now, 2 percent.

The question is, is this direction we are moving in, increasing Social Security, a modest increase in individual rates overall, a decline in corporate rates—is that a desirable trend in the way we tax the American people?

Mrs. TEETERS. It is a completely political decision.

Representative HAMILTON. It is not economic?

Mrs. TEETERS. It is not an economic decision. You will have some effect on incentives, but you also have some offsets. I think the thing that is striking is that the total share of revenue of the Federal Government has not changed a great deal.

I mean, the ratio has changed about 1 percent over a period of 30 years.

[The following table was subsequently supplied for the record by Mrs. Teeters:]

FEDERAL RECEIPTS AND EXPENDITURES
as Percent of Fiscal Year GNP

	1945	1950	1960	1970	1980	1988
Total Receipts	21.3%	14.8%	18.3%	19.5%	19.4%	19.0%
Individual Income	8.6	5.9	8.0	9.1	9.1	8.4
Corporate Profits	7.5	3.9	4.2	3.3	2.4	2.0
Social Security	1.6	1.6	2.9	4.5	5.9	7.0
Excise/Other	3.6	3.4	3.2	2.6	1.9	1.6
Total Expenditures	43.6	16.0	18.2	19.8	22.1	22.3
Defense	39.1	5.1	9.5	8.3	5.0	6.1
Social Security	0.8	4.7	4.3	5.7	9.2	9.2
Interest	1.5	1.8	1.4	1.5	2.0	3.2
Other	2.2	4.4	3.0	4.3	5.9	3.8

Source: Historical Tables, Budget of the United States Government, Fiscal Year 1990 Table 2.3 pp 28-29; Table 6.2 pp 134-140.

Representative HAMILTON. That is right. The figures we have just pulled out here, 17 to 19 percent in the 1950's, an 19 to 20 percent in the 1980's.

Mrs. TEETERS. You then get into a question of incidence. Who actually pays the corporate tax? Who actually pays the payroll tax? One that does not seem to be able to be shifted very much is the individual income tax. There are all sorts of theoretical and academic discussion of who actually pays these taxes. I do not think that has been settled, frankly, as to who pays them.

Mr. KUDLOW. I think Social Security taxes are too high. That is my view.

Mrs. TEETERS. It is my view, too.

Representative HAMILTON. Why do you say that?

Mr. KUDLOW. I think it is a real penalty. It is becoming a real penalty for the work effort and for saving.

I think my home State Senator is on to something here. I may not agree with every part of his plan, but I think the thrust of his remarks are sound.

Representative HAMILTON. How would each of you, in a sentence or two, describe the core economic problem confronting the United States today? What is the heart of our economic problem?

Mrs. TEETERS. I honestly think we are doing fairly well. I think we are getting a lot of competition from abroad, which is making us more competitive and is making us keep our costs down.

Representative HAMILTON. So you think that competitiveness is the core problem for us?

Mrs. TEETERS. It is part of it. But we also have a fairly low rate of unemployment. We have a prospect over the next 10 years of low rates of growth in the labor force and an opportunity for job training. I think that we have the wherewithal now to educate our children and to change things so that we can get to work on the poverty problems.

Representative HAMILTON. I am trying to get you to tell me where you think the real economic problem is, if any, in the country. Maybe you do not feel there is one. There is the assumption in my question that there is a problem.

Mrs. TEETERS. I think the real problem is basically that we have not broken the cycle of poverty.

Representative HAMILTON. You are worried about that?

Mrs. TEETERS. I am very worried about that. And I think we have a continuing unemployment problem among minorities that has not been approached, that do not have an educational system that breaks into that particular problem.

Representative HAMILTON. How would you express that, Mr. Kudlow?

Mr. KUDLOW. I would say, inflation uncertainty remains my biggest concern in the 1990's. I think we need a clear sense of stabilizing the value of money and prices, and I really believe zero inflation is a crucial goal to the economic success of the 1990's.

If I had a second shot at it, I would probably agree with Nancy Teeters' point. I think breaking the cycle of poverty, and minority enterprise, minority opportunity and all that goes with it, is a really vital issue.

Mr. WYSS. I would say, first of all that I echo Nancy Teeters' point, that the economic expansion looks pretty good. Economic problems are probably less at this time than in the last 20 years.

At the same time, I have a slightly different focus. I think the biggest macroeconomic problem remains the large imbalances in this economy and our continued reliance on foreign capital—the large trade deficit, and, of course, related to that the large imbalance between saving and borrowing led by the Federal deficit.

On the microeconomic side, we have the same kind of imbalances. There is an increasing gap between the rich and the poor in this country. We are leaving a lot of people behind in this economic expansion, and that is going to cause us serious social trouble in the future, if we do not figure out how to solve it.

Representative HAMILTON. One of the things I noticed was not in your answers was productivity. I know you understand it is important. A lot of other testimony we have stresses that. The point I want to make is this.

In a hearing last year, some witnesses made a very direct connection between inadequate investment in infrastructure and education, as contributing to the less than satisfactory performance on productivity. How do you react to that?

Mrs. TEETERS. Let me say first, I am not sure productivity is measured right. I think we may have an economic data problem that is overwhelming.

Representative HAMILTON. Is it better, or worse, than we think?

Mrs. TEETERS. I think it is probably better.

Representative HAMILTON. The crisis, or the statistics?

Mrs. TEETERS. First of all, in terms of measuring productivity, there is an assumption in the Government statistics that services have low or no productivity—you have seen the many articles that there is low productivity in computers; I look at what my secretary does today compared to what she did 25 years ago, and she may be getting a comparable wage, and that wage is the same as it was 25 years ago, she is doing entirely different things.

And I think that we have basically underestimated the impact of the computers. Obviously, I am prejudiced here, but I think we are not picking it up.

You also have a demographic problem. As the "baby boomers" came in, we had a very rapidly growing labor force, and you got a lot of kids working at McDonald's. We do not have many kids working at McDonald's now and they are going to automate McDonald's.

If you have a rapidly growing labor force, you do not put in as much capital as you do when you have a slowly growing labor force. So in the next 10 years, with a very slow growing labor force again, you are going to see a lot of capital investment. I think you are going to see rising productivity, even as they measure it now.

Representative HAMILTON. So you are really saying, we do not have that much of a productivity problem.

Mrs. TEETERS. We do not know whether we have a productivity problem, because nobody has been able to explain why it changed, when there is good reason to think that it is measured wrong.

Representative HAMILTON. Is it something that Members of Congress ought to be concerned about?

Mrs. TEETERS. I think you ought to give some money——

Representative HAMILTON. I am not talking about measurement, now. Is it something we need to be concerned about, to get the Nation's productivity up?

Mrs. TEETERS. I think you need to be concerned about it, but I do not know how big a problem it is.

Mr. WYSS. One thing that is interesting is that, if you look at manufacturing, where we feel that we have a good idea of how to measure productivity, you cannot see any slowdown in the productivity trends.

Representative HAMILTON. That is pretty good; isn't it?

Mr. WYSS. It is pretty good, and it is about the same that it has been since World War II. There is no slowdown in the manufacturing sector.

Mrs. TEETERS. I think that is because they are attributing to manufacturing productivity that should be going elsewhere.

Representative HAMILTON. Do you worry about inadequate investment in infrastructure?

Mr. WYSS. Yes.

Mrs. TEETERS. Yes.

Representative HAMILTON. There is an area where all of you agree.

Mr. WYSS. When bridges fall down on highways that I drive on, I worry a lot about it. [Laughter.]

Representative HAMILTON. Your comment, Mr. Wyss, interested me, on inflation. I think I quote it right: "In spite of the brave talk of zero inflation, the Fed seems willing to accept a stable inflation rate if the alternative is a downturn in the economy. If the Fed were serious about a zero inflation rate, it would be tightening."

Have we come now to accept a 4-percent inflation as perfectly OK? Some of us can remember back when President Nixon put wage and price controls on. What was the inflation rate then?

Mr. WYSS. 4.1 percent.

Representative HAMILTON. Today, we congratulate ourselves for 4.3 percent, or whatever it is.

Mr. WYSS. I think that is very true. This economy got adjusted to a much higher inflation rate. It is going to take a while for us to get unadjusted to the idea that 4 percent is good. Four percent looks very good compared with the 10 percent that we were looking at 5 and 10 years ago.

Because of that, I think the Federal Reserve feels—and I think rightly so—that there is not political consensus in this country to put the economy through a wringer to reduce the inflation rate further.

Mr. KUDLOW. My first priority when you asked that question initially was fighting inflation. So I want to return to that.

I do not believe that economic growth causes inflation, by the way. Let me make that point very clear. I think there is a great opportunity for this committee, which down through the years has had leadership on so many of these big, macro-type issues, to go through a thorough overhaul of monetary policy, domestic and international.

By that, I mean not just the conduct of Federal Reserve policy, but how do we reach zero inflation, which should be our national goal? What are we going to do about wildly fluctuating currency exchange rates, which I think are extremely destabilizing to every single country in the world? And most importantly, how we can get interest rates much lower in the 1990's? Because after all, from an economic impact standpoint, nothing is more important than getting interest rates down.

A 4-percent mortgage rate is going to solve a lot of housing problems. A 4½- to 5-percent corporate bond rate is going to solve a lot of investment problems. A 4-percent tax exempt bond rate is going to make infrastructure financing and building a lot easier in the 1990's and the next century.

But all of these issues in my judgment revolve around the monetary nexus.

Representative HAMILTON. You do not make much of a connection between the deficit and interest rates? In other words, you want to get interest rates down; the deficit is not a big factor there?

Mr. KUDLOW. No. In my visceral computer, I make a connection; I always have. But in my quantitative professional work I have tried. I think if you had to weigh the two, Mr. Chairman, monetary and the deficit, for the impact on interest rates, my own view is that by far the larger influence on interest rates comes from the monetary side.

Representative HAMILTON. The White House called on the Federal Reserve to lower interest rates, Mr. Fitzwater's statement. Do you agree with that? How did you react? Or, do you just want to give the reaction when you saw it?

Mrs. TEETERS. Remember that the power to control the money and the value thereof was given to Congress by the Constitution, and the Federal Reserve——

Representative HAMILTON. Most people say it is a good thing we do not. [Laughter.]

Mrs. TEETERS. The Federal Reserve operates under powers delegated to them by the Congress.

During the period of time Mr. Regan was the Secretary of the Treasury, every 2 weeks we had a different view from the administration. I do not think the administration's jawboning the Federal Reserve accomplishes anything, frankly.

Mr. WYSS. I think my reaction was, business as usual. I have never heard the administration, any administration, call for higher interest rates. I think right now the Federal Reserve has done a very good job in controlling monetary policy over the last few years, and I think they deserve a chance to continue to do that.

Representative HAMILTON. Mr. Kudlow.

Mr. KUDLOW. This will dovetail to your point.

Representative HAMILTON. I read it, and I say, "Why do they? What is the purpose?"

Mr. KUDLOW. I think Presidents and Treasury Secretaries and Members of Congress have a right to talk about monetary policy. I do not think it is a holy preserve.

Having said that, I think President Bush is wrong on that. I do not regard his remark only as a political desire for lower rates, I think he is in fact trying to nudge the Fed toward a more aggressive easing policy. And a very important development in the financial markets is that in the last 3 or 4 weeks since the Fed eased the last time, as measured by reduction in the Federal funds rate from 8½ to 8¼ percent, the bond market has fallen apart.

Private market rates, private open market rates from 5 years and out on the yield curve have risen significantly, particularly in the 10- to 30-year area, which is so crucial for home investment and company investment.

You have had a 60 basis point rise from 7.8 percent of a 30-year Treasury bond to, as of this morning when the market leveled off another half-point, 8.4 percent. That is occurring at a time when the economy is generally weak, which means it is unusual that interest rates would go up in a weak economy.

So I think that the White House is dead wrong on this. I think if the Fed pushes down artificially on the Fed funds rate and pumps too much money into the economy, inflation expectations will rise and the policy will backfire, and interest rates will go up, instead of down.

Mrs. TEETERS. Let me add one more thing to what Larry Kudlow is talking about. There now really is an international capital market and it is very fluid. I think the demand for capital is above the supply of capital on a worldwide basis, particularly as Eastern Europe and the developing countries are added. I do not think you are going to get the rates back down to the level that he is talking about. I also think that the conduct of monetary policy is no longer something that is a domestic policy. I think it is intertwined now with the international monetary operations. International monetary policy is increasingly established by the G–7. We cannot carry out an independent monetary policy in this country unless it is agreed to by the major trading partners around the world.

Mr. KUDLOW. That is a very important point. Because, while I agree with the globalness with this analysis, the dollar is still the principal transaction currency, it is still the world's reserve currency, both in the commercial sector as well as among central banks. That means, whatever our Federal Reserve does has a disproportionate significance on the foreign monetary inflation situation.

I am prepared to argue that the reason bond rates have gone up globally in the last 4 weeks is the concern of the world, of the one world market that Nancy Teeters described that the Fed is creating too many dollars. That in turn is going to reinflate world inflation. The White House is pushing the Fed to reinflate far beyond any responsible policy action.

And all this boils down to my plea to the committee that you have the mandate and the ability to undergo a thorough international monetary review. Because I think these things, for whatever reason, are not being looked at in total, and they really are important.

Representative HAMILTON. Let me ask you this, just to pursue that point a moment. If you have, for example, tight money policies in Japan and Europe, and they cause recessions in those areas, would that cause a recession in the United States?

Mrs. TEETERS. We have tried to look at this. It is very difficult. It was not until 1973 that you began to have worldwide recessions. Before 1973, Japan and Europe were basically having growth cycles, as they recovered from World War II. But 1973–74, the period of the first oil shock, and 1979 and 1980, the second oil shock have both been times in which the recession has gone worldwide. Based just on two episodes, it looks as if it either starts or occurs simultaneously in Japan and the United States, and then spreads to Europe. In 1986 the slowdown that we experienced was not a recession. We had a growth cycle in 1986. That too seemed to start simultaneously in the United States and Japan, and then spread to Europe.

The thing that I think hooks it together—it is almost overwhelmingly important—seems to be the transmission of interest rate changes. At the present time, my judgment of what is going on is that the G–7 made an agreement whereby the rates have been raised in Germany and Japan and have been decreased in the United States in order to bring about a decrease in the international value of the dollar.

Chairman Greenspan complained about this in the Moscow speech. The dollar has depreciated against the European currencies. It has not budged against the yen. You may get another movement in interest rates—a sort of twisting of interest rates in order to manipulate the international currency values.

Mr. KUDLOW. I think right now in the current monetary situation, monetary coordination between the Federal Reserve and Treasury is at a low ebb. I think this is a very serious problem. It impacts and comes together with respect to exchange rate problems.

I think the Treasury Department is conducting an exchange rate policy for G–7 which is not in accord with the desires and the views and consensus of the Federal Reserve. I think the differences are significant differences, with domestic and international conferences.

And Nancy Teeters hit it right on the head. The Chairman of the Federal Reserve has diplomatically tried to raise this, little calls for help, and the Treasury Department has turned a deaf ear in their international division. I think that is most regrettable.

I worry more about the Fed versus the Treasury right now than I do about the White House.

Mr. WYSS. I think there is a connecting matter here, though, and that is that you can no longer run a domestic monetary policy, and you certainly cannot run a domestic monetary policy separate from your exchange rate policy. And that old division of responsibility between the Treasury and the Fed, where the Treasury runs exchange rate policy and the Fed runs domestic monetary policy, has to come to an end.

Mr. KUDLOW. They are like two ships passing in the night right now. And I can tell you, as not only a student of it but as someone who watches it, and as someone who has good contacts in both agencies, it is like two ships passing in the night.

I think it is ultimately the American consumers who are going to suffer the consequences.

Representative HAMILTON. I am runing out of time, and I am sure you are, too. I have just one final question.

Mrs. Teeters, you commented on U.S. economic statistics. I do not know, Mr. Kudlow and Mr. Wyss, if you did. What is your impression of the quality of our economic statistics?

Mr. KUDLOW. I agree with Nancy Teeters.

Representative HAMILTON. You agree with her point of view?

Mr. WYSS. It scares me right now. One thing that scares me is to look at the employment statistics. Those are the ones that we used to trust the most. This year they have been averaging revisions of over 50,000 a month.

Representative HAMILTON. We have had an excellent hearing. Thank you very much for your participation. It is a pleasure to have you with the committee.

We stand adjourned.

[Whereupon, at 12:35 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1990 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, JANUARY 30, 1990

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

The committee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Obey, Scheuer, Wylie, Snowe, and Upton; and Senator Sarbanes.

Also present: Joseph J. Minarik, executive director; David R. Malpass, minority staff director; and William Buechner, Jim Klumpner, and Susan Lepper, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

This morning the Joint Economic Committee continues its hearings on the economy and economic policy for 1990 and fiscal year 1991.

We are very pleased to welcome as our witness the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve.

Yesterday President Bush submitted his proposed budget for fiscal year 1991. The projected deficit of $63.1 billion is based on the assumption that the economy will grow 2.6 percent between the fourth quarter of 1989 and the fourth quarter of 1990, that both short- and long-term interest rates will decline by a percentage point or more between 1989 and 1990, that inflation will decline and corporate profits will rise by 19 percent.

The weak fourth quarter growth of the economy and recent rise in long-term interest rates both here and abroad cast some shadows on that forecast.

Chairman Greenspan is here this morning to present his thoughts on the economic outlook and the appropriate monetary and fiscal policies for 1990.

The committee will now turn to Chairman Greenspan for his testimony, unless either of my colleagues care to make a comment.

Congressman Wylie.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Mr. Chairman, I have just a brief opening statement. I would like to welcome the Chairman here this morning and look forward to his testimony.

I can recall the sense of confidence expressed by financial markets when you were named as Chairman of the Federal Reserve, and my perception is that sense of confidence has grown steadily ever since, and we are glad to have you at the helm. The Federal Reserve is widely viewed as one of the most important parts of the U.S. Government, and its policies are probably the most critical variables in economic policy. As such it deserves substantial credit for the length of the U.S. expasnion in my judgment.

I will be interested in hearing your views on the state of the economy and the role that you see monetary policy playing. I thankfully haven't seen the direct political response of voters of unfavorable pocketbook issues like recessions, and I am concerned that the very high real interest rates of the last year and a half and the wide fluctuations in money supply growth rates are causing very real problems.

We extend a warm welcome, Mr. Greenspan, and thank you, Mr. Chairman, for the opportunity to make this opening statement.

Representative HAMILTON. Thank you, Congressman Wylie.

Before you begin, Mr. Greenspan, Congressman Upton has requested that his opening statement be placed in the hearing. If there are no objections, it is so ordered.

[The written opening statement follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE UPTON

Thank you, Mr. Chairman, and welcome to you, Mr. Greenspan. I am pleased that you could be here with us today, for several reasons.

First, your visit comes at a timely moment -- corresponding with the first presidential budget proposed by George Bush. As everyone here knows, in recent years a key debate in our budget process -- on both the spending and taxing side -- has been over the accuracy of the economic projections for the coming year. One result is that the forecast for GNP growth -- a dry little figure that used to be crunched by some elf with green eyeshade -- now is the subject of vigorous political debate. And because of the Federal Reserve Board's role in economic trends, the Fed Chairman often is caught in the crossfire -- as you well know.

Last week we had several witnesses here who said they expected slow economic growth in the coming year, but not a recession -- or, as on of your predecessors, Fred Kahn, used to call it a "banana." We haven't had a banana in quite a while, and I guess we all worry about the whether there's one just over the horizon. If there is, you, of course, will be under pressure to ease up on your fight against inflation and start feeding the economy. Even though this is an election year, I am sure that politics will have nothing to do with the pressure that will be put on you.

I believe the long stretch of economic growth we have been enjoying has come about partly because of your resolve. I hope you're able to continue along this course if the waters do get rougher.

I will be interested in hearing your views on the state of the economy, and also the role that you see monetary policy playing.

I extend a warm welcome to you, and I look forward to hearing your views.

Representative HAMILTON. Mr. Greenspan, you may begin.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. I am pleased as always to appear before this distinguished committee. As you know, the Federal Reserve will be submitting its semiannual Humphrey-Hawkins report to the Congress in just a few weeks. At that time, I'll be in a position to address more meaningfully the tactics and strategy of monetary policy. Under the circumstances, I thought it might be useful for me to focus my initial remarks this morning on the current state of the economy.

Concerns that our long economic expansion may be nearing an end may have been intensified last week by the release of initial estimates showing that real GNP rose by only one-half percent at an annual rate in the fourth quarter of 1989. To be sure, activity in that period was affected by a number of special transitory influences—the California earthquake, Hurricane Hugo, extraordinarily cold weather, and the long strike at Boeing. But even allowing for those factors, business activity in recent months clearly has been less vigorous than it was earlier.

The locus of the recent softness is in what we can broadly characterize as "durable" goods. Most notably, weakness has emerged in the auto industry, and this has spread to related supplier industries, including metals, textiles, and machine tools. In addition, a number of categories of capital goods and consumer hard goods, as well as construction of both residential and nonresidential buildings have softened in recent months.

In evaluating trends in such long-lived physical assets, one must remember that household and business users' ownership of them does not appear anywhere in the gross national income and product accounts; nevertheless, by providing flows of services, these balance sheet items are an important determinant of the level of production. A fundamental characteristic of such durable items is that demand for them is shaped in part by the size of outstanding stocks relative to current household and producer needs. Viewed in this light, the current economic slowdown represents, at least to an extent, a pause in the accumulation of physical assets, a form of "inventory correction," so that levels of ownership do not get too far ahead of the long-term desired levels.

Because of their importance in understanding the current economic situation, it is worth examining some of these stock adjustment relationships in detail. Let me start with motor vehicles, where manufacturers have made sizable production cutbacks recently. It appears that auto assemblies in January may fall short of a 4½ million unit annual rate, will below the 7 million unit rate over 1989 as a whole. The proximate cause of the recent production cutback was soft demand and rising dealer inventories last fall. The soft demand reflects a payback from the elevated sales pace of the third quarter during which the use of price incentives was especially heavy on the 1989 model-year cars. Moreover, demand for 1990 model-year cars has been restrained by increases in sticker prices, which in many cases exceeded 5 percent. However, with the introduction of new incentive programs, sales picked up in late December and early January. This has reduced dealer inventories to more acceptable levels, and automakers reportedly plan to step up production somewhat in the coming weeks.

Looking beneath these short-run variations in sales, production, and dealer inventories, however, current and prospective developments in the auto market reflect in part longer range demand factors. Among the underlying forces are the existing number of motor vehicles owned per household and the average age of the auto and truck stocks. In order to see the role of these factors more clearly, it is useful to go back to the beginning of the last decade. Between 1979 and 1983, the number of vehicles per household—which had been on a strong uptrend throughout the postwar period—fell nearly 3 percent. A decline of 3 percent may not sound very large until you consider that it represented a shortfall on the order of 10 million cars and trucks between the actual stock of motor vehicles and the underlying trend stock. This decline in the per household ownership of motor vehicles was likely a result of consumer reaction to the relative increase in gasoline prices and the downturn in economic activity that occurred during that period. Also, during the late 1970's and early 1980's consumers slowed the pace at which they scrapped their existing cars and light trucks. The combination of lower scrappage and the lower sales of new vehicles pushed the average age of both the auto and truck stocks up by approximately 1 year to over 7 years.

The combination of an enormous pent-up demand—reflecting the gap between actual and presumptive desired levels of ownership—as well as increased replacement needs associated with an aging auto stock, provided the stimulus for the extraordinarily strong pace of auto sales posted from 1983 through much of the remainder of the decade. The number of vehicles per household has risen substantially, rising well above the earlier peak, and, as scrappage rates have returned to prior levels, the average ages of the auto and truck stocks have leveled out. This rebuilding of the motor vehicle stock and stabilization in its average age suggests that the number of autos sitting in America's driveways is adequate to meet much of the desired demand for transportation equipment, and lowered sales are at this point are likely to reflect primarily replacement needs and growth in the driving-age population.

In contrast to motor vehicles, the current slowdown in construction of new homes and commercial buildings seems to reflect a situation where earlier activity was so robust that the actual stocks of residential and nonresidential structures exceed desired levels—at least in some locales. Moreover, in the housing market longer run demographic factors also are having an effect on the underlying stock demand—especially the rate of household formation. This rate has been slowing and will slow further as more and more of the low birth rate cohort of the 1960's and 1970's matures into adulthood. What this means, of course, is that we need to lower our sights about what constitutes "normal" levels of homebuilding activity during the 1990's compared with the 1980's.

How the broad decade averages of demand get distributed from year to year depends in large part on financial conditions. Interest rates on home mortgages have been around 10 percent since mid-

1989, and so, from the homebuyer's perspective, financial considerations have not varied to a great extent. In recent months, however, segments of the construction industry have reported difficulty in obtaining credit in the wake of newly imposed restrictions on lending by thrift institutions. Some added caution in acquisition, development, and construction lending was called for, given the riskiness of this activity, but the difficulties now being experienced by builders should diminish considerably over time as these businesses secure other financing sources for their creditworthy projects.

Despite the reduced pace of housing construction, there continues to be an overhang of new single-family homes and condominiums for sale in a few regions of the country, and rental vacancy rates in the multifamily market remain high. But, it is important to note that much of the market overhang is concentrated in the northeast and shows few signs of leading to a national real estate market contraction. The reason is that the spread of local problems generally is limited by the geographical segmentation of real estate markets. Because neither residential property nor occupants are perfectly mobile, the market will not necessarily arbitrage away price differences observed in different local markets. Hence, softness in housing prices in some areas is unlikely to prove highly contagious in the short run. Indeed, in most areas, and on average nationally, real estate values have continued to increase.

In the case of nonresidential structures, there also is an indication of stock overhang, with vacancy rates for office space in metropolitan areas at near record levels. Moreover, lending institutions—stung by a long series of questionable investments—are more carefully scrutinizing loan applications than in the past so that highly risky projects are not getting funded as readily. Reflecting these developments, building permits have turned down and new construction spending has been stagnant over the past year in all major sectors except industrial building.

Business demands for new equipment also reflect, to a large degree, stock-adjustment motives. Recently available data for the fourth quarter show that a sizable deceleration in business equipment spending is underway, reflecting the general slowdown in economic activity and expected sales. Real spending on producers' durable equipment fell more than 4 percent at an annual rate in the fourth quarter. Part of the decline resulted from the work stoppage at Boeing; but even allowing for that special factor, real equipment outlays still declined somewhat.

Looking forward, recent data are offering mixed signals about future capital spending. For example, orders for nondefense capital goods received in November and December show a bounceback from the decline that had occurred in the third quarter. Other indicators of capital spending, however, give the impression of softness ahead. For example, recent declines in real cash-flow of nonfinancial corporations do not bode well for investment spending in the near term. In the 1980's, growth in cash-flow—measured as the sum of undistributed aftertax profits and depreciation allowances—tended to move with growth in real gross business fixed investment. Thus the recent cash-flow experience—which has signaled a deterioration in the availability of internal funds—is one factor likely to be a restraining influence on capital spending in 1990. Moreover, this signal is being reinforced by surveys of plant and equipment expenditures taken this past fall that indicate real capital spending will grow less this year than last, the deceleration being most noticeable among nondurable manufacturing and nonmanufacturing firms.

Until now, I have been sketching the negative side of the economic landscape. Let me now suggest where we can look for more favorable signs. First, demand for long-lived assets is still growing in some areas, creating opportunities for strong production growth. This is most clearly evident in the case of civilian aircraft for which the level of the orders backlog has doubled over the past 2 years. Second, in contrast to some past cycles, we have not seen the type of speculative buildups of materials and finished goods by businesses that can exacerbate the effects of any weakening in sales trends. I believe one reason for this is that thus far we have avoided a cyclical upswing in inflation, so that the buy-in-advance motive has been less of an influence. Third, foreign demand for many of our manufactured products is strong. Real export growth of manufactured goods, although down somewhat from the torrid pace of 1988, remains sizable. Strength runs across a wide variety of consumer and capital goods as well as industrial supplies.

Fourth, there is evidence from labor markets that the spillover effects from durable manufacturing have been limited. Although manufacturing employment has fallen nearly 195,000 jobs since last March, total private nonfarm payrolls have continued to rise, with the increase totaling about 1½ million over that period. The contribution from the health services area to the overall increase has been especially noteworthy. Employment in medical care, which made up about 7 percent of total payroll employment early last year, has increased nearly 400,000 since then. Other sizable employment contributions have come from business services and State and local governments.

Favorable signs about the economy's economic health are also revealed by comparing recent movements in an index of leading economic indicators with its pattern of movements just before and during previous recessions. Recently, statistical procedures have been developed that allow such a comparison to be translated into the likelihood of a recession. These procedures have been applied by Board staff to the Commerce Department's index of leading economic indicators, which comprise several real and financial market variables. The resulting measure suggests that the probability of a recession developing in the next 6 months increased last spring to almost 30 percent, but according to the most recent estimates has declined to about 20 percent.

A second probability-of-recession measure is based on a leading index recently compiled by economists at the National Bureau of Economic Research, which relies less heavily on data from the manufacturing sector than does the Commerce Department index and does not include stock prices. The probability of a recession in the next 6 months based on the NBER index also has declined since last spring and according to the December reading stands at about 10 percent. Both probabilities are much smaller than those occurring at the beginning of each of the four recessions since the late 1960's. For example, the probability exceeded 50 percent shortly before each of the previous recessions using the NBER index.

I wouldn't want to bet the ranch on such statistical measures. I think we must continue to monitor developments closely and stay alert to the possibility that, perhaps reinforced by some adverse shock not now visible, the weakness in the several sectors I've discussed might cumulate and lead to a more widespread downturn in activity. But such imbalances and dislocations as we see in the economy today probably do not suggest anything more than a temporary hesitation in the continuing expansion of the economy.

Thank you very much, Mr. Chairman.

Representative HAMILTON. Thank you very much, Mr. Greenspan.

We will proceed in the committee under the 10-minute rule.

Let me direct a question first to the area that you concluded your statement with, and that is the possibility of a recession. We had several distinguished economists here last week to testify about the outlook for the economy, and one of them estimated the chance of a recession at 35 percent. I noted the figures used in your statement from various statistical studies, which you said you would not bet the ranch on.

Mr. GREENSPAN. Or most anything else. [Laughter.]

Representative HAMILTON. How do you describe for us the risk of a recession this year?

Mr. GREENSPAN. First, let me say that the probability numbers that are being used are very weak, and by that I mean they are very general orders of magnitude, and say the difference between 10 and 25 percent or even 30 percent, in my judgment, is not significant.

I do think that what the measures suggest is that the probability is less than 50 percent, and if we look back at the period, say, from the early spring through the summer of 1989, it's clear at that point that the probability of a recession, whatever it was, was rising. As we moved into the fall you began to get the types of conditions which usually signal the cumulative downturn that we so typically have seen in our economy.

We have not seen that process accelerating. We are observing an economy which is continuing to soften, but not in a way which is cumulatively progressive. And to the extent that that process can be stretched out, we will effectively eliminate the types of inflationary imbalances which existed say in a good part of 1988 and the early months of 1989 and, hence, can resume balanced economic growth.

Representative HAMILTON. Are you less or more optimistic about avoiding a recession in January 1990 than you were a few months ago?

Mr. GREENSPAN. I would say that the probability of a recession now is less. I do not think it is negligible, nor do I think that one can just readily dismiss those probabilities as irrelevant. We are still at risk, and as a consequence I think we must continue to monitor, as indeed we do at the Federal Reserve, on a day-by-day basis all of the various elements in the economic process which could lead to a recession.

Representative HAMILTON. Let me turn to another problem, and that is inflation. In 1989 we had a 4.6 percent rate of inflation. What is your comment with respect to that performance and its impact on the economy and how you see inflation in 1990?

Mr. GREENSPAN. An inflation rate, as I've said many times in the recent past, Mr. Chairman, at 4½ percent is unacceptable. It's unacceptable because it is very difficult in that type of environment to prevent it from accelerating. And should the inflation rate begin to accelerate in any measurable form from where we are today then I think we create the types of imbalances which indeed then do create the type of recession which we've had in the past.

So in a sense inflation at this stage represents the greatest threat of recession that we have because it will bring with it the types of imbalances which turn the economy down.

At the moment I would say that the underlying cost structure is not accelerating, but it also is not decelerating either.

Representative HAMILTON. Is a gradual acceleration in wages occurring and is that having an impact on the inflation rate?

Mr. GREENSPAN. I don't think so. I think the latest data that we saw, the so-called employment cost index, which is the broadest measure that we have of the wage structure, actually showed a mild decrease in the rate of wages and salaries, but for statistical purposes, seasonally adjusted, and for all practical purposes, it has been flat.

What concerns me is that we have been experiencing in this context of a relatively stable rate of inflation a decline in profit margins, which is another way of saying that there has been a gradual increase in underlying unit costs.

Now, I wouldn't describe them as in any way an issue of concern. The data on costs and prices generally are reasonably stable, but they are all at a rate of increase which I and my colleagues find unacceptably high.

Representative HAMILTON. We've had a rise in long-term interest rates since December, and in testimony before this committee in recent weeks two explanations for it have been given.

One is that it is a reaction to the Fed's loosening of money policy, the decline in the Federal funds rate, which investors fear will increase inflation. That's one explanation.

The other explanation is based on the international markets. They see the rise in long-term interest rates, especially in Japan, as having an impact, and that has made the United States relatively less attractive to Japanese and other investors.

Do you find either of these explanations compelling?

Mr. GREENSPAN. It's very difficult to know precisely why in world markets the participants do what they do. I think we can say that a perception in the American economy of a declining probability of recession has probably increased and the number of those who had been expecting a significant decline in rates and who had accumulated holdings in long-term U.S. Treasury bonds as a speculative investment for that prospect, have pulled back as the probability of that occurring has fallen.

As a consequence of at least some expectation that we may be coming out of this very soft period, there may be a modest increase in inflationary expectations which is embodying itself in long-term U.S. Treasury rates.

I think similar issues are arising in Europe and in Japan, and that has clearly moved rates higher, especially in Japan, and obviously, since we are dealing in an international market, there is considerable arbitrage which is going on between the various different markets. If one looks at the exchange rate structure, it's clear that the expected inflation rates or changes in inflation rates are not changing significantly but that there is a general probability at this stage of a moderate increase in inflation expectations worldwide.

It's very difficult to ascertain exactly what various motives are or their relative importance is, but I think that is probably the most general expectation.

Representative HAMILTON. You don't have a concern at this point in time that foreign investors, particularly the Japanese who are buying up a large number of our securities, will stop coming into our markets?

Mr. GREENSPAN. Well, I should certainly think that, if we make our markets unattractive, they will do so. And having an inflationary environment, which clearly will make the long-term purchasing power of Treasury instruments less, could essentially deter them.

Representative HAMILTON. Is that happening now?

Mr. GREENSPAN. It's difficult to say. I think that the concerns of the Japanese investors are probably not distinguishable from the concerns of American investors, but I do think that there is probably some element of shift by Japanese investors, as far as their general attitudes are concerned, to their domestic securities as their long-term rates have risen rather sharply relative to ours. But I would not overly stress that point. There is more to this process I think than simply a modest shift of that dimension.

Representative HAMILTON. Congress Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

Those last answers caused me to move into another area. I was with the Reserve City Bankers yesterday, and they are concerned about foreign investors and what they will do and whether the foreigners who have money invested in the U.S. economy will act differently from U.S. investors.

Now you answered it in part, but are their views different when they look at the investments in the United States? Would a Japanese investor or a West German investor look at it differently?

Mr. GREENSPAN. Do you mean look at our investments differently from looking at their own domestic ones?

Representative WYLIE. Yes.

Mr. GREENSPAN. I don't think so. I think that they basically look for the highest long-term real rate of return, and so long as our markets are open and so long as the ability for them to invest long term and then withdraw their funds, which, of course, is the basis of our laws, they should make no distinction between domestic investment and investment in the United States. I surely hope we do not put impediments in the way of that free flow of capital because, as I testified recently before the Ways and Means Committee, there is an accelerating globalization of finance that is going on. Not only is trade growing relative to domestic production and therefore goods are flowing across national boundaries at an accelerating pace, but it is also true, of necessity, of finance. And if we endeavor to block that type of flow, I think that we undercut the growth and living standards in the United States, and it surely does not serve our purposes.

Representative WYLIE. I think that was their concern, as to whether our markets would remain open, and I think you've used the key word there, rather than whether we get into protectionist activity or protectionist measures.

You and the Treasury Department are actively intervening in foreign exchange markets. According to your December report on foreign exchange operations, you spent $5.9 billion to buy yen and German marks last fall. What is the objective of such active intervention in the markets?

Mr. GREENSPAN. The basic purpose is to try to avoid undue fluctuations in the exchange rates. Because of the increased globalization, it's becoming increasingly evident that stability of exchange rates is an important goal for the major trading countries of the world. While keeping domestic inflation under control is by far the most important way that we all can keep exchange rates stable, nonetheless we do employ at the margin techniques which we believe will smooth out some of the fluctuations and enhance stability, and the actions by the Treasury and the Federal Reserve in that regard were directed toward that purpose.

Representative WYLIE. Is that intended to stabilize interest rates, and the reason I ask that question is how does the recent rise in foreign interest rates affect our own monetary policy, and is that part of the reason for the intervention?

Mr. GREENSPAN. No. The intervention was solely related to our perception that there were elements within the market that intervention could move against effectively.

Representative WYLIE. I think as you ended your statement here, and I wasn't quite clear at the beginning, but you said you wouldn't bet the ranch on statistical measures as to where we're coming out, but I believed I detected a note of optimism as to how you feel about economic activity and strength in the months ahead.

Mr. GREENSPAN. Well, I don't like to appear either pessimistic or optimistic, but it is certainly the case that if one were to sketch the typical pattern of American business cycle expansion and contraction, the timeframe for when there would be significant acceleration of factors causing recession should have begun was several months back, a number of months back.

However, we don't have a fixed pattern. It varies and anyone who has been in the forecasting business as long as I have and been chastened more times than I would like to mention, Congressman Wylie, doesn't take that fact in and of itself for more than a modest element of optimism.

Representative WYLIE. Well, you noted that consumer confidence was down in recent months, and I wonder if that in part is due to the fact that economic activity in the last 3 months of 1989 was somewhat depressed, and I think it was partly because, and you can correct me if I'm wrong, of strikes at Boeing and the telephone companies, Hurricane Hugo on the East Coast, the earthquake in California, and the severe winter during the month of December.

Is your optimism in part based on the fact that January has been very mild so far and that there does seem to be a more favorable atmosphere vis-a-vis catastrophic happenings?

Mr. GREENSPAN. No, not actually, Congressman Wylie. I think that, in fact, while it is certainly true that January has been somewhat milder, it's more an issue of the fact that automobile sales, after being down and looking as though they had been really going to hold at exceptionally low levels, have at least come back a bit, and that's not a particularly bad sign considering their role in this most recent period.

I must say I was somewhat heartened—perhaps that is too strong a word—but looking at some of the underlying materials orders patterns, they have held up somewhat better than one would have expected, and I think what that is suggestive of is the usual inventory backup that occurs in the durable good materials areas has not been evident this time, at least not to the degree that it was in previous periods.

Representative WYLIE. Thank you very much, Mr. Chairman.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Welcome back to us, Mr. Greenspan. Your testimony is always stimulating and thoughtful.

Mr. GREENSPAN. Thank you.

Representative SCHEUER. Just glancing through your testimony one gets the feeling that recession may not be around the corner, but you get a sort of an "oochie" feeling that all is not well, and that this isn't the typical American gutsy, muscular economy—just putting together bits and pieces of your language. You talk about recent softness in the durable goods market, soft demand and rising dealer inventories for cars, demand for 1990 models has been restrained by increases in sticker prices, slowdown in construction of new homes and commercial buildings and reduced pace of housing construction, sizable deceleration in business equipment spending, capital spending gives the impression of softness ahead, real capital spending will grow less this year than last, manufacturing employment down nearly 195,000 jobs. You speak of real export growth of manufactured goods, and that's an encouraging note.

But I can't help seeing an economy that is lax, that is not surging, that is not the typical economy that has provided an increase in living standards, an increase in wages, and an increase in gross national product.

From the point of view of decisionmakers in the Congress, we look at this sort of weak, lackadaisical performance of the economy, and I can't help wondering what should the Congress do that we aren't doing now to stimulate things. Is it that we need to be more competitive, raise educational levels, raise savings levels so there is more capital investment to increase our productivity?

What do you see as the underlying causes for this sort of lackadaisical, weak-kneed, rather pusillanimous, faint-hearted level of energy in our economy? What should we be doing that we aren't doing and what should we stop doing that we are doing to give this whole economy a shot in the arm?

Mr. GREENSPAN. Well, first of all, let's remember that the economy has gone through an extraordinary expansion. We have had 7 years of reasonably strong growth with rising productivity and rising standards of living.

What we are observing now is a process of adjustment, and if we manage to get through this period without a recession, which is the typical process that we in the United States have had to rebalance the system, we shall have done it by what we used to call rolling readjustments—that is, the fact that individual industries or individual areas would go through a recession but not accumulate into a widespread slowdown.

But I think you're raising a much broader question about the future, and I think I would pick up on the particular point you raise with respect to saving. What is wrong with our economy, if one can say there is something fundamentally wrong, is that we do not save enough. And while there are other elements that cause productivity to rise and standards of living to rise, there is no question that saving and investment, and specifically it is the investment that creates a substantial part of the growth in productivity and, hence, in living standards.

Our domestic saving has been inadequate to really create capital investment to move us forward, and we are fortunate in that respect that foreigners are putting their saving in our economy in record amounts because they see this is a potentially expanding economy and an economy with potentially appreciable real rates of return in it.

Representative SCHEUER. Well, excuse me for interrupting, but doesn't it give you some concern that we're borrowing $150 or $160 billion a year more than we are earning?

Mr. GREENSPAN. It certainly does, Congressman Scheuer.

Representative SCHEUER. And the Japanese and the West Germans are lending $150 or $160 billion a year less than they are earning. I mean this is sort of a narcotic drug, isn't it?

Mr. GREENSPAN. I don't want to necessarily subscribe to your choice of words, but I do agree. Look, there is no question that, to the extent that we have a current account deficit, which means that we in fact are taking in foreign saving, it means that we are consuming more than we are producing in goods and services as a nation.

Representative SCHEUER. And now, Mr. Greenspan, we read that the interest rate differential between what the Japanese pay their own savers and what we pay our savers is now 2 percent or less. Might that not mean, if we want to hold onto that flow of savings into our country from Japan and other countries, that we are going to have to increase interest rates since we don't seem to be able to generate enough domestic savings to fuel a muscular, burgeoning, expanding economy.

Mr. GREENSPAN. No, that doesn't necessarily follow, but I think what does follow without question is that we have to increase our domestic saving either by increasing private saving, which has not been adequate, or where government policy clearly is most appropriate in this respect, bring down the Federal Government deficit, because the Federal Government deficit is negative domestic saving—very substantial negative domestic saving.

If we could bring down the Federal budget deficit, and in fact hopefully eliminate it and go to a surplus, that means that the need that we would have for importing savings to finance our domestic investment would accordingly decline and much of the problem that you see, quite correctly with respect to our overconsuming, would be eliminated.

Representative SCHEUER. Let's talk about the budget deficit and let's talk about this morning's papers. I don't want to drag you into a discussion on the peace deal, although I would love to. But take, for example, the difference between Mr. McNamara's expectation and hope that our defense budget could go down on the order of magnitude of about 5 percent in real dollars over the next 10 years—so that we would have a 50-percent reduction in defense expenditures—and the administration, Mr. Cheney, who is sort of hovering around 2 percent or a little bit less. Obviously, there would be a tremendous peace dividend if we could get away from the big ticket items, the big hardware items that we still seem to plan on continuing in the face of a Russian empire that seems to be unraveling before our eyes, and the military threat of a major aggressive action by the Soviet Union seems to be disappearing into the morning mist.

Can you tell us what the differential effects on our economy would be if we could achieve the McNamara 5 percent in real dollar reduction of the budget over 10 years as against this projected reduction of less than half of that?

Mr. GREENSPAN. Well, Congressman Scheuer, I certainly don't want to get into a debate on appropriate military structure.

Representative SCHEUER. And I'm not asking you to.

Mr. GREENSPAN. But I think it is important to recognize that the differences between Messrs. Cheney and McNamara probably is the forecast that they are making of the evolution of the events that we are all seeing occurring in front of us. There are lots of different scenarios that can occur, and as a consequence of that, different paths for a defense budget.

But clearly we all would be hopeful that the need for a defense budget falls very dramatically because that proportion of GNP that goes for armaments around the world in all countries is a net reduction in living standards, and that applies to us as well as to anybody else. So I don't think it's a question of would it be desirable if we could do it. The basic real fundamental question is that extraordinarily crucial judgment about what is the state of risk in the world and how it will materialize in the next number of years.

Representative SCHEUER. Thank you, Mr. Chairman.

Representative HAMILTON. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

Thank you, Mr. Greenspan for being here this morning.

Would this quarter's figures when they are released in April determine whether or not we've turned the corner on a recession?

Mr. GREENSPAN. I don't think so. I think we probably will need data into the spring to be reasonably secure in that respect because the process that we're going through is almost glacial, and that's probably good and not bad. And if it continues, I don't think we will get a clear fix until we are well into the spring months.

Representative SNOWE. So it could be a better part of this year before we actually have an understanding of where this economy is going?

Mr. GREENSPAN. We never really know where it's going. [Laughter.]

Representative SNOWE. That I know. We certainly do here.

Mr. GREENSPAN. In retrospect it was always self-evident, but it never is.

Representative SNOWE. Well, coming from the Northeast where we obviously have some serious economic problems, especially in New England at this point with revenue shortfalls and probably unprecedented in many respects, and much of it is due to real estate, as you mentioned in your testimony, but it also is due to other major purchases like automobiles. For example, in the State of Maine 35 percent of our sales tax comes from revenues from the sale of automobiles and housing.

Well, how does that reflect on the national economy as a whole when you see the Big Three, Ford, General Motors, and Chrysler, who may have a drop in profits of 60 percent. How does that reflect overall for the national economy if avoiding a recession really is dependent on a strong consumer spending?

Mr. GREENSPAN. Well, I think that avoiding a recession is dependent on more than consumer spending. It's related to exports, and also the elimination of the negative factors. Once you start to eliminate things that are going down and just make them neutral, that is a net plus to the system.

Remember that at the moment the level of economic activity is high. The unemployment rate is really quite modest and in certain analysts' minds below the "natural rate." So we are not at this stage in an economy which can be described as weak.

That other side of that coin is that you cannot therefore be expecting a rebound in the economy as a whole that is the typical rebound we see coming out of a recession. It is certainly the case that what we are going through is very slow growth and that the pickup that will occur at some point is going to have the characteristic of seeming that the economy is really improving significantly, but we are not looking at, you know, 4, 5, or 6 percent annual growth rates, which are the types of numbers that we often would see, coming out of a recession.

Representative SNOWE. Well, do you look at regional economies? For example, a recent Wall Street Journal article indicated there may be as many as 34 States that are facing problems with their revenues. Do you look at the regions in determining monetary policy, or do you think it's just unique to that particular region?

Mr. GREENSPAN. No. Unfortunately, our monetary policy can only be national because we are dealing with a national interest rate, a national currency and basically national prices. Nonetheless, in crafting our policies, we are exceptionally aware of local conditions because you can really only understand the economy as a whole as a sum of its parts. Because of the very nature of the Federal Reserve—the fact that we have these regional banks which each have their own research departments—we absorb as a system an extraordinary amount of regional information, which I think is exceptionally useful, in fact indispensable to the policy actions that the Federal Open Market Committee is required to take.

Representative SNOWE. Would you say that New England is in a recession?

Mr. GREENSPAN. I don't want to characterize any individual area as being in a recession or not in a recession, but clearly New England is in a much weaker state than it was, and it has come down from a very strong, in fact almost hyper, state of economic activity to something which is very significantly less.

Representative SNOWE. Well, I've just noticed in my own State, for example, that people are retrenching in terms of their spending. I mean they just lack the confidence. Even though they have a job and the unemployment rate hasn't increased significantly to indicate that there is something seriously wrong in that area, people are, nevertheless, hesitant about spending because of the decline in the value of real estate and whatever else has happened that they are just not spending, and I just wonder if that is a precursor on a nationwide basis.

Mr. GREENSPAN. I wouldn't say so. In fact, if you're looking at the full detail of what is going on in this country at all times, you can even in the periods of extraordinary economic buoyancy find a significant number of pockets which are doing poorly—either industries or regions. There will always be in a market economy as diverse as ours fairly substantial numbers of pockets which are doing far less well than the average over the country as a whole.

Representative SNOWE. What impact do you think the capital gains tax would have on our economy at this point? Would it serve as an appropriate stimulus?

Mr. GREENSPAN. Well, I've always been in favor of a much lower capital gains tax rate because I think that, at the margin, it encourages capital investment, and my only concern, as I have stated before committees of the Congress over the past couple of years, is that I reluctantly, to the extent that I was involved in any discussions with colleagues, acquiesced in eliminating the capital gains differential as part of the significant decline in marginal tax rates in the 1986 tax reform. And while I would have preferred a lower capital gains tax rate, I thought that bringing down marginal income tax rates was very important to the economy and I still believe that is the case.

If the cost of getting a reduction in the capital gains tax rate is to raise that marginal rate, I would be doubtful as to the merit. But if you're asking me would it be helpful to the economy if only the capital gains tax rate was reduced, the answer is unequivocally yes.

Representative SNOWE. Thank you.

Thank you, Mr. Chairman.

Representative HAMILTON. Congressman Obey.

Representative OBEY. Thank you, Mr. Chairman.

Mr. Greenspan, you have a very tough job. Sometimes you have to exercise the use of the tools available to you within a very narrow range given other conflicting pressures in both the world economy and our own, and you get a lot of advice in doing that. You get advice from Members of Congress, you got advice from some members of the Cabinet recently, and indeed even the press secretary for the White House has given you some advice.

I'm wondering if you would like to return the favor. You do have, depending upon what our fiscal policy is and depending upon what other actions are occurring in the economy worldwide, you do sometimes have an extraordinarily limited road that you can walk.

As you know, the administration this year estimates growth at about 2.6 percent in their new budget, and CBO estimates about 1.7 percent. As I understand it, the difference in the estimates between CBO and OMB over a 2-year period result in a difference of about $19 billion on the revenue side for fiscal 1991.

What assumptions do you think would be the most prudent for the Congress and the President to agree upon if we were to be following a fiscal policy that would give you as much room as posible to maneuver over the next year or two in helping to manage an economy in a very delicate situation?

Mr. GREENSPAN. Well, Congressman Obey, I think there is no question that the lower the Federal budget deficit, the better it is for the American economy overall, essentially for the reasons which I discussed with Congressman Scheuer; namely, the question of savings and investment.

The problem that you have when you go through this annual evaluation is that implicit in the President's budget is an economic forecast which of necessity requires that the President and his advisers assume that what is requested is accepted by the Congress.

I think, as Mr. Boskin mentioned yesterday in discussing the economic proposals of the administration, implicit in their forecast is the enactment by the Congress of all of the proposals that are in the President's budget.

The CBO evaluation, on the other hand, essentially makes a projection for current services and does not embody a policy implementation in its forecast, and one can very readily agree that if the budget deficit is brought down appreciably in line with what is in the President's budget, then the forecasts that they are making are not by any means unreasonable. I wouldn't consider that they were particularly inappropriate for the conditional outlook which presupposes full passage of all proposals in the budget.

Representative OBEY. So in Congress' fashioning of the budget for the coming year you would be comfortable if we assume a revenue level for 1991 which is $19 billion above CBO's estimate?

Mr. GREENSPAN. First of all, I think that it's important for the Congress to evaluate in detail all of the various elements, as I'm certain you will. I don't want to stick a specific number because I'm not sure that I would agree with all of the elements even with the presumption of the budget change implicit.

But what I do think is crucially important is that, if we are to meet the Gramm-Rudman targets, then it is appropriate to make a presumption with respect to the outlook that does endeavor to encompass that feature in it. If you do not, the irony of it is that you probably will achieve more with a deficit cut then the requirement to go to the $64 billion in fiscal 1991.

Representative OBEY. Well, my concern is this. If we assume the administration's revenue number and therefore assume that it will be necessary to make fewer reductions on the spending side than would be required if we assumed a lower revenue number, then in fact at the end of the year we would wind up with a deficit higher than that that would meet the Gramm-Rudman target.

Mr. GREENSPAN. Well, maybe. If you're asking me would I prefer more rather than less, the answer is yes.

Representative OBEY. We've been talking percentages in terms of a recession, and 10 percent, 20 percent, 30 percent has been used by different people. If we adopted the growth assumptions of the administration and therefore the revenue assumptions, what percentage chance do you think we would have of then actually hitting the required deficit reduction target for the following year?

Mr. GREENSPAN. Do you mean fiscal 1991?

Representative OBEY. Yes.

Mr. GREENSPAN. Well, first of all, I'm not sure that I necessarily agree that if you accept their growth assumptions you would therefore accept their revenue assumptions because, remember, when you estimate revenues from growth, you still have to make judgments about the level of corporate profits and the level of personal incomes that are consistent with that, and even though the Tax Reform Act of 1986 has brought the marginal tax rates for businesses and individuals closer and there are a lot of other elements involved in the estimate of corporate profits tax liabilities which are not directly affected by real GNP growth rate which can affect revenues. So I don't want to necessarily say that you lock that closely in.

But in a general way I would be inclined to say that if we really made the types of cuts which brought the level of outlays in line with the President's budget, I think you would come out perhaps not all that far from Gramm-Rudman targets.

Representative OBEY. I'll write it down and talk to you about it next year and see where we have come out.

One other question. Does the chairman of this committee look like a bomb-throwing institutional radical to you? [Laughter.]

Mr. GREENSPAN. Are you saying that he is but doesn't look it? [Laughter.]

Representative OBEY. No, I'm asking how you feel about that? Here is what I'm getting at. As you know, Representative Hamilton has introduced an interesting bill.

Mr. GREENSPAN. It has come to our attention. [Laughter.]

Representative OBEY. It requires the Federal Open Market Committee to meet with the Council of Economic Advisers, the Secretary of the Treasury, and OMB several times in addition to the more formally scheduled meetings to try to establish better policy coordination communications between the Fed and the administration. It would also require you to publish your budget in the Federal budget.

Why is that not a reasonable proposition, and why would that not lead to at least some degree of improved trust on the part of the American public in institutions about which they have sometimes little understanding and about which there is a great deal of mystification?

Mr. GREENSPAN. This can be addressed to the two issues that you raise with respect to the chairman's bill. On the issue of coordination, there is a very significant degree of coordination that goes on between the administration and the Federal Reserve. We meet, I would say, fairly often. I meet with the Secretary of the Treasury at least once and more often twice a week to discuss all of the various sorts of issues and monetary policy is one of them. I discuss it at considerable length with the Chairman of the Council of Economic Advisers and the Director of the Office of Management and Budget, and there is no lack of communication in the sense that the views, ideas, and disagreements get fully discussed.

The issue which we are concerned about basically is that the formalizing of specific meetings at specific times, and most importantly immediately before an FOMC meeting, could become a vehicle by which undue pressures could be exerted. I don't think frankly it is a very major issue, but if you asked me how I would come out on the issue one way or the other, I think that we're doing fine the way it is. The communications issues which the chairman rightfully thinks are important are being appropriately addressed. If they were not, then I would have to rethink my position and perhaps would come out much closer to his position on that.

On the publication of what it is that we do, we, as you know, do have an annual publication in which we publish in considerable detail what the Federal Reserve Board spends, what we receive, what we do, and we do it for the individual banks as well.

Because such a significant part of the revenue of the Federal Reserve banks and of the System as a whole is on services which we provide to the private sector and are required to price at competitive rates so as not to unduly undercut the private competition for many of the check clearing services, for example, which we are involved in, we keep a set of books which are different from the way books are kept in the Government.

Now, obviously, we can translate everything we do into fiscal year budgeting in precise terms as to the format which appears in the budget. That, however, would be quite expensive.

Representative OBEY. The bill doesn't exactly require you to do that, does it?

Mr. GREENSPAN. No, but I think the issue is essentially the question of making projections. The major issue is the projections of our expenses. We can do it for a short period, but extended projections of what it is we do we find very difficult to do accurately, and the main area of receipts, which is the receipts of the Treasury, namely, our dividend payments to the Treasury, which is all of our moneys other than are required for internal use, essentially depends on a forecast of interest rates. We don't make that forecast. The Treasury makes its projection of what the Federal Reserve payments will be to the Treasury.

We had hoped that the fairly significant detail that we publish, which is greater than most agencies, fully fulfills the chairman's appropriate notion that we should be out in the open as much as possible on what it is we expend money on.

Representative OBEY. I remain unconvinced, but I thank you for your comments.

I know my time is up, Mr. Chairman.

Representative HAMILTON. I think we probably want to get Mr. Greenspan to answer that question of whether or not I'm a bomb-throwing radical. [Laughter.]

Mr. GREENSPAN. If you insist, Mr. Chairman. I will acknowlege that you show no signs of same. [Laughter.]

Representative HAMILTON. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Greenspan, I was interested in your response to Congressman Obey where you said you meet fairly often with administrative representatives and that there is no lack of communication, and then you mentioned Secretary Brady and the CEA Chairman and the OMB Director.

Does the White House press secretary appear in those meetings?

Mr. GREENSPAN. He does not.

Senator SARBANES. Well, what is your response to an article of 10 days ago that I'm looking at, in which Marlin Fitzwater in effect called on the Fed and said that lower interest rates are justified? I'm interested in this process, and also interested in the substance of this.

Mr. GREENSPAN. First of all, with the exception of, and I'm trying to recall whether or not meetings of this group, the so-called quadriad with the President, had Mr. Fitzwater there. I don't think so. But he is briefed on what it is that goes on in such meetings. I don't think I can appropriately respond to your question other than answer to the fact that of my knowledge he was not there.

Senator SARBANES. How often do you meet with the President?

Mr. GREENSPAN. Reasonably often. I speak to him on the phone on occasion, and I see him from time to time. I don't recall a case in which I requested an appointment in which I was turned down.

Senator SARBANES. Now what about the substance of Mr. Fitzwater's statement here, that lower interest rates are justified? Does the Fed agree or disagree with it?

Mr. GREENSPAN. I would say we allow our record to speak for itself at this stage.

Senator SARBANES. Are you then supportive of what Mr. Fitzwater said?

Mr. GREENSPAN. I wouldn't interpret it in that manner.

Senator SARBANES. What do you think of this method of communication?

Mr. GREENSPAN. I think it's inappropriate.

Senator SARBANES. Inappropriate?

Mr. GREENSPAN. Yes, I do.

Senator SARBANES. What do you think brought it about?

Mr. GREENSPAN. I cannot answer that. I don't frankly think it's an important issue. As I said I believe it was to the House Banking Committee the other day, I did not consider that the President was in fact bashing us at that time. I did not think it then and I do not think it now.

Senator SARBANES. Because you didn't think that Mr. Fitzwater was communicating the President's view and therefore it was Mr. Fitzwater that was bashing you, or because you don't regard this as bashing?

Mr. GREENSPAN. In all honesty, I know Marlin Fitzwater fairly well, and he is not a basher by inclination. I don't consider this particular choice of words that way I would phrase it. The President subsequently said that he preferred lower interest rates.

Now, as I indicated to the House Banking Committee, I think we all would prefer lower real interest rates, meaning in effect interest rates adjusted for inflation expectations, which were as low as we could make them because clearly to the extent that we succeed in that direction, economic growth will be at a maximum.

I did not consider, for example, that the President's speech in Atlanta, which I think was a day or so later, stated anything which I found inappropriate.

Senator SARBANES. This article says, and I continue to quote from it, "The comments were a clear break with past administration policy. While White House officials have privately urged the Fed to ease, they have avoided public criticism of the Central Bank." Do you see it as such a break?

Mr. GREENSPAN. No. I think that there have been public comments here and there which I don't frankly consider to be terribly important. I would say if you look at the overall relationship that the Federal Reserve has had with this administration, I would say it has been excellent.

Senator SARBANES. I understand that, but do you regard this as a worsening of the relationship?

Mr. GREENSPAN. I do not, Senator.

Senator SARBANES. Why is it inappropriate, then, for Mr. Fitzwater to make these comments?

Mr. GREENSPAN. I think basically because any comments with respect to specific judgments as to where interest rates should go are best done in private. I think that the choice of words that Marlin Fitzwater used probably was looser than I think they should have been. But I do not consider that that is an important issue, very honestly, and I just tell you I was not particularly concerned about it. If I were to have run into Mr. Fitzwater shortly thereafter, I'm not even sure I would have mentioned it.

Senator SARBANES. You've made no mention of it to him?

Mr. GREENSPAN. I have not, and I frankly don't think it's necessary.

Senator SARBANES. Until today.

Mr. GREENSPAN. Until today. But I mean a lot of people in this town say things which I disagree with.

Senator SARBANES. I want to reestablish this communication between you and Mr. Fitzwater. [Laughter.] Let me ask you about Congressman Hamilton's bill, about a provision that Congressman Obey did not touch on. There is a provision in that bill that would allow the President to set up the term of the Chairman of the Federal Reserve Board in such a way that a President would appoint a Chairman a year after taking office.

I understand you oppose that provision, and I'm interested why, particularly since both Bill Martin and Paul Volcker in the past have supported it.

Mr. GREENSPAN. I think that is correct, and it is a very marginal call. The issue really rests whether you want to create a problem which would be that the Chairman would be appointed for a short period of time, which would occur if there was an automatic appointment a year after the President took office, or whether you want to lock in the 3 years, as the chairman says, in which the

Chairman of the Federal Reserve Board is not subject to concern about reappointment by the President.

My impression basically is that both McChesney Martin and Paul Volcker agreed with Lee Hamilton on that issue. Arthur Burns did not, and I must say I just sort of marginally come out where Arthur Burns did.

But having said that, let me just say very honestly if one has to come up yes or no on a specific issue, and I think the weight of evidence as I see it is no, but I will tell you that clearly it's not an issue which I think is frankly all that important. I think there are pluses and minuses on both sides of that question.

Senator SARBANES. Is the Federal Reserve playing any role with respect to the Eastern European countries in giving them advice or counsel on a establishing a modern banking system or credit market?

Mr. GREENSPAN. We stand ready to do that and, as you know, Senator, I spent some time in the Soviet Union discussing such issues with them.

Senator SARBANES. With the Soviet Union?

Mr. GREENSPAN. The Soviet Union.

Senator SARBANES. What about Eastern Europe?

Mr. GREENSPAN. I have been informed that we are working through the IMF on technical banking assistance to the Eastern European countries.

Senator SARBANES. Which ones of the Eastern European countries?

Mr. GREENSPAN. Poland now, but we do stand ready to be of assistance and will be should the issue surface as we expect it will.

Senator SARBANES. There is often talk about a package deal for tighter fiscal policy and a looser monetary policy. Is that even realistic to think about?

Mr. GREENSPAN. I don't think it's necessary, and I'll say this for this reason, that if there is a budget compromise which significantly brings down the deficit, not only for fiscal 1991, but in a manner in which the markets would perceive permanent shifts in the trends of spending and revenues, the first thing that would happen is that long-term interest rates would fall, I think fairly quickly, and that would pull on short-term rates, and we in the Federal Reserve when confronted with those market forces would make appropriate adjustments in the Federal funds rate to follow those markets. Essentially it would be a market adjustment process.

The implication of a deal is that the markets might not respond appropriately, and therefore the Federal Reserve should in a sense force the markets. But the only condition which I could conceive in which the markets would not respond is if they thought that the budget agreement was a phony, that in effect there really was more paper juggling and gimmickry than real deficit reduction.

Obviously, were that the case, it would be inappropriate for the markets to bring rates down, and it would be inappropriate for the Federal Reserve policy to respond to that. So it's not a real problem.

We have been arguing and discussing this issue at great length for I think a number of years, and I am as convinced as ever that if we make a major cut in the budget deficit I think we would be surprised at how prompt the markets would react to that cut.

Senator SARBANES. What is your view of the use of the surplus in the Social Security trust fund to mask the dimensions of the budget deficit?

Mr. GREENSPAN. Well, I think that Senator Moynihan raises the correct issue, namely, it is fairly apparent, as a number of us have discussed numerous times in the past, that the purpose of building up the surplus was essentially to effectively get a mirror effect in the physical volume of investment and the production of goods and services so that the resources would be available to meet the physical consuming requirements of the retirees, the so-called baby boom, as they come due in 2020 and thereafter.

To the extent that the Federal Government builds up a surplus in the Social Security accounts which are not then used to finance other parts of the deficit, that means that the Federal Government is adding to domestic saving, adding presumably to domestic investment and creating an increase in the productivity and real per capita output which will eventually provide the wherewithal for those who are retiring in large numbers in say 30 years or more.

The problem that I have with the Moynihan proposal, unfortunately, is that merely cutting the Social Security tax and going to a pay-as-you-go basis doesn't answer how pay-as-you-go is going to function because we are either going to have to very significantly increase taxes at the time when the benefits are forthcoming, and that raises some very serious policy questions about the stability of our economy and the size of the type of tax increase that would be required, or basically scale down benefits, or find other means of financing.

And all I would suggest, Senator, is that before we move in that direction, we think of the package which resolves all of these other issues because, if nothing else other than cutting the Social Security tax occurs, the situation which Senator Moynihan I think very correctly evaluates is made worse and not better.

Senator SARBANES. Mr. Chairman, my time has expired.

Representative HAMILTON. Mr. Greenspan, let me go back to Senator Sarbanes' questions with respect to Marlin Fitzwater's statement.

It's inconceivable to me that Mr. Fitzwater would make that statement without the direct direction of the President of the United States. Would you agree with that?

Mr. GREENSPAN. Not necessarily.

Representative HAMILTON. Do you think a press secretary would get up and call upon the Fed to lower interest rates without the approval of his boss?

Mr. GREENSPAN. I'm not sure I would interpret the phrase exactly in that respect. You're asking me to certify events which I was not privy to, and I just don't think that's something I can do.

Representative HAMILTON. All right, that's fair enough. You have informal contacts you said, and that's the way you coordinate your policy. During those informal contacts have any of the President's economic spokesmen or the President ever said to you we want interest rates lowered?

Mr. GREENSPAN. Yes.

Representative HAMILTON. So Mr. Fitzwater then was saying to you what you had previously understood to be the President's desire?

Mr. GREENSPAN. Well, I'm not saying that they are saying that now or at that time, but in the past the answer is yes.

Representative HAMILTON. I don't want to beat that horse any more. I just want to make clear the circumstances under which it occurred. Let me go to another topic.

Senator SARBANES. Mr. Chairman, could I simply say that this report doesn't reach to the President, but it does say that the official said Mr. Fitzwater's comments grew out of a discussion among senior White House staff. So it apparently was not simply a Marlin Fitzwater solo flight into this area, but represented a concerted judgment in the White House.

Mr. GREENSPAN. Let me say this in response to your question. You phrased it in terms of the President and his advisers, and I said yes. I should separate the President and his advisers. I'm answering to his advisers. The President and I have had different conversations that bordered on this, but we don't get into the detail that I would have with the advisers.

Representative HAMILTON. All right. Let me go to another topic. If I understood your position with respect to the President's assumptions in the budget, you said that those assumptions, the economic assumptions in the budget are all right. To get the deficit reduction that the President favors and projects—the problem with that, it seems to me, is that the President gets that reduction in his budget only because he uses very optimistic economic assumptions.

Now if our goal is really to get the deficit down, wouldn't it be better if we did not have such optimistic economic assumptions which tend to mislead us with respect to the difficulty of getting that deficit down?

Mr. GREENSPAN. Well, Mr. Chairman, I think you could look at it in two different ways. I mean you can say that the $64 billion should be a lower figure, or you can say that we should bring it down at least to $64 billion.

I would put it this way. There is no question that the deficit is basically sensitive to economic assumptions, and various different assumptions will give you various different outlooks. If there is any concern that the degree of budget deficit reduction will be inadequate, then there is nothing to prevent the Congress from setting a number in its reconciliation to less than $64 billion.

Representative HAMILTON. There is a lot to prevent us from doing that.

Mr. GREENSPAN. There is a lot to prevent you, but if the economic assumptions are something you think, and I think quite appropriately, have margins of error, then I would suggest that one takes the margin of error into consideration when deciding what the budget is.

Representative HAMILTON. I don't blame the President any more than I blame the Congress. I think both of us adopt economic assumptions that are misleading and make it more difficult for us to get the deficit down. It seems to me the prudent way to proceed is to adopt economic assumptions that are not on the optimistic side.

Now I understand that the President's economic assumptions are defensible. They are not off the wall types of assumptions. But to the extent that either the President or the Congress adopt optimistic economic assumptions on the high side, then you deceive yourself to some extent into thinking that the job of cutting spending is not going to be as difficult. And if you adopted say the Blue Chip forecasts or something that is more broadly accepted, then you would see that the magnitude of the problem of getting down to a balanced budget, or something approaching that, is greater. That's the only point.

Mr. GREENSPAN. Well, Mr. Chairman, in fairness to the administration, however, I do think that if you gave to that group of Blue Chip economic forecasters a firm commitment to take as a given that the budget deficit would be brought down and the programs would be put in place to very significantly lower the budget deficit, I think you would find that the average of their forecasts would come up much closer to where the administration is currently in its forecast.

Representative HAMILTON. I understand that. I have a couple more questions and I know Congressman Wylie has a question.

You're generally considered to be a consumer of economic statistics, and you know we've had in this committee an interest in the quality of government statistics. I would just like to get your general sense, as you and your colleagues use economic statistics, are we having a decline in the quality of economic data? And I might acknowledge here that the President is calling for an increase in his budget, which I commend him for, for statistical agencies.

Mr. GREENSPAN. Relative to the changes that are occurring in the economy, the answer is yes. By that I mean we still have very good data in the manufacturing area and we have extraordinarily adequate data in vast parts of our economy. To be sure, there are certain types of surveys which we at the Federal Reserve who publish the Industrial Production Index are chagrined to learn may be eliminated, but overall American statistics are really extraordinarily good.

The problem, however, is that the nature of our economy is changing increasingly in a manner which the old statistical structure doesn't capture. In other words, for example, a very significant increase in the unit of production in this country is computer software, and to try and define a unit of computer software is exceptionally difficult, and in areas such as that we need major improvement and a major increase in resources.

I am hesitant, however, to talk about increased Federal resources because I think that one really has to get to the point where major problems exist before I think it is relevant, and especially in the context of our budget problems.

Representative HAMILTON. Are there gaps in statistical data that affect the ability of the Federal Reserve to analyze the performance of the economy?

Mr. GREENSPAN. Some, but I think we have filled them in an ad hoc basis probably reasonably adequately. I do think it would be most helpful if we had in certain areas better quality data to make judgments.

For example, there has been a huge increase in international transactions as the economy becomes more globalized, so to speak, and our data systems have not fully caught up to being able to fully evaluate all of the data that are coming in, especially in the services area. In that sense we would think that it would be most useful to have some improvements.

Representative HAMILTON. Mr. Greenspan, I have noted in the press some public statements by Fed Governors with respect to their views on interest rates. I was just checking with JEC staff—my own recollection is I don't really recall Fed members speaking publicly about these matters—and I am told it may have been done in the past.

You will recall that in the middle of this month two Fed Governors who reportedly had been proponents of easing interest rates have recently altered their positions, if I understand the press correctly, and now oppose further reductions in interest rates.

I would like you to comment on that practice and any other comment you care to make about that.

Mr. GREENSPAN. Well, I think, Mr. Chairman, there is a very fine line here that one has to be aware of. Federal Reserve Governors and presidents of the Federal reserve banks have over the years been making speeches about the economy and about a number of different issues, and I think that is most appropriate. I think that the education process is fostered by that.

Another interesting occurrence which I don't think people are aware of is that the ability of the so-called business press to fine-tune statements of Governors and FOMC members has improved dramatically and there is much greater technical understanding in the press to read between the lines of what individuals may be saying. And knowing full well what the two Governors to whom you refer were saying at different times in different contexts, it really is basically I think a heightened ability of the business press to read between the lines, which then creates stories which I think did not exist to the extent that they exist in today's environment say 20 or 30 years ago.

Representative HAMILTON. What strikes me, Mr. Chairman, about this is not the fact that a Fed Governor gives a speech on the economy, but that they speak rather pointedly and bluntly and directly to the issue, which is interest rates, and apparently indicate a change of position on their part. I mean that is what is really extraordinary.

Mr. GREENSPAN. I would say that when that happens, and it happens rarely, it is usually a slip either on my part or on their part. We try to avoid that, and regrettably on occasion we fail.

Representative HAMILTON. Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

Mr. Greenspan, I think I understand where Senator Sarbanes and Congressman Hamilton are really coming from, and that is their perception that there is a communications problem between the administration and the Fed over monetary policy. I think it's not really the interest rate issue that they're getting at, and I think it was I who raised a similar question in the House Banking Committee to which you responded.

All of us I think would like to see interest rates come down, and I don't think you have to be a genius to suggest that lower interest rates might stimulate the economy right now or help the economy, but why are interest rates as high as they are?

Mr. GREENSPAN. At the moment?

Representative WYLIE. At the moment.

Mr. GREENSPAN. I would say for two reasons. Well, no, I think fundamentally one reason, namely, that inflation expectations are high over the long run, higher than we would like them. They are lower than they have been earlier in this decade, but still too high.

That has two effects. One, long-term inflation expectations embody themselves as inflation premiums in long-term interest rates. There is also some evidence that the higher the inflation rate, the greater the instability in the economy, meaning the greater the uncertainty about the outlook, which means that so-called real interest rates also require an additional premium.

So we are getting in effect an increase in both real and nominal interest rates because of a view of the longer term, which is other than an expected stable price level.

Representative WYLIE. I thought it was good to have that answer for the record here.

I thought someone else might ask this question about the funny actions of the bond market, using the word "funny" advisedly. The bond market has been very weak since the first of the year and yields have risen substantially, as you know.

Are you confident about the state of financial markets in the United States?

Mr. GREENSPAN. Confident in what respect, Congressman Wylie?

Representative WYLIE. In the state of the financial markets given what is happening in the bond market.

Mr. GREENSPAN. I'm still not following you. Do you mean am I confident about their stability?

Representative WYLIE. Yes.

Mr. GREENSPAN. I would say that the markets have been fairly stable. I would put one caveat in there. As we have gone increasingly international and we get far greater international flows in all of our countries, I think there is a sense of greater instability which I think is false. I think it's merely the process of greater dynamics, more markets and more instruments. We have now so many different forms of markets, interest rate swaps, options on futures, futures on interest rates, and we have a very extraordinary interest in what is going on in Tokyo and London. So you get a sense of instability which is really only evidence of the fact of this globalization and is in no way reflective of underlying imbalances which can create problems.

Representative WYLIE. That is where I was coming from. Are you concerned about Japan's financial markets and perhaps the effect they might be having on the bond market?

Mr. GREENSPAN. I think the markets around the world have affected us for quite a long while. I think it's increasingly so as the globalization continues, and I think we will find that the interaction among all of the various different markets is going to increase.

Representative WYLIE. All right. I think you have been about as specific as you can.

Thank you very much, Mr. Chairman.

Representative HAMILTON. Mr. Greenspan, I'm going to meet in a few minutes with Douglas Hurd who, as you know, is the Secretary of State for Foreign and Commonwealth Affairs in the United Kingdom, and one of the topics of discussion I think will be the proposal for a common European currency.

I would just like to have your thoughts on how a common European currency and integrated credit market in Europe will affect on the U.S. economy.

Mr. GREENSPAN. I think it is, as far as we are concerned, not a major change because, remember, at the moment what we confront as far as Europe is concerned is a European monetary system which has 2¼ percent bands across certain fixed rates. So that the difference between a common currency in Europe and what we have today is really not that major so far as we in the United States are concerned with respect to trade and finance.

I would only look at it as further integration of the financial system, and to the financial system, and to the extent that we respond to it, my impression is that it will not create any significant discontinuity of which we are aware.

Representative HAMILTON. A couple of other questions and then we will close up.

We began our questions with respect to the prospect of recession, and you made your views clear.

In the event, however, the U.S. economy would slip into a recession, I'm interested to know what kinds of tools are available to the Federal Reserve under present circumstances to help the U.S. economy. It's generally acknowledged, of course, that fiscal policy is immobilized because of the deficit situation, but we also have to recognize that the Fed has to be careful not to disturb foreign investors. What kinds of tools are available to the Fed in the event of a recession in 1990?

Mr. GREENSPAN. Well, I don't want to get into too detailed a discussion on this subject largely because how a recession ultimately occurs, and I say I don't believe it's going to occur this year, but I also don't think the business cycle has been repealed, but how the recession occurs and its nature will influence the form of the response and what types of monetary instruments the Fed would bring to bear.

You are quite correct though in the sense that not having fiscal policy as a variable to deal with does make it more difficult for the Federal Reserve, but we do believe we have adequate tools to make a difference and hopefully a significant difference.

Representative HAMILTON. Even in that circumstance.

Then, finally, you were discussing with Senator Sarbanes the Social Security tax problem. Those who propose to cut the Social Security tax argue that the surplus is being misused, that it goes into the general revenues of government and in addition disguises the size of the deficit.

Do you object to using the suplus—which came about, as I recall, because of the Commission recommendation which you headed—do you object to using that surplus for general government spending? Did you anticipate that that would have to be done and do you favor it?

Mr. GREENSPAN. We anticipated that it would be done in part because implicit in our overall view was that basically the budget would be moving eventually toward surplus, and in that respect it was the general view of all of us to a greater or lesser extent that prior to that point, in the period say between 1983 and when the presumption of the deficit disappearing occurred, that there would be that form of financing, and I think we all recognized it, and decided in considering the various alternatives it was the lesser of evils.

Representative HAMILTON. Do you have anything further?

Representative WYLIE. No.

Representative HAMILTON. Thank you very much, Mr. Greenspan. We are very pleased to have had you this morning.

The committee stands adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

THE 1990 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 2, 1990

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

The committee met, pursuant to notice, at 10:35 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Upton; and Senators Sarbanes and Symms.

Also present: Joseph J. Minarik, executive director; David R. Malpass, minority staff director; and William Buechner, Judith Keenan, Stephen Quick, Chris Frenze, and Joe Cobb, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

Today, the Joint Economic Committee resumes its annual hearings on the economy and economic policy for 1990 and fiscal year 1991.

On behalf of the committee, I am very pleased to welcome our witness, the Honorable Nicholas Brady, Secretary of the Treasury.

As we head into the last decade of the 20th century, our nation faces a number of important challenges. One is to substantially reduce the deficit in the Federal budget so that more of the Nation's savings can be channeled into investments, both public and private, that will increase our growth and living standards.

Another is to make American industry more productive and more competitive and less dependent on foreign countries for the capital needed for new factories and equipment.

The third challenge is to strengthen coordination and cooperation on economic issues between the United States and the other industrial countries and to resolve the international debt problems that are depressing the economies of the less developed countries.

These are the issues, among others, that the committee will address this morning with Secretary Brady.

Mr. Secretary, we are very pleased to have you and to see you recovering so nicely from your recent surgery.

We turn now to your testimony. We welcome you, sir, before the committee.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman.

I'd like to read a shortened statement and ask that my prepared statement be included in the record.

Representative HAMILTON. Without objection, it will be so included.

Secretary BRADY. Mr. Chairman, members of the committee, I am pleased to meet with you to discuss the Bush administration's fiscal policy plans. My comments will concentrate on the economic policy consequences of the budget and international economic conditions and recommendations for revenue initiatives.

Three points should be emphasized.

First, significant progress has been made in reducing the unacceptable level of Federal budget deficits.

Second, we still have a long way to go.

Third, intensified effort is required to meet the challenges created by changing economic conditions and national priorities.

The budget deficit has declined from $220 billion in fiscal year 1986 to $152 billion in fiscal year 1989. It is expected to fall to $123 billion during the current fiscal year and to a target of $63 billion in fiscal year 1991.

This administration has submitted a budget proposal that meets the statutory targets without increasing taxes.

Government spending has been restrained while revenues have increased, both in the direction of historic averages. The spending restraint has reduced the growth of Federal budget outlays. Further deceleration for the years through 1995 is projected in the new budget.

The combination of spending restraint and improved remedies has narrowed the size of the budget deficit as the share of the GNP from 6 percent in 1983 to 2.9 percent last year.

Further progress to 2.3 percent in fiscal year 1990 and 1.1 percent in fiscal year 1991 is anticipated. Reduction of annual budget deficits, combined with continued economic growth has reversed the upward trend in the national debt held by the public as a proportion of the GNP.

If we continue to reduce respective budget deficits and achieve a lower interest rate, target the rising trend of interest payments on the national debt as a share of total budget outlays, it will be reversed.

Progress in controlling budget deficits has improved the U.S. record in comparison with other major industrial nations. This effort is part of our commitment to the G–7 international coordination process.

Part of the progress in reducing Federal budget deficits is the result of a growing size of annual surpluses in the Social Security trust fund. The surpluses are expected to continue to grow rapidly until the baby boom generation begins to retire, early in the next century.

The impact of these surpluses on the deficit follows from the use of unified budget rules. These rules were adopted in 1968 based on the recommendations of a national commission appointed to study the Federal budget.

The unified budget was designed to measure the broad economic impact of Federal outlays and revenues. These rules were in place in 1983 when the Social Security trust fund decisions were made. They were used in 1985 when the Gramm-Rudman-Hollings budget deficit goals were established, and they were well understood in 1987 when the original Gramm-Rudman targets were revised.

Measured against the targets established, progress toward the mandated goals has occurred.

Our fiscal year 1991 budget sets forth in separate columns the projected deficits before and after the effects of Social Security trust fund surpluses are considered. So, analysts can form their own opinion.

The Bush administration is committed to reducing the prospective budget deficits and has prepared a formal proposal to protect the Social Security trust fund starting in fiscal year 1993, when the required unified budget balance is achieved.

Budget plans must recognize the link between investment and the achievement of national long-term goals to invest in new plant and equipment; new technology and human resources through better education, training and health care depends on a matching supply of savings.

However, the United States now has a national savings rate that is lower than its historical average and far below the record of most industrial countries.

The necessary improvement in the national savings rate should become the crucial test in evaluating budget outlays and revenue strategies. The administration's budget for 1991 recognizes the link between long-term national priorities and the need to increase in national savings by emphasizing two policies.

First, continue to reduce prospective budget deficits to achieve a balanced position by fiscal year 1993 by controlling budget outlays through Federal credit programs.

Second, enact a Savings and Economic Growth Act of 1990 to increase family savings, stimulate long-term investment and strengthen the ability of American businesses to compete in a challenging global economy.

Improving the national savings rate will help to lower the cost of capital to American firms and provide the funds for investment in our future.

There are three parts to this legislation.

First, a new family savings account is established to give most American families an incentive to save, a simple and understandable tax-free savings program. The new family savings account would provide a way for Americans to save as they see the benefits of changing their behavior.

In addition, the time limit is short enough to focus attention on specific goals: savings to buy a home, preparing for education costs, protecting against unexpected events or saving for any high-priority goals.

Second, the capital gains tax is reduced and restructured to lower the cost of capital and encourage new long-term investment and create jobs and enhance the Nation's economic competitiveness.

A reduction in the capital gains tax rate, which is an important component of the cost of capital, will, in turn, directly affect the ability of U.S. companies to compete worldwide.

Our major trading partners already have either a lower capital gains tax or none at all.

By reducing the tax we pay on capital gains, we will encourage new venture investments in entrepreneurial gains. A sliding scale of capital gains tax rates would provide incentives toward longer term investments.

The benefits of the capital gains tax cut would be widely distributed through the population. Based on 1987 tax data, about 41 percent of the net long-term capital gains that were reported by taxpayers for adjusted gross income, excluding capital gains or losses of under $50,000.

Furthermore, it is estimated that nearly one-half of all taxpayers report capital gains for one year or another during their lifetime.

The third part of the new savings initiative is an innovative home ownership proposal. It is created to provide millions of Americans who aspire to buy their first home a better opportunity to do so. This would enhance the attractiveness of IRA's as a vehicle for savers.

Turning now to current economic conditions, the U.S. economy is now in its 8th year of sustained growth, a record peacetime expansion during which output gains have averaged 4 percent annually.

The strong economic growth achieved during this expansion has been accompanied by a low and stable inflation. Perhaps the most impressive aspect of this sustained growth has been the creation of nearly 21 million jobs since the beginning of the current expansion.

As a result, the civilian unemployment rate has fallen from a high of 10.8 percent in November 1982 to 5.3 percent, which persisted during the last half of 1989.

Economic growth has been solid and sustained in the international economy as well, both reflecting and contributing to the long upswing in the United States.

This favorable outlook partly reflects the intensified economic policy coordination process among industrialized nations. Exchange rates are now more consistent with economic fundamentals than they were several years ago.

Growing world trade flows due in part to bilateral and multilateral U.S. efforts to promote an open trade and investment system have supported this expansion.

As a result, the U.S. merchandise trade deficit has been reduced from a record $152 billion deficit in 1987 to an estimated $110 billion this year, and we hope that important progress is being made in regaining lost market shares.

This progress notwithstanding, additional efforts are needed to reduce trade and current account imbalances. In the case of Japan, we have engaged in very intensive talks about structural barriers to reducing the trade imbalances in the United States-Japan structural impediments initiative.

While it's too early to assess progress in these obviously delicate discussions, it will be both critical to Japan and the United States to address structural barriers in their economies.

Our dialogue with the European Community has also expanded as the EC has embarked on its ambitious 1992 program.

The administration supports the EC economic integration. However, it is important that this process result in an open and dynamic Europe. We are monitoring developments closely in this area.

Turning to the international debt strategy, this debt strategy has been broadly endorsed by the international community and is being used in actual financing packages. Three countries—Mexico, the Philippines, and Costa Rica—have already adopted IMF-World Bank reform programs and have reached an agreement on commercial bank financial programs.

This weekend, Mexico will sign a historic agreement which offers substantial benefits to the benefit of the Mexican economy. I believe we have made significant progress in implementing the strengthened debt strategy which encourages far-reaching debtor reforms. It's flexible and can be tailored to individual country needs.

Its benefits are real to potential growth and in fostering sustainable growth.

Finally, the historical developments in Eastern Europe carry strong U.S. support. In Poland, for example, we have taken the lead role in coordinating the establishment of a $1 billion stabilization fund. The President's fiscal year 1991 budget proposals request an additional $300 million for special assistance initiatives for countries in Eastern Europe to help them evolve toward democratic societies with market-oriented economies.

Let me touch briefly on the Treasury revenue estimates and tax policies. The Bush administration's fiscal policies contained in the fiscal year 1991 budget build upon the major tax reforms adopted in the Tax Reform Act of 1986.

The Treasury predicts budget revenues of $1,172 billion for fiscal year 1990, a 9-percent increase. This estimated increase is based on sustained economic growth and several important tax policy initiatives.

Revenue initiatives are also projected to continue in the future years.

In conclusion, the realities of domestic and international responsibilities indicate that budget plans must be made in the context of continued fiscal restraint. The 1991 budget proposals and the 5-year planning horizon concentrate on two priorities, reducing future Federal budget deficits and reallocating resources through investments in people, technology, and capital goods to prepare for the future.

The administration's budget will yield several major benefits. It will curtail Federal credit demands in the financial markets leading to better access to capital and lower interest rates for consumers, home buyers, business and State and local government.

It will reduce the share of total national output allocated to government and shift resources into the private sector to create more jobs and improve our international competitiveness. It will help ease the burden of future interest payments on the accumulated national debt, and it will provide increased flexibility to the Federal Reserve System in the management of monetary policy.

Finally, the most important aspect of the 1991 budget is the emphasis placed on long-term national goals. Economic events have demonstrated the relationship between saving and investment and the problems created by our disappointing national savings rate.

The fiscal year 1991 budget provides a package of incentives to enhance national savings and investment. When combined with a significant reduction in budget deficits, these recommendations will improve the national savings rate without increasing the tax burdens on the American people.

The Bush administration is prepared to work with Congress to enact the budget for 1991.

Mr. Chairman, thank you.

[The prepared statement of Secretary Brady follows:]

PREPARED STATEMENT OF HON. NICHOLAS F. BRADY

Chairman and Members of the Committee, I am pleased to meet with you to discuss the Bush Administration's fiscal policy plans. These hearings provide a useful opportunity to analyze our budget spending and revenue strategies. My comments will concentrate on the economic policy consequences of the budget and recommendations for revenue initiatives.

Three points should be emphasized. First, significant progress has been made in reducing the unacceptable level of budget deficits. Second, we still have a long way to go to achieve our budget goals. Third, intensified effort is required to meet the challenges created by changing economic conditions and national priorities.

- The budget deficit has declined from $221.2 billion in FY 1986 to $152.0 billion in FY 1989. It is expected to fall to $123.8 billion during the current fiscal year and to a target of $63.1 billion in FY 1991. Our budget proposal fulfills the mandatory Gramm-Rudman-Hollings deficit reduction goal.

- Government spending has been restrained while revenues have increased. Federal outlays as a percent of the gross national product are expected to decline from a peak of 24.3 percent in FY 1983 to a proposed 20.9 percent level in FY 1991, a figure closer to the 19.2 percent average which existed from 1950 through 1979 (see Exhibit 1). Budget revenues have increased during the current cyclical expansion and are estimated to total 19.9 percent of the GNP in FY 1991, a figure well above the average of 18.0 percent during the 1950 to 1979 period.

- Spending restraint has reduced the growth rate of Federal budget outlays. Expressed in nominal terms, the pace of annual spending increases was cut nearly in half in the Fiscal Years 1983 through 1989 from the prior seven-year period. Further deceleration for the years through 1995 is projected in our new budget. Adjusting for the effects of inflation reduces the pace of the slowdown but the pattern is similar (See Exhibit 2).

- The combination of spending restraint and improving revenues has narrowed the size of the budget deficit as a share of the GNP from 6.3 percent in 1983 to 2.9 percent last year. Further progress to 2.3 in FY 1990 and 1.1 percent in FY 1991 is anticipated (see Exhibit 3).

- The reduction of annual budget deficits, combined with continued economic growth, has reversed the upward trend in the national debt held by the public as a proportion of the GNP (see Exhibit 4).

- If we continue to reduce prospective budget deficits and achieve the lower interest rate targets, the rising trend of interest payments on the national debt as a share of total budget outlays will be reversed (see Exhibit 5).

- Progress in controlling budget deficits has improved the U.S. record in comparison with other major industrial nations. This effort is part of our commitment to the G-7 international coordination of domestic economic policies (see Exhibit 6).

Part of the progress in reducing Federal budget deficits is the result of the growing size of annual surpluses in the Social Security Trust Fund. A surplus results when current benefits paid are less than the payroll tax contributions collected, interest earned on the government bonds held by the trust fund, and taxes levied on social security benefits. The size of the annual surplus has grown from $262 million in FY 1984 to $52.4 billion in 1989. The estimated surplus for FY 1990 is $62.0 billion and for FY 1991 it is $80.3 billion. The annual surpluses are expected to continue to grow rapidly until the baby boom generation begins to retire early in the next century.

The impact of social security surpluses on the deficit follows from the use of the unified budget rules. These rules were adopted in 1968, based on the recommendations of a national commission appointed to study the Federal budget. The unified budget was designed to measure the broad economic impact of Federal outlays and revenues. Those rules were in place in 1983 when the Social Security Trust Fund decisions were made. They were used in 1985 when the Gramm-Rudman-Hollings budget deficit goals were established. And they were well understood in 1987 when the original Gramm-Rudman-Hollings targets were revised. The targets adopted were based on the unified budget concept.

Measured against the targets established, progress toward the mandated goals has occurred. Our FY 1991 budget sets forth in separate columns the projected deficit before and after the effects of the Social Security Trust Fund surpluses are considered so that analysts can form their own opinion. The Bush Administration is committed to reducing prospective budget deficits and has prepared a formal proposal to protect the Social Security Trust Fund starting in FY 1993 when the required unified budget balance is achieved.

ECONOMIC POLICY GOALS AND THE BUDGET

Budget plans are used to identify national priorities and coordinate the allocation of resources. They also are used to develop government policies to help achieve the fundamental goals of sustaining economic growth, improving our national ability to compete in an integrated world economy, and adjusting to fundamental demographic trends. Budget plans must recognize the link between investment and the achievement of national long-term goals. Investment in new plant and equipment, new technology, and human resources through better education, training, and health care depends upon a matching supply of savings. To avoid excessive reliance on foreign capital inflows to finance these crucial investment needs, national savings must be increased.

The disappointing national saving rate is a combination of personal, business, and government saving behavior. There has been erosion in the personal saving rate in recent years and business saving has remained stable only because of higher depreciation charges. However, chronic Federal budget deficits, reported in 28 of the last 29 fiscal years, have become the dominant factor in the overall decline in the national saving rate (see Exhibits 7 and 8). The United States now has a national saving rate that is lower than its historical average and far below the record of most industrial nations. The key policy action for correcting this serious problem will be to reduce future Federal budget deficits.

The necessary improvement in the national saving rate should become the crucial test in evaluating budget outlay and revenue strategies. The Bush Administration budget for FY 1991 recognizes the link between long-term national priorities and the need to increase investment and national saving by emphasizing two basic policies.

First, continue to reduce prospective budget deficits to achieve a balanced position by FY 1993 by controlling budget outlays and Federal credit programs.

Second, enact The Savings and Economic Growth Act of 1990 to increase family savings, stimulate job-creating, long-term investment, and strengthen the ability of American businesses to compete in a challenging global economy. Improving the national saving rate is important because it will help to lower the cost

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of capital to American firms and provide the funds for investment in our future. There are three parts to The Savings and Economic Growth Act:

- A new Family Savings Account is established to give most American families an incentive to save through a simple and understandable tax-free savings program.

- Capital gains tax rates are reduced and restructured to lower the cost of capital, encourage new long-term investment, create jobs, and enhance the Nation's economic competitiveness.

- An innovative Home Ownership Initiative is created to provide millions of Americans who aspire to buy their first home a better opportunity to do so.

Current Economic Conditions

While the budget provides an important guide for the long-term development of the economy, the pace of economic activity is an important factor in determining the size and shape of the budget. Economic conditions affect the level and composition of outlays, particularly those benefits indexed to inflation and those spending programs designed to act automatically to offset some of the cyclical shifts in activity. The status of the economy also influences the level and composition of revenues.

The U.S. economy is now in its eighth year of sustained real growth -- a record peacetime expansion -- during which output gains have averaged 4 percent annually. The strong economic growth achieved during this expansion has been accompanied by a low and stable inflation rate. The annual increase in the CPI averaged 3.7 percent from 1982 through 1989, dipping down to 1.1 percent in 1986 when oil prices fell. It never exceeded 4.6 percent in earlier years, in sharp contrast to the double-digit rates at the turn of the decade. Excluding the more volatile food and energy components, inflation has held in the 4 to 5 percent range throughout most of the expansion. The reduction and stabilization of inflation rates have helped to reduce interest rates from the unusually high levels at the beginning of the 1980s.

Perhaps the most impressive aspect of the sustained growth of the U.S. economy has been the creation of nearly 21 million jobs since the beginning of the current expansion. New jobs have been created in the services industries, such as transportation, public utilities, wholesale and retail trade, government functions, and diverse health, education, and financial activities. Employment has increased in the manufacturing and construction sectors as well. As a result, the civilian unemployment rate has fallen from a peak of 10.8 percent in November 1982 to the 5.3 percent level that persisted during the last half of 1989. Figures compiled by the Organization for

Economic Cooperation and Development (OECD) covering the period 1965 to 1988 dramatize the rapid growth of new jobs in the United States.

Employment Increases 1965-1988
(in millions)

	United States	Japan	OECD Europe
1965-1988	41.9	12.8	10.0
1975-1988	27.4	7.9	5.9

International Economic Conditions

Economic growth also has been solid and sustained in the international economy as well, both reflecting and contributing to the long upswing in the United States. Growth in the OECD industrial economies should be about 3 percent in real terms in 1990, the eighth consecutive expansion year, and inflation pressures are well contained. Prospects also are good for strengthened growth in the developing countries, especially as the outlook for the large debtor nations improves.

This favorable outlook partly reflects the intensified economic policy coordination process among the major industrial nations. Exchange rates are now more consistent with economic fundamentals than they were several years ago. The U.S. dollar has been relatively stable since 1987, especially when compared with the sharp appreciation of value from July 1980 through February 1985 and the subsequent rundown through 1987. Growing world trade flows, due in part to bilateral and multilateral U.S. efforts to promote an open trade and investment system, have supported the expansion. And a much higher level of confidence about the future has led to an increase in investment in industrialized countries. U.S. producers in particular have benefited from improved international competitiveness, as well as expanded export opportunities resulting from stronger growth abroad. As a result, the U.S. merchandise trade deficit has been reduced from a record $152 billion in 1987 to an estimated $110 billion last year, and important progress has been made in regaining lost market shares (census basis). But while progress has been made in reducing large global external imbalances, these imbalances, especially in the United States, Japan and Germany, still are too high and need to be reduced further.

Economic ties between the United States and Japan are increasingly close. This development offers both challenges and opportunities. Japan now is our second largest trading partner (after Canada), and our second largest source of foreign direct investment (after the United Kingdom). But our very large bilateral trade deficit with Japan changed very little last year.

In addition to continuing efforts within the G-7 coordination process and bilateral discussions with Japan on specific trade issues, we have been engaged in very intensive talks with the Japanese about structural impediments to external adjustment in the U.S.-Japan Structural Impediments Initiative (SII). While it is too early to assess progress in these obviously delicate discussions, we remain convinced that lasting progress can be made only by addressing the fundamental roots of Japanese external surpluses.

Our dialogue with EC member countries and EC institutions also has expanded as the EC has embarked on its ambitious "1992" program. The Administration supports EC economic integration. However, it is important for the United States, the world economy, and the EC countries themselves that the 1992 integration efforts result in an open and dynamic Europe. We have seen some important progress on the issue of reciprocity in financial services over the past year. We are monitoring these developments closely.

The EC is pursuing monetary union, including the possible creation of an EC central bank and common currency. Given the potential importance of these developments, I decided last September to create a special policy group under the Economic Policy Council to look at the implications of these possible monetary and financial changes in Europe. The Bush Administration is continuing to focus on trade policy questions with the EC. Many of these issues are being discussed in the Uruguay Trade Round. The President's top trade policy priority is the successful completion of the Uruguay Round.

Turning to the international debt strategy, the proposals I made last spring have been broadly endorsed by the international community and are being used in actual financing packages. Three countries -- Mexico, the Philippines and Costa Rica -- already have adopted IMF and World Bank reform programs and have reached agreement on commerical bank financial packages.

The Mexican agreement, in which virtually all banks are participating, offers substantial benefits to Mexico. Commercial bank debt will be reduced immediately by about $7 billion and by a total of at least $10 billion (or 20 percent) by 1992. Annual commercial bank interest payments will be cut by nearly one-third, contributing to total debt service savings of $12 billion by 1992. And the burden of repaying $35 billion in principal -- or more than 80 percent of Mexico's remaining medium-term bank debt -- has been completely lifted through the purchase by Mexico of collateral in the form of zero-coupon bonds. In practical terms for Mexico, the overall debt service reduction provided by the package effectively represents savings of domestic resources amounting to about 4 percent of GNP. The immediate effect of the agreement has been to improve confidence in the Mexican economy, as evidenced by the fall in domestic Mexican interest rates and sizable private capital inflows during 1989.

The financing packages in the Philippines and Costa Rica differ from the Mexican package in order to meet the particular needs of each country. The Philippine's agreement places more emphasis on new money, while permitting direct buybacks of bank debt. The buyback, completed earlier this month, retired $1.3 billion (20 percent) of the Philippine's commercial bank debt. The Costa Rican package involves a buyback, debt service reduction, and special measures to address accumulated interest arrears. Costa Rica's debt service payments and outstanding debt to commercial banks will each be reduced by about 60 percent, more in line with its ability to pay.

We have made significant progress in implementing a strengthened debt strategy which encourages far-reaching debtor reforms. It is flexible and can be tailored to individual country needs. And its benefits are real, with the potential to foster sustainable growth.

Turning to a different issue, the historic developments in Eastern Europe have many dimensions -- political as well as economic -- and merit strong U.S. support. The basic objectives of the Administration are to support the development of multi-party democracies and economic reforms aimed at promoting market-oriented economies with strong private sectors. We have taken a major step in implementing these objectives in Poland. The United States took a lead role in coordinating the establishment of a $1 billion stabilization fund to support limited convertibility of the Polish zloty and made a $200 million grant contribution out of funds provided by the Support for Eastern European Democracy Act (the "SEED Act"). The United States also helped organize a $500 million bridge loan to Poland to help meet temporary liquidity needs and made available $200 million as our contribution to the bridge facility.

The SEED Act calls for additional measures to be taken in Poland and Hungary, and the Administration is working on their implementation. The President's FY 1991 budget proposals request an additional $300 million for a special assistance initiative for countries in Eastern Europe. Finally, we are cooperating with other countries and international institutions to review opportunities, such as the proposed European Bank for Reconstruction and Development, to help Eastern European countries evolve toward democratic societies with market-oriented economies.

Summary

In summary, the seven-year economic expansion in the United States has provided sustained growth, a stable inflation rate, creation of nearly 21 million jobs and lower unemployment rates, improved balance among major sectors and geographical areas, and, since 1987, a more stable U.S. dollar foreign exchange rate and improvement in the merchandise trade and current account deficits.

Mid-Session Budget Review Economic Forecast

Last July, the Bush Administration published its first economic forecast as part of the Mid-Session Budget Review. Administration economists adjusted the previous forecast, published in the FY 1990 budget last January, by reducing the projected rate of real economic growth and raising the anticipated inflation rate and interest rate estimates for 1989 and 1990.

RECORD OF ADMINISTRATION MID-SESSION FORECAST

	ADMINISTRATION FORECAST	ACTUAL
	(PERCENT)	
Real GNP (4th Q to 4th Q)	2.7	2.4 (1)
GNP Price Deflator (4th Q to 4th Q)	4.2	3.8 (1)
Total Unemployment Rate (Yr. Avg.)	5.2	5.2
3-Month T-Bill Rates (Yr. Avg.)	8.0	8.1
10-Year T-Notes (Yr. Avg.)	8.5	8.5

(1)Department of Commerce Estimates, 1/26/90.

According to the preliminary estimates released on January 26, 1990, real GNP increased 2.4 percent in 1989, a pace very close to the Bush Administration figures published last July and above the more pessimistic projections of most comparable economic forecasts. There was, however, considerable deceleration of activity during the last three months of the year and a worrisome acceleration of food and energy prices at year-end. These developments will have to be watched closely.

Economic Assumptions Used in Preparing the FY 1991 Budget

The Bush Administration's new forecast continues to anticipate moderate growth this year, followed by some acceleration in 1991, and then a return to the long-term growth track of 3.0 percent. Most private forecasts agree that an economic recession will not occur in 1990 even though there is some disagreement about the probable growth rate of real output. Most of the Administration's economic assumptions are quite similar to the expectations of private forecasters.

ADMINISTRATION FORECAST FOR 1990 COMPARED WITH BLUE CHIP CONSENSUS
(PERCENT)

	Administration January 1990	Blue Chip January 1990
	(Percent)	
Real GNP (4th Q to 4th Q)	2.6	1.8
GNP Price Deflator (4th Q to 4th Q)	4.2	4.0
Consumer Price Index (4th Q to 4th Q)	4.1	4.2
Unemployment Rate, Civilian (Yr. Avg.)	5.5	5.6
3-Month T-Bills (1) (Yr. Avg.)	6.7	7.1
10-Year T-Notes (1) (Yr. Avg.)	7.7	N/A

(1) Calendar year average.

THE FY 1991 BUDGET SPENDING PLANS

The President's FY 1991 budget continues to make progress on his agenda announced last February for "Building a Better America." But there is still much that must be done to achieve his goals. First, we must enforce tough spending restraint to create a more realistic match of spending claims with public resources generated by a tax system that the American people will support. The Bush Administration budget for FY 1991 calls for outlays of $1,233.3 billion, an increase of only $36.1 billion over the estimated spending this year. This modest increase of 3.0 percent in FY 1991 continues the recent slowdown in the growth of budget outlays. For example, for the years FY 1976 through FY 1982, Federal spending increased at a rapid annual rate of 11.8 percent, a pace more rapid than the average nominal GNP growth rate of 10.5 percent. During the last seven years, the growth rate of government spending has slowed to an annual pace of 6.3 percent while the nominal GNP has increased at an average 7.3 percent rate. Our budget proposal calls for further deceleration in the growth of spending to an annual rate of 4.4 percent through FY 1995, or nearly 2-1/2 percentage points slower than the projected growth rate of the nominal GNP. As the overall economy grows more rapidly than the pace of Federal budget increases, the relative burden of government spending is eased.

Second, costly new initiatives that reach beyond our prospective public resources are avoided. There are, of course, a large number of existing and potential claims against our budget resources. The difficult part is ranking the proposals so that we allocate government funds to the highest priorities.

Third, within the overall context of spending restraint, there will be continuing changes in the rankings of competing claims. This process reflects the familiar axiom that "every good thing is not equally good." Examination of the three major spending components of the budget demonstrates the realignment process that is underway. The prospective growth of defense spending has been constrained, reflecting changing international conditions. During the five-year budget plan presented, defense spending is projected to rise from $296.3 billion in FY 1990 to $318.6 billion by FY 1995. As a result, defense spending as a share of the GNP will decline from 5.4 percent in 1990 to 4.2 percent in 1995. As a share of budget outlays, defense spending will drop from 24.8 percent of the total in FY 1990 to 21.6 percent by FY 1995. Stated in constant 1982 dollars, defense spending is projected to decline from $256 billion in FY 1989 to $241 billion in FY 1990 and to $214 billion by FY 1995. The entitlements and mandatory spending programs are projected to grow approximately at the rate of inflation. Spending for nondefense discretionary programs is expected to have the largest relative gain.

Proposed Changes in Budget Spending Categories
For FY 1991 From FY 1990
(billions of dollars)

	FY 1990	FY 1991	Dollar Change	Percent Change
Defense	296.3	303.3	+ 6.9	+2.3
Nondefense Discretionary Programs	201.6	213.6	+12.0	+6.0
Entitlements and Mandatory Programs	562.5	589.7	+27.2	+4.8

Fourth, within the overall strategy of rigorous spending restraint, we must meet our existing responsibilities while addressing new opportunities and needs.

REVENUE ESTIMATES AND TAX POLICY INITIATIVES

The Bush Administration's fiscal policies contained in the FY 1991 budget build upon the major reforms adopted in the Tax Reform Act of 1986. Treasury projects budget revenues of $1,170.2 billion for FY 1991. This is $96.8 higher than the estimated FY 1990 total, following an anticipated increase of $82.8 billion during the current fiscal year and $81.7 billion last year. The estimated 9.0 percent increase in revenues in FY 1991 is based on sustained economic growth and several important tax policy initiatives. Revenue increases also are projected to continue in future budget years (see Exhibit 9 for revenue estimates).

THE SAVINGS AND ECONOMIC GROWTH ACT

In his State of the Union address, President Bush announced The Savings and Economic Growth Act. This legislation is designed to promote long-term investment, to encourage Americans to save, and to make it easier for them to purchase their first home. The President's proposal has three components.

Family Savings Accounts

An important goal for the 1990s is to increase the rate of growth of America's productive capacity. A higher growth rate will significantly increase living standards for both current and future generations. More saving is needed, however, to finance increases in our productive capacity. We believe that the Federal Government should foster an environment that is conducive to saving, and we have a plan to achieve this objective.

The Family Savings Account (FSA) proposal will allow non-deductible contributions of up to $2,500 per taxpayer with a maximum of two accounts per family. Contributions will be allowed for single people with adjusted gross incomes (AGIs) below $60,000, for those filing as heads of households with AGIs below $100,000, and for married couples filing joint returns with AGIs below $120,000. These contributions will be allowed in addition to contributions to qualified pension plans, IRAs, 401(k) plans, and other tax-favored savings plans.

After meeting the required seven-year holding period, all savings, including the accumulated earnings, can be withdrawn tax-free. Withdrawals of savings within three years of the time the contribution was made will result in a 10-percent excise tax penalty and an income tax on the associated earnings. Earnings on funds withdrawn between three and seven years after contribution will be subject only to income tax with no excise tax penalty.

We believe that the FSA will provide a significant savings incentive, at a cost to the Treasury that is less than many other savings proposals. During fiscal year 1991, the revenue loss would be only $200 million; for the entire period 1990-95, it would be $4.7 billion. These estimates refer only to possible revenue losses and do not include prospective revenue gains resulting from increased investment and economic growth.

The new FSAs will provide a simple and understandable program for Americans to save and to see the benefits of changing their behavior. The time limit is short enough to focus attention on specific personal goals--saving to buy a home, preparing for education costs, for building a financial reserve to protect against unexpected events, or for any high-priority goals. This is a program that Americans can understand and can participate in without having to wait for long periods to have access to their savings.

From the Government's perspective, the FSA does not cause large revenue losses at the beginning of the program because the contributions are not tax deductible. Instead, the earnings created by the contributions to FSAs will be exempt from taxes. This approach is prudent because we can evaluate the results as we proceed.

Capital Gains Tax Rates

The President's first initiative for enhancing saving and investment involves a permanent reduction and restructuring of the capital gains tax rate. To encourage Americans to invest for longer periods of time, we believe that the tax rate for capital gains on real estate, timber, homes, farms, land and corporate stock should be reduced based on the length of time an asset has been held. If an investment is held for one year, a 10 percent exclusion of the capital gain from taxable income would be permitted. If the asset had been held for two years, an exclusion of 20 percent would be permitted. The maximum exclusion would be 30 percent of the gain for assets held three or more years. For a taxpayer in the 28 percent bracket, this proposal would generally result in effective tax rates of 25.2 percent, 22.4 percent, and 19.6 percent, respectively.

For the balance of 1990, the 30 percent exclusion would apply to all qualified capital assets held at least one year. For assets disposed of in 1991, the 30 percent exclusion would apply to assets held at least two years, and the 20 percent exclusion would apply to assets held at least one year but less than two years. The general rule would apply in 1992 and all years thereafter. The excluded gains would be subject to the alternative minimum tax. Prior depreciation deductions would be recaptured in full at ordinary rates of tax.

The Bush Administration believes that a reduction in the tax rate on capital gains would have several beneficial effects:

- The capital gains tax rate is an important component of the cost of capital, which in turn directly affects the ability of U.S. companies to compete worldwide. Our major trading partners already have either a lower capital gains tax rate or no tax on capital gains at all. By reducing capital gains tax rates, we will enhance our ability to compete.

- Individuals will invest in growing businesses only when they believe they will reap an adequate reward if the venture succeeds. By reducing the tax rate on capital gains, we will encourage venture capital investments and entrepreneurial activities. The result will be a better economy, more jobs, and a higher standard of living for all Americans.

- The sliding scale of capital gains tax rates would provide incentives for longer-term investments. To the extent individuals are rewarded for holding their investments longer, stability in the marketplace is enhanced. Stable investment opportunities will increase the creation of jobs and improve economic performance.

- The benefits of a capital gains tax rate cut would be widely distributed throughout the population. In a typical year, 14 million tax returns (representing approximately 26 million taxpayers) report income from the sale of capital assets. Based on 1987 tax data, about 41 percent of net long-term capital gains were reported by taxpayers with adjusted gross income, excluding capital gains or losses, of under $50,000. Furthermore, it is estimated that nearly one-half of all taxpayers report capital gains in one year or another during their life.

- Our capital gains tax rate reduction will raise revenues for deficit reduction--$4.9 billion in fiscal year 1991 and $12.5 billion during the period 1990-1995.

Home Ownership Initiative

As I have already noted, individuals can continue to use current-law IRAs. To encourage home purchases, we also propose that the 10-percent excise tax on early withdrawals of up to $10,000 from these IRAs be waived if the funds withdrawn are used for a first-time purchase of an eligible home. This would enhance the attractiveness of IRAs as a vehicle for savings.

OTHER INITIATIVES

Incentives for Research and Experimentation

Technological change plays a central role in economic growth. The Government has an important function in promoting innovation and basic research. In order to do so, we believe that the 20-percent Research and Experimentation (R&E) tax credit, which is set to expire on December 31, 1990, should be made permanent. Research is inherently a long-term process. Making the R&E tax credit permanent will permit businesses to begin projects without having to worry that the credit will be withdrawn in the future. For the same reasons, we propose to make permanent the current rules for the allocation of research expenses between U.S. and foreign-source income. Permanent R&E expense allocation rules are essential for U.S. companies to plan for the long-term costs of their R&E programs.

Internal Revenue Service (IRS) Items

The IRS currently allocates substantial resources to direct enforcement of the tax laws. The IRS has identified a number of enforcement areas in which receipts could be increased by introducing management reforms which would change the allocation of existing resources within the IRS. In most cases, these management reforms would accelerate the receipt of taxes, penalties, and interest. In addition, the IRS has identified a number of ways in which enforcement could be improved by the application of additional resources. Therefore, we propose an increase in IRS funding for tax-law enforcement and for collection of delinquent taxes, penalties, and interest. Taken together, the new resources and the management reforms would lead to revenue increases of $3 billion in FY 1991.

Finally, we have proposed specific user fees. These fees are intended to allocate the costs of government facilities and services to the actual beneficiaries. Specific exemptions and deductions also are included to encourage certain actions.

Extensions of Current Programs

We also propose the extension of certain programs that would otherwise expire:

- The 3 percent excise tax on telephone service, currently scheduled to expire after December 31, 1990, should be made permanent.

- The low-income housing credit encourages the private sector to construct and rehabilitate the Nation's housing stock and make it available to the working poor and low-income income families. It should be extended through 1991.

- The deduction for 25 percent of health insurance costs by self-employed individuals should be made permanent. This provision would mitigate the disparity between the owners of incorporated and nonincorporated businesses.

A more detailed description of all the receipts proposals is included in the Treasury Department's publication, General Explanations of the President's Budget Proposals Affecting Receipts.

The Bush Administration believes that our budget goals can be achieved without increasing tax burdens on the American people. The pledge to submit a budget proposal that meets the statutory target without increasing taxes has been fulfilled. The budget outlay and revenue proposals presented in the FY 1991 budget are intended to sustain the impressive economic progress of the last seven years.

CONCLUSIONS

The realities of domestic and international responsibilities indicate that budget plans must be made in the context of continuing fiscal restraint. After many years of simply adding new government spending programs to existing budget claims, we must rearrange existing priorities.

The FY 1991 budget proposals, and the five-year planning horizon, concentrate on two priorities.

- Reduce future Federal budget deficits.

- Reallocate resources into investments in people, technology, and capital goods to prepare for the future.

The proposed budget will achieve a significant reduction in the deficit to $63.1 billion in FY 1991, meeting the statutory target. Reaching this ambitious goal will yield several major benefits.

- It will curtail Federal credit demands in the financial markets, leading to better access to capital and lower interest rates for consumers, home buyers, business firms, and state and local governments.

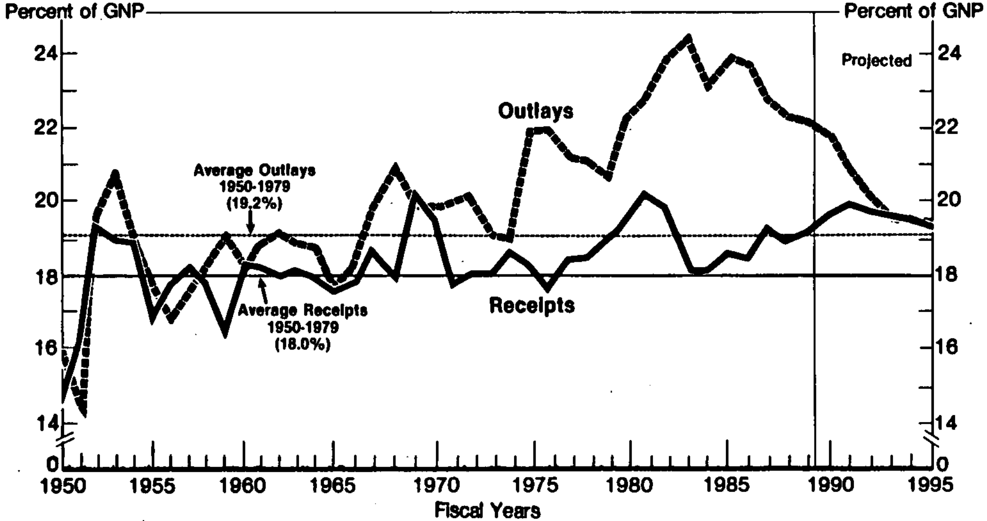
- It will reduce the share of total national output allocated to government and shift resources into the private sector creating more jobs and improving our international competitiveness.

- It will help ease the burden of future interest payments on the accumulated national debt.

Achieving the dual goals of reducing prospective budget deficits and realigning spending priorities is dependent upon sustaining economic growth that provides tax revenues and creates investment opportunities. Our budget proposals assume moderate growth in the 2-1/2 percent zone in 1990, although the quarterly pattern may fluctuate, and that inflation remains under control. This outcome will lead to the eighth year of continuous economic expansion. A second benefit of continued budget spending restraint and deficit reduction will be the increased flexibility provided to the Federal Reserve System in the management of monetary policy.

Finally, the most important aspect of the FY 1991 budget is the emphasis placed on long-term national goals. Economic events have demonstrated the relationship between saving and investment and the problems created by our disappointing national saving rate. The FY 1991 budget provides a package of incentives to enhance national saving and investment. When combined with a significant reduction of budget deficits, these recommendations will improve the national saving rate without increasing tax burdens on the American people. The Bush Administration is prepared to work with Congress to enact a responsible budget for FY 1991.

FEDERAL OUTLAYS AND RECEIPTS AS A SHARE OF GNP



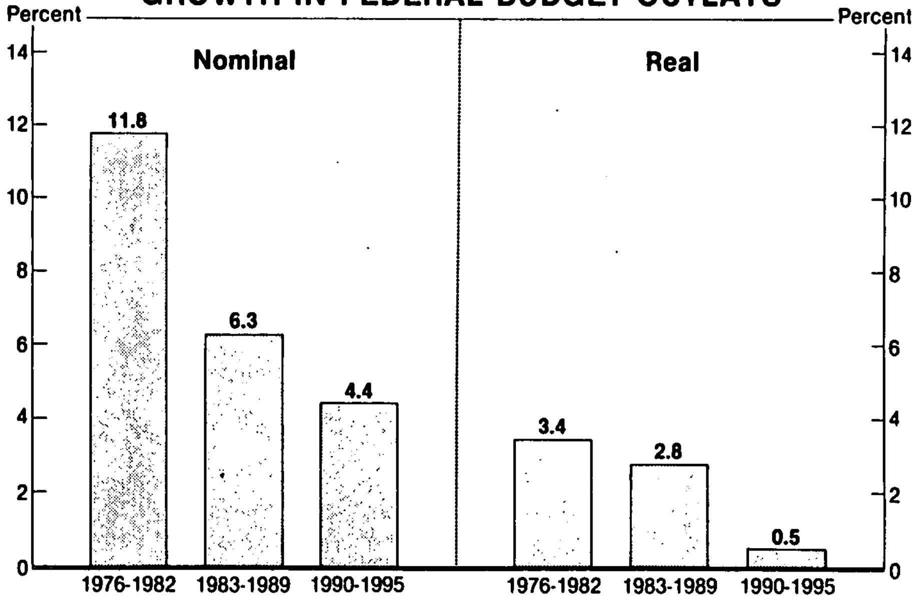
Note: Outlays and receipts include on- and off-budget items.

January 26, 1990-A817

EXHIBIT 1

EXHIBIT 2

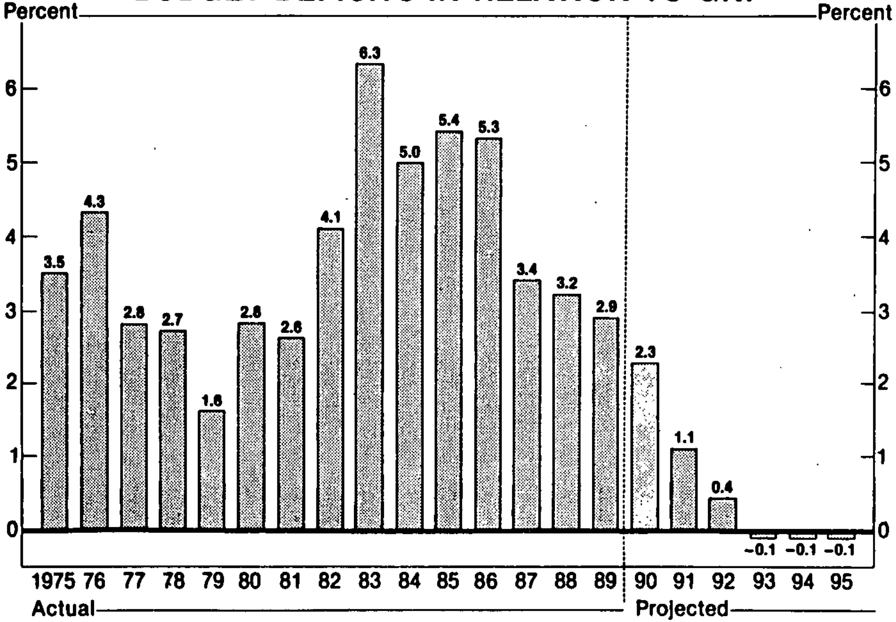
GROWTH IN FEDERAL BUDGET OUTLAYS



Compound rates of growth for designated periods 1976-1989 are actual; 1990-1995 projected.

January 26, 1990-A562a

BUDGET DEFICITS IN RELATION TO GNP*

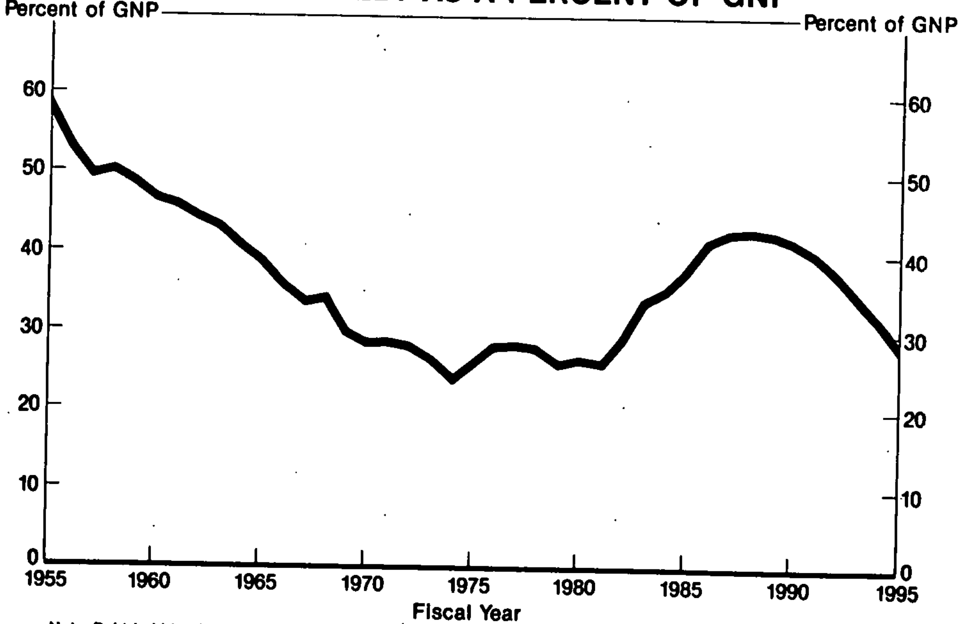


*On and off budget as percent of fiscal year GNP. FY 1991 Budget.

January 30, 1990-A849

EXHIBIT 3

FEDERAL DEBT AS A PERCENT OF GNP

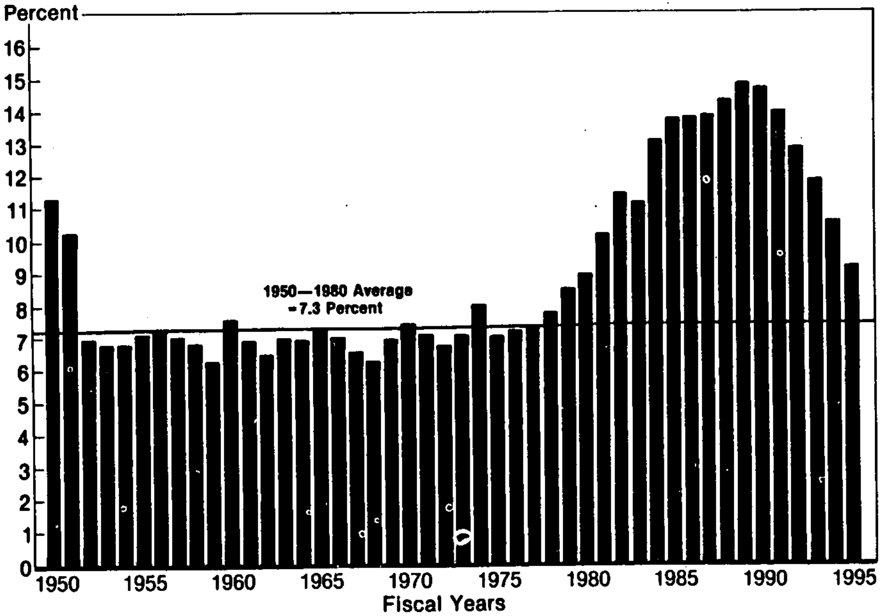


Note: Debt held by the public, inluding the Federal Reserve. Administration forecasts for FY-1990 thru FY-1995.

January 26, 1990-A953

EXHIBIT 4

NET INTEREST AS A SHARE OF FEDERAL OUTLAYS



January 26, 1990-A881

EXHIBIT 5

U.S. AND FOREIGN BUDGET DEFICITS

(Percent of GNP; Total Government)

	1988
Canada	—2.6
France	—1.3
Germany	—2.1
Italy	—10.6
Japan	+1.3
United Kingdom	+0.8
United States	—2.0
Federal	—3.0
State and Local	+1.0

Source: OECD Economic Outlook, December 1989.

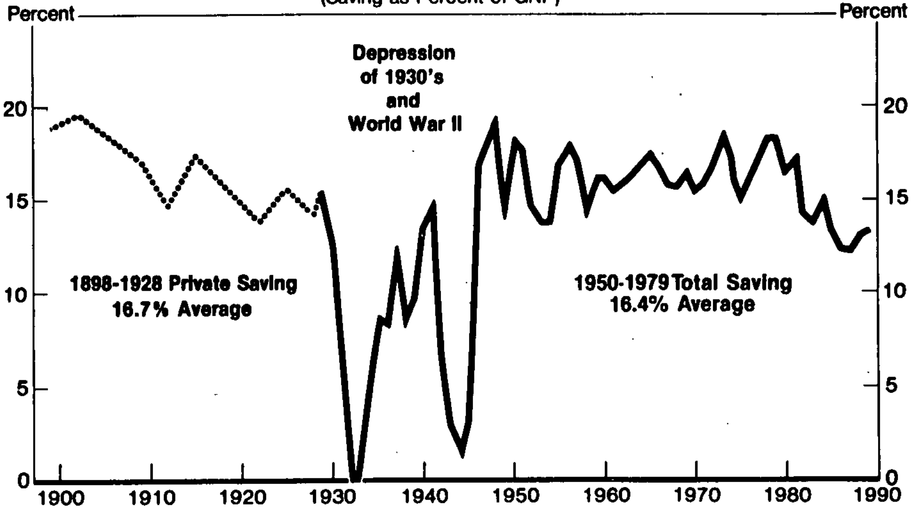
Total Government is aggregate deficit or surplus of government sector (federal, state, and local). Data are on a national income account basis and are for the calendar year.

January 10, 1990-A233

EXHIBIT 6

U.S. GROSS SAVING RATIO, 1898-1989

(Saving as Percent of GNP)



Note: 1898-1928 data from David and Scadding, Journal of Political Economy, April 1974.
Data following 1928 are from U.S. Department of Commerce.

January 30, 1990-A857a

EXHIBIT 7

Gross Saving and Investment as a Share of Gross National Product

	1950's	1960's	1970's	1980-88	1987	1988	1989(p)
Gross Domestic Saving	16.1	16.3	16.7	14.1	12.2	13.2	13.4
Private[1]	16.5	17.1	18.4	18.0	16.1	16.6	16.9
Personal[1]	5.1	5.1	6.4	5.1	3.7	4.4	5.4
Corporate Undist. Profits	2.8	3.5	2.5	1.7	1.7	1.6	0.9
Depreciation Allowances	8.7	8.5	9.6	11.0	10.8	10.5	10.6
Government[1]	−0.4	−0.8	−1.8	−3.8	−3.8	−3.4	−3.5
Federal	0.1	−0.3	−1.7	−3.9	−3.6	−3.0	−2.9
State & Local[1]	−0.6	−0.5	0.0	0.1	−0.3	−0.4	−0.6
Gross Investment	16.3	16.2	16.7	14.2	12.1	13.0	12.9
Gross Private Domestic	16.2	15.5	16.4	15.8	15.5	15.4	14.8
Business Fixed	9.6	9.9	10.7	10.9	9.8	10.0	9.8
Net Foreign	0.1	0.6	0.2	−1.6	−3.3	−2.4	−1.9
ADDENDUM:							
Net Domestic Saving[2]	8.1	8.6	7.9	3.4	1.7	3.0	3.2
Private[1]	8.6	9.4	9.8	7.7	6.0	6.8	7.1
Government[1]	−0.5	−0.8	−1.9	−4.3	−4.3	−3.8	−3.9
Personal Saving Rate[3]	6.8	6.7	8.0	5.4	3.2	4.2	5.5

Note: Small difference between gross domestic saving and gross domestic investment represents the statistical discrepancy. Other components may not add exactly to totals due to rounding.

1. Employee pension funds of state and local governments are allocated to personal saving to match the treatment of private pension funds.
2. Net saving equals gross saving minus depreciation allowances. It is shown as a share of net national product (GNP minus depreciation).
3. Personal saving as a percent of disposable personal income.

p-preliminary.

January 29 1990 A 171

EXHIBIT 8

PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS

	Fiscal Years					
	1990	1991	1992	1993	1994	1995
	($'s in billions)					
Capital Gains Tax Rate for Individuals	0.5	4.9	2.8	1.2	1.7	1.4
Family Savings Accounts	—*	—0.2	—0.6	—1.0	—1.3	—1.6
Permanent Research and Experimentation Tax Credit	—0.1	—0.5	—0.9	—1.1	—1.3	—1.6
Research and Experimentation Expense Allocation Rules	0.0	—0.4	—0.7	—0.8	—0.8	—0.9
Energy Tax Incentives:						
Credit for Intangible Drilling Expenses	0.0	—0.2	—0.3	—0.3	—0.4	—0.4
Credit for Tertiary Recovery	0.0	—*	—*	—*	—*	—*
Modify Oil and Gas Depletion Rules	0.0	—*	—*	—*	—*	—*
Revise AMT for Exploratory Drilling by Independents	0.0	—0.1	—0.1	—0.1	—0.1	—0.1
Enterprise Zone Tax Incentives	0.0	—0.1	—0.2	—0.3	—0.5	—0.8
Establish Refundable Child and Dependent Care Tax Credit	0.0	—*	—*	—*	—0.1	—0.1
Deduction for Special Needs Adoption	0.0	—*	—*	—*	—*	—*
Penalty-Free IRA Withdrawals for First-Time Home Buyers	—*	—*	—0.1	—0.1	—0.1	—0.1
Extension of Low-Income Housing Credit	—*	—0.1	—0.3	—0.4	—0.4	—0.4
Extend Special Rules for Health Insurance Costs of Self Employed Individuals	—*	—0.2	—0.4	—0.5	—0.5	—0.6
Extend Social Security Coverage to Certain Employees of State and Local Governments	0.0	2.1	2.2	2.3	2.5	2.7
Medicare Hospital Insurance (HI) for State and Local Employees	0.0	1.7	1.7	1.7	1.7	1.6
Airport and Airway Trust Fund	0.0	0.5	0.8	0.9	0.9	1.0
Extension of Telephone Excise Tax	0.0	1.5	2.5	2.7	2.9	3.1

January 30, 1990-A893

EXHIBIT 9

PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS
(Continued)

	Fiscal Years					
	1990	1991	1992	1993	1994	1995
	($'s in billions)					
Treatment of Salvage Value by Property and Casualty Companies	0.2	0.2	0.2	0.2	0.1	0.1
Payroll Tax Deposit Stabilization	0.0	0.9	2.2	—3.1	0.0	0.0
Permit Limited Use of Excess Pension Funds to Pay Retiree Health Benefits	0.0	0.2	0.4	0.2	0.0	0.0
Initiate IRS Management Reforms	0.1	2.5	1.1	0.5	—*	—0.4
Increase IRS Enforcement Funding	0.0	0.5	0.8	1.3	1.5	1.6
Miscellaneous Proposals Affecting Receipts:						
Increase D.C. Contributions of CSRS	0.0	*	*	*	0.1	0.1
Increase Ad Valorem Fees on Shippers	0.0	0.3	0.3	0.3	0.4	0.4
Increase and Expand SEC Fees	*	0.1	0.1	0.1	0.1	0.1
Modify Collection Period of Telephone Excise Tax	0.0	0.1	*	*	*	*
Extend Abandoned Mine Reclamation Fees	0.0	0.0	0.1	0.3	0.3	0.3
Establish CFTC Fee	0.0	*	*	*	0.1	0.1
Change Collection Point for Liquor Occupation Taxes	0.0	*	*	*	*	*
Extend OASDHI to D.C. Employees	0.0	*	*	*	*	*
Extend IRS User Fee	0.0	0.1	0.1	0.1	0.1	0.1
Establish FEMA Fees	*	*	*	*	*	*
Extend and Expand Railroad UI Reimbursable Status	0.0	—*	—*	0.0	—*	—*
Modify Federal Reserve Reimbursement	0.0	0.1	0.1	0.1	0.1	0.1
Delay Federal Pay Raise	0.0	—*	—0.1	—0.1	—0.1	—0.1
Establish Corps of Engineers Fees	0.0	*	*	*	*	*
Other	0.0	—0.1	—0.2	—*	—*	—*

* Revenue gain of less than $50 million.
—* Revenue loss of less than $50 million.

January 30, 1990-A893a

Representative HAMILTON. Thank you very much, Mr. Secretary.

We will follow the 10-minute rule on questions. And I'll turn to Senator Sarbanes, vice chairman of the Joint Economic Committee, for the initial questioning.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Secretary, we are pleased to welcome you here this morning.

I want to turn to the international arena to begin with. It's my understanding that the administration, in its budget request, decided to request from the Congress sufficient funds to eliminate all arrearages in the various international financial institutions.

Is that correct?

Secretary BRADY. That's correct.

Senator SARBANES. Let me say I very strongly support you in that effort. I think it's a disgrace that we should be the principal deadbeat when it comes to meeting our commitments in some of these international institutions, many of which we look to to help us achieve very important objectives in terms of international security and international development.

How much of a burden or handicap have you found it to our work in these institutions and our efforts to influence their policy directions? What does it mean for the United States to come to the policy table as the one principal actor who hasn't met its responsibilities?

Have you encountered that attitude?

Secretary BRADY. Senator Sarbanes, you put your finger on a very important point. As we try to make sure that U.S. foreign policy objectives are put into place, we continue to be faced by the counterthought that why don't you put the money up for these international institutions that are trying to get these policy objectives accomplished.

I know the same thing is true with the United Nations and you feel very strongly about that. But, I can't overemphasize the difficulty that we have in trying to get things accomplished which are U.S. objectives because of the fact that we simply don't come up with our own part of the international economic multilateral attempts to try and make these things work.

It's very difficult.

Senator SARBANES. I'm very hopeful that the Congress will respond positively to this initiative. It's one thing to question a future commitment and to argue about it among ourselves. But one undertaking we ought to make for the future, it seems to me, is to deliver on past commitments. We find ourselves in the position of not having done so in a number of these institutions.

Now we are almost alone in that regard. The Soviet Union, which for many years was much further behind in some of these institutions, has now paid up, leaving the United States as the principal deadbeat on the block.

I commend you and the administration for taking this issue on; I know it's been a matter of concern to you.

Could I ask where you see the international debt strategy moving next? If we can put that on the record.

You've indicated Mexico, the Philippines, and Costa Rica are behind us, more or less. I feel we need to broaden that list, or lengthen it.

Where are you working now?

Secretary BRADY. Our main effort, while not trying to forget the concerns of small countries, but the two big items before us in 1990 are Venezuela and Brazil.

As you are well aware, Brazil is the largest debtor, bigger even than Mexico. Brazil has elected a new President. He was in town last week, and we met and talked with him at great length about his aspirations to do something about the debt problem. That will be a matter of enormous importance at the Treasury.

It's also true that Venezuela is making progress with its bank advisory committee and we've been trying to work with them to bring about that understanding there, which will follow on Mexico.

Morocco is another country that is of extreme interest. The Europeans feel very strongly that a debt strategy solution could be brought into focus there. There's another country where we're spending time currently. But I don't want to indicate, Senator Sarbanes, in answering you, that there aren't all manner or range of people that we are talking to. The President of Uruguay will be here next week. So, the big ones, like any financial problem, are the ones you concentrate on. That does not mean we are forgetting the smaller countries.

Senator SARBANES. What role are you planning in the proposed European Bank for Reconstruction and Development for the United States?

Secretary BRADY. The discussions about our role in that organization are underway at this moment. We are planning to be a senior subscriber to that organization at the top level. There are certain items on which we are stuck, such as whether the payments should be in dollars or ECU's. They're mostly technical.

But, that organization, which is going forward at a pretty rapid rate, is one that we plan to be a part of unless people put to us conditions we can't accept.

At this moment, I don't see that.

Senator SARBANES. Would you agree that the dissaving reflected in the Federal deficit is the single most significant thing that we could do to change the savings situation in this country?

Secretary BRADY. I would, followed closely by some sort of increased recognition among all of us that we have a savings problem in this country, a national consensus that we have to do something about the problem as a whole.

But, the answer is yes.

Senator SARBANES. Having said that, you have, at least in the short run, it seems to me, a conflict between policies designed to encourage private saving, which I agree are desirable, but which carry with them an increase in the deficit in the short run.

On that conflict, how do you come out and why?

Secretary BRADY. Well, there is a conflict. Just talking about savings won't get the job done. People act on how they face their particular circumstances. And in the family savings plan that's in the President's budget, there is a budget hit for establishing that program. The first year, it's $200 million.

There are other savings initiatives which people have suggested, most of which have a budget effect, a negative budget effect.

So, the way we've recognized it is that we work on both funds at the same time. We can't be as aggressive in savings as we'd like to be, but take some steps and see what they produce. The savings plan is one of those steps.

Senator SARBANES. It's your position, I take it, that with the cut in the capital gains tax rate that you are talking about, we do not lose revenue.

Secretary BRADY. That is correct.

Senator SARBANES. For how many years do we have that happy state of affairs?

Secretary BRADY. Under the Treasury revenue estimates for the total of 5 years that we estimate based on the plan that we've submitted in the budget, we get revenue-positive figures. Treasury staff has guessed that the JCT will show a loss over this period.

Senator SARBANES. If you carried it out further, would your plans be to reflect a plus figure?

Secretary BRADY. Yes.

Senator SARBANES. That's wonderful. I'm really looking for—well, I was going to say a comparable hoax, but that language may be too strong—something where I can say I'm going to cut taxes to the ordinary taxpayer, but the Government will get more revenues.

With those greater revenues, we would be able to fund programs or show a lower deficit.

Why don't we have a bigger tax cut here and then produce more revenues?

Secretary BRADY. Two reasons, I would say, Senator. One, there is feeling among people in Congress that the tax cut should only be of a certain size, that we shouldn't go too far. But there is a crossover at some point in time. Not to be ridiculous, but if we had a zero tax rate, we wouldn't get any revenues.

Senator SARBANES. I take it from that answer, you think it could be even lower but shy of the zero?

Secretary BRADY. I'm not sure what the crossover point is.

Senator SARBANES. Do you think you're at the crossover point with your proposal?

Secretary BRADY. We are very near it.

Senator SARBANES. Mr. Chairman, on that Alice in Wonderland exchange, I think my time is up.

Representative HAMILTON. Congressman Upton.

Representative UPTON. Thank you, Mr. Chairman.

Welcome, Secretary Brady.

We are all concerned about the rate of savings in America, particularly with our international friends. This committee has had a number of hearings over the course of the last year to focus on raising our national savings. And it was about a year ago that Michael Boskin came to testify before this committee and indicated that the administration would not be adverse to coming back with an IRA-type proposal, something that we saw end in the tax bill of 1986.

And I presume that the family savings plan that was unveiled by the administration follows along those lines.

I have a couple of concerns that I wanted to raise with you with regard to that. I support the IRA's. I thought it was a very worthwhile program. As I go back to my district in Michigan, it comes up quite often at town meetings and business folks and others that I meet with in my district.

You indicated that the family savings plan actually will probably increase the deficit by $200 million.

What is the real difference between the family savings plan and the tax-free money markets and other things that are, today, already available?

Secretary BRADY. The money market funds, as I understand it, are not tax free.

Representative UPTON. There are a number of them.

Secretary BRADY. Are you talking about money market funds that are invested?

Representative UPTON. Invested solely in tax-free securities.

Secretary BRADY. In some sense, there is no difference except for the fact that those funds are not generally known by the broad population in the country.

I think what we've done is personalized the tax-free municipal bond so that the average guy can understand it.

Representative UPTON. There has been quite a bit of press with regard to Senator Moynihan's Social Security proposal over the last couple of weeks. And I want to go into a hypothetical here for a moment.

If this proposal came to pass somehow, all the experts indicate that the deficit would probably raise because of the loss of revenues by about $60 billion.

If all that came to pass, would you as Secretary of the Treasury be more likely to promote what type of alternative to meet the Gramm-Rudman target, to either sequestration, raise other revenues, which I don't think you've been saying, or perhaps changing Gramm-Rudman so that we wouldn't face the sequestration in 1992 of about $60 billion?

Secretary BRADY. Congressman Upton, we don't think it is going to come to pass.

Representative UPTON. But let's say that it does. Let's say we have a nightmare on Elm Street.

Secretary BRADY. Obviously, if it did come to pass and you had to then—we would obviously be in sequestration almost immediately because of the size of the Social Security trust fund surplus. I can't see the body politic going for that kind of a solution at this particular point in time.

I think what it would call for would be a change in the Gramm-Rudman targets.

Representative UPTON. Under the Gramm-Rudman deficit reduction schedule, it can be suspended by the Congress if there are two consecutive quarters of real GNP that are less than 1 percent.

What is the probability that the real growth in the last quarter of 1989 and the first quater of 1990 might be below 1 percent?

Secretary BRADY. I would refer you to Mr. Greenspan's testimony the other day where he was looking for an upturn in the first quarter.

He is a world-renowned economist. Our figures would agree with that. So I don't think that's going to happen.

Representative UPTON. My last question focuses on debt, particularly to the Third World. The Brady plan has received many accolades throughout the last year. In fact, as I recall, it was even mentioned in the State of the Union Address a year ago. And in other speeches by the President.

A couple of weeks ago, I was able to participate in a conference with Central and South American leaders in Florida. Leaders from Venezuela, Peru, and several other Central American countries were represented.

And the plan with regard to Mexico we established sometime ago won quite a bit of praise. Mexico was not represented. The indicators that we received from the other nations that were present were that they also have a debt plan.

Senator Sarbanes, I know, referenced that a little while ago. And their thoughts were that they would like to see something for their countries that paralleled or was very similar to what we had established one on one with Mexico.

What are your thoughts in that regard? What are some of the problems and traps?

Secretary BRADY. Congressman Upton, let me just elaborate slightly. We did not at the beginning of the debt strategy, which was announced about a year ago at the Bretton Woods annual conference, come up with a plan which was designed just for Mexico.

What we elaborated was a set of broad principles which called on the people involved in this process to come up with debt reduction for the debtor countries, called on the IFI's, particularly the IMF and the World Bank, to supply funds which would be used to aid this process.

And perhaps most importantly we called on the countries involved to establish economic programs which would be sound from their own point of view, and that would encourage flight capital to come back to those countries. If you look at the problem facing the debtor countries from a schematical, global point of view, there really isn't enough money going into that system unless you get a return of flight capital to the constituent countries. And that can only happen when good, solid economic programs are set forward.

So, the same principles that we enunciated a year ago at Bretton Woods are still the guiding ones of new debt strategy. I think what you're seeing in the change in leadership in the Latin American countries is a new wave of leaders coming on who embrace this principle, although all of them may not be able to effect it.

But, to make a sort of long-winded answer to your question, the plan is still in effect more or less the way we started it in terms of broad principles. And we think each individual country has to see how it fits into it.

For instance, the deal with the Philippines is quite a lot different than the one with Mexico, as you are aware. And, Costa Rica, is different than the other two country agreements.

Representative UPTON. Are you content that the flight capital in Mexico has been curbed?

Secretary BRADY. Well, really, all we know is what the statistics show. And I believe that since the announcement of the agreement between Mexico and the commercial banks in July 1989, between that time and the end of the year, there was an increase in investment flows to Mexico of over $3 billion. And I think it's been even better since that time.

Representative HAMILTON. Mr. Secretary, in 1989, the inflation rate was 4.6 percent. That's the highest inflation rate since 1981. You may have noted that when Mr. Greenspan testified before this committee last week, he said that figure is unacceptable.

The administration projects that the inflation rate will fall to 4.1 percent in 1990. That's from the current rate of 4.6 percent. Now, what's the basis in your view for a decline in the inflation rate at a time, for example, when the Chairman of the Fed is concerned that inflation is accelerating?

Secretary BRADY. Mr. Chairman, as you know, all of these estimates are, in the last analysis, filled with a lot of subjective input. Our feeling is that in the last several years, inflation has dropped from 10 percent in 1982 down to this level. And although it may fribulate around the 4-percent level that we see in the years coming, that the fact that we worked on the fiscal deficit to push that down, and perhaps some of the other factors which go into the inflation category, will just bring it down.

Representative HAMILTON. You would agree with him that 4.6 percent is unacceptable, I presume?

Secretary BRADY. As a broad goal, yes. But I think, frankly, the fact that it's stable over a period of time has some bearing on it. That doesn't change the point that if it were stable at 10 percent it would be bad. But, the fact that it has come down and is now stable around 4.5 percent is something—stability is something to be sought after.

Representative HAMILTON. It's amazing how these things change. Some of us have been around here long enough to remember that President Nixon put on wage and price controls when we had 4 percent inflation. Now we seem to be accepting a 4.5-percent inflation rate on the basis of stability and you don't seem very exercised about it.

Secretary BRADY. It's not that I'm not exercised about it, it's that you have to balance off growth against the rate of inflation. It's theoretically possible to drive the inflation rate down to zero but to do that, in my opinion, you would have to put brakes on the economy which work on the other side of the equation.

Representative HAMILTON. Now, you called through the President's press secretary for lower interest rates. Lower interest rates would be a suggestion that you want to stimulate the economy more and are not much worried about inflation.

Is that a fair view? A fair interpretation?

Secretary BRADY. I think the two events to which you referred to one, but they're really part of a 2-day comment on the subject of interest rates.

On Thursday, the President's press secretary called for low interest rates, and I think that was anticipation on the President's appearance at a housing conference where I think it's not untraditional, if that's the word, for Presidents to talk about increased home production and lower interest rates.

So it was not meant to be a contest with the Fed that particular time. He has in the past at every housing conference expressed the hope for lower interest rates.

Representative HAMILTON. Surely, the press secretary of the President would not call for lower interest rates unless the President had clearly instructed him to do so.

Secretary BRADY. Well, I'm not sure, in the way these things take place, that's true. In the face of a speech by the President for the next day before a housing conference, it could very easily be, in trying to inform the press ahead of time of some of the things the President was going to talk about, that could be the case.

Representative HAMILTON. Is it the position of the President and the administration today that you want the Fed to move to lower interest rates?

Secretary BRADY. Mr. Chairman, as I'm sure you're aware, our position, and the President supports it, is that we conduct discussions with the Chairman of the Fed once a week, and our meetings are vigorous and they very often include differences in point of view.

I think the way I stated it in the past is that the administration probably has a bias toward growth that's greater than that of the Fed. At the same time, we keep a weather eye on inflation. And I think the reverse is probably true of the Federal Reserve System.

Representative HAMILTON. Among those differences at the moment is that you're pushing the Fed for lower interest rates at this point in time.

Secretary BRADY. Again, sir, with all due respect, the discussions at our meeting with Mr. Greenspan are vigorous. There are differences in point of view openly expressed. It's something that I think is best kept between he and I.

Representative HAMILTON. Why did the press secretary of the White House then go public with it?

Secretary BRADY. As I tried to clear up by stating the facts, I don't believe he was talking about Federal Reserve policy in that particular instance. I think he had in mind the fact that the President the next day was going to speak at a housing conference. And Presidents generally talk about lower interest rates at housing conferences.

Representative HAMILTON. Are these informal channels that you refer to satisfactory for you in conveying the views of the administration to the Fed with respect to the steps that ought to be taken?

Secretary BRADY. Sir, given the independence of the Fed, taking that as a given, I don't see that a public revealing of the discussions between the Treasury and the Fed would do much. I don't know as it would change the Fed's opinion as long as they have the votes to do what they're going to do.

Representative HAMILTON. Mr. Greenspan labeled Mr. Fitzwater's statement as inappropriate.

Would you agree with that?

Secretary BRADY. Not in light of what I understand was the reason for the statement being given.

Representative HAMILTON. On interest rates, long-term interest rates have risen by about half a percentage point in the past month. Some experts say this is because of a reluctance by foreign investors to buy our bonds for whatever reason.

How do you account for the rise in long-term interest rates? How concerned are you about it?

Secretary BRADY. Obviously, we would like lower long-term interest rates. I think a couple of things are happening, which I hope will have only a short-term effect on the market. One of the things that's happening is interest rates in Germany and Japan have been raised, while interest rates in the United States have been lowered.

So that the attractiveness of U.S. debts and fixed-income securities is obviously less in comparison to Germany and Japan than it used to be. So, for the short term, that will produce an uptick in the rate of interest in the Treasury bills and 30-year bonds.

It's unfortunate but it's one of the things that happens as countries readjust their interest rate policies.

Representative HAMILTON. Is there any doubt that the influence of these foreign markets on our own economy is increasing? Is that fair to say?

Secretary BRADY. I think it's very fair to say. If I may, just one statistic, Mr. Chairman, which has always fascinated me is that every night through the Federal Reserve System in New York, there are 1 trillion dollars' worth of settlements on the Fed and the CHIP's wire. It's an enormous figure. It's one-fifth of our gross national product every night.

Representative HAMILTON. When you served as the head of the President's commission to look at that 1987 stock market crash, you commented that—I think you used the words—the "catalyst for the crash" was the rise of interest rates in 1987.

Does that situation seem to be repeating itself? Could this rise lead to another crash in the stock market?

Secretary BRADY. If we talk about a crash as being one that produces a 500 point decline in one day, I don't think so. In October 1989, we had a serious day of declines. I believe it was over a hundred points. The upshot of that was, on the following Monday, the market went back up again.

So I think what has happened in the period of time between 1987 and 1989, is that people now understand better the interaction of forces from all over the world, but particularly the interaction of forces between the Chicago Futures Market and the New York Stock Market.

One of the main conclusions of the 1987 report is that we have one market. It's an electronic market that exists in computers and in the transmission of electronic data. But it is one market. So, once you realize that these two markets have to balance out between each other and you understand how those markets balance, in my opinion, that is the reason why the October 1987 crash was not repeated this last year.

Representative HAMILTON. One of the reasons that the 1987 crash did not hurt the economy may have been because corporate profits were very high and rising at the time. Currently, they're moving in the other direction. That's one important distinction.

Well, I have some other questions that I want to come back to. My time has expired, and I recognize Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman.

Welcome, Mr. Secretary.

And I appreciate the testimony you have given here this morning. I want to say just as a tale before I start on my subject here this morning, Mr. Secretary, I hope that we in the United States and you in the Treasury Department do not join on the bandwagon of some of the overzealous regulators who are opposed to the trading of stock index futures and drive those markets to Tokyo, because they're not going to go away, I don't believe. They'll just go offshore somewhere if we don't have them in the United States.

And I compliment your ability to put into perspective with the electronics now of New York and Chicago and the relationship between the two. And I thank you for that answer you just gave.

But, Mr. Secretary, I want to thank you and the President for your strong stand and the President's statement Wednesday night that he was going to follow through on his budget plan with no new taxes.

I'd have to say, Mr. Chairman, I want to thank all my friends in the Democratic Party that were on the floor that refused to stand up and clap for the President when he said that, so that we could make it clear to the American people just who it is that wants to raise their taxes in order to solve the problems of the budget.

I also think, Mr. Secretary, that the administration, I would hope, would look favorably, and at least with an open mind, to what the message is that Senators Moynihan, Kasten, Sasser, Sanford, Heinz, and others, who have really opened up the debate about the Social Security trust fund and the correct level of taxation for it.

I think it's very interesting if you notice here what the General Accounting Office says about it. They say that:

"In our view, the preferable course of action"—this is with respect to the Social Security trust fund and surplus—"In our view, the preferable course of action would be to make the accumulation of Social Security trust fund reserves an economically meaningful process, one that represents a net additional addition to national savings."

Last week, I introduced a bill which has been sent down to the administration to study, review, and see what point it is that I'm driving at, because I think it's a perfect compromise between what the President is calling for with the family savings account. I laud you and the President for coming up with the plan, recognizing that one of your cornerstones of the administration is to increase Americans' personal savings rate. I think that's a good goal and we should do it.

The bill I introduced, S. 2026, I think provides for an economically meaningful process. In other words, what we would do is put the surplus of each worker's money from Social Security into a family savings plan to protect it from the spenders in the Congress.

Senator Moynihan and others are correct that we in the Congress spend the money that comes in from Social Security tax in the unified budget or other processes.

If you'd move that chart, please, I'd like to show this out. This area right here, this line, is the administration's budget line where we'll hit a zero budget by 1993. This is the surplus, and I call this the Darman fund here, which is the plan to start accumulating that.

Maybe it's a good plan. It's very hard at a town meeting with a group of constituents to explain how that's supposed to work. And I fear it may be too little too late.

This is the line of what the deficit would be under the proposal by Senator Kasten and Senator Moynihan.

And that would be Senator Kasten's line. Senator Moynihan I don't think mentioned Gramm-Rudman. I think his thought was that if Senator Hollings or someone would come in with another tax increase, we would pass that to make up the difference.

Senator Kasten came along and offered this plan where he slipped the targets of Gramm-Rudman, and admit to ourselves that, if we can control government spending, whether we borrow money, whether we tax the money or whether we inflate the currency, I think inflating the currency would be the least good. It would be the most immoral way to stop this problem. But, we would slip the target over to here. So it would be in 1995 and 1996, we would have a balaned budget instead of 1993–94.

My plan takes the President's family savings accounts, takes all of this money that's in here between these two lines and puts it into Social Security supplemental family savings plans, accounts for each American, patterned after the President's program.

I'm not married to what I've introduced in my plan with respect to how those would be worked out, but we have taken what the President has suggested and what you've suggested at Treasury and said that the money for the surplus and Social Security can go here.

And the difference between this plan and the one that has received some notoriety in the press, that this would not interfere with the beneficiaries of Social Security; the Social Security trustees would, in case there was a recession, there would be less money in this section. They would put the money in to pay the current beneficiaries.

If we had a good booming economy 20 years from now, 15 years from now, more liberal immigration policy, more workers coming into the country, feeding into the chain letter, than it would still pile up this big savings in the future for each individual American.

So you would gain from this program a net increased savings for all Americans. Congress would be denied access to all these billions of dollars that they would want to spend to buy votes to get themselves reelected. And the American people will at the end product, when the baby boomers reach retirement, have a substantial savings account.

So I hope we can bring this into this debate and not say that it's just an open and shut case on what Senator Moynihan has brought up.

I think he's brought something to the national debate that the American people are interested in. As one who is in office, Mr. Secretary—and you had that experience of going home and talking to the voters—the voters are very concerned in America about what's happening to the Social Security funds and why is the Social Security fund taxed more to pay for other programs.

So I hope that you'll look at that. I don't expect a blanket endorsement of it this morning, but I would hope that it would not have a blanket turnaround.

I just say before I ask for your comment on it:

You made the statement that you don't think we should mess around with Social Security. The President said we should not mess around with Social Security. I respect you for that. My plan does not mess around with Social Security. It protects current beneficiaries and future beneficiaries that would have a priority over the private savings plans.

But we would establish a defined contribution account similar to what Federal employees enjoy today in the Federal employees thrift savings plan, which is a very nice way for Federal employees to accumulate their own private pensions in addition to the Federal pension.

And I think, Mr. Secretary, you know that, in my heart, I'm still an apple grower and I think that this kind of a plan—and the reason I say that is I think in terms of 20- to 25-year plans. When you plant an apple tree, you don't start harvesting very many apples for at least 10 years. And you don't reach full production until 20 years. And by 20 years from now, if we would enact this into law now, we would have a massive pool of private savings. If we go the other way and we really did it right and Congress didn't squander the money and the Government saved it all, which, you know, I'm a little skeptical—I'm too much like Barry Goldwater, I guess. I'd like to see the cigar box where all the money is. So far, it keeps getting to be more debt.

But, if we did it theoretically correct and were responsible, I think it would not be healthy for the economy to have the Federal Government be the person that owns all the money, because then you would have to go to the Federal Government to get a loan to start your factory or whatever you were going to do.

I think that would be unhealthy also. So I hope you'll look at that. I think it answers a lot of questions. And we mailed that out to some 600 outlets and it's going to be talked about. And we want to heighten the debate on that issue as part of this overall package.

Secretary Brady. Thank you, Senator Symms. We certainly will take a look at it. I'm not sure I can understand all the aspects of it just from looking at it quickly.

I would make several comments, and we do want to promise you that we will take a look at it.

First of all, I think we don't want to confuse the American people about what the Social Security trust fund does. The Social Security trust fund is not investing in the deficit. The Social Security trust fund, all of the funds that come into the Social Security trust fund, are invested in U.S. Government securities. There is no real connection between the budget deficit and the Social Security trust fund from a mechanical point of view.

Simply, the people's money and the corporation's share of the total contributions are used to buy the U.S. Government notes. It's the full faith and credit of the U.S. Government that ultimately pays that off.

I would admit that, when you are looking at the Federal budget deficit, it's a valid point to say why are you adding Social Security trust fund surplus to the operating deficit and thereby reducing the size of the deficit.

In the budget document that was submitted this year, Director Darman put three columns in. One is the Social Security surplus. The second is the operating deficit. The third is the unified budget. Those two added together would show for Gramm-Rudman purposes how those three columns all appear to relate.

But I think we ought to be very careful in implying, and I know you're not, that money that goes into the Social Security trust fund is going into the budget deficit. It's not. It's going into a trust fund which is a very tight trust fund, the principal assets of which are going to be used to pay off the benefits when they're needed.

I must say that, again, I don't know how your plan, which is very thoughtful and a useful addition to the debate, would affect this. But, we have taken the position with regard to earlier discussions on this subject by Senator Moynihan and others that reducing the Social Security taxes by $55 billion is not something we would advocate at this particular point in time, because, really, all it does is to shift the generational burden of providing the benefits in the trust fund from our children to our grandchildren. This is just statistically inevitable from this cut that's been suggested.

And we do not think that's a good idea. And as you know, back in 1983 and prior to that time, we had a debate in this country as to whether the Social Security trust fund system was sound and whether it would pay the benefits off when they're due.

I think most Americans feel that that debate is behind us and they're satisfied that they'll get their money when it's due. I do. I feel that way, that we do have a sound system.

I think we ought to always look at innovative ideas, but I hope we don't take something that the American people believe in and change that view, because I don't think that's the case.

Senator SYMMS. Thank you very much.

Thank you, Mr. Chairman.

Thank you for your excellent testimony this morning.

Representative HAMILTON. Mr. Secretary, I have a few questions on the debt situation.

The goal, of course, in any international debt strategy, is to get a resumption of growth.

Do we have any evidence now that the current debt strategy is raising the growth rates of these developing countries or will raise them?

Secretary BRADY. Mr. Chairman, I can only tell you about several particular instances. One is the case of Mexico. A part of the process by which you access funds in the IMF and the World Bank in order to reduce your debt is to agree to strong and solid economic programs based on growth. The programs would include measures to bring back into the country flight capital and to encourage investment. These programs, of course, give courage to the banks who are making private sector loans. That has been certainly a hallmark of President Salinas' administration.

In Argentina, where the situation is very, very severe, President Menem just this last year has embarked on that kind of a program himself. And in the meetings with President Collor, recently elected in Brazil, he, too, is adopting economic programs which are solid, sound and which allow, hopefully, the IMF and the World Bank to be participants in that particular country's problems.

So I think that by using this approach, we help the process by which individual countries try to produce programs which provide growth.

Representative HAMILTON. Are we seeing that growth occur yet?

Secretary BRADY. In the case of Mexico, which is the country that I'm most familiar with, the answer is yes. We are getting enormous growth in Mexico. We're getting a return of flight capital to that country, a decrease in the rate of inflation, a decrease in the interest rates, and increased investment by foreigners. The Mexicans have now sold the national airline to their own private sector plus to foreign investors as well.

Mexico's largest copper company is being turned over to the private sector. And growth is abounding.

Representative HAMILTON. Do you think we'll begin now to see the rate of growth increase for these heavily indebted countries?

Secretary BRADY. I think so, but not in every country because it's hard. But I believe that a return to sound economic policies will do that.

Representative HAMILTON. The Wall Street Journal this morning reports that the Mexican debt agreement is only going to slightly reduce Mexico's debt service and may ultimately increase Mexico's $93 billion debt.

How does that strike you?

Secretary BRADY. Perhaps you know more about the press than I do, but it seems to me that we see in these reports on Mexico an example of the glass being half empty instead of half full.

Let me just cite some statistics.

First, the comparison that should be made is not the fact that we are lowering debt and debt service, which we are significantly, but what it would have been if we hadn't approached the problem this way. Under the traditional new money approach, Mexico's debt would have skyrocketed and the situation in that country would have been much more severe.

Second, perhaps the most important statistic of all, and I don't understand why it isn't in the newspaper reports, is that the structure of the Mexican transaction removes the obligation to pay over $40 billion in principal from the backs of this generation of Mexicans and their children. This is because the principal payment on that debt is collateralized by zero-coupon bonds.

That's an incredible statistic. Before this plan, it was entirely the credit and responsibility to pay off that principal was Mexico's alone.

After the plan, the Mexican debt is, to a great extent, backed by U.S. Treasury securities purchased by the Mexicans, these securities mature at the same time the Mexican bonds mature, thereby supplying the funds to pay off the debt.

I can't understand why that factor isn't mentioned in the newspaper stories to a greater effect.

Representative HAMILTON. Did the Treasury give Mexico a favorable rate on those zero-coupon securities you were talking about?

Secretary BRADY. Not at all. There's been some discussion about that. There are many arguments I have seen since the time that allegation was made that the Mexican zero transaction was priced right on the mark, or that it was even below the mark.

But, most importantly of all, the Mexican transaction with respect to zeroes is based on the 1987 precedent, when we also sold zeros to Mexico.

Representative HAMILTON. So there was no favorable pricing there for Mexico as the press has reported?

Secretary BRADY. Not in my mind.

Representative HAMILTON. What about the banks that chose the so-called new money option? What percent of banks opted to take the new money option?

Secretary BRADY. Very few, Mr. Chairman.

Representative HAMILTON. Were you disappointed in that?

Secretary BRADY. Well, yes, I was. But not surprised. It has been said that the new debt strategy is the reason commercial banks have not come forward with new money. That, in my opinion, is not the case. There has been a trend by the commercial banks over the last 5 years not to provide new money for the debtor countries, a trend downward.

So it didn't surprise me. In fact, it's the reason we changed the strategy. I was surprised, however, that in the case of the Philippines new lending seems to be picking back up again.

Representative HAMILTON. Do you believe on the basis of your experience in these negotiations that banks are prepared to put significant amounts of new money into these heavily indebted countries over the next several years?

Secretary BRADY. I think that will be determined on a case-by-case basis in those countries which can show strong economic programs and the political will to maintain them. I can't imagine that international banks won't want to be part of that expansion.

Where countries don't show a strong economic program, I think we are going to have trouble getting new bond lending.

So it's really in a sense up to two forces to get these problems solved. One is the country itself in terms of new, strong economic programs. The IMF and the World Bank have been incredibly helpful in encouraging reform programs and helping out when those policies are in place.

Representative HAMILTON. Most of our banks in this country or at least some of them have sharply increased their reserves against these debts. But what they have not done is taken a general write-down on their Third World loan debt portfolios. They've set aside the reserves, but they have not acknowledged that those reserves are going to have to cover real losses.

Do you think it's now time for banks to begin looking in general at that?

Secretary BRADY. I think the fact that they increased reserves indicates to us what they think the loans might be worth. I think that most banks have a legal problem, Chairman Hamilton, which I understand from having been in the industry, where when you have a legal obligation on your book, it's a big step to take that legal obligation off your book.

The lawyers will probably advise them that the directors, if they do so, are subject to suit. So it's a complex problem.

Representative HAMILTON. As I mentioned a little earlier, we have an increase in long-term interest rates that is underway. Is that going to make it easier or harder to arrange some kind of global solution to the debt problem?

Secretary BRADY. You know if interest rates go up worldwide, that's not helpful. But I would point out that at least in our own country, interest rates in the long-term sector of the market are down some 60 to 70 basis points since a year ago. And, of course, before this recent rise, they were down even further than that.

Actually, one of the peculiarities of the Mexican financing was that international rates were falling and, therefore, a great many banks which previously would have taken an option which reduced interest rates to Mexico decided instead to take a principal reduction.

In the last year or so, we've been aided in the Third World debt crisis by having London interbank rates come down and our own bank rates come down. If they go back up again, it's not helpful.

Representative HAMILTON. A bill that passed last year for Poland and Hungary is premised, as you'll recall, on trying to get private sector development into those countries.

What is your impression at this point? Of course, that law has only been on the books a few months. But, is there any evidence that private investors from the United States or from Japan or Europe are prepared to make substantial investments in Eastern Europe? Do you see anything encouraging there?

Secretary BRADY. Well, is your question about the U.S. investors?

Representative HAMILTON. I'm just wondering if you're getting any private investment in Eastern Europe from any source, including the United States.

Secretary BRADY. Well, I think quite naturally the understanding of exactly how those economies work is probably better understood in Europe than it is here. But I see among American bankers the same interest that I see among European bankers, which is that, as these economies progress, they are going to be interested, because, in the long run, they'll be integrated into the European Community and be useful participants therein, and also be creditworthy countries. In the short run, I think everybody understands the difficulty of the problem.

None of these countries have a market economy. In some of them, there is a very weak central banking and banking community. So some of the things we take for granted in this country, which are pricing policies which are free-market derived, just simply don't exist there.

And until you get those things going, it's going to be difficult.

Representative HAMILTON. You don't see any move yet for private money to go into those countries?

Secretary BRADY. You can refer to the case of General Electric, that bought 50 percent of the largest light bulb company in Hungary with a view toward supplying the European Community from there. There will be transactions that take place in that fashion.

But these countries must work hard to help develop a more market-oriented economy. Until Western companies understand that there is a free market economy working there and that the structures that are necessary to get that done are more in place, the pace of new investment is going to be slow.

Representative HAMILTON. I wanted to ask you about coordination of our economic policies with the G-7 nations.

When the Federal Reserve and the Treasury Department disagree on policy coordination, how do you resolve that conflict within the administration? Who is the lead here? Is it the Treasury or the Fed?

Secretary BRADY. In terms of intervention, you're talking about now?

Representative HAMILTON. And coordination.

Secretary BRADY. Coordination and intervention are slightly separate things, sir. The procedure in the delegation to the G-7 meetings is that Treasury takes the lead. I wouldn't want to by saying that indicate that all the Fed's concerns aren't as well taken into consideration. And, of course, Mr. Greenspan comes to those meetings.

Representative HAMILTON. So the Treasury then is the agency that has the primary responsibility for coordinating with G-7?

Secretary BRADY. That's correct. But, at the same time, we have another railroad track that goes along in parallel, which is the central bankers around the world. And, of course, Mr. Greenspan and the Fed have primary responsibility for that coordination.

Representative HAMILTON. Mr. Secretary, I have introduced a little bill relating to reform of the Federal Reserve. I'm not going to go into that with you now. But I have written to you and asked for your analysis of it and your judgment about it. And I would like to ask you to respond to that, if you would.

Secretary BRADY. I would, indeed.

Representative HAMILTON. I wanted to raise a few questions with respect to the capital gains tax as well, so that I understand your position on that.

Your proposal is to exclude 30 percent of the assets held for 3 years and 20 percent of the assets that are held 2 years and 10 percent for assets that are held 1 year. It applies to all assets except collectibles. It applies to purchases that were made some time ago. And the rationale which you've given is that it's to enhance long-term investment.

Now, today, institutions own about half of the shares in the stock market and they do about three-fourths of the trading. Individuals already hold shares longer in part because they escape capital gains taxation entirely at death.

Is it the administration's position that individuals need more of an incentive than forgiveness of capital gains on death to hold stock for a long period?

Secretary BRADY. More of an incentive? I didn't quite hear the question.

Representative HAMILTON. More of an incentive than the forgiveness of capital gains completely on death. Do you need more of an incentive to get them to hold stock for longer periods?

Secretary BRADY. Mr. Chairman, if I could, we have to go back to the fundamental thought that we've had in our mind, the basis for our theory, which is the whole nature of savings in this country and the cost of capital to U.S. corporations as opposed to our competitors in Japan, Germany, Taiwan, Korea, and elsewhere.

I think it's statistically correct to say that we have from a cost of capital point of view a much more expensive burden on our corporations than do those in Germany and Japan. So, reducing the cost of capital is our major thrust.

Obviously, I don't want to drone on, but that's just the way my own mind worked. When a U.S. corporation making a car, say, competes with a Japanese or German manufacturer, it has to compete on what it pays for steel. And I presume that's about the same for all three countries. It has to compete on what it pays for labor, and that's getting closer and closer. And it has to compete on what it pays for capital, and that's not close.

In the case of Japan, the cost of capital is estimated to be 50 percent of what it is in the United States. And, compared to Germany—U.S. corporations pay twice as much.

So what we're aiming at is to try and lower the cost of capital to some large extent and the fact that we have capital gains taxes and Germany and Japan do not for long-term investments is part of that cost of capital differential.

So that is really the basis on which we approach this problem. That leads into savings; in a mechanical way, the family savings plan is an attempt to do something about that. I know that's a long-winded answer.

Representative HAMILTON. No. I'm struggling with this, Mr. Secretary.

We had a previous experiment with this sliding scale holding period. We had that tax provision during the Great Depression. And I think the result of that experience was that it discouraged trading and hurt the market.

Did you look at that experience when you were looking at making this proposal?

Secretary BRADY. I do not know the answer to that question. I would like to get it for you and supply it to you going back as far as the Depression. I don't know if we did or we didn't.

Representative HAMILTON. We had capital gains tax cuts in 1978, 1981, and 1984. Is the record clear that in each of those cases when we had a capital gains tax cut, that we increased our investment?

Secretary BRADY. I think the record, to say it's clear would be to overstate the case. It's our impression that it had an effect on investment and at that time, obviously, the differential parallel that our competitors enjoyed at the same time.

Representative HAMILTON. I just would like for you to furnish the committee any economic study that identifies an improvement in investment as the results of the capital gains tax cuts of 1978, 1981, and 1984. My recollection is that the Reagan Treasury Department's own study of the 1978 capital gains tax cut said that its impact on economic growth and the allocation of resources was really quite small.

So I'm interested in your basis, if you would, for believing that these proposed cuts in capital gains taxes will in fact increase investment.

[The following information was subsequently supplied for the record by Secretary Brady:]

You have asked me to furnish the Committee any economic study that identifies an improvement in investment as a result of a capital gains tax cut. In this response I shall provide a series of references to studies which relate to the extent to which a cut in capital gains tax rates may be expected to increase investment. While these various studies reach somewhat differing conclusions, I believe it is fair to say that they all support the belief that an increase in investment should be anticipated.

Several studies suggest that taxes in general, and capital gains taxes in particular, affect investment and overall economic performance. For example, Hall and Jorgenson (1967, 1971), Jorgenson (1971), Feldstein and Flemming (1971), Feldstein (1982), Boskin (1985), and Feldstein and Jun (1986) argue that taxes can be important determinants of investment. They emphasize the importance of the "cost of capital" as a determinant of investment decisions. The cost of capital is the rate of return an investment must earn to cover all costs, including taxes and depreciation, and yield investors their desired after tax return. All else constant, a lower cost of capital will encourage investment. Lower taxes, including lower capital gains taxes, can reduce the cost of capital, and therefore can stimulate investment. Feldstein (1982) and Feldstein and Jun (1986) also suggest that taxes are an important determinant of investment.

Factors other than taxes also affect investment decisions. For example, output and cash flow are also important determinants of investment spending. The fact that macroeconomic conditions can change at the same time as taxes make it difficult to sort out the independent effect of taxes. Chirinko (1986) provides a technical discussion of these problems.

Several studies focus more directly on capital gains taxes. These include 1978 Congressional testimony by Evans, Ciminero, and Eckstein, based on the output of large macroeconomic simulation models of the U.S. economy. In addition, Becker and Fullerton (1980) simulate the effect of a cut in capital gains taxes on economic activity, and a Treasury study (1985) shows that cutting the capital gains tax can stimulate investment and improve economic performance. A recent analysis by Henderson (1989) suggests that the increase in the tax rate on capital gains contributed about one-half of the 1986 Tax Reform's overall increase in the corporate cost of capital.

These simulation studies show how cutting the capital gains tax can stimulate investment and improve economic performance. The size of the effects varies from model to model (and from proposal to proposal). Importantly, even a modest increase in annual investment can, over several years, result in a significant increase in the nation's productivity.

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Representative HAMILTON. Of course, you're applying the capital gains tax under your proposal to existing investments. If the goal is to encourage new investments, why would you do that?

Secretary BRADY. It's applied to assets held one year or more. It's not if you bought the asset yesterday and the law went into effect today. You wouldn't get the benefit from that until you've held it for more than 1 year, or for 3 years to receive the maximum exclusion.

The reason for doing that is, obviously, it has a revenue effect. First of all, the intent is to try and make it only apply for the long term. We picked 3 years. Somebody could pick 2½ or 3½ years, or 4 and 2 years. But we thought that was the right period.

Then we wanted to phase it in because, obviously, if the fundamental theory is that you're trying to give this break only to people that invest for 3 years, then if you do so, just cold turkey, so-called, you produce a revenue dip in the first year and budget constraints wouldn't allow that.

The thing would obviously be dead on arrival and we think it's important that it's not dead on arrival. In fact, that it's flourishing and is a good idea.

Representative HAMILTON. You made a comment a while ago about the cost of capital in the United States in comparison to other countries. This is a very general kind of a question. Do you think our tax system is much more detrimental to the accumulation of capital than, say, Japan's tax system?

Secretary BRADY. Well, I think it's much more detrimental from the cost of capital point of view.

I almost hate to even bring this up, but I think the one thing we could really do, and we don't have a solution, would be to come up with some system where we didn't doubly tax dividends. I believe most of our major trading partners do not do so.

And, again, as we go down this road on this journey to try and increase savings in the United States, I have no pride in authorship. If it works in Germany, Japan, and elsewhere and their savings rates are higher and their cost of capital is lower, let's take a look at what they do and try and follow it.

But I've gone off the subject a little bit. I think the best thing we can do would be to try to remove the double taxation of dividends.

Representative HAMILTON. You're not proposing that?

Secretary BRADY. No, sir, I'm not because we can't afford it.

Representative HAMILTON. We would have a huge revenue loss.

Secretary BRADY. Absolutely. But I'm hoping that, as your committee and we all try and think this thing through and the importance of savings and lower costs for our corporations—more jobs, better products, and lower prices—I hope we can consider this subject because almost all of our competitors do so.

Excuse me for running on, Mr. Chairman, but also we have an enormous amount of feeling in this country which is shared by the Treasury that the LBO phenomenon that we've seen in the last year or so isn't basically something we want to continue. And in previous testimony before your committee and other committees a year ago, I put forth my real worries on this subject.

But, if you didn't, that phenomenon in my opinion is almost totally a result of the fact that dividends are tax-deductible and only taxed once, and common stock dividends are subject to double taxation.

So I think, if we were ever able to make this change, people would be able to stop talking about the LBO's.

Representative HAMILTON. I don't want to keep you too long. You've been very good in testifying. I do note that, in your proposal, you do not choose to propose in the capital gains tax proposal any indexing for inflation, and that's always seemed to me at least to be very desirable.

Why did you not include that in your proposal?

Secretary BRADY. Well, let me say I don't think we have a monopoly on every good idea with regard to capital gains, but we do have certain parameters within which we have to stick if we're going to get some action on the capital gains proposal. Indexing is something we considered. It is a useful idea.

However, two things I think are important to realize that ought to be contemplated. One is that it is expensive. And, two, it's very complicated. How we would actually have IRS forms which are understandable by the public on this subject is something that IRS continually poses to us as something they feel would not be something they would want to do.

So, cost and complexity.

Representative HAMILTON. OK, Mr. Secretary, we want to thank you for your appearance this morning before the Joint Economic Committee. We know you had some difficulty arranging it on your schedule. We appreciate that and your appearance on a Friday morning.

Thank you very much.

The Joint Economic Committee stands adjourned.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

[The following written questions and answers were subsequently supplied for the record:]

RESPONSES OF HON. NICHOLAS F. BRADY TO WRITTEN QUESTIONS

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 5, 1990

The Honorable Lee H. Hamilton
Chairman
Joint Economic Committee
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

I am responding to your request to Secretary Brady for answers to a number of questions submitted by members with respect to his testimony before the Committee on February 2.

Enclosed are the responses to those questions. I hope they satisfactorily address the concerns raised by the Committee.

Please let me know whenever we can be of service.

Sincerely,

B Harlow

Bryce L. Harlow
Assistant Secretary
(Legislative Affairs)

Enclosures

Question 1:

A number of recent studies have found that the burden of federal taxes as a percent of income has declined during the 1980's for the wealthiest 20 percent of taxpayers and has gone up for the bottom 60 percent. The reason for this, according to the Congressional Budget Office, is the increased reliance on payroll taxes, which are levied only on earnings and only below a maximum amount and thus are regressive. During the hearing, you testified that you are comfortable with this shift in the tax burden because the Social Security program is progressive when benefits are taken into account even though the tax burden is regressive. How is this computation affected by the fact that payroll taxes will raise about $74 billion more in fiscal 1991 than will be paid out in Social Security benefits?

Answer:

The Social Security system is not a welfare plan but a compulsory savings plan. It achieves its progressive result by giving a higher rate of return to low-earnings workers than to higher-earnings workers. For example, a retiring worker with monthly earnings under $356 receives 90 cents in monthly benefits for each dollar in average earnings. A worker earning greater monthly income (but less than $2,145) receives only 32 cents in additional benefits for each additional dollar in taxable earning. Those earning more than $2,145 per month receive only 15 cents for each additional dollar of additional average earnings. This means that a worker with only minimum wage earnings will receive benefits of about 61 percent of earnings, while a worker at the taxable maximum ($51,300 annual income in 1990) receives benefits equal to about 27 percent of earnings. The changing demographic composition of the United States makes it desirable to build up the trust fund now, while there are many workers, in order to finance the future retirement benefits of those same workers. However, the funding requirements called for by these demographic changes do not defeat the progressivity implicit in the differential rates of return offered to Social Security contributors.

Question 2:

Should other income redistribution programs, such as Medicaid, WIC, AFDC, and Head Start, be funded through regressive taxes?

Answer:

A number of Federal programs, including Social Security and Unemployment Insurance, are financed by payroll taxes. These programs share five characteristics: they are available only to those covered by special taxes, those taxes are segregated in trust funds, benefits are related to the taxes paid and are not adjusted for the income of the recipient, and the benefits are capped at a modest level.

Since Medicaid, WIC, AFDC and Head Start do not share these characteristics, they would not be appropriate candidates for funding via a payroll tax. Certainly it would be unwise to limit participation in these programs to employed persons, or to remove the means tests associated with these programs.

Question 3:

Is the Administration concerned about the recent growth in the share of federal revenue raised through payroll taxes and the decline in the share raised through income taxes? Will you propose any changes in either the income or payroll taxes to reverse this trend?

Answer:

Increases in the Social Security tax, the last of which became effective this year, were enacted in 1977. The increases were accelerated somewhat in the 1983 Amendments, and the rate on self-employment equalized. The increases were required to maintain the solvency of the trust fund. Any reduction in the tax would either be temporary, or would undermine public confidence in the Social Security system.

An increase in the income tax is neither necessary nor appropriate. The President's Budget meets the Gramm-Rudman-Hollings deficit reduction goals for FY 1991, and will produce a balanced budget by 1993, without increasing taxes. An increase in the income tax, in particular, is therefore not needed. An increase in the income tax would also be inappropriate; through years of legislative effort, we have been able to broaden the income tax base and lower rates, thereby reducing the disincentive effect of income tax rates on work effort, savings, and investments. Further, this transformation of the income tax has been accomplished without reducing its progressivity. This effort has been rewarded by a unprecendented period of sustained economic growth, low inflation, and high employment. To return to an income tax system based on high rates would be a negative step backward.

Question 4:

Is the Administration concerned about the fact that tax as a percent of income has declined since 1980 for the wealthiest twenty percent of families and risen for the poorest, next-to-poorest, and the middle fifths of the population? What policies will the Administration propose to reverse this trend?

Answer:

The Federal tax system is in fact very progressive. All recent studies agree on this point. For example, the recent analysis prepared by the Council of Economic Advisers and the Office of Management and Budget ("Progressivity: An Analysis of the Ways and Means Study") estimates that the net impact of the Federal tax and transfer system in 1987 increases the income of families in the lowest family income quintile by 3.7 percent, and decreases by 6.6 percent the income of families in the highest family income quintile.

Question 5:

To the extent that wealthy taxpayers pay a higher percent of total Federal taxes now than a decade ago, CBO points out that the reason is because their incomes have increased even more rapidly. The result has been a significant increase in income inequality during the past decade. Is the Bush Administration concerned about this increase in income inequality? If so, is the Administration prepared to propose or support tax or spending policies that would reduce or offset the increase in income inequality?

Answer:

The current distribution of the tax burden has proven itself compatible with national prosperity and has increased the share of the tax burden borne by higher income taxpayers. While we will, of course, evaluate particular proposals on their merits as presented, we do not believe that the statistics you cite make a case for increasing taxes solely in order to redistribute the tax burden.

THE 1990 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 8, 1990

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

The committee met, pursuant to notice, at 10:35 a.m., in room B-352, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Hawkins, Obey, Scheuer, Stark, and Upton; and Senator Sarbanes.

Also present: Joseph J. Minarik, executive director; David R. Malpass, minority staff director; and William Buechner and Jim Klumpner, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The committee will come to order. This morning, the committee will continue its hearings on the economic outlook and the Economic Report of the President.

Our witnesses this morning are Chairman Michael Boskin of the Council of Economic Advisers and the other Council members, John Taylor and Richard Schmalensee—did I pronounce that corretly?

Mr. SCHMALENSEE. Yes, sir.

Representative HAMILTON. Close enough?

Mr. SCHMALENSEE. Close enough.

Representative HAMILTON. Mr. Boskin and his colleagues will speak on the economic outlook and economic policies.

This hearing on the President's Economic Report is an important part of the process that leads to the Joint Economic Report to Congress, going back to 1946.

Mr. Boskin, we will turn to you now for your testimony. We have your statement, of course, and that statement will be entered into the record in full. And you may make whatever comment you like with respect to that statement and then we will proceed to questions.

Before you begin, Mr. Boskin, Congressman Upton has requested that his opening statement be inserted in the hearing. If there are no objections, it is so ordered.

[The written opening statement follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE UPTON

Thank you, Mr. Chairman, and welcome to you, Mr. Boskin, and your distinguished colleagues.

As some of you know, in a previous life I had the honor of serving for a time on the Administration side of the budget and economic forecasting -- in the Office of Management and Budget under President Reagan. That was before I chose the simpler life of a Congressman. So I like to say that I have a special sympathy for the way you in the Executive Branch look at these issues, and the way we in Congress do. I've even gone so far as quoting Joni Mitchell's line -- "I've looked at life from both sides now" -- but I think it only reminds people that Fred Upton is a member of the Pepsi Generation.

In any event, I think all of us realize the importance of the discussions we are carrying on here today. The recent testimony before this committee by Fed Chairman Greenspan and Treasury Secretary Brady received widespread publicity -- indicating the significance of their public comments here. I hope your remarks here similarly get the attention they deserve.

This discussion is not simply about whether Congress or the Administration is right. It's about whether, and to what degree, the American people can reasonably hope for more of the economic growth we have enjoyed over the last several years. It is also about the very serious policy choices we in the Federal Government should make to promote continued prosperity.

With that in mind I very much look forward to your testimony today.

Representative HAMILTON. Please proceed, Mr. Boskin.

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY RICHARD L. SCHMALENSEE AND JOHN B. TAYLOR, MEMBERS

Mr. BOSKIN. Thank you very much, Mr. Chairman.

It is indeed a pleasure to be here before the Joint Economic Committee and to report to you on the 1990 Economic Report of the President.

Mr. Chairman and other distinguished members of the committee, you have introduced Mr. Schmalensee and Mr. Taylor. I will make opening comments and ask each of them to make a brief comment.

Mr. Schmalensee is in the awkward position of having to rejoin the clean air negotiations over on the Senate side later this morning, so I might ask if in particular there was anything that was likely to be addressed to his areas of expertise, that those questions might, if at all possible, come first, because he will have to depart for those negotiations.

The 1990 Economic Report of the President's interpretation of economic events and economic outlook, principles and policies—because this is the first report of a new administration, it devotes particular attention to general principles and policy themes.

In his message, the President discusses the successes as well as the problems of the 1980's, a period of extraordinary economic transformation and growth and the market-oriented principles and philosophies that produced them.

Since 1982, when the expansion began, the United States has produced the longest peacetime economic expansion on record and it has created more than 20 million new jobs.

The containment of inflation during this long economic expansion is a milestone in postwar U.S. history. The expansion became the second longest on record and continued in 1989. The fraction of the population employed reached its highest level ever, with nearly 2.5 million additional jobs created during the year.

U.S. living standards remain the highest of any major industrialized nation. The U.S. exports rose to new heights. The United States regained its position as the world's leading exporter. What has come to be called the revolution of 1989 in Eastern Europe, and the contrast in U.S. economic performance between the 1970's and the 1980's confirmed our faith in economic and political freedom.

To quote the President, "Despite the successes, we cannot be satisfied with the strong record of the eighties, we must improve on that record, deal with inherited problems and meet the new challenges and seize the new opportunities before us."

The President advances his economic goal to achieve the highest possible sustainable rate to economic growth.

Quoting the President, "Growth is the key to raising living standards, leaving a legacy of prosperity to our children, uplifting those most in need and retaining America's leadership in the world. To achieve this goal, we must both enhance our nation's ability to produce and ensure that its potential is more often fully utilized than in previous decades."

To this end, he presents five basic policy principles:

Reducing government borrowing until the budget is balanced, and reducing the national debt thereafter; support for a credible systematic monetary policy that sustains maximum growth while controlling and reducing inflation; removing barriers to innovation, investment, work and saving in the tax, legal and regulatory systems; avoid unnecessary regulation and, where regulation is necessary, design necessary regulatory programs so that it enhances performance, so that it balances benefits and costs and it achieves our nation's objectives in the most cost-effective way, minimally disruptive to the economy; and continuing to lead the world to freer trade and more open markets, while supporting market-oriented reforms around the world.

Let me briefly summarize what is in the main text of the report, which is a somewhat more detailed discussion of economic performance policies and principles.

Chapter I obviously highlights the principles, policies, analyses developed in the rest of the report.

Chapter II reviews the economic events of 1989 in substantial detail; real or inflation-adjusted GNP grew for the seventh straight year. Inflation was contained, laying a solid foundation for future growth.

While the economy is currently growing more slowly than it had earlier, we expect as 1990 progresses the economy to pick up as the year progresses.

We do not believe a recession is likely in the near term. Contingent upon that, a successful implementation of the President's proposed policies, the expansion that is projected to continue in 1990 with economic activity picking up in the second half of the year relative to the first half.

And, again, into 1991, as the economy moves back to its potential level of output which it currently is slightly below.

We expect it to grow roughly 3 percent per year thereafter. Inflation is projected to decline gradually over the next several years; unemployment to remain relatively steady, and interest rates to decline heavily contingent upon the strong fiscal discipline the President has proposed.

Chapter III discusses the design of monetary and fiscal policy to enhance the economy's growth potential and to ensure the potential is more fully utilized. The key principle is that macroeconomic policies, both fiscal and monetary, should be systematic and credible, and that shortsighted discretionary finetuning often fails to achieve even its limited objective, and then continuously, generally harms longer term performance.

The President's actions last fall clearly demonstrated his commitment to a credible and systematic policy, fiscal policy, and to the principles of the Gramm-Rudman-Hollings law.

We laid out in the Economic Report a new rule for fiscal policy that would reduce the Federal debt in the hands of the public after 1993 to the proposed Social Security Integrity and Debt Reduction Fund.

This would transform the Federal Government from a chronic borrower draining the Nation's scarce savings pool to a saver for growth enhancement and investment.

The administration also supports a monetary policy that is credibly committed to sustaining strong economic growth and stability while predictively controlling inflation.

Sustainable growth will achieve a variety of important objectives, raise living standards, expand employment opportunities not only for new entrants to the labor force but for those seeking upward social and economic mobility, and provide the resources to satisfy a variety of private and public needs and wants.

Chapter IV discusses administration initiatives to enhance private sector investment, retain low marginal tax rates, and reduce the tax rate on capital gains.

It also discusses initiatives to strengthen the Nation's basic research base, and to enhance private sector incentives to translate this knowledge into productivity innovations, and it also discusses efforts to raise the U.S. national saving rate by reducing the Federal budget deficit, and, after 1993, the national debt through the policies included in the Savings and Economic Growth Act of 1990.

The administration, however, strongly rejects and opposes industrial policy design to have the Government picking winners and losers and second-guessing the market. Quoting the President:

"That is the way to raise budget and taxes and not living standards."

We also reject restrictions on the flow of foreign investment worldwide.

Chapter V stresses an important long-term trend in labor markets, one that this committee has paid substantial attention to over the years, based on major demographic changes.

We are undergoing a sea change in our labor markets. While episodes of declining economic growth and rising unemployment will undoubtedly occur every once in a while in the future, labor market trends suggest new concerns about the supply of workers and skills will dominate longrun labor market concerns in the decades ahead.

It will be important to increase their availability, for example, by improving the performance of our students in elementary and secondary schools and by bringing the disadvantaged into the economic mainstream.

The administration, through its proposed Educational Excellence Act, through working with the Nation's Governors and pursuant to the education summit to develop national education performance goals, is trying to lead the way toward improving the performance of the U.S. educational system.

While the most effective administration antipoverty program is a commitment to a healthy economy, the administration supports other initiatives in a variety of areas to try to bring the disadvantaged into the mainstream and to assist them. And this includes proposals for a targeted and refundable child care tax credit, support for the Americans With Disabilities Act, improvement of the Job Training Partnership Act and initiatives for home ownership, and so on.

Chapter VI stresses that a healthy environment and a sound economy can be compatible if—and I must emphasize only if—environmental regulation is well designed. Well-designed environmental regulation sets targets that balance benefits and costs and uses flexible regulatory methods that enhance private incentives to meet those targets without unnecessary additional costs, for example, to utility rate payers, or unemployment to our workers.

The administration proposed amendments to the Clean Air Act involve both sensible targets and effective methods.

Chapter VII stresses the administration's strong commitment to freer trade and open markets and supporting market-oriented reforms worldwide.

Successful completion of the Uruguay Round of the GATT this year is the administration's highest trade policy priority. Successful completion of these negotiations would confer substantial benefits on the United States and global economies.

The administration also strongly supports market-oriented reforms in Eastern Europe and in heavily indebted countries. In particular, the planned economies have a long road to travel to prosperity despite the inspiring and dramatic events of 1989. But we know that the only hope for these countries to achieve sustained increases in living standards for the population is to move further along the road to market-oriented reform.

That is a brief overview of the report. Let me ask Mr. Schmalensee and Mr. Taylor if they would like to make a brief comment.

Mr. TAYLOR. I would like to make comments about chapter III and then chapter VII.

Chapter III focuses on what we call the design of macroeconomic policy. It establishes two essential principles of policy. First, to design fiscal and monetary policy, it is important to emphasize what we call in the report systematic policy rather than purely discretionary changes in the instruments of policy.

Shortsighted discretionary policy neither attempts to lay out a policy plan nor to maintain a commitment to that stated plan. On the contrary, a systematic policy is forward looking.

The report goes on to explain how the administration's proposals and the administration's actions during the first year do follow the principles of both the systematic and a credible policy.

Examples of the systematic policies are the promise not to raise marginal tax rates as well as the administration's proposal for a new rule for fiscal policy, which Mr. Boskin mentioned.

The second policy principle is credibility. Credibility is the policy. Policy should be as credible as we possibly can make it.

Improved credibility can favorably affect expectations. It can also resolve uncertainties that inevitably arise and complicate policymaking in the context of changes and structural relationships in the economy.

The focus on systematic and credible policy may seem like an obvious choice. Indeed, as we read recent economic research and practical experience, it mandates such a choice, but this was not always the case. The report attempts to discuss contrary views that have been espoused by some in the past.

The report also endeavors to explain the particular advantages from an economic viewpoint of improved economic performance that comes from credible systematic sets of policies. And in this, we appeal to recent economic research and practical experience.

Chapter VII is the chapter on growth and market reform in the global economy. Basically, we think of this chapter as ringing the bell for free markets. And in doing so, we focus on several different areas in which there have already been substantial economic gains from the move to free markets or in which there is the potential for enormous gains in the future.

As Mr. Boskin indicated, there is substantial discussion of the economic reforms that are already underway in some countries or are planned in the countries of Eastern Europe.

We emphasize in the report, and I think it is important to emphasize this here, that political reform goes hand in hand with economic reform. Indeed, several Eastern European countries, including Poland and Hungary, have attempted piecemeal reforms for a number of years; Hungary, since 1968.

While certain prices and wages were adjusted, it is clear that without private property and political freedom through which firms and individuals are responsible for economic success or failure, these reforms would not work.

We think the new reforms are particularly encouraging, especially in Poland. And the President has actively reported this reform to the Stabilization Fund and other groups. The rationale is described in the report.

Of course, the gains for market reform are evidenced not only in Eastern Europe but in our own hemisphere. There is a discussion of the reforms in Mexico, Costa Rica, and other countries. And in particular a description of how the Brady initiative is assisting in reducing some of the debt burden in these countries.

Market reform goes beyond individual countries, but also pertains to relationships between countries. And a second aspect of this whole chapter is the focus on international trade, as Mr. Boskin indicated. The Uruguay Round is the President's highest priority, and we describe why that is the case in the report.

We still need to go a long way to reduce barriers internationally. Indeed, there is evidence that barriers have been on the increase in recent years. Successful completion of the GATT Round is a manifestation of the President's pledge not to resort to managed trade.

The U.S. proposal on agriculture is particularly promising, particularly significant and, therefore, it is discussed in detail in the report.

There's also a discussion of our trade relationships with Japan, a discussion of the Structural Impediments Initiative and how we feel that these discussions are also an alternative to managed trade.

And, finally, there is a discussion of EC 1992. We make the point that claims concerning Europe are exaggerated. There are enormous benefits, not only to the citizens of Europe, but to citizens around the world from this integration and the reduction of barriers in these countries.

Now we need to be vigilant and careful that barriers to other countries are not created either intentionally or inadvertently, as barriers within the EC are reduced. That, in fact, is the administration's policy at this time.

Thank you, Mr. Chairman.

Representative HAMILTON. Thank you very much, Mr. Taylor.

Mr. Schmalensee.

Mr. SCHMALENSEE. Mr Chairman, thank you. I will just briefly discuss a couple of themes that run through the report.

As Chairman Boskin indicated, the President stresses growth, sustainable growth, as his key objective. And one naturally thinks about monetary and fiscal policy in that context.

The point I want to make briefly is that the importance of growth is reflected throughout the report, not just in, if you will, the macroeconomic policy discussion.

One of the five goals that Chairman Boskin read was the removal of impediments to saving, to work, to investment, to innovation. And as one goes through the body of the report, one sees a discussion of a variety of impediments and policies designed to remove them—on the tax side, capital gains, and in the research and experimentation credit. The whole question of well-designed support for research in general, basic research, most importantly, is discussed.

On the legal side, we discuss product liability law and its implications of innovations. On the regulatory side, we discuss environmental regulation and the issue of reconciling the environment and the economy.

And, finally, on the trade side, the whole question of opening markets. The whole policy of opening markets in a progrowth policy at its base.

I would also suggest that the discussion of human resources and human capital in chapter V is at once both a response to the impending changes in the labor market as the growth of the working age population slows and as the demand for skills rises, and is at the same time a progrowth response to that challenge. That investment in education, enhancement of effectiveness of investment in education, is as much a progrowth policy as removal of impediments to investment in bricks and mortar. Similarly, while, as the President says, one wants to bring the disadvantaged more fully into the mainstream as a matter of decency, I think simply decency was his phrase, it is also a means to enhance the growth potential of the economy.

Second, in the area of regulatory policy, this report does not spend a lot of time talking about the burden of ill-designed economic regulation. In part, because, as you well know, much of the regulation of that sort that burdened the economy for some decades was removed in the 1980's. And also because a variety of new regulatory problems, ones for which deregulation is not the answer, have emerged.

And, thus, the report talks in general about the importance of selecting regulatory targets on the basis of careful balancing of benefits and costs, of selecting regulatory methods in ways that provide incentives and flexibility, and of providing information where information is needed to make intelligent regulatory policy decisions. It also discusses clean air and global change as examples of the application of those principles.

I would point out, though, that even though the report does not spend a lot of time talking about the costs of unnecessary economic regulation, the faith, if you will, in the power of market forces and the role of the marketplace as the engine driving economic growth is certainly reflected in the President's opposition to industrial policy, to protectionism, to managed trade, and to a whole hope of impediments to market forces.

Thank you.

[The prepared statement of the Council of Economic Advisers follows:]

PREPARED STATEMENT OF

MICHAEL J. BOSKIN, CHAIRMAN;

RICHARD L. SCHMALENSEE

JOHN B. TAYLOR

Members
of the

COUNCIL OF ECONOMIC ADVISERS

Before the

JOINT ECONOMIC COMMITTEE

February 8, 1990
10:00 a.m.

Mr. Chairman and other members of this distinguished committee, we have looked forward to this opportunity to appear before you today to discuss the 1990 Economic Report of the President. Because this is the first Report of a new Administration, it devotes particular attention to general principles and policy themes. The Report's analysis of economic events, the economic outlook and economic policies reflects the best available economic research as well as historical experience.

We would like to begin by briefly summarizing the Administration's basic economic policy principles as described in the Report. We will then turn to an overview of the main body of the Report.

The President's Message

The Report begins with the President's message, a brief discussion of the Administration's basic economic principles and key initiatives. The President discusses the successes of the 1980s, a period of extraordinary economic transformation and growth, and the market-oriented principles and policies that produced them. During 1989 the longest peacetime expansion on record continued. Since the expansion began in 1982, more than 20 million new jobs have been created. The containment of inflation during this long economic expansion is a milestone in U.S. history.

The expansion became the second-longest on record in 1989. The fraction of the population employed reached its highest level ever, and nearly 2-1/2 million additional jobs were created during the year. The unemployment rate reached its lowest level since 1973. But not only did the overall unemployment rate fall in 1989 to levels not seen since the early 1970s, so did unemployment rates for blacks and teenagers. (The unemployment rate of Hispanics was the lowest since 1980, when the Labor Department began regularly reporting it.)

The experience of the 1980s stands in sharp contrast to the 1970s when both inflation and unemployment rose. It also stands in sharp contrast to the poor performance of countries that severely restricted economic and political freedom. In the President's words, "We have proven to the world that economic and political freedom works. After years of economic decline, the people of Eastern Europe are turning toward free markets to revive economic growth and raise living standards. I remain strongly committed to aiding the efforts of these brave men and women to transform their societies--and thereby to change the world."

U.S. living standards remain the highest of any major industrialized nation. U.S. exports rose to new heights in 1989, and the U.S. regained its position as the world's leading exporter.

These successes provide us with a challenging opportunity. In the President's words, "Despite our successes, we cannot be satisfied with simply sustaining the strong record of the 1980s. We must improve on that record, deal with inherited problems, and meet the new challenges and seize the new opportunities before us."

The President advances as his main economic goal "to achieve the highest possible rate of sustainable economic growth." "Growth is the key to raising living standards, to leaving a legacy of prosperity for our children, to uplifting those most in need, and to maintaining America's leadership in the world." "To achieve this goal, we must both enhance our economy's ability to grow and ensure that its potential is more often fully utilized than in previous decades." To this end, he presents five <u>policy principles</u>:

- o Reduce government borrowing by slowing the growth of Federal spending while economic growth raises revenue until the budget is balanced, and reduce the national debt thereafter;
- o Support a credible, systematic monetary policy program that sustains maximum economic growth while controlling and reducing inflation;

- o Remove barriers to innovation, investment, work, and saving in the tax, legal, and regulatory systems;

- o Avoid unnecessary regulation and design necessary regulatory programs to harness market forces effectively to serve the nation's interest; and

- o Continue to lead the world to freer trade and more open markets, and to support market-oriented reforms around the world.

The President stresses the importance of choosing ambitious but realistic goals. He reaffirms his strong opposition to industrial policy. Again, in the President's words, "Second-guessing the market is the way to raise government spending and taxes, not living standards." And he reaffirms his strong opposition to protectionism: "To serve the interests of all Americans, we must open markets here and abroad, not close them.".

The tone of the message is forward-looking: "Our excellent economic health will allow us to build on the successes of the 1980s as we prepare for the next century. I am confident that the United States can enjoy strong, sustained economic growth and use the fruits of that growth to raise living standards, solve longstanding problems, deal with new challenges, and make the most of new opportunities."

The remainder of the Report discusses the policy principles presented by the President and applies them to particular areas of the economy, stressing the importance of growth, the value of taking the long view, and the power of market forces.

Chapter 1: Building on Success

Chapter 1 provides a link between the President's message and the six chapters that follow by giving a thematic overview of the those chapters and highlighting key principles, policies, and analyses that are developed in the Report. The Chapter emphasizes that now is the time to build on the economic successes of the past decade and to address the problems that remain. Some of the key themes and initiatives are:

- o A new rule for fiscal policy that would require the Federal Government to maintain a balanced non-Social Security budget after 1993.

- o Initiatives to encourage private saving and investment, including reducing the tax rate on capital gains and establishing Family Savings Accounts to encourage saving for pre-retirement objectives.

- o The need to improve the skills of our workers and to expand opportunities for disadvantaged Americans, not just to enhance our Nation's economic growth, but as a matter of simple decency.
- o The design of environmental regulations that preserve both a healthy environment and a sound economy.
- o A commitment to support the historic efforts of the governments and people of Eastern Europe to implement market-oriented reforms.

Chapter 2: Developments in 1989 and Future Prospects

Chapter 2 begins with a review of events in 1989. Real GNP grew for the seventh straight year, setting a new peacetime record. Real GNP growth (adjusted for the effects of the 1988 drought) was 1.9 percent during 1989, slower than the very rapid rates of 5.4 percent in 1987 and 4.0 percent in 1988. The civilian unemployment rate ended the year at 5.3 percent, also its average for the year as a whole. Nearly 2.5 million jobs were created.

Inflation was contained: the fixed-weighted GNP price index, the broadest measure of the price level, increased 4.1 percent during 1989, down from 4.5 percent in 1988. This containment of inflation is a particularly important achievement and sets the stage for continued expansion in the years ahead. Growth in consumption and government spending slowed in 1989, while growth in investment was maintained, and net exports continued to improve. Both government and household saving rates rose.

Economic expansions end because of particular external shocks to the economy, policy errors, or widespread imbalances (such as an overaccumulation of inventories); they do not come with preset expiration dates, and they do not die of old age. Every post-war recession has been preceded by a rise in inflation which has caused imbalances or policy responses that have led to recession. Hence, the containment of inflation in this expansion has laid a solid foundation for future growth. A recession is not likely in the near term.

Contingent upon the successful implementation of the President's proposed policies, particularly his proposal to balance the budget by 1993 and to reduce the national debt thereafter, real GNP is expected to grow 2.6 percent during 1990, with a pickup in activity in the second half of the year. In 1991, GNP growth is expected to increase further as the level of output approaches its full potential. Thereafter, growth is projected to return to its expected potential pace of about 3.0

percent per year. Inflation is anticipated to remain close to its 1989 rate in 1990, and then to decline gradually in later years.

One area that has received a great deal of attention recently is defense spending and the "peace dividend." From FY 1989 to FY 1990, real defense spending is projected to decline by about 5 percent, and the FY 1991 budget calls for an additional real reduction of about 2 percent per year. Over the five-year period FY 1991-1995, real defense spending would decline by about 10 percent. Only if world events, negotiations for troop reductions, and progress in limiting strategic weapons permit, can the size of the "peace dividend" become larger over time. Whatever its size, the "peace dividend" should first be used for deficit reduction; it should not be used to fuel large increases in entitlement programs.

Chapter 3: Design of Fiscal, Monetary, and Financial Policies

Chapter 3 includes a discussion of the design of monetary and fiscal policy to enhance the economy's growth potential and to ensure that its potential is more fully utilized than in previous decades. The key principle is that macroeconomic policy should be systematic and credible: it should lay out a sound plan and build credibility by following it and achieving its goals. The Report endeavors to explain the tremendous advantage of a systematic and credible policy by drawing on recent economic research and practical experience.

The President has clearly demonstrated his commitment to a credible and systematic fiscal policy and to the goals of deficit reduction. The President's insistence last fall that Congress pass a clean reconciliation bill and his subsequent order that sequestered amounts not be restored after the sequester period have established an important precedent for fiscal policy. Moreover, the Administration supports the principle that any supplemental spending increase in the current fiscal year must be offset by decreases in other parts of the budget.

The President has also laid out a new rule for fiscal policy that would reduce the Federal debt in the hands of the public after 1993 through the proposed Social Security Integrity and Debt Reduction Fund. This proposal would transform the Federal government from a chronic borrower, draining the Nation's scarce savings pool, to a saver, providing funds for growth-enhancing investment. It would ensure that expected future Social Security surpluses are not spent for other purposes but are used to build reserves necessary to help provide Social Security benefits when the baby-boom generation retires. By reducing the National debt, these reserves would free up substantial funds for private capital formation, thereby expanding investment, raising productivity and living standards, and spurring growth. A credible commitment to the Social Security Integrity and Debt Reduction Fund would have an immediate effect on interest rates and capital formation.

Monetary policy should be designed and credibly committed to sustaining strong economic growth and macroeconomic stability while predictability controlling inflation. Changes in financial markets make the formulation of monetary policy complex. Simple, mechanical monetary policy rules, like constant money growth, are inappropriate. Despite these problems, the Federal Reserve has not adopted a purely discretionary approach to policy. Rather, the Federal Reserve has made clear its commitment to promoting economic growth by reducing inflation and achieving price stability. Over long periods of time, the monetary aggregates are useful guides to policy and can serve as an anchor for price stability.

The increased openness of the U.S. economy to both trade and investment has increased the importance of the international aspects of macroeconomic policies. While the main concern of U.S. monetary and fiscal policies must be the health of the domestic economy, on which they have their main effects, relatively stable exchange rates and sustainable external balances are part of a policy environment conducive to strong noninflationary growth in the United States. The successes of the international coordination process in recent years argue for continued efforts to improve that process.

When confronted with a threat to the solvency of the thrift industry, the Administration moved swiftly to resolve the crisis. Chapter 3 stresses the importance of designing regulation to maintain the soundness of the financial system while encouraging both innovation and competition.

Chapter 4: Investing in America's Future

Strong, sustainable economic growth will raise living standards, expand employment opportunities, and provide the resources to satisfy a variety of private and public needs and wants. Chapter 4 discusses physical capital (buildings and equipment) and intellectual capital (knowledge and technology) as sources of growth; chapter 5 concentrates on human capital (skills and abilities of the work force).

While U.S. investment in physical capital has been healthy by historical standards in recent years, it is low by international standards. In addition, the United States devotes a smaller share of its GNP to non-defense R&D, which builds intellectual capital directly, than either West Germany or Japan. Federal policy should encourage investment but not second-guess private market judgements about its composition and direction.

A key item on the Administration's agenda, reducing the tax on capital gains, will enhance investment by lowering the cost of investment funds and encouraging innovation and invention. Credible and systematic macroeconomic policies that are conducive to strong non-inflationary growth will help to stimulate investment. So will tax policies that retain low marginal rates and reduce the double taxation of corporate equity earnings.

Administration initiatives to strengthen the nation's basic research base and to enhance private-sector incentives to translate this knowledge into productive innovations include: improving the legal environment (GATT proposals and product liability law reform), making the research and experimentation tax credit permanent, and increasing Federal support for research with widespread societal benefits that private firms would lack adequate incentives to undertake. The Administration strongly opposes expansion of the Federal role in technology in the direction of an industrial policy, which would pick winners and losers through tax breaks or direct subsidies.

The total flow of foreign saving into the United States in recent years has been about one-sixth of domestic investment. Foreign direct investment, a component of this flow, primarily reflects the increasing integration of the global economy. It is important to recognize that U.S. holdings in foreign countries are generally larger (relative to GNP) than foreign holdings in the United States and that U.S. firms continue to invest abroad. We must continue to work to reduce barriers to U.S. investment abroad and oppose restrictions on the flow of foreign saving into the United States, restrictions that would harm the domestic economy.

Increases in the U.S. national saving rate would also enhance growth in U.S. productivity and living standards by supporting high levels of investment in the United States. A higher saving rate would also reduce the trade deficits that give rise to calls for protectionist measures, which would lower living standards.

However, current policies are biased against saving. U.S. national saving is low by both historical and international standards. Businesses, governments, and households in the U.S. all save at lower rates than their counterparts in other advanced countries.

The most direct and effective policy to increase national saving is to continue to reduce the Federal budget deficit and, as the President has proposed, after the budget has been balanced, to begin to reduce the national debt. The Savings and Economic Growth Act of 1990, which the President has just sent to Congress, would increase private saving by reducing the tax rate on capital gains, allowing IRAs to be used for first-time home purchases, and by creating Family Savings Accounts to encourage saving for pre-retirement objectives.

Chapter 5: Human Resources in the 1990s

Chapter 5 stresses that labor markets will undergo a sea change in the 1990s. The growth in the working-age population has slowed as the baby boom generation has entered their 30s and 40s and the baby bust generation enters the labor force. At the same time, the demand for skilled workers continues to increase.

Episodes of declining economic growth and rising unemployment will undoubtedly occur in the future, with appropriate concerns about economic hardships. But labor market trends suggest that ongoing concerns about the supply of jobs, which have dominated discussions of labor markets for decades, are giving way to new concerns about the supply of workers and skills.

Labor market developments in the 1980s indicate that our flexible labor markets can adapt to these changes. But it will also be important to expand the supply of workers and skills, by increasing the skills of our workers, by maintaining labor mobility, through the careful design of immigration policy, and by expanding the economic opportunities available to disadvantaged Americans.

Increasing the skills of the Nation's work force requires improving the performance of the our elementary and secondary schools. Levels of educational attainment have not risen much in this decade, despite an increase in the returns to education. Moreover, the performance of U.S. elementary and secondary students is low by international standards, despite comparatively high per-pupil expenditures. The challenge is thus not to spend more on education, but to invest time, money, and attention more effectively. Education is primarily a State and local responsibility. But, the Federal government and the private sector can lead in promoting excellence in education. Through the proposed Educational Excellence Act and the Education Summit (which has already produced an ambitious set of national goals), the Administration has led the way toward improvements of the performance of the U.S. educational system.

In order to bring the disadvantaged into the economic mainstream, the Administration has supported a number of initiatives. The most important policy in this area is a commitment to a healthy economy, the most effective antipoverty program there is. Not only does economic growth aid the disadvantaged, but bringing more of the disadvantaged into the economic mainstream will enhance the economy's growth potential. Other Administration policies in this area include its vigorous implementation of the Family Support Act of 1988, its proposal for a new and refundable income tax credit for child care, the recently enacted expansion in medicaid coverage, its proposed amendments to the Job Training and Partnership Act of 1982, its support for the Americans with Disabilities Act, and its proposals to increase aid to the homeless and to expand home ownership opportunities.

Labor market developments in the 1980s, including the maturation of the baby boom generation, have reduced the minimal rate of unemployment compatible with non-accelerating inflation--

the so-called NAIRU or natural rate of unemployment. The decline in the NAIRU was a factor supporting strong non-inflationary growth in the 1980s, and policies to bring this rate down farther would be desirable. The current rate of unemployment, 5.3 percent, may not be far above the NAIRU, underscoring the need to pursue these longer-run labor market strategies.

Chapter 6: The Economy and the Environment

Chapter 6 stresses that a healthy environment and a sound economy can be compatible if--and only if--environmental regulation is well-designed. A well-designed environmental regulation sets targets that balance benefits and costs and uses flexible regulatory methods that enhance private incentives to meet those targets. Government policy should also encourage development and dissemination of relevant scientific information. (U.S. spending on environmental protection, about $81 billion in 1987, is already roughly equal to all U.S. households' electric and gas utility bills.)

The Administration's proposed Amendments to the Clean Air Act involve both sensible targets (e.g., rejection of overly-strict tailpipe standards) and effective methods (e.g., the tradable allowances system for acid rain control). The merits of the tradable allowances system have been advocated in the *Report* for over a decade. The use of targeted programs to control pollution caused by soil erosion and the Administration proposals to reform pesticide regulation also illustrate the application of these principles.

On the issue of possible global climate change, the need for scientific and economic research to resolve important uncertainties is stressed. The extent of possible future climate change is much-debated, as are its possible effects and the costs of reducing the ("greenhouse gas") emissions that may produce it. Available evidence suggests that the costs of substantially reducing carbon dioxide emissions, in particular, could be substantial -- of the same order of magnitude as the costs imposed on American businesses and households by the sharp oil price increases of the 1970s. It may be desirable now to adopt policies that are defensible on other grounds and that also reduce greenhouse gas emissions. But, until major scientific and economic uncertainties are resolved, it is important to the health of the economy to avoid the temptation to adopt costly policies just because they would produce small emissions reductions.

Chapter 7: Growth and Market Reform in the Global Economy

Chapter 7 stresses the recent gains and future potential of free markets and an open trading system. It also stresses the Administration's support of market-oriented reform worldwide.

Increased global economic integration is an opportunity for the United States, not a problem, and the Nation must work to open markets here and abroad, not to close them.

The ongoing reforms in centrally planned economies of Eastern Europe are inspiring and dramatic. Comprehensive reform will be necessary and will be painful at times, but such reform is the only hope for major improvements in the living standards of these peoples.

Comprehensive market-oriented reforms will be necessary to restore growth in heavily-indebted countries. The recent reforms in Mexico are particularly noteworthy. Through the Brady initiative, the United States is continuing to take a leadership role in developing and implementing a strategy of coordinated debt restructuring and support for economic policy reforms in the indebted countries -- for example, in Mexico, The Philippines, and Costa Rica.

Administration policies pertaining to the Asian Pacific Rim economies include the two-way Structural Impediments Initiative involving the U.S. and Japan. This initiative focuses on aspects of each economy that may create barriers to trade or impede domestic and international adjustment. It is important to keep in mind, however, that overall trade deficits and surpluses are primarily macroeconomic phenomena, reflecting saving-investment imbalances, and that bilateral trade imbalances between pairs of countries are not in and of themselves evidence of trade barriers.

The EC92 initiatives represent important potential opportunities and benefits for U.S. firms and consumers as well as for EC firms and consumers. Whether U.S. firms and consumers benefit hinges on the continued openness of the European market to foreign trade and investment.

Successful completion of the Uruguay round GATT negotiations this year is the highest trade policy priority of the Administration, with stress on reform of agricultural policies. Successful completion of these negotiations would confer substantial benefits on the U.S. and global economies.

Representative HAMILTON. You said that Mr. Schmalensee has to leave shortly and to direct questions to him first.

What is your area particularly?

Mr. SCHMALENSEE. I am a microeconomist, Mr. Chairman.

In this report, I worked most heavily on chapters III and V—I'm sorry—IV, V, and VI.

Senator SARBANES. You're really an economist that deals with microeconomic issues? [Laughter.]

Mr. BOSKIN. We preferred that phraseology.

Mr. SCHMALENSEE. I almost said I was a poor country microeconomist, but I will claim the larger title.

Representative HAMILTON. The way to proceed is to see if there are any particular questions that should be directed to Mr. Schmalensee and, in the chairman's case, I do not have any particularly for him.

Congressman Upton, then Congressman Scheuer.

Representative UPTON. I have, I think, probably one very brief question. I raised it last week with the Secretary of the Treasury, who was testifying before the committee.

It was about a year ago that Mr. Boskin appeared before this committee and we talked a little bit about IRA's, and the administration's role and thoughts for coming back with an IRA-type program.

In speaking with the Secretary last week, we sort of concurred that the family savings plan, which I would imagine is under your realm, is the administration's response to the IRA discussion that we had last week, or last year before you were on board.

I inquired of the Secretary specifically the difference between the family savings plan as it was unveiled and the already present tax-free money markets and others that are already available now to individuals.

And his response, to paraphrase it, was:

There really wasn't much difference between the two.

And I am most interested to get your reaction.

Mr. SCHMALENSEE. Congressman Upton, while I had a heavy editorial responsibility for the discussion of that plan in chapter IV, the Chairman and Mr. Taylor, in fact, worked more on developing it.

Representative UPTON. I will save that for another time then.

Representative HAMILTON. Are there questions for Mr. Schmalensee?

Congressman Scheuer.

Representative SCHEUER. Mr. Schmalensee, you are responsible for much of the thinking in chapter VI, I take it. Now, just to take a particular phrase, you say:

"The cost of substantially reducing carbon dioxide emissions could be substantial and we should avoid the temptation to adopt costly policies just because they would produce small emission reductions."

Now, from the point of view of micromanagement, that is absolutely right. But the converse of that is that there are comparatively inexpensive policies that produce major reductions in polluting emissions, and in pollution in general.

Have you considered, for example, the cost-benefit potential of simply using less energy? Of conservation? Is there a national program that would help us perhaps change our behavior—turning out the lights, lowering the temperature a degree or two in the winter and increasing the threshold before which we start air conditioning in the summer? These would be very modest expenditures, as would increasing per gallon mileage on cars.

We have the technology in our country to get mileage up to about 50 miles per gallon with modest expenditures.

Now, in France, in Germany, in Sweden, and in Japan, they already have cars on the drawing boards that get 80 miles per gallon in the cities and up to 100 miles per gallon in the countryside.

And the Japanese have a prototype for up to 120 miles.

Now, those improvements admittedly cost billions of dollars to produce, and they tax gas so that their price of gas may be $3.50 or $4 a gallon. When you price gas at a dollar a gallon or $1.10 a gallon, it doesn't make any sense for anybody to make any investment in anything that you price in a fashion that people would look upon it as something to be used in a very wasteful manner.

There are things that we can do with modest investments that have enormous payoff. And we in the congressional research community have been trying to make that point. We can't delay making investments in energy technology until we know everything. There are a lot of things that we can do now that are sensible, that are cost effective, that will produce a big bang for the buck with comparatively modest expenditures.

We can produce enormous reductions in pollution. I don't see any reference to that potential here.

Have you thought about micromanagement from the point of view of the available small investments that produce major payoffs in energy use and in energy pollution?

Mr. SCHMALENSEE. I have. Let me try to give you a fairly complete response, but it is first important to note that, as the report tries to make clear, if the emissions of carbon dioxide and other Greenhouse gases produce global climate change, the problem is a global one. And the United States is not the main emitter. So, if the United States produces 20 percent of global emissions, a number that is expected to decline—I think it is a bit above 20 now and it is expected to be below 20—unilateral action by the United States, given growth trends and emissions abroad, will make a significant difference to global CO_2 emissions.

And let me come back to your point.

Representative SCHEUER. Let me intervene there.

This administration in the last couple of months has turned down two opportunities to join with the other nations of the world in facing up to the problems of global warming. It sabotaged the conference at The Hague when 68 other countries wanted to move in concert to reduce the polluting effects of energy use. And it was the United States that shot that down.

And just in the last week, the President has said:

"We are not going to take an initiative on global warming. We don't know enough."

The fact is we will never have perfect knowledge and unless we move on a respectable knowledge base, we will never do anything.

Mr. BOSKIN. If I may intervene for one second, I think we make it very clear in the report that it is the position of the United States to do things that it would be desirable to do anyway, a no-regret policy enunciated by Secretary Baker approximately a year ago in this regard.

And we are proceeding along those lines. We are investing over $1 billion in research to resolve as quickly as possible the very legitimate and substantial scientific uncertainty.

Representative SCHEUER. Mr. Boskin, with respect, Secretary Baker, Secretary Watkins and soon to be Secretary Riley made a joint recommendation to the President of the United States urging that we participate and show some leadership in the upcoming conference on global warming. And the President apparently on the misbegotten advice of Mr. Sununu who, to my knowledge, is not an expert in these areas, turned down the unanimous advice of three of his distinguished Cabinet Secretaries.

I think that was a sad day in our country.

Mr. BOSKIN. If I may, Congressman Scheuer, with all due respect, I think those press stories were not accurate and I think I will just leave it at that. And I will say that there is unanimous administration position on this. We are moving forward with all deliberate speed with a very large investment in improving our scientific understanding.

We have a conference at the White House on April 17 and 18 bringing together people from many nations to try to resolve that scientific uncertainty. We are moving forward with all deliberate speed in that regard.

Senator SARBANES. Was there a unanimous administration position before the decision was taken?

Mr. BOSKIN. I don't know what decision was taken. There is the no-regret strategy and the desire to move forward with all deliberate speed on the scientific side of the equation and the feeling that we need to know more about the science before we potentially embark on an irreversible policy which might prove to be wrong on the basis of improved scientific knowledge that we may have 6 or 12 months from now.

I think, from all of the meeting I was at, it was unanimously regarded.

Representative SCHEUER. According to the press reports, three Cabinet Secretaries agreed that we had a sufficient scientific fact base to move ahead prudently on policies that were not very expensive and that were easily reversible.

Mr. BOSKIN. We lay out in the report that it is very important that one should take seriously the projections of that subset of climatologists who do believe global warming is likely and can cause some serious concerns as the years progress, as well as those other reputable scientists who believe that it is overstated.

We're trying to resolve those uncertainties. That story that was in the newspaper, if you go back, there wasn't even a source quoted. I think there is this notion to try to set everybody up against each other. We're trying to move forward with all deliberate speed.

It is also not my place here to be defending my colleagues, each of whom I have an immense regard for—Administrator Riley, Secretary Watkins, Secretary Baker, and Governor Sununu. They are people I work with every day and I have an immense regard for them, and I think these stories were primarily the source of an emotional reaction by people much further down. There's a big exaggeration of any disagreement on this issue.

Representative HAMILTON. Mr. Schmalensee.

Mr. SCHMALENSEE. Let me add to that. The United States remains permanently committed to participating fully in the work of the United Nations, IPPC. I spent last Saturday morning discussing designs of control strategies with the Response Strategies Working Group delegates, a group headed by the United States.

The President is hosting a conference in April on this subject. We have certainly considered energy conservation issues. They come to my mind in two parts. There are some that are responses to market failures or information failures, a variety of reforms in State regulations which are being done in New England and elsewhere, to enhance information, to make cost-effective conservation more widely known and, thus, more likely to be followed.

Those are not discussed here except perhaps obliquely. But we do discuss addressing market failures and, of course, we ought to move forward on that.

More serious measures such as stringent mileage standards, or stringent appliance standards, and so forth, are not typically in the category of no-regret measures.

If one thinks about the performance costs, the amenity cost to consumers that would be imposed by stringent, say, mileage standards, they are not free. They may turn out to be worth doing. There may be other approaches. We are studying the problem.

But I think, as Chairman Boskin has indicated, the administration's position is to move forward on things that make sense—to pursue the no-regret strategy, to remain actively involved in international discussions because this is the global strategy, to pursue and to consider all of these issues as we develop a national energy strategy.

Mr. BOSKIN. Let me amplify that briefly. Secretary Watkins is in the process of developing a national energy strategy. An interagency process has been involved. We have been actively working with the Energy Department on this, as have other agencies.

And, certainly, conservation is one of the major issues they are addressing.

Representative HAMILTON. OK. Are there other questions for Mr. Schmalensee?

Representative HAWKINS. If he is responsible for chapter V.

Mr. BOSKIN. Let me say that he is not reponsible for any of the chapters by and of himself. We all do them all and with our staff, which has responsibility for a lot of it. But, his particular area of expertise is in the subject matter of chapters IV, V, and VI.

Representative HAWKINS. If you are able then to discuss chapter V, we don't need to detain him.

Mr. SCHMALENSEE. The Chairman can discuss all the chapters.

Representative HAMILTON. Senator Sarbanes, go ahead.

Senator SARBANES. First of all, Mr. Boskin, I would observe that it is not a crime for administration advisers to disagree among themselves over what policy ought to be and, in fact, given that they are doing that with some intensity now in the Soviet Union within the ranks of the Communist Party itself, it is not quite clear to me why you feel so compelled to deny any disagreement among Cabinet members and Governor Sununu and others over what the approach ought to be.

Why don't we admit that there are some differences that people have—Riley and Sununu, for example—and the President finally made a decision.

President Roosevelt used to set off those kinds of disagreements deliberately as part of his management strategy. I don't quite see why you have to assert so vehemently that there is just a kind of party line without any dissent. Even in the Soviet Union, that is no longer the case.

Mr. BOSKIN. I take the point. But I meant to suggest that the unsourced stories that appeared about this particular speech greatly exaggerated any differences that there may be.

Senator SARBANES. But, there were some differences, I take it?

Mr. BOSKIN. There were discussions about what ought to be stressed, whether new policy ought to be made. And there certainly was substantial attention placed on the speech by a variety of people other than the Cabinet members mentioned.

And all I was trying to suggest was that there were large differences, certainly greatly exaggerated by those stories. And we do have an administration position that I think everybody seems to be comfortable with generally. While they may differ on specifics, President Bush is by no means desirous of stifling debate and discussion. He has encouraged it.

Senator SARBANES. Mr. Schmalensee, are you the industrial policy man or, more accurately put, the nonindustrial policy man?

Mr. SCHMALENSEE. As the Chairman indicated, we all bear some responsibility for everything. But I would be happy to take questions on that subject.

Senator SARBANES. The President in his report says: "I remain strongly opposed to any sort of industrial policy." Is that correct?

Mr. SCHMALENSEE. That sounds like what he said, yes, sir.

Senator SARBANES. That is the administration's marching orders on this issue, I take it. Is that right?

Mr. SCHMALENSEE. Yes, sir.

Senator SARBANES. According to press reports, the Defense Department has decided to invest almost $100 million over the next 5 years in Sematech-type research and development consortia to rejuvenate and ensure the survivability of four industries—optics, precision gears, apparel, and food processing.

And their rationale is that we need them for national security purposes.

My first question is how do you reconcile the Bush administration's own position on government industrial policy which I just quoted with the Defense Department's decision to conduct its own industrial policy?

Mr. SCHMALENSEE. My understanding of those particular initiatives is that they are directed not at ensuring that the food processing industry survives—its survival I don't take to be widely doubted—but are directed at particular Defense Department procurement needs.

There is, of course, a rather different set of issues that arises when one considers technology-intensive Defense Department procurement when the Government is the primary customer and the Government, unlike the market, cannot give large monetary rewards for successful innovations.

And the Government tends to finance research for which it is the main customer. We didn't discuss that in any length because it is not particularly controversial. Those particular initiatives were, as I understand it—in apparel, for instance—fairly narrowly targeted to Defense Department needs.

Senator SARBANES. Was the CEA consulted by the Defense Department to assist or design the kind of system——

Mr. BOSKIN. I can speak briefly on that. Not with respect to the specific issues. I have had extensive discussions with Secretary Cheney and Deputy Secretary Atwood on the general issue. And they assure me that they have no intention whatsoever of engaging in industrial policy through DARPA or anything else unless there is a very clear-cut specific need that is impossible to satisfy, extremely unlikely to be satisfied in the private sector.

Mr. SCHMALENSEE. We saw the detailed proposal and the general legislative clearance process and had no quarrel.

Senator SARBANES. So, the CEA is supportive of this industrial policy that the Defense Department is pursuing?

Mr. BOSKIN. We tried to make clear what we meant by industrial policy. And I know that means different things for different people, Senator.

There is a very clear statement in the report that talks about policies that the Government should be doing. The Government should be doing things that have broad societal benefits that would not be undertaken by private firms who cannot appropriate the full returns, but that it shouldn't be second-guessing the marketplace and what to produce.

We also make a distinction between civilian and security-related technology where there is a very clear-cut specific need for a very specific technology where there is a very clear-cut Defense Department need, which generally wouldn't be commercially profitable for firms.

Or it may occur in a situation, as Mr. Schmalensee mentioned, like the particular food-processing concern, where the Government was the primary customer and it was very unlikely that the need could be satisfied in the private market.

Representative HAMILTON. Would the Senator yield?

Senator SARBANES. Yes.

Representative HAMILTON. Of the four industries, two are apparel and food processing.

Now, those are not peculiar to the Defense Department. If the Defense Department can pump money into the apparel industry and into the food processing industry on a rationale of national security, what industry in the country would not be able to be helped by that kind of a rationale?

Mr. BOSKIN. I take your point. In response to this exact query, Secretary Cheney and Deputy Secretary Atwood assured me that there are very specific, precise reasons for these and they have no desire whatsoever to make a broad interpretation of security or to make DARPA or some other part of the Defense Department into a broad industrial policy.

Representative HAMILTON. These must have broad spinoffs in the civilian sector. You are helping a very specific American industry which is just as much civilian as it is Defense Department in its orientation. More so.

And you are helping them with major sums of money.

Now, why is that not an industrial policy?

Mr. SCHMALENSEE. Because the help is not just a broad subsidy. The objective is not to let the food processing industry grow; given the size of the industry, the scale of the subsidies we are talking about would be inadequate to do much for the industry at large.

Representative HAMILTON. I know all kinds of industries that would like even small help, Mr. Schmalensee.

Mr. SCHMALENSEE. I know. And we run into the truth that you cannot subsidize everything.

Senator SARBANES. Particularly when you said you're not going to subsidize anything. We're trying to square the rhetoric and the reality.

Mr. SCHMALENSEE. These are, as I understand, the details of the program. It amounts to government finance of the development of products, technology perhaps of which it is the primary customer.

This happens to be occurring in nontraditional industries. One is not too surprised if the Government spends on electronics research, or if the Government spends on research in sophisticated exotic materials. One is a little bit surprised if the Government spends on apparel.

The Government, however, is a major customer in the apparel industry. The defense industry has specialized needs that differ; despite the way my sons play, their needs in clothing are not exactly the same as those of our Armed Forces.

And there are specific Defense Department needs in that industry, and that's how this is targeted, as I understand it.

Mr. BOSKIN. Your general concern I think is very well taken. We have no desire to have an industrial policy. And as I said, Secretary Cheney and Deputy Secretary Atwood had made clear to me that this would not be the policy. I'm not familiar with the exact details, but they assured me that there were very, very specific reasons that made it appropriate in this case.

Representative HAMILTON. I interrupted you, Senator. Go ahead.

Senator SARBANES. What were the criteria that were used in order to make this decision? Do you know?

Mr. BOSKIN. The criteria, as I understand it, has to do with the fact that there were very, very specific needs of the Defense Department which could not be satisfied generically through the private sector. I do not know exactly what those are; I would be happy to look into it and get the full report.

Senator SARBANES. I take it that the decision had been made by the Defense Department before the CEA ever became cognizant of it. Is that correct?

Mr. BOSKIN. No. There was an interagency review.

Senator SARBANES. Did you object to it?

Mr. BOSKIN. We raised the issue and we were assured by both Cheney and Atwood that this met the criteria that had been laid down, and was not inconsistent.

Mr. SCHMALENSEE. We also had, if I remember, staff-level contacts in which we discussed the application of the general criteria.

Mr. BOSKIN. I would be happy to get you a full report on the specifics, which I do not have with me now. I can assure you that they're not—were Secretary Cheney and Director Atwood not able to state unequivocally that there were very specific needs and there was no intention to moving to a general subsidy in this industry, I would have objected vehemently and, if necessary, taken it to the President.

Senator SARBANES. But I assume you would always be in a position to do that. The fact of the matter is that although it may be specifically directed, it serves a general purpose with respect to the posturing in the economy.

Representative HAMILTON. Congressman Stark.

Representative STARK. Thank you, Mr. Chairman.

Concerning Mr. Schmalensee's comments on the consumption of the vast amount of apparel by the military, I'm sure the good doctor, being interested in microeconomics, is aware of the great efficiency of the private market in distributing goods and services.

And I believe the administration still views vouchers as a useful tool.

I was going to suggest that if the Armed Services are buying so much, that one might look at the age-old scientific distribution system called small, medium, and large, and hand out vouchers to the female members of our Armed Services rather than have a study for 352 different sizes.

It seems to me that we just had a report from the GAO that our warehouses are bulging with overstock and too much inventory.

And I just wonder if you don't think that a good dose of micromanagement might save millions of dollars there. Let them buy their uniforms from Land's End. That's where I get my back to school clothes.

And I bet they would be a hell of a lot cheaper.

That was just an aside. [Laughter.]

I would like to pick up on Congressman Scheuer's question on the future of the American environment and the statement, which I apologize for missing, by Mr. Boskin early on.

My question is on the care with which the administration intends to strengthen our basic research base. You talked about support for research with widespread benefits, and particularly you mentioned the expansion of the Federal role in technology which would pick the winners and losers through tax breaks and other gimmicks rather than letting the technology speak for itself. You would let the cream rise to the top, so to speak.

Would that be a correct assumption?

Mr. SCHMALENSEE. Yes, as a general rule.

Representative STARK. I don't know whose chapter it was, but one chapter talked about the difference between our spending on R&D and Japan's, for example, where they spend 1 percent of their total R&D for military and we spend 33 percent of ours for R&D.

Did you use the same process for evaluating what research you would emphasize in the environmental area? You had a process you went through to decide what areas of the environmental research the Government would support and which it would back off.

Is that correct?

Mr. SCHMALENSEE. That is a question about the budget process more than a question about this report. And I was not intimately involved in that aspect of the budget process.

Representative STARK. Did that same process go on in the decision to spend $5 billion on Star Wars, for example, which no credible scientist in the United States thinks will work, but, say, Edward Teller, and that might be a project all by itself. How does that wash? How can you talk about wanting to be cautious about spending money on research that will help us keep the environment sound and spend a total of $1 billion, which is admirable, but then increase by $1 billion a project that is best described as modern day lunacy from $4 to $5 billion.

How does that wash in the way economists would help us make rational decisions?

Mr. SCHMALENSEE. I'm not intimately involved in the Star Wars decision. It certainly fits the description of a research effort which, if successful, would have widespread benefits.

Representative HAMILTON. It would?

Mr. SCHMALENSEE. If successful, it would have other widespread benefits like other national defense research. I'm not knowledgeable about the state of the science nor about the budget deliberations that went on.

Mr. BOSKIN. We will have to excuse Mr. Schmalensee.

Representative HAMILTON. Mr. Schmalensee, this little diversion took quite a bit of time. I appreciate your willingness to respond, and you are certainly excused.

Mr. SCHMALENSEE. Mr. Chairman, thank you for allowing me to leave early.

Representative HAMILTON. We will start now with the regular 10-minute rule and focus on some of the other economic issues.

Let me begin with taxes, Mr. Boskin. I want to understand the President's position on taxes, and I don't know that I do.

All of us are familiar with the "no new tax" pledge that the President has made, although I note, so far as I know, that I did not see that pledge repeated in a quick survey of this Economic Report. What I did see is the President's statement early on:

"I remain strongly committed to the principles of low marginal tax rates and a broad tax base developed in the 1981-86 laws."

So he is not repeating, and you are not repeating, "no new taxes." And, of course, as a matter of fact, in the budget that you submitted, there are 33 proposed changes in various taxes, 20 of which raise revenue in fiscal year 1991 for a total of $13.9 million.

So, the question then is:

What is the President's position with regard to taxes?

How do we construe the famous phrase "no new taxes"?

Mr. BOSKIN. As I think has been said for some time, the President desires to bring the budget into balance through a combination of slower growth of spending than would otherwise occur and economic growth bringing in revenues. So that $13 billion you are referring to, several billion of that is—I don't have the budget in front of me. Maybe one of my assistants does. There's some amount of that that is user fees.

Representative HAMILTON. But, user fees——

Mr. BOSKIN. When there are clearly defined beneficiaries for a particular government service or program, we believe that those people should be footing the bill for those services.

Representative HAMILTON. Don't you consider that a tax?

Mr. BOSKIN. I consider it a user fee.

Representative HAMILTON. Look, the ordinary definition of a tax is a sum of money demanded by government for its support. Now, you are using a definition of the word "tax" that is not in the dictionary, if you are saying that user fees are not taxes.

You see, that is what confuses me. You say "no new taxes," and then you testify, oh, user fees are not taxes.

But, if you look up the definition of "taxes," user fees are certainly included.

Mr. BOSKIN. Well, I don't have the definition that you have referred to in front of me. We have argued that where there is a specific beneficiary who receives the benefit of government services fees are appropriate. And we can get into a semantic argument about whether one would want to define it that way according to anybody's definition, in whatever dictionary, but, no, we are not saying that those are taxes.

Senator SARBANES. Is that gasoline tax a user fee?

Mr. BOSKIN. No. I would argue that the gasoline tax is a tax.

Senator SARBANES. It is all committed to be used for transportation purposes directly related to highway travel.

Mr. BOSKIN. Some percentage of the previous round of increases were so targeted. But I think one can get into a lengthy discussion about the extent to which that targeting is at all effective. And some of it is not related to the demands on the roads, and so on, that are really—but let me make the following point.

Representative HAMILTON. I want to understand what your view is.

Mr. BOSKIN. My view is that, ultimately, obviously, there is basically a political test. Basically, it is a statement that says: The tax burden on the American people is high enough that we should live within this general amount of resources. And that, ultimately, there's going to have to be a political test as to whether taxes are being raised or not.

They certainly are. I think Dick Darman enunciated the duck test by our definition. The duck test, some of these very clearly targeted modest user fees, we would not call taxes.

Representative HAMILTON. Let me ask you this. We have to look ahead on the budget, as you do. As legislators, one of the questions that we have to ask ourselves is:

You look at the various budget options out there. Is it possible to raise taxes as you define them during the President's first term of office?

And if the President says: No, I am not going to approve any tax increase, as you define taxes, then that has very broad implications for any legislator. We have to figure that because we know very,

very well that we're not going to get two-thirds vote in this institution to override the President's position on taxes.

So, is it the President's position that there will be no new taxes during his first term of office,

Mr. BOSKIN. The President has made it very clear that it is his desire to balance the budget by slowing the growth of spending to continue economic growth. He has also made it clear that he believes that we have done that in the first year of office. We can get into the same kind of argument on semantics about some of the changes that were made as part of reconciliation last year, whether some of those revenue things were taxes or not.

We submitted a budget which we believe is a sound document, a sound basis, and we believe makes the "no new taxes" pledge. You might disagree with that, sir, and we can debate or argue that at the margin.

The President, to my knowledge, has not said that there is no conceivable possibility over a 4-year term. What he has said is that his hope is that he will be able to extend this as long as possible. And we certainly hope we will be able to do it this year.

Representative HAMILTON. One other question about taxes.

Mr. BOSKIN. We certainly have enunciated extreme situations where this would have to be reconsidered. Director Darman and myself have both said—to take an extreme.

Representative HAMILTON. But you are saying to me, then, that the President has not pledged that he would not raise taxes throughout his first term.

Mr. BOSKIN. He has said that he hopes to be able to continue the "no new taxes" pledge throughout his first term. He is saying it one year at a time.

Representative HAMILTON. That is an important point, and that is helpful to me in understanding the President's position.

Now, with regard to the composition of taxes, you have seen, I am sure, the studies that suggest that the percent of income paid in taxes by the richest 5 percent of the Americans fell from 29.5 percent in 1980 to 26.7 percent in 1990.

Mr. BOSKIN. We have not paid taxes yet for 1990, sir.

Maybe it was 1988 or something.

Representative HAMILTON. Estimated. You are correct. Estimated 26.7 percent.

In any event, the trendline is down for this group at the top. At the same time, the tax burden for the poorest and the next to poorest and the middle fifths of the population have all gone up.

And I suppose that the reason for that, and there may be other reasons, but an important one, I am sure, is reliance on Social Security tax.

What I want to know is how you view that.

Are you comfortable with that? Do you think it is healthy for the American economy to shift from income to payroll tax as sources of Federal revenues? And are you comfortable with the fact that the top all paying less and the middle paying more and the very poor paying more?

Mr. BOSKIN. If you took the share of income taxes, it is not true that the top is paying less. In the total, that would be correct.

Representative HAMILTON. The important measure for the ordinary person is the total, right?

Mr. BOSKIN. I'm going to come back to that. I think you may have to make a very different argument in terms of payroll taxes. Social Security contributions have risen as a fraction of the total amount of Federal receipts.

However, Social Security outlays have also risen. And Social Security outlays are the most progressive item in the entire tax transfer system we have for two reasons. One is the benefit formula; it is very progressive, returning a much larger fraction of average index monthly earnings in the working life to lower income people than to high income people; and also transferring resources to the generation of retirees who, over their lifetime, on average, if there is economic growth, will be poorer than the generations that succeed them.

So, if you take Social Security as a whole, it is quite progressive. And I believe that the growth in Social Security outlays, which is very, very progressive, swamps or offsets the higher share of payroll taxes or Social Security taxes in the total tax contribution.

If you look, as you, yourself, just said, Mr. Chairman, at a more comprehensive picture of what the tax and transfer system does to the distribution of burdens and benefits, there also were some other major features that I think changed things.

In the second half of this period, for example, I viewed one of the highlights—and it doesn't get mentioned very often—of the 1986 tax reform as removing several million of the lowest income people from the tax rolls.

So I think if you broke this period into two parts, I think, on the income tax side, there would be something of a difference in the last 5 years of the decade than the first 5 years because of the removal of people at the very bottom.

Representative HAMILTON. You're not really concerned about the trends that I have cited? You think that they are counterbalancing?

Mr. BOSKIN. On the outlay side, they are counterbalanced by the progressive nature of the Social Security benefits.

Representative HAMILTON. When you see the statistics about what the upper 5 percent and then the other groups pay, that doesn't bother you? You think it is a healthy development?

Mr. BOSKIN. I would not say it is healthy or unhealthy. I would say that it is part of looking at the overall picture of what the tax transfer system does.

I think it is very important to have humane——

Representative HAMILTON. You are one of the chief economic spokesmen of the administration. Don't you have a feeling about the way our tax structure has changed significantly over the last decade?

Mr. BOSKIN. It is changed not just significantly. That change is a secular trend. It has changed too often rather radically over the decade. We had major tax reforms in the 1980's, but I believe that the tax system, with a couple of exceptions, is now fair and more efficient than it was when we got started.

Representative HAMILTON. From 1980. Do you think it is fairer today than it was in 1980?

Mr. BOSKIN. Yes. Certainly, I believe that. You can't just look at the tax system in 1980. You have to ask yourself: What if the tax system had stayed in place? I remind everyone here that the tax brackets in 1980 were not indexed for inflation. There were a variety of other things that were major problems then.

We would have had millions more people below the poverty line paying income taxes had we not had the 1987 tax reform.

Representative HAMILTON. Are you comfortable then with the fact that since 1980, tax as a percentage of income has declined for the wealthiest 5 percent of families, and risen for the poorest, next to poorest and middle fifths of the population?

Mr. BOSKIN. I would want to take a look at the specific figures you are referring to in detail and get back to you with a detailed answer. To the extent that it is because payroll taxes have risen and expected future Social Security benefits have risen a pace, I think you have to take the payroll taxes and tie them to the benefits.

So I believe that Social Security is a good deal, and expecially good deal for low-income people, because they're going to be getting back a very high rate of return on payments relative to the rest of the population.

Representative HAMILTON. Do you believe that there has been an increase in income inequality in the last few years?

Mr. BOSKIN. I believe, generally, that income inequality has been relatively stable and I think that there are various ways that you can measure it. But I think, expecially when you average over several years and don't look at a particular year, it has not changed markedly.

I think that, if you look just at shares, there certainly has been an increase in the share of income in the top 20 percent. I think, if you look at the decade as a whole, one of the most remarkable phenomena is the dramatic increase in the percentage of families that have incomes above any given level—say, $50,000. I think there has been very large upward mobility because of the economic expansion and because of other policies.

Representative HAMILTON. There certainly has been—incomes have increased. There's no question about that. I'm talking here about tax burden.

Well, we may want to submit some specific questions to you in that area.

Mr. BOSKIN. I think this is a very important area. I don't mean to be at all flippant, but to the extent that it is primarily the issue of the payroll tax, then I would associate that with either current benefits or projected future revenues.

Representative HAMILTON. What comes through to me in your responses to my questions is that you are not greatly concerned about the statistics I am referring to or sufficiently concerned about it to recommend policy changes.

Mr. BOSKIN. I think, well, I will look into this further. But, to the extent that this is primarily due, which I believe it is—off the top of my head—to the rise in the payroll tax, then I'm not deeply concerned about it, per se.

Representative HAMILTON. Congressman Hawkins.

Representative HAWKINS. Yes. I am a little surprised and somewhat amazed and not a little disappointed. My concept of why we created the Council of Economic Advisers was to give us a factual situation prevailing at any particular time, provide goals and timetables to remove any difficulties that we were experiencing in the economy, and to plan ahead.

Now, if we cannot even get the truth with respect to conditions that actually exist, then I don't see that the Council of Economic Advisers performs any constructive function in the system of government.

And this is not to reflect on you, Mr. Boskin, as an individual, because I have noted that all throughout the eighties, the Council of Economic Advisers did nothing more than congratulate the administration that was in power and never disagree with it. And that comes through as being very remarkable because there certainly were some things that went astray.

Now I am not impressed with the approach that we have had 8 years of expansion. That is damned slow growth, it seems to me, that it takes that long to rebound from the deep recession of 1981–82 and the one that we had in 1980.

And so this great creation of jobs is not of new jobs, it is merely a returning of individuals to jobs but at a lower scale, as we shifted from manufacturing to the service industry.

And the number of individuals do not reflect the hardships that families experience. I don't think that we take note of the hardship that is involved when it takes up 8 years to get back to a real unemployment rate of 7.9 percent.

That certainly is not progress. And you fake the numbers by counting unemployed individuals but not including them in the official rate.

But I am even more concerned about the handling of at least one of the chapters—and I'm not so sure that this is the only one—the one on human resources, which is in sharp contrast to what we are being told officially by educators across this country.

Now, you seem to equate productivity with education. And you certainly pay some lipservice to it by indicating that we do have problems in U.S. elementary and secondary education.

But then you seem to assert that on a per-pupil expenditure basis, that we are spending more money or lavishing more money, as the President says, on education. And this is remarkable because there has been a report that says that UNESCO, which deals in international comparisons, has indicated that we are not at the top in terms of investing in education to get the school people, the educated people, and so forth, that we need in this decade before the year 2000.

According to information provided to the Education and Labor Committee recently by the Economic Policy Institute—which was rebutted by the Department of Education, and they rebutted again by the Institute, showing the fallacy of the Department of Education's schedule which apparently you depend on and also the President—as a nation we are spending less than almost any other industrialized nation today.

As a matter of fact, according to this, we rank 14th among the Nations in terms of expenditures on education for K through 12. As a matter of fact, we are not even halfway. And according to their estimate, even if we spent $20 billion in added money, we would only be halfway. In other words, there would still be at least six or seven nations that outspend us.

Now, these are factual reports which have been discussed. Attempts have been made to rebut them, but the fact is that we are not investing in education, as is claimed.

Now, the Committee for Economic Development, which certainly is not a leftwing organization, indicates that 85 percent of those entering the labor market between now and the year 2000 will be minorities, women, immigrants, non-English-speaking students. These are the very ones, the disadvantaged, that are being shortchanged, where no progress is being made.

Now, I know that the President said that we are putting $500 million into Head Start. But when we talk about the other great needs, we are talking about billions, we are not talking about millions. But even at the $500 million amount that the President featured in his State of the Union Message that would be only about half of the inflation rate. So we would still, in effect, be below current services in the field of education.

And I cannot feature chapter V—such as this, knowing of the tremendous importance there is to this country, to the economy as well as to our defense, to have a well-educated and trained work force—not to point out to us the necessity of investing in education. You say we are going to change the programs, money is not the answer—well, that is what rich people say to the poor people, that money is not the answer. But I have not seen any poor people saying that money did not matter.

And this baloney that you are going to do something to improve education and you are not going to spend more money, to me, is not recognizing the facts of modern life. We are going to have to pay teachers, and we are not getting the teachers. These are tremendous problems that lay ahead of us, and we are not recognizing them.

As a matter of fact, the Council and other reports are ignoring it. And what I cannot understand is how it is that you can justify this, and why you have come before us without at least alerting us to the danger that we run into in competition with other countries. We keep bashing them, and they keep moving ahead of us, because they are committed to having the best educated, the best trained people. And then we want to criticize them for being unfair, because we do not do our job.

I would like to have you react to that, and to explain to us whether or not you need to redirect chapter V, to tell us the truth in the field of education and in training and the other programs that are vital to our security, as well as to our defense, and certainly vital to the well-being of American people.

Mr. BOSKIN. Congressman Hawkins, are you asking a question? Or, may I take leave to reply?

Representative HAWKINS. I would like you to comment, yes. That was the reason.

Mr. BOSKIN. First of all, while you may not have liked what we said in chapter V, and I certainly respect your right to analyze things differently and to disagree, the chapter highlights the tremendous problems that we have in our education system, highlights the tremendous importance to economic growth that is at stake in improving the quality of education, highlights the disparities in educational performance on test scores, highlights the problems of access for minorities and so on, throughout the chapter.

I will come back to the specific points that you mentioned. After being accused of having a rosy scenario when I was projecting this year would be about four-fifths of an average postwar year—and I guess I have become used to some statements—I would offer you the following deal, sir; if you refrain from accusing me of faking numbers, of not telling the truth and things of that sort, I will invoke a very important aspect of symmetry and I will do the same for you, sir.

Representative HAWKINS. I would not say you faked them, but you left out the facts. Let's put it that way.

Mr. BOSKIN. Let me come back to our disagreement about the interpretation of the education numbers.

Representative HAWKINS. Not an interpretation, the facts. Are we better in international test scores? Are we spending as much as other industrialized nations? These are facts. They are not a question of interpretation.

Mr. BOSKIN. This is correct. And they are correctly stated in the report. We are doing poorly on international tests, and we spend more than any other industrialized nation on K through 12 education, other than Switzerland. The numbers you are referring to——

Representative HAWKINS. That is not a fact. Would you give us the source of that?

Representative OBEY. That is not true.

Representative HAWKINS. Give us the source of your statement.

Mr. BOSKIN. The source is stated in the report.

Representative HAWKINS. That report is yours. It is not an outside——

Mr. BOSKIN. The numbers are based on international United Nations and OECD comparisons. We are looking at expenditures per pupil, and you are referring to shares of GNP. Those are heavily affected by lots of other things—for example, the share of the school-age population, and so on.

On a per-pupil basis, the United States is second to Switzerland. That may not be enough, it may not be the right spending. We highlight the importance of this. The whole dispute between the Economic Policy Institute and the Department of Education revolves primarily around whether share of GNP is the appropriate measure, or dollars spent is the appropriate measure.

And I am just telling you that on a purchasing power basis, et cetera, that we rank second. Maybe we are not—and we state that we are not getting enough for that. So that is the isssue. And that is what I meant by an interpretation, sir.

And I respectfully would agree, on the numbers that you quote on the percentage of GNP, we are further down, well down toward the bottom. On a per-pupil basis, which would more appropriately measure what actually you could purchase and provide for children, we are second to Switzerland among the major industrialized countries.

I would be happy to go into this in more detail.

Representative HAWKINS. May I ask, Mr. Chairman, that the Economic Policy Institute's original study be put into the record, and that the Department of Education rebuttal, which is what Mr. Boskin is now pleading, be also inserted in the record, and that the Policy Institute rebuttal to the rebuttal be put in.

Because what they are talking about on the per-pupil expenditure basis leaves out the exchange rates of the countries, it leaves out the prices and wages, and so forth, which is a faulty way of trying to measure it. But it was their strong defense of why they are now saying that budget cuts, not expenditures, but budget cuts that we experienced in 1981 and subsequently are a way to educate the American people.

I do not know how budget cuts will do that, if we agree that money is not the answer. But, certainly, budget cuts are what they have been pleading for, and that is their defense.

Representative HAMILTON. The various documents will be made part of the record, without objection.

[The documents follow:]

EMBARGOED

Economic Policy Institute

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THINK TANK FINDS BUSH IS WRONG: U.S. SPENDING ON EDUCATION LAGS BEHIND THAT OF MOST OTHER INDUSTRIAL NATIONS

Report Shows Bush Administration Rationale Against Increased Education Investment Is Not Supported by Analysis of K-12 Outlays

U.S. ranks 14th of 16 nations in international comparison

Washington, DC -- President Bush, despite his desire to be known as the "Education President," has repeatedly opposed substantially increased spending on the nation's schools. The President and officials of his administration have claimed that this country already spends more on education than those nations which regularly surpass us in tests of educational performance. (See compiled quotes in report, pp. 1 and 2.)

A new report released today by the **Economic Policy Institute** concludes that the facts do not support the President's arguments. The study finds that 13 other industrial countries invest more, relative to the size of their economy, on grades K-12 than does the United States. Among the 16 countries whose education spending the EPI study measures, Sweden ranked first. Others whose spending was found to be higher than the U.S. are Japan (ranked 6th), West Germany (tied with France for 9th highest spender), Norway (4th), and Austria (2nd). Only Ireland and Australia were found to invest less on basic education than the U.S. (ranked 14th).

The report points out that the statistics cited by the Administration measure <u>total</u> education spending, including expenditures for postsecondary, college and university education, but that virtually all of the recent reports and commissions on U.S. educational deficiencies have identified education in grades K through 12 as the part of the system which needs improvement. When spending on higher education is removed from the comparative data, the relative position of U.S. spending falls from a three -

way tie for second highest in spending to close to the bottom of the group of 16 industrial nations.

The EPI report, entitled ***Shortchanging Education: How U.S. Spending on Grades K-12 Lags Behind Other Industrial Nations***, was written by Edith Rasell, a staff economist at the Institute and by EPI Research Director Lawrence Mishel. The authors used widely-accepted data published by UNESCO and the *U.S. Digest of Education Statistics*, to compare education spending for 1985 (the latest data available) in 16 industrialized countries including most of Western Europe, Japan, Canada and the U.S. The data come from the same sources relied on by the Administration.

Among the report's major findings are the following:

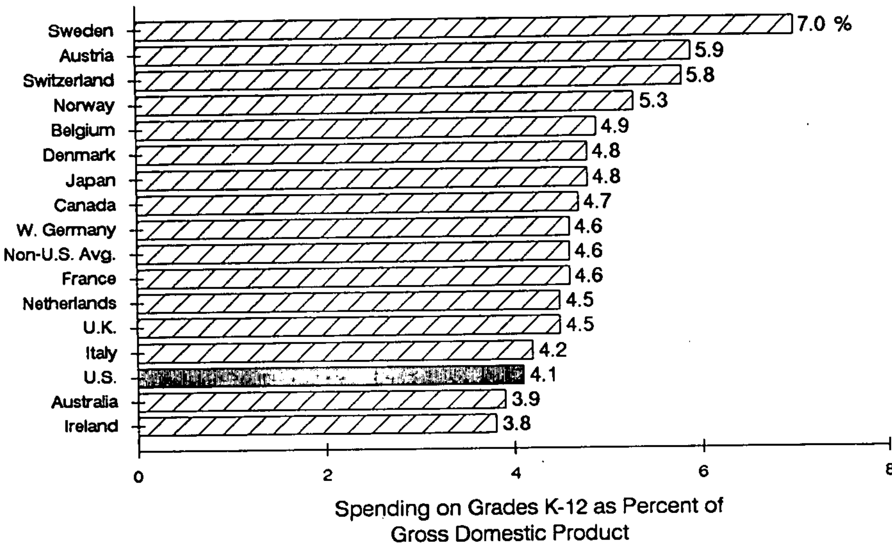
- U.S. public and private spending on pre-primary, primary and secondary education, is lower than in most other countries. When the raw (unadjusted) data are considered, the U.S. ties for twelfth place among 16 industrialized nations, investing less than all but three countries.

- Because some countries have a larger percentage of school age children in their population than others, the study also calculates expenditures for K-12 adjusted to account for these differences in enrollment rates and finds that the U.S. falls to fourteenth place, spending less than all the other countries but two.

- If the U.S. were to increase spending for primary and secondary school up to the average level found in the other 15 countries, we would need to raise spending by over $20 billion annually.

Bush Administration officials' claims of high relative levels of U.S. education spending are sometimes couched in terms of spending as a percent of total national income ("We spend a very large amount of our national income on education." -- Council of Economic Advisers Chairman, Michael Boskin), and they are sometimes couched in terms of spending per pupil ("We are already spending more money per student than our major foreign competitors, Japan and Germany." -- Secretary of Education Lauro Cavazos). The EPI report calculates its education spending comparisons both ways and finds that, when size differences of school age population and currency fluctuations are accounted for, the relative position of the United States turns out to be virtually the same: only two or three other nations out of the 16 studied invest less on basic education than the U.S.

Comparison of Industrialized Country Education Expenditures, 1985



The authors of the report note that this is the first time that economists have examined the factual underpinnings of the Bush Administration's claims about education spending, which have had a major impact on the public debate about educational reform. "Over the past year, as they have declared their interest in improving education, President Bush, CEA Chairman Michael Boskin, White House Chief of Staff John Sununu, Education Secretary Lauro Cavazos and other Administration officials have repeated these statistical claims which have effectively ruled out consideration of increased federal financial support for education," declared report co-author Lawrence Mishel. "But when you examine the parts of the educational system which need improvement. It turns out that the U.S spends less than any of our major international competitors. Although not all needed educational reforms cost more money, this report shows that we cannot dismiss the idea that more money might help improve basic education," said Mishel.

The study calculates that it would take additional investments of more than $20 billion per year just to bring the U.S. up to the average level of spending of the 16 nations studied. But the report's other author, economist Edith Rasell, noted that there are many characteristics of the U.S. education system that might make it more expensive for the U.S. to achieve levels of educational performance comparable to that of other countries. "Because the United States is a huge continental nation with a decentralized school system and with higher rates of poverty and immigration than most other industrialized countries, we could expect education expenses to be higher than in a smaller, more homogeneous nation," she observed. "For example, France and Belgium have near-universal enrollment of three to six-year-olds in pre-kindergarten educational programs. But despite the overwhelming evidence of the value of early education, the U.S., with its decentralized system, has a much smaller percentage of children in these programs. As a result, we have to invest more money in compensatory education thereafter just to achieve the same level of performance."

The report concludes by noting that more money is not the only answer to the difficult problems of revitalizing primary and secondary education in the U.S. But, it warns, "the data presented here indicate that, in education, as in every other service, we may 'get what we pay for.' Given the level of investment in our pre-primary, primary, and secondary schools, it is not surprising that we are slipping behind in comparative measures of performance as well."

The report issued today is one of a series of analytical briefing paper studies on key economic policy issues regularly published by the **Economic Policy Institute**, a non-profit, non-partisan economic think tank founded in 1986 and supported by grants from foundations, labor unions, corporations, and individuals. The Institute's founders include economic policy experts Lester Thurow, Robert Reich, Robert Kuttner, Barry Bluestone, Ray Marshall, and EPI's President, Jeff Faux.

Economic Policy Institute **Briefing Paper**

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SHORTCHANGING EDUCATION

HOW U.S. SPENDING ON GRADES K-12 LAGS BEHIND OTHER INDUSTRIAL NATIONS

Release Date 1-17-90

By M. Edith Rasell and Lawrence Mishel

Introduction and Summary

Over the past decade, Americans have become increasingly concerned about the educational and academic achievements of U.S. students, particularly at the primary and secondary levels. Numerous high-level commissions, composed of leaders from government, education, and business, have examined the schools, and most recently, state governors and Administration officials, including President Bush, met at the "Education Summit" to discuss needed reforms. Improving the education of U.S. students has risen to the top of the public agenda.

President Bush, who has declared his desire to be known as the "education president," has, however, attempted to limit the discussion of educational reform initiatives to those which do not involve spending additional public funds. At the "Education Summit" in September, President Bush declared that the U.S. "lavishes unsurpassed resources on [our children's] schooling." Therefore, "our focus must no longer be on resources. It must be on results."[1] At this same conference, Secretary of Education Lauro Cavazos stated that the problem with U.S. education "is not ... an issue of dollars... [F]unding is truly not an issue."[2]

The President and Administration officials have justified this anti-spending stance by asserting that the U.S. education system is already well-funded in comparison with other industrialized nations. Two measures of spending have been used by Administration officials and others to compare U.S. expenditures with those of other countries. One measure is spending per pupil. According to Secretary of Education Cavazos, "we are already spending more money per student than our major foreign competitors, Japan and Germany."[3] President Bush's Chairman of the Council of Economic Advisers, Michael J. Boskin, agrees: "[w]e spend more, per pupil, than most of the other major industrialized economies."[4] In *The New York Times*, Chester E. Finn, Jr., former Assistant Secretary of Education in the Reagan Administration and now director of the Educational Excellence Network of Vanderbilt University, wrote: "[w]e already spend far more per pupil than any other nation."[5]

The second measure of spending which is used to make international comparisons is the share of national income devoted to education. In an appearance on the NBC "Today Show" just before the September 1989 "Education Summit," President Bush's Chief of Staff John Sununu declared: "[w]e spend twice as much [on education] as the Japanese and almost 40 percent more than all of the other major industrialized countries of the world."[6] The Council of Economic Advisors chairman Michael Boskin stated, "we spend a very large amount of our national income on education."[7]

The Administration's proposition that U.S. education is well-funded and therefore poor student performance cannot be a matter of insufficient monies is a key element in the national debate over education. It has provided policymakers at federal, state, and local levels a convenient rationale for not devoting more resources to education in a time of budgetary stress.

This paper is an examination of the statistical under-pinnings of the Administration's claims. It concludes that the assertions about funding are misleading and therefore are invalid guides to education policy. Specifically, our examination of education expenditures in 16 industrialized countries, adjusted for differences in national income, shows:

*** U.S. public and private spending on pre-primary, primary and secondary education, the levels of schooling which have been the focus of most concern, is lower than in most other countries. The U.S. ties for twelfth place among 16 industrialized nations, spending less than all but three countries.

*** When expenditures for K-12 are further adjusted to reflect differences in enrollment rates, the U.S. falls to fourteenth place, spending less than all the other countries but two.

*** When U.S. *public* spending alone is compared to *public* spending abroad, we rank fourteenth in spending for *all* levels of schooling, fourteenth in spending on K-12, and thirteenth in K-12 spending adjusted for enrollments.

*** If the U.S. were to increase spending for primary and secondary school up to the *average* level found in the other 15 countries, we would need to raise spending by over $20 billion annually.

*** Because the U.S. spends comparatively more than other countries on higher education, when expenditures on all levels of education -- pre-primary, primary, secondary and post-secondary -- are calculated, we are in a three-way tie for second place among the countries studied.

This paper is focused on education spending. It is not a prescription for improving the U.S. education system. We recognize that money does not guarantee excellence and we suspect that other changes -- in curriculum, in the status of teachers, and in expectations about students, to name just a few, will also be fundamental to any improvement in education quality and student achievement. But to begin a process of education reform by denying the need to increase spending, especially when U.S. schools are under-funded compared to those in other industrialized countries, places a severely limiting constraint on any plans for educational improvement.

Comparing Educational Effort

This paper compares education spending in 16 industrialized countries: most of western Europe, Canada, Japan and the U.S.[8] Our data source is the United Nations Educational, Scientific and Cultural Organization (UNESCO)[9], virtually the only commonly accepted source for such comparisons and the same source used by Administration officials. U.S. 1985 expenditure data come from the *Digest of Education Statistics*[10] (see Appendix A for details).

International Comparisons: Education Share of National Income

We will begin our study by comparing education expenditures expressed as a percentage of national income (Gross Domestic Product). This is a common method used for international comparisons which allows us to avoid the distortions caused by fluctuating exchange rates. Also, education expenditures expressed as a percentage of national income provide a measure of the national effort which each country directs toward education.

Table 1 shows education expenditures as a percentage of national income for 16 countries in 1985, the last year for which such data are available (tables appear beginning on page 11). A first but, as we will show later, misleading glance shows that U.S. spending on all levels of schooling, including pre-school, primary, secondary and higher education, in 1985 amounted to 6.8 percent of national income. This places the U.S. in a three-way tie for second place with one of the highest expenditure levels among the 16 countries studied. By this measure it appears that only Sweden spends a larger share of national income on education than does the U.S., and Canada and the Netherlands spend equivalent amounts. This figure showing the U.S. to spend a relatively large percentage of national income on education is the basis for the claims made by the President and others that the U.S. spends "lavishly" on education and that we spend more than most other countries.

This comparatively high expenditure on education is due, in large part, to the substantial sums the U.S. spends on *higher* education. A relatively larger number of U.S. students are enrolled in post-secondary education than in most other countries. In 1985, 5.1 percent of the entire U.S. population was enrolled in some form of higher education, a figure two to three times larger than the percentage enrollments of any other country, except Canada (see Table 2). Larger enrollments, in what is also a more expensive form of education, raise U.S. total education expenditures above levels in many other countries.

But the current crisis of American schools is not in higher education; it is in the primary and secondary school systems. A comparison of funding for *all* levels of education combined thus obscures the main focus of concern about American education. If spending on K-12 only is compared, as shown in column 2 of Table 1, in 1985 the U.S. tied for twelfth place, spending *less* than 11 of the other countries. Only three of the countries studied spent less than the U.S. on primary and secondary education.[11]

But this picture of relative spending is still incomplete. Calculations of funding adequacy must also be related to the size of the school age population in each country. Among the countries studied, the U.S. enrolls a relatively large percentage of the population in pre-primary, primary and secondary school (see Table 2). For example, over 19 percent of the U.S. population is enrolled in K-12, but less than 15 percent of the West German population and only 14 percent of the population in Switzerland. In Table 1, column 3, the K-12 expenditure figures of column 2 are adjusted to take into account the relative size of each country's K-12 enrollment (see Appendix A for methodology). By this more accurate calculation, among the 16 countries studied, *the U.S. spends less on pre-primary, primary and secondary education than all but two other countries.* Only Australia and Ireland spend less than the U.S. for the critically important grades K-12 (see Figure 1).

We can also compare U.S. education spending as a share of national income with the *average* share of the other 15 countries as shown in the bottom row of Table 1. The U.S. spent 4.1 percent of its national income on K-12 education in 1985, while the average abroad was 4.6 percent. If the U.S. were to have reached this average in 1985, we would have needed to raise spending for pre-primary, primary, and secondary school by over 12 percent, or by $20.6 billion annually. In 1988 dollars, the equivalent sum is $23.5 billion.

All the international comparisons made thus far still give an incomplete picture of comparative education spending. Large U.S., Japanese and German trade imbalances skew the data and make the U.S. education expenditure appear larger than is actually the case. A more accurate picture of education spending, taking into account trade imbalances, would lower U.S. spending and raise Japanese and German spending beyond the levels shown in Table 1. Further details and data appear in Appendix B.

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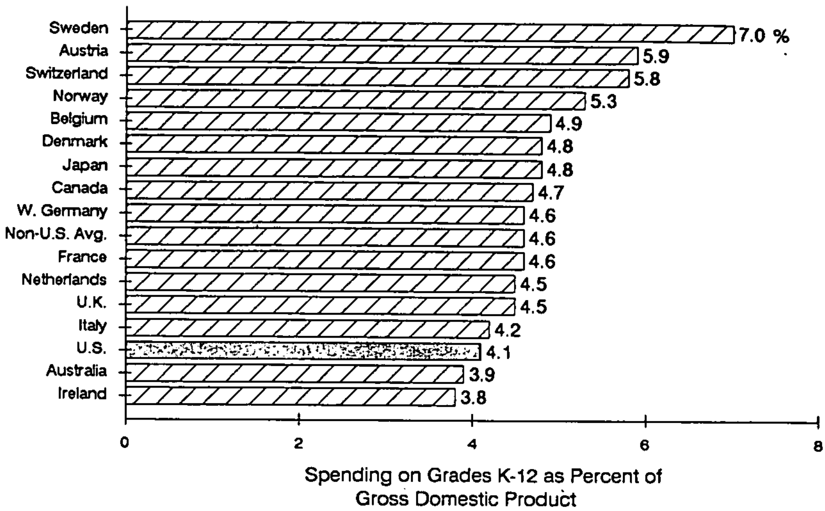
Figure 1
Comparison of Country Education Expenditures, 1985



Source: Table 1.

Operating and Capital Expenditures

The rankings described above are derived from comparisons of education spending which include both operating expenses and capital expenditures. In order to judge whether the low U.S. rankings might be a result of some unique allocation of spending between capital and operating accounts, Table 3 ranks the 16 nations according to operating expenditures only. The comparison shows the U.S. position, relative to the other countries, to be nearly unchanged.

Public Spending on Education Compared

We have seen that the U.S. spends a smaller share of its national resources on K-12 than do most other industrialized countries. But there is another dimension in which the characterization of the U.S. as a big spender on education is wrong -- *public expenditures.*

For most of the 16 countries studied, UNESCO assembles data on *public* expenditures for education because public revenues provide virtually all of the money spent on education. Even in countries where a sizable segment of the school population is enrolled in private school, most private schools' expenses are paid with public money. Thus, public expenditures approximate total education spending. The two exceptions are Japan and the U.S. where 20-25 percent of all education funding comes from private sources. For these two countries, UNESCO provides data on public *and* private education expenditures.

Education policy is primarily, although not exclusively, concerned with public schools. Moreover, public education spending reflects the conscious national commitment to educating the next generation. It is therefore useful to compare levels of public spending in the U.S. and Japan, with public spending in the other 14 countries.

As Table 4 shows, when public spending abroad for all levels of education is compared with public spending in the U.S., the U.S. no longer ties for second place, but falls to fourteenth. Japanese public spending on all levels of education was 5.1 percent of national income, compared with 5.0 percent for the U.S. In a comparison of public funding for K-12 only, the U.S. falls from the already low ranking of 12 (when both public and private money is included), to number 14. If we educated public and private K-12 students at the actual per pupil expenditure rate found in public schools, this would increase spending and raise the U.S. ranking from 14 to 13.[12]

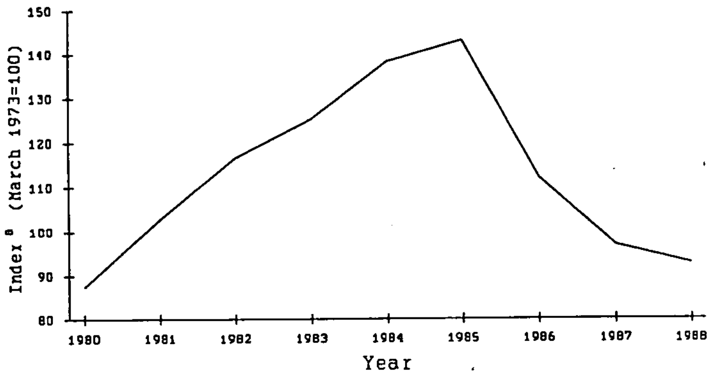
International Comparisons: Expenditures per Pupil

Thus far we have focused on education's share of national income in different countries. Education investment can also be analyzed by comparing expenditures per pupil. As we have seen, this is the measure Messrs. Cavazos, Boskin, and Finn have sometimes used to claim that the U.S. spends more on education than its economic competitors.

However, there are two potential sources of error in the use of per pupil expenditures to compare nations' spending on education. The first is the instability of exchange rates. Before cross-national comparisons can be made, expenditures measured in each country's national currency must be expressed in some common unit of measurement, e.g. dollars, yen, marks, etc. But whatever measure one chooses, it requires converting data collected in all other currencies to one currency.[13] However, exchange rates fluctuate, sometimes markedly, and this has been particularly true in the 1980s. For instance, in 1985, if $100,000 would have purchased a German school bus, by 1988, due to a decline in the value of the dollar, the same bus would have cost $166,000. If exchange rates were used to convert German expenditures into dollars, the purchase of the bus by a German school district in 1985 would have been shown as an expenditure of

$100,000, while the same purchase in 1988 would appear as an expenditure of $166,000. The size of the German expenditure measured in German marks would be unchanged, but fluctuations in the exchange rate used to convert marks to dollars would markedly change the dollar value of the expenditure. In 1985, the year which we have been examining, the dollar was particularly overvalued (see Figure 2). The effect is to make the U.S. expenditures on education appear relatively greater than those in other countries.

Figure 2
Value of the Dollar, 1980-88



a. Nominal multilateral trade-weighted value of the U.S. dollar.

Source: Federal Reserve Board.

The problem of using exchange rates to make spending comparisons is illustrated in Table 5. Using 1985 exchange rates, as shown in column 1, the U.S. ranked fourth among the 16 countries studied. But if some other value of the dollar is used to make the conversion, e.g., the 1988 exchange rate, then the U.S. ranking changes to ninth (column 2).

The second problem in using per pupil expenditures is that they do not necessarily reflect the national effort devoted to education. The real issue underlying cross-national comparisons is not the numbers of dollars or pounds which each country spends, but the relative national effort devoted to education. For example, a poorer country could spend a relatively large share of national income on education, i.e., could make a large national effort to educate its youth, but have a much lower spending per pupil than a richer country devoting a smaller share of its income to education. Before meaningful international comparisons can be made, education expenditure levels must be related to some measure of total national income.

Moreover, countries with high per capita incomes will also have higher wages reflecting a higher standard of living. For example, high living standards in the U.S. mean that, in general, workers are better paid than in other countries. Therefore, we would expect education expenditures per pupil to be higher in the U.S. than in other countries.

Per pupil expenditures can be used to make international comparisons if two conditions are met: exchange rates are avoided, and if some measure of national income is included in the calculation. Such a measure is shown in Table 6. Expenditures per student are expressed as a percentage of per capita income measured in each nation's *own* currency. We find that of the 16 countries studied, U.S. spending on pre-primary, primary, and secondary education is lower than in all but two other countries.[14]

The Historical Record

The study thus far has examined expenditures at a single point in time, 1985, and has found that the U.S. spent relatively little on pre-primary, primary, and secondary education compared with other industrialized countries. Another important issue is how U.S. funding for education has changed over time and how U.S. spending has changed relative to that of other countries. Tables 7 and 8 show U.S. funding of K-12 education in the postwar period. Expenditures are expressed as a percentage of national income.

As shown in Table 7, expenditures for pre-primary, primary and secondary education peaked in 1974, and have fallen steadily since (see column 1). Thus, spending for education has not kept pace with overall economic growth. Over this same period, however, enrollments also have fallen (see column 3). Primary and secondary school enrollment, as a percentage of the total population, was at its highest level in 1969, and has been gradually falling since that time. Adjusting expenditure figures for the changing enrollments, using the same method as in the international comparisons, shows that the decline in spending for education has been more than offset by shrinking enrollments (see Table 7, column 2). In the 1980s, the declining fraction of the population enrolled in school has meant adjusted expenditures have risen, despite the slowdown in actual funding for education.

Table 8 shows how the funding sources for public education have changed over time. Adjusted federal revenues, after rising until 1980, by 1985 had fallen by .08 percent of national income. In the same five year period, state and local revenues rose by .14 percent and .08 percent, respectively. (Since these are percentages of our two to three billion dollar national income, these small changes of less than one percent actually indicate billion dollar variations in education expenditures. In 1988, 0.1 percent of national income equaled $4.46 billion.) Thus, the federal government's education funding responsibilities were shifted onto states and localities. The observed rise in adjusted total revenue is solely due to increased funding by states and localities. Among other consequences, this has increased the potential for greater disparities in funding between school districts across the nation.

Despite the increase in overall U.S. education funding of K-12 between 1980 and 1985, our position relative to other countries declined. Table 9 shows K-12 expenditures in 1980 and 1985 for the 16 countries we have been comparing, with both years' expenditures adjusted for the 1985 U.S. enrollment rate. In 1980 the U.S. ranked twelfth in adjusted spending on K-12, spending less than eleven other countries. But by 1985, the U.S. had fallen in rank to number fourteen.

U.S. education expenditures since 1985 are shown in Table 10.[15] Spending for pre-primary, primary, and secondary education, expressed as a percentage of national income and adjusted for 1985 enrollments, rose from 3.88 percent in 1980, to 4.08 percent in 1985, reached 4.21 percent in 1987, and has been relatively constant between 1987 and 1989. Because comparable international data are not available, we cannot determine how this post-1985 U.S. trend affects its relative ranking with the other countries.

Conclusion

We have seen that when public plus private spending on all levels of education is compared with spending in other industrialized countries, the U.S. is in a three-way tie for second place among the countries studied. However, when spending for primary and secondary education alone is compared with expenditures abroad, the U.S. ranking falls to a tie for twelfth place. And when adjustments are made for enrollment size, the U.S. falls further to fourteenth place, spending less than all the other countries except two.

When levels of public spending on education only are compared, showing the social commitment to public education, again the U.S. compares unfavorably with the other countries. Comparisons of public spending for all levels of education, and for K-12 alone, both place the U.S. in fourteenth place. In enrollment adjusted K-12 public expenditures, the U.S. does slightly better, ranking number thirteenth. But by all comparisons, the U.S. devotes fewer resources to primary and secondary education than do most industrialized nations.

The claim that the U.S. spends more than other nations on education is misleading. By all comparisons, the U.S. devotes a smaller share of its resources to pre-primary, primary and secondary education than do most industrialized countries.

The comparatively weak U.S. investment in K-12 is not a result of a more efficient administrative structure or favorable demographics. In fact, the U.S. might be expected to spend proportionally *more* than other countries because of the particular characteristics of the U.S. school system and American society. Our decentralized school system gives more local autonomy and local choice, but is also more expensive than a single, centrally administered system. Our population is more heterogeneous than in most other countries. Some immigrants do not speak English. Students come from a variety of cultural backgrounds. The very high number of children living in poverty makes additional demands on the school system.

Available data do not permit cross-country comparisons to be made in much more detail, but other evidence suggests that the spending gap is particularly wide between the youngest American and foreign children. For example, it is generally accepted that the U.S. Head Start Program of early childhood education for disadvantaged children age three to five is valuable and cost effective, yet limited federal funding permits only 20 percent of eligible children to take part. Many of our competitors seem to have a stronger commitment to early childhood education, and some of them have nearly universal pre-kindergarten enrollments. In France, 100 percent of four- and five-year-olds attend school/educational day care, 90 percent of three-year-olds attend, and 36 percent of two-year-olds. In Belgium, 96 percent of three- to six-year-olds are in school, and in the Netherlands, 98 percent of four- and five-year-olds.[16]

Spending more money is not, of course, the only answer to the difficult problem of revitalizing primary and secondary education in the U.S. But the data presented here indicate that in education, as in every other service, we may "get what we pay for." Given the level of investment in our pre-primary, primary, and secondary schools, it is not surprising that we are slipping behind in comparative measures of performance as well.

TABLE 1: COMPARISON OF INDUSTRIALIZED COUNTRY EXPENDITURES FOR EDUCATION, 1985

	EXPENDITURES /GDP	RANK				
	(1) K-12 and Higher Education		(2) K-12 Only		(3) Adjusted[a] K-12	
Country						
United States	6.8%	2	4.1%	12	4.1%	14
Australia	5.5	12	3.7	15	3.9	15
Austria	5.8	11	4.7	7	5.9	2
Belgium	6.1	7	4.9	5	4.9	5
Canada	6.8	2	4.7	7	4.7	8
Denmark	6.0	8	4.5	10	4.8	6
France[b]	5.9	10	5.1	3	4.6	9
Germany, West	4.6	16	3.5	16	4.6	9
Ireland[b]	6.0	8	5.0	4	3.8	16
Italy[c]	4.8	15	4.1	12	4.2	13
Japan	6.5	5	4.8	6	4.8	6
Netherlands[b]	6.8	2	4.7	7	4.5	11
Norway	6.3	6	5.4	2	5.3	4
Sweden	7.6	1	6.3	1	7.0	1
Switzerland	5.1	14	4.2	11	5.8	3
United Kingdom[b]	5.2	13	3.9	14	4.5	11
Non-U.S. Average	5.8		4.5		4.6	

[a] Adjusted for the 1985 U.S. K-12 enrollment rate
[b] 1984 data
[c] 1983 data

Sources: UNESCO; Statistical Yearbook, 1988.
National Center for Education Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 2: COMPARISONS OF PERCENTAGE ENROLLMENTS, 1985

Country	Higher Education (ENROLLMENT/TOTAL POPULATION)	K-12 (ENROLLMENT/TOTAL POPULATION)
United States	5.1%	19.7%
Australia	2.3	18.8
Austria	2.4	15.8
Belgium	2.6	19.8
Canada	4.9	19.6
Denmark	2.3	18.5
France[a]	2.3	21.8
Germany, West	2.5	14.9
Ireland[a]	1.9	25.6
Italy[b]	2.0	19.5
Japan	1.9	20.1
Netherlands[a]	2.7	20.4
Norway	2.1	19.8
Sweden	2.6	18.0
Switzerland	1.7	14.0
United Kingdom[a]	1.8	17.1

[a] 1984 data
[b] 1983 data

Sources: UNESCO; Statistical Yearbook, 1988.
National Center for Educations Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 3: COMPARISON OF INDUSTRIALIZED COUNTRY OPERATING EXPENDITURES FOR EDUCATION, 1985

	EXPENDITURES /GDP RANK					
	(1)		(2)		(3)	
Country	K-12 and Higher Education		K-12 Only		Adjusted[a] K-12	
United States	6.2%	3	3.8%	10	3.8%	13
Australia	5.0	11	3.4	15	3.5	15
Austria	5.3	10	4.2	8	5.3	2
Belgium	5.8	5	4.7	3	4.7	4
Canada	6.4	2	4.4	6	4.4	7
Denmark	5.8	5	4.3	7	4.6	6
France[b]	5.6	7	4.8	2	4.3	8
Germany, West	4.1	16	3.2	16	4.2	10
Ireland[b]	5.5	9	4.5	5	3.5	15
Italy[c]	4.4	15	3.8	10	3.9	12
Japan	4.8	13	3.6	14	3.6	14
Netherlands[b]	6.0	4	4.1	9	4.0	11
Norway	5.6	7	4.7	3	4.7	4
Sweden	6.7	1	5.6	1	6.2	1
Switzerland	4.7	14	3.8	10	5.3	2
United Kingdom[b]	5.0	11	3.7	13	4.3	8
Non-US Average	5.1		3.9		4.1	

[a] Adjusted for the 1985 U.S. K-12 enrollment rate
[b] 1984 data
[c] 1983 data

Sources: UNESCO; Statistical Yearbook, 1988.
National Center for Education Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 4: JAPAN AND THE UNITED STATES: PUBLIC AND PRIVATE EDUCATION EXPENDITURES, 1985

	EXPENDITURES/GDP (rank)		
	K-12 and Higher Education	K-12 Only	Adjusted[a] K-12
United States			
Public and Private	6.8% (2)	4.1% (12)	4.1% (14)
Public only	5.0 (14)	3.8 (14)	4.3[b] (13)
Japan			
Public and Private	6.5% (5)	4.8% (6)	4.8% (6)
Public only	5.1 (13)	NA.	NA.

[a] Adjusted for the 1985 U.S. K-12 enrollment rate (public plus private)
[b] The 1985 U.S. K-12 public enrollment rate is adjusted for the 1985 U.S. K-12 public plus private enrollment rate
NA = not available

Source: UNESCO; Statistical Yearbook, 1988.
National Center for Education Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 5: COMPARISON OF K-12 1985 EXPENDITURES PER PUPIL IN INDUSTRIALIZED COUNTRIES

	Converted to Dollars Using:			
	1985 EXCHANGE RATES		1988 EXCHANGE RATES	
Country	Expenditures Per Pupil	Rank	Expenditures Per Pupil	Rank
United States	$3,456	4	$3,456	9
Australia	2,040	11	2,291	14
Austria	2,564	8	4,297	6
Belgium	2,015	12	3,254	10
Canada	3,322	5	3,683	8
Denmark	2,802	6	4,410	5
France[a]	2,051	10	3,094	12
Germany, West	2,395	9	4,016	7
Ireland[a]	956	16	1,380	16
Italy[b]	1,233	15	1,809	15
Japan	2,647	7	4,927	4
Netherlands[a]	1,919	13	3,224	11
Norway	3,792	3	5,002	3
Sweden	4,224	1	5,932	2
Switzerland	4,205	2	7,061	1
United Kingdom[a]	1,668	14	2,314	13

[a] 1984 data
[b] 1983 data

Sources: UNESCO; Statistical Yearbook, 1988. National Center for Education Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 6: COMPARISON OF INDUSTRIALIZED COUNTRY K-12 EXPENDITURES PER PUPIL AS A PERCENT OF PER CAPITA INCOME, 1985

Country	Percent	Rank
United States	20.8%	14
Australia	19.5	15
Austria	29.7	2
Belgium	25.0	5
Canada	24.0	8
Denmark	24.5	6
France[a]	23.2	10
Germany, West	23.5	9
Ireland[a]	19.4	16
Italy[b]	21.1	13
Japan	24.1	7
Netherlands[a]	23.0	11
Norway	27.1	4
Sweden	35.3	1
Switzerland	29.6	3
United Kingdom[a]	22.8	12
Non-U.S. Average	23.5	

[a] 1984 data
[b] 1983 data

Sources: UNESCO; Statistical Yearbook, 1988.
National Center for Education Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 7: UNITED STATES K-12 EXPENDITURES, 1949-1985

Year	EXPENDITURES/GDP (1) Total	(2) Adjusted[a] Total	(3) Enrollment as % of Population
1949	2.41%	2.38%	19.08%
1959	3.39	2.78	22.98
1965	4.01	3.03	24.95
1969	4.51	3.37	25.22
1972	4.57	3.56	24.18
1974	4.74	3.81	23.41
1976	4.50	3.73	22.70
1978	4.19	3.69	21.40
1980	4.18	3.88	20.34
1982	4.13	4.00	19.46
1984	4.01	3.98	18.98
1985	4.08	4.08	18.83

[a] Adjusted to the 1985 K-12 enrollment rate.

Note: These 1980 and 1985 adjusted expenditures differ from those shown in Tables 1 and 9. See endnote 15 for an explanation.

Source: National Center for Education Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 8: SOURCE OF PUBLIC REVENUES FOR UNITED STATES PUBLIC K-12, 1949-1985

	ADJUSTED[a] REVENUES/GDP		
Year	(1) Federal	(2) State	(3) Local
1949	.06%	.82%	1.18%
1959	.11	.98	1.41
1965	.22	1.08	1.46
1969	.25	1.23	1.61
1972	.29	1.31	1.69
1974	.31	1.47	1.69
1976	.31	1.51	1.66
1978	.33	1.56	1.53
1980	.33	1.72	1.57
1982	.26	1.75	1.64
1984	.24	1.80	1.63
1985	.25	1.86	1.65
Change 1980-1985	-.08	+.14	+.08

[a] Adjusted to the 1985 K-12 enrollment rate.

Source: National Center for Education Statistics, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 9: COMPARISON OF INDUSTRIALIZED COUNTRY 1980 AND 1985 EXPENDITURES FOR EDUCATION

Country	Total K-12 Expenditures/GDP 1980[a]	Rank 1980[a]	Total K-12 Expenditures/GDP 1985[a]	Rank 1985[a]
United States	4.1%	12	4.1%	14
Australia	4.0	13	3.9	15
Austria	5.3	4	5.9	2
Belgium	4.6	9	4.9	5
Canada	4.9	7	4.7	8
Denmark	5.5	3	4.8	6
France[b]	3.8	15	4.6	9
Germany, West	4.4	10	4.6	9
Ireland[b]	4.0	14	3.8	16
Italy[c]	3.8	16	4.2	13
Japan	5.3	4	4.8	6
Netherlands[b]	4.8	8	4.5	11
Norway	5.7	2	5.3	4
Sweden	8.5	1	7.0	1
Switzerland	5.1	6	5.8	3
United Kingdom[b]	4.4	10	4.5	11
Non-U.S. Average	4.6		4.6	

[a] Adjusted for 1985 U.S. K-12 enrollment
[b] Data listed for 1985 is actually 1984
[c] Data listed for 1985 is actually 1983; data listed for 1980 is actually 1979.

Sources: UNESCO; Statistical Yearbook, 1988.
NCES, U.S. Department of Education; Digest of Education Statistics, 1988.

TABLE 10: UNITED STATES K-12 EXPENDITURES, 1980-1989

Year	Expenditures/GDP[b]
1980	3.88%
1982	4.00
1985	4.08
1986	4.19
1987[a]	4.21
1988[a]	4.20
1989[a]	4.22

[a] Estimate
[b] Adjusted for the 1985 K-12 enrollment rate

Source: National Center for Education Statistics, U.S. Department of Education; Digest of Educational Statistics, 1988, and 1989 (forthcoming).

APPENDIX A: METHODOLOGY FOR COMPARING EXPENDITURES

The purpose of this paper is to compare education expenditures, in particular for pre-primary, primary and secondary education, among industrialized countries. The only source of education expenditure data for multiple countries is the UNESCO *Statistical Yearbook*. Data from 1985 and 1980 were examined. 1985 is the most recent year for which data are available for most countries, and 1980 was chosen arbitrarily as a starting point from which to estimate trends.

The 1988 *Yearbook* provides the enrollment and expenditure data for all countries in this report, with the exception of the U.S. 1985 expenditure. Since UNESCO lists no U.S. education expenditure figures for years since 1983, these figures were obtained from the U.S. Department of Education's 1988 *Digest of Education Statistics*. A question immediately arises concerning the comparability of the U.S. and UNESCO data. Examination of total education expenditure figures for 1982 and 1983, the most recent years for which both UNESCO and *Digest* data are available, shows that the numbers correspond quite closely. In 1982, UNESCO's figure was 1.5 percent greater than the *Digest*'s, and in 1983, the *Digest*'s was .93 percent larger than UNESCO's.

Public and Private Expenditures

For all countries except the U.S. and Japan, UNESCO provides data on *public* spending for education which includes nearly all education expenditures. In the U.S., about 25 percent of all education spending is private money which is spent primarily for higher education. The UNESCO figures given for the U.S. are for combined public and private spending. In Japan, approximately 20 percent of all education spending is private and it is also biased toward higher education. Since 1984, the UNESCO figures for Japan include both public and private expenditures. Our calculation of 1980 public *and* private Japanese education spending is explained below.

Spending for Pre-Primary, Primary, and Secondary Education

Our primary goal is to compare K-12 spending among industrialized countries. Unfortunately, UNESCO does not disaggregate total expenditures into spending for K-12 and higher education, but this information can be calculated from the data given. (In this paper, when the expression K-12 is used, "K" represents all the pre-primary years.) UNESCO divides total education spending into current (operating expenses) and capital expenditures and provides the distribution of *current* expenditures between K-12 and higher education. However, data on capital expenditures are not available by level of schooling. It is therefore necessary to estimate total spending on K-12 by making assumptions about the distribution of capital spending between K-12 and higher education. (For most countries, capital spending is less than ten percent of total spending.)

First, the ratio of current spending on K-12 to current spending on both K-12 and higher education is determined. This ratio is then applied to total capital expenditures to estimate capital spending for K-12. The estimated K-12 capital spending is added to K-12 current spending to give a preliminary figure for K-12 expenditures. (Other additions to this amount are described below.) This method assumes that capital spending is apportioned between K-12 and higher education exactly as is current spending. Although this assumption is probably not strictly accurate (see below), it affects the calculation of every country's expenditures (by a very small amount), and so will not bias our results toward any particular country. The comparison of K-12 operating expenses (current expenditures) shown in Table 4 yields essentially the same rankings as our comparison of total K-12 spending.

As mentioned above, current expenditures are disaggregated into spending for K-12 and higher education, but also into two additional categories: "other" and "not distributed." The latter two categories, as defined by UNESCO, include, respectively, spending on "special, adult, and other types of education which cannot be classified by level" and "administration for which there is no breakdown by level of education." The U.S. assigns no expenditures to these two categories while in other countries these two items account for up to 25 percent of all current expenditures. Ignoring these two categories would have seriously biased our results. To compare K-12 expenditures among countries, all education spending, including the sizable expenditures listed in the "other" and "not distributed" categories, must be assigned to either K-12 or higher education.

The exact distribution of these expenditures by level of education is not available. Therefore, we estimate their contribution to total K-12 spending by assuming that spending in these two categories is distributed between K-12 and higher education in the same proportion as is the rest of current spending. Adding these amounts to the preliminary K-12 total described above gives total K-12 spending.

1985 U.S. education expenditures are obtained from the *Digest of Education Statistics*. We want to estimate 1985 U.S. spending on K-12 by the same method that is used for the other countries, i.e., by assuming that the percentage of total capital spending which goes to K-12 is the same as the percentage of current spending for K-12. Therefore, we need to know the percentage of current spending for K-12, as well as total current and capital spending for all levels of education. The *Digest* supplies most of these data, except the distribution of private K-12 spending between current and capital expenses. So one additional assumption is necessary to calculate total U.S. K-12 spending. We assume that the ratio of current to capital K-12 spending is the same for private expenditures as for public. We can then determine total K-12 spending for the U.S.

More detailed data show that current and capital spending in the U.S. are not distributed between K-12 and higher education in the same proportions. K-12 usually accounts for a larger share of current spending than of capital spending. Put another way, capital spending is skewed toward higher education. In our treatment of capital expenditures, some fraction of capital spending for higher education is attributed to K-12. Our method tends to over-estimate K-12 spending, especially for the U.S. where expenditures on higher education are so large. This upward bias in our estimate of K-12 spending, particularly for the U.S., is a bias against our conclusion that the U.S. is a low spender on pre-primary, primary, and secondary education.

Japan presents other difficulties. As noted above, 20 percent of all education spending in Japan is private money. Therefore we need to include both public and private expenditures in our calculations of K-12 spending. Beginning in 1984, UNESCO lists both total (public plus private) education spending and public spending for Japan. Prior to 1984, only public expenditures are provided. In Table 9, 1980 combined public and private education expenditures are estimated by increasing the 1980 public spending figure by the percentage of 1985 private to public spending. This assumes that private expenditure as a percentage of total spending was equal in 1980 and 1985. Another piece of information is also lacking. To calculate public plus private K-12 spending in 1980, the distribution of private as well as public spending by level of education is needed. But this information is provided for public spending only. Since private expenditures are skewed toward higher education, we would be wrong to assume equivalent distributions between K-12 and higher education for both public and private expenditures. Therefore, we use the 1985 distribution figure for public plus private spending, applied to the 1980 combined expenditures, to estimate total 1980 K-12 spending in Japan.

Enrollments and Enrollment Adjusted Expenditures

UNESCO data on enrollments are used to make all the international comparisons. The enrollment figures include students in both private and public schools since the expenditures cover both private and public schools.

Because different countries have different proportions of school-age children in their populations, some adjustment must be made for differing enrollment rates among countries. For example, when expenditures are expressed as a percentage of national income, a country with 20 percent of its population enrolled in school would be expected to spend more on education than a country with an enrollment rate of only 15 percent. To permit meaningful comparisons, expenditures must be adjusted to a common enrollment rate, where the enrollment rate is calculated as the percentage of the population actually enrolled in school.

Any enrollment rate could have been chosen as the standard to which all countries' expenditures are adjusted. We chose the 1985 U.S. rate. To adjust other countries' expenditures to the U.S. enrollment rate, foreign expenditures as a percentage of GDP are multiplied by the ratio of the U.S. enrollment rate to the foreign enrollment rate. This raises (lowers) expenditures for countries with enrollment rates below (above) those of the U.S. The adjusted expenditure figure shows the level of spending which would occur if each country enrolled the same percentage of the population as did the U.S., while its rate of spending remained unchanged. This adjustment assumes constant returns to scale in education.

Non-U.S. Averages

A non-U.S. average is the weighted average of all countries' (except the U.S.) expenditures expressed as a percentage of GDP. The weights are the ratio of the number of each country's students over the total number of students in all (except the U.S.) countries.

APPENDIX B: EDUCATION SHARE OF NATIONAL SPENDING

To indicate the national effort expended on education by each country, the education spending data in Table 1 is expressed as a portion of total national *income*, i.e., Gross Domestic Product. Usually national spending equals national income. However, when a country has a trade deficit (or surplus), national income and national spending diverge by the amount of the deficit (or surplus). This has the effect of making the education effort appear relatively greater in a deficit nation and relatively smaller in a surplus country. In effect, using national income as the denominator does not take into account the fact that the total national spending in a trade deficit country has been swollen by borrowing from abroad. In a trade deficit country, national spending is greater than national income, and education expenditures are a smaller share of national spending than of national income. Thus, a more accurate picture might be obtained by comparing the fraction of each country's total national *spending* which is devoted to education.

Table B1 shows education expenditures as a percentage of national spending for the U.S., which has a large trade deficit, and the two major trade surplus countries -- West Germany and Japan. In 1985, U.S. spending on pre-primary, primary and secondary education was only 3.99 percent of total national spending, while Germany spent 4.81 percent and Japan 4.92 percent. In either case, whether education expenditures are calculated as a share of national income or national spending, the U.S. spends less than all but two of the 16 countries studied.

TABLE B1: TRADE ADJUSTED EDUCATION EXPENDITURES, 1985
(in millions)

	Germany (DM)	Japan (Y)	United States ($)
1. GDP	1,830,490	316,303,000	3,967,472
2. Trade Surplus	66,390	10,775,000	-118,652
3. Total Spending (1-2)	1,764,100	305,528,000	4,086,124
4. Adjusted K-12 Spending	84,806	15,022,619	162,960
-As Share of GDP	4.6%	4.8%	4.1%
-As Share of Total Spending	4.8%	4.9%	4.0%

Sources: National Center for Education Statistics, U.S. Department of Education; Digest of Educational Statistics, 1988.
UNESCO; Statistical Yearbook, 1988.
OECD, National Accounts, Vol. 1, 1989.

Endnotes

1. Speech at Education Summit, University of Virginia, September, 28, 1989. (White House transcript).

2. Press Briefing, Charlottesville, Virginia; September 27, 1989. (White House transcript).

3. Press Conference, May 3, 1989. (U.S. Department of Education transcript).

4. Speech at an American Council for Capital Formation conference, Washington, D.C., October 12, 1989. (ACCF transcript).

5. "Bargain Remedies for our Educators," *New York Times*, June 22, 1989.

6. NBC "Today Show," September 27, 1989.

7. Speech at an American Council for Capital Formation conference, Washington, D.C., October 12, 1989. (ACCF transcript).

8. Included in the study are Canada, Japan, Australia, and all of western Europe, except for the three least wealthy countries: Turkey, Greece and Portugal. Spain is omitted because the UNESCO data are insufficient, and Luxembourg because of its small size. Other analysts might prefer another grouping of countries. However, any selection of industrialized countries would show the U.S. to be a relatively low spender on education.

9. UNESCO. 1988. *Statistical Yearbook*. Paris: UNESCO. This is virtually the only source of data for making international comparisons of education spending. It was the data source for comparative studies of education spending done by the U.S. Department of Education and the Congressional Research Service. Some of the UNESCO data are reproduced in the annual *Statistical Abstract of the United States* by the U.S. Department of Commerce.

10. National Center for Education Statistics, U.S. Department of Education. 1988. *Digest of Education Statistics*. Washington, D.C.: Government Printing Office.

11. It might be argued that the U.S. "backloads" education system by putting more money into higher education. If so, comparing education spending at the K-12 level, as we do, biases any comparison against the U.S. system and the appropriate comparison is spending for all education levels (which shows the U.S. is a relatively high spender). This may or may not be so. However, if the U.S. system must be evaluated at the collegiate level then no cross-country comparisons of spending and student performance are

possible since student test scores are only available for fourteen year olds. As a result, there are no data to support the claim that we have high spending and low performance.

12. There are many factors which account for the lower expenditures of private schools. In 1985, 75 percent of private primary and secondary students were in grades K-8, and only 25 percent were in grades 9-12. Education in the lower grades is less expensive than education in higher grades. Many private schools offer fewer extracurricular activities and special classes than do public schools. Private schools also receive some public monies, although the U.S. Department of Education does not calculate the exact amounts. The sources of these funds include the Title I program for low income students, salaries for some special education teachers, sharing of textbooks and bus transportation, and others.

13. Purchasing power parity rates could be used for the conversions, but these also give misleading results. Expenditures must be related to some measure of national income.

14. This is not a second, independent confirmation of this ranking, but a different calculation using the same data as in Table 1.

15. The enrollment adjusted expenditure figures of Tables 7 and 10 differ from those in Tables 1 and 9. Since UNESCO does not provide any expenditure or enrollment information for years after 1986, all data, both expenditures and enrollments, in Tables 7 and 10 were obtained from the 1988 and 1989 (forthcoming) *Digest of Education Statistics*. The 1985 figure of 4.08 percent, calculated from the *Digest* data, is close to the value in Tables 1 and 9 of 4.1 percent. Differences stem from our use of a calculated capital expenditure figure which is greater than true spending, and from minor discrepancies between the U.S. and UNESCO data. The 1980 figure of 4.1 percent in Table 9 is 6 percent greater than the 3.88 percent shown in Tables 7 and 10. UNESCO lists 1980 K-12 expenditure as $116.0 billion which is very similar to the 1981 *Digest*'s figure of $116.3 billion. However, the 1988 *Digest* gives a revised 1980 K-12 expenditure of $112.3 billion, and this is the value used in Tables 7 and 10. Also, UNESCO enrollment figures tend to be larger than those reported by the U.S. These two factors account for the difference between the 1980 numbers.

16. Hough, J.R. 1984. "France" in *Educational Policy, an International Survey*, J.R.Hough, ed., New York: St Martin's Press.

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Portions in Brackets

White House Statement
Not for Ed to release

~~January 17, 1990~~

Education Report

The Education Department has examined the Economic Policy Institute report and found it seriously flawed. The figures the think tank used are not relevant.

The only relevant comparative measure for international education spending is per student spending. [The EPI report compares spending only as a share of gross domestic product. Measured on a per student basis the U.S. spends on average $3,310 per elementary and secondary school student, second only to Switzerland.

In the current school year we will invest $199 billion educating students in Kindergarten through the 12th grade -- an increase of 27 percent over the past decade. Total education spending is expected to reach $353 billion.

While spending has increased, we have witnessed little improvement in the basic scholastic skills of our students. Money is not the problem. We need a better return on our investment. What matters is not how much we spend but how the money is spent and whether it produces results. Clearly the solution is not more of the same.

Recognising this challenge the President has taken a number of steps to reform our education system. Last April he sent the Educational Excellence Act of 1989 to Congress with $441 million in new spending and seven initiatives desigend to reward excellence and achievement, increase accountability, and foster flexibility and choice. In June he created the President's Education Policy Advisory Committee to gather input from business, education, labor and the media. In September he called the Nation's Governors together at the Education Summit which lead to new efforts to create national education goals, bring greater flexibility, accountability and results in education.]

Note: In addition, the EPI study neglected to take into account private school spending for elementary and secondary education.

Response to EPI Report

UNITED STATES DEPARTMENT OF EDUCATION
PUBLIC AFFAIRS

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TO EDUCATION EDITORS:

Following is embargoed response by U.S. Education Department to Economic Policy Institute (EPI) briefing report on international comparisons in education spending. Embargo, set by EPI, is 6 p.m. Jan. 16 (for a.m. papers Jan. 17).

EPI's report on international comparisons of education spending shows why economics can indeed be a dismal science. This "nonpartisan economic think tank" has mixed apples, oranges and moonbeams to produce an indigestible concoction.

The EPI report confuses the share of national spending with actual spending -- a false comparison to support a spurious conclusion. It's fun to play with numbers, but it can be a dangerous delusion if used as the basis for public policy.

EPI claims that by eliminating higher education spending from the comparison, they have discovered a lack of commitment to our nation's students. Not true. When K-12 spending is accurately compared to other nations -- as average per pupil expenditures and not as "share of national income" -- the U.S. ranks 2nd only to Switzerland. (If the nebulous "other" category in included, the U.S. is 5th.)

Americans are generous supporters of education, but we are not getting what we pay for. Until we admit that it is time to restructure -- to rethink an education system created more than a century ago to serve a largely agrarian nation -- we will continue to be disappointed in the academic performance of our children.

NOTE: Attached is a discussion of methodology. A more technical analysis will be available from the Department shortly.

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DISCUSSION OF METHODOLOGY

EPI uses seriously flawed methodology to arrive at dubious conclusions:

- in stating that meaningful international comparisons of education spending must be related to shares of national income.

The more appropriate comparative measure is actual funds spent, but EPI rejects this traditional approach and irrelevantly substitutes "percentage of national income (Gross Domestic Product)." A simple example makes this point: in 1986, Mississippi spent 3.9 percent of its state domestic product on K-12 education, a greater percentage than Minnesota's 3.7 percent. But -- much more significantly -- Minnesota spent $4180 per pupil; Mississippi, $2350. EPI's "share of national income" comparison is an inappropriate, unaccepted measure of spending on education.

By analogy EPI would presumably argue that U.S. food expenditure as a percentage of total private consumption expenditures is extremely low when compared to other OECD nations such as France (17.9%), Norway (20%), the UK (14.5%) and Switzerland (20.2%). The average for all OECD nations approaches 20%. In the U.S. the percentage is 11%. Does this mean that the U.S. is a seriously undernourished nation -- and not the breadbasket of the world? Or that we should spend additional resources on food so that we can reach a figure closer to the OECD average?

- in arguing that exchange rate instability undermines the ability to use per pupil expenditures as a reliable measure of international education spending.

Most of the countries surveyed in the EPI report belong to the Organization for Economic Cooperation and Development (OECD) which makes such comparisons on the basis of equivalent purchasing power, i.e. "the purchasing power parities" index, an index not influenced by exchange rate fluctuations. Using OECD's commonly accepted measure, the U.S. spends more per student on K-12 education than all countries cited in the EPI report, except Switzerland (if the category "other" is included, the U.S. ranks 5th).

- by including UNESCO categories "other" and "not distributed."

These categories are not clearly defined and are reported by the U.S. as $0.

-- by defining K-12 to include pre-primary spending, while excluding private pre-primary expenditures in the U.S.

In the U.S. much of pre-primary education is supported privately by families, not reported by the U.S. in K-12 tabulations. Thus, EPI has significantly underreported U.S. spending in this imprecise category.

Finally, spending does not equate with academic achievement. In a comprehensive review of 187 studies, Eric Hanushek of the University of Rochester found no significant correlation between the two, though U.S. K-12 spending has increased about 27% in 1988-89 dollars since the 1980-81 school year (from $157 billion to $199 billion).

The Department will shortly issue a more detailed technical analysis which will address additional flaws in methodology.

National Comparisons of Per Student Expenditures 1/

(Pre-K through Secondary School)

	Year	Current Expenditures Per Student	Rank	Current Expenditures Per Student Including Unknown Other Expenditures	Rank
Switzerland	1985	$3,683	1	$3,874	1
United States	1985	$3,310	2	$3,310	5
Sweden	1985	$3,214	3	$3,819	2
Canada	1985	$3,192	4	$3,499	4
Denmark	1986	$3,089	5	$3,596	3
Norway	1985	$2,900	6	$3,277	6
Luxembourg	1983	$2,596	7	$2,970	7
Austria	1985	$2,497	8	$2,829	8
West Germany	1985	$2,253	9	$2,530	9
Belgium	1985	$2,234	10	$2,509	10
France	1984	$1,996	11	$2,329	11
Australia	1985	$1,995	12	$2,147	14
United Kingdom	1984	$1,897	13	$2,155	12
Netherlands	1984	$1,860	14	$2,152	13
Japan	1985	$1,805	15	$2,079	15
New Zealand	1985	$1,262	16	$1,324	17
Italy	1983	$1,249	17	$1,568	16
Ireland	1984	$1,108	18	$1,143	18
Portugal	1985	$911	19	$963	19
Spain	1979	$598	20	$623	20
Greece	1984	$514	21	$520	21
Turkey	1985	$241	22	$260	22

(1) Per student expenditures in foreign currencies are expressed in dollar values using the 1985 Purchasing Power Parities (PPP) Index supplied by the OECD.

Dept. of Ed's Rebuttal to EPI Study

SHORTCHANGING EDUCATION: A CASE STUDY IN FLAWED ECONOMICS

Technical Assessment

Overview

The Economic Policy Institute (EPI) study never does what it claims to do--measure comparative education spending levels between the United States and other industrialized nations. Such a comparison requires a measure of per pupil spending in each country's value in a common currency (e.g., U.S. dollars). Hence, the EPI study shifts the focus of the education debate away from the critical issue of how to reform the U.S. education system to that of matching spending with other nations.

1. **The Economic Policy Institute's proposed measure, education's share of national income, is not an appropriate measure of the commitment of a nation for education.**

   The Economic Policy Institute (EPI) calculates a country's education spending as the ratio of that country's educational expenditures to its national income. In fact, this is not a measure of spending commitment at all. Its value depends not only on what a country is spending on education (i.e., the numerator of the ratio), but also on the size of its economy (i.e., the denominator of the ratio).

Although the EPI report uses its measure as interchangeable with spending levels, the two are not equivalent. The following examples illustrate the differences among measures. Applying the EPI statistic tc the 50 U.S. States (1986), Minnesota's education expenditures absorbed 3.7 percent of its State's income and Mississippi's education expenditures absorbed 3.9 percent of its State's income. Yet no one would conclude that Mississippi, a relatively low-income State, devotes more resources to education than Minnesota, a relatively high-income State. Actual expenditures per pupil, an appropriate measure of educational spending, varied widely between the two States--$4,180 in Minnesota compared to $2,350 per pupil in Mississippi.

Food expenditure comparisons among nations further illustrate the wrong headedness of the EPI approach. Impoverished nations, such as Ethiopia and India, devote about half their national income to food, roughly five times the U.S. percentage. Yet, no one would conclude that these nations actually achieve higher real levels of food expenditures, nor that the U.S. should increase its food expenditures to reach the percentages spent in less well-off countries.

2. The Purchasing Power Parity (PPP) index is a superior method for equating education expenditure levels among countries. The PPP adjusted expenditures "can be applied to obtain 'real' quantity comparisons between countries at a certain time." (OECD) When used to equate per student expenditures across nations, the ranking of nations changes dramatically from the EPI analysis.

Within a country, resources for education are measured by its spending per pupil, with education spending expressed in terms of that country's own currency. For the U.S., this is expressed as the dollar value of its expenditures per pupil. International spending comparisons require equating currency values across countries. While market exchange rates would translate expenditures of foreign currencies into their U.S. dollar equivalents, the results would be questionable because of the substantial fluctuations in exchange rates.

While the exchange rate approach is flawed, the solution is not to throw out per pupil spending comparisons, but to apply a more accurate method for equating currencies. The Purchasing Power Parity (PPP) index is such a measure. The Organization for Economic Cooperation and Development (OECD), whose member countries are included in the EPI list of countries, commonly uses this index for generating comparative international expenditure statistics.

Construction of the PPP index is similar to that of the U.S. Consumer Price Index (CPI). Both are based on the comparative cost of a fixed market basket of goods. While the CPI measures comparative costs of purchasing a fixed market basket between two time periods, the PPP measures comparative costs of a common market basket between two countries. Thus, the PPP measures "the number of U.S. dollars needed in each country to buy the same representative basket of fixed goods and services costing $100 in the United States."

Table 1 displays the PPP values for OECD nations for three years--1985, 1987, and 1988. An increase in the index means that it costs more dollars to purchase the same goods. (Note the generally small changes in the magnitudes between 1985 and 1988 for most nations, in contrast to the sharp decline in the value of the dollar as shown by the market exchange rates.)

3. The EPI paper classifies K through 12 as including pre-primary education.

Appendix A of the EPI paper states that "In this paper, when the expression K-12 is used, 'K' represents all the pre-primary years." This definition of K through 12 is not only deceptive, but biases aggregate public expenditure figures against the U.S. Private spending by families with young children constitutes a much more significant share of total pre-primary education in the U.S. than in most other nations. Hence, total U.S. spending for pre-primary education is understated relative to those of other nations in which pre-primary education is publicly supported and included in their government's reported figures.

4. <u>The inclusion of expenditures in the "other" and "not distributed" categories may bias results against the U.S. which does not report spending under these categories.</u>

These categories are not well-defined by UNESCO, and moreover, there is no breakdown by education level. According to OECD, "other expenditures" are those which cannot be classified in categories such as instructional staff, administration, and materials. The "not distributed" category refers to government subsidies or transfers to public and private institutions which cannot be separated by purpose, mainly due to the administrative autonomy of the recipient institutions.

5. When pre-K through 12 spending is accurately compared to other nations, the U.S. ranks second only to Switzerland out of 22 OECD countries. If the uncertain "other" and "not

distributed" categories are included, the U.S. ranks fifth (Table 2). (Note: The EPI comparisons have been extended to include all 22 OECD countries for which the PPP is available.)

Table 2 uses the same UNESCO information on country expenditures and enrollments as did the EPI. It applies the PPP index to equate currencies across countries.

Two rankings are shown. U.S. per pupil spending ranks second out of 22 OECD countries, using only known expenditures. When the unknown spending categories are included, the U.S. ranks fifth out of 22.

6. Research has supported the position that the discussion on how to improve education must focus on how to improve the use of resources.

In a comprehensive review of 187 studies of the relationship between spending and achievement scores, Eric Hanushek of the University of Rochester found no significant correlation between the two.

Moreover, between school years 1980-1981 and 1988-1989, aggregate spending on elementary and secondary education, adjusted for inflation, rose from $157 to $199 billion (in

1988-89 dollars) for an increase of about 27 percent. Average salaries for public school teachers rose from $24,632 to $29,567 (in constant dollars) over the same period. Pupil-to-teacher ratios decreased from 18.9 to 17.6 students per teacher.

However, over this same period, test scores have improved very little. Recent evidence from the National Assessment of Educational Progress (NAEP) shows that reading and writing scores have remained virtually unchanged.

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TABLE 1

COMPARISON OF INTERNATIONAL CURRENCIES

	Comparative Price Levels		
	1985	1987	1988
Australia	86	94	111
Austria	80	133	133
Belgium	75	119	118
Canada	89	93	101
Denmark	92	149	164
Finland	96	141	153
France	81	124	124
Germany	84	137	138
Greece	56	74	77
Iceland	91	138	150
Ireland	76	110	111
Italy	68	108	111
Japan	93	147	162
Luxembourg	73	110	110
Netherlands	77	119	119
New Zealand	67	99	114
Norway	100	128	132
Portugal	39	60	63
Spain	56	86	93
Sweden	95	137	146
Switzerland	98	163	166
Turkey	29	31	30
United Kingdom	73	95	107
United States	100	100	100

The comparative price levels show the number of U.S. dollars needed in each country to buy the same representative basket of final goods and services costing $100 in the United States. They are based on the purchasing power parity index for each country.

SOURCE: Organization for Economic Cooperation and Development (OECD)

TABLE 2

INTERNATIONAL COMPARISONS OF PER STUDENT EXPENDITURES (1)
(Pre–K through Secondary School)

	Year	Current Expenditures Per Student	Rank	Current Expenditures Per Student Including Unknown Other Expenditures	Rank
Switzerland	1985	$3,683	1	$3,874	1
United States	1985	$3,310	2	$3,310	5
Sweden	1985	$3,214	3	$3,819	2
Canada	1985	$3,192	4	$3,499	4
Denmark	1986	$3,089	5	$3,596	3
Norway	1985	$2,900	6	$3,277	6
Luxembourg	1983	$2,596	7	$2,970	7
Austria	1985	$2,497	8	$2,829	8
West Germany	1985	$2,253	9	$2,530	9
Belgium	1985	$2,234	10	$2,509	10
France	1984	$1,996	11	$2,329	11
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Spain	1979	$598	20	$623	20
Greece	1984	$514	21	$520	21
Turkey	1985	$241	22	$260	22

(1) Per student expenditures in foreign currencies are expressed in dollar values using the 1985 Purchasing Power Parities (PPP) index supplied by the Organization for Economic Cooperation and Development (OECD).

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MEASURING COMPARATIVE EDUCATION SPENDING: A RESPONSE TO THE DEPARTMENT OF EDUCATION

by M. Edith Rasell and Lawrence Mishel

INTRODUCTION

On January 17 the Economic Policy Institute released our study, ***Shortchanging Education***, which shows that the U.S. spends less on pre-primary, primary and secondary education than all other industrialized countries except two. The study has been widely reported in the news media. Shortly after its release, the Department of Education issued a "Technical Assessment" of the report in which they challenged our methodology and conclusions. This paper gives our responses to each of the issues raised by the Department of Education. It is our conclusion, based on the evaluation outlined below, that the Department of Education's criticisms are without merit and do not affect our original finding: the U.S. spends less than most other industrialized countries on K-12 education. Following a brief overview, detailed discussion of each point begins on page 3.

I. The Department charges that our method, comparing expenditures expressed as a share of national income, is inappropriate.

Our Response: Expenditures expressed as a share of national income provide the most accurate comparisons of education effort and resources provided to students. This is the most commonly used and widely accepted measure of expenditure comparison. It has been frequently cited by Administration officials in the past and, contrary to claims made by the Department of Education, it is the measure used by the Organisation for Economic Co-operation and Development (OECD), as seen in their recent comparative study on education.

II. The Department would use per pupil expenditures as the preferred measure of comparison.

Our Response: Per pupil expenditures provide valid comparisons only if used in conjunction with a measure of relative incomes or prices. The Department's Mississippi - Minnesota example, discussed below, illustrates how misleading per pupil expenditure figures are, and shows the validity of share-of-income comparisons.

III. The Department recommends using Purchasing Power Parity (PPP) exchange rates to translate foreign expenditure per pupil figures into dollars which can then be compared directly.

Our Response: PPPs show relative standards of living among countries, but cannot be used to compare the quantity or quality of goods and services which can be purchased with a given expenditure.

IV. The Department charges that including expenditures listed by UNESCO in the "other" and "not distributed" categories may bias results against the U.S.

Our Response: Omitting these two categories of education spending, as the Department of Education suggests, would lessen the accuracy of the study.

V. The Department charges that we understate U.S. spending on pre-primary education.

Our Response: The U.S. expenditure figure, obtained from the Department of Education, does not include all private spending on pre-primary education. However, in all the other countries except Japan, the expenditures do not include any private expenditures on either pre-primary, primary or secondary school. Since these expenditures are all relatively small, their inclusion or omission has only minor affects on countries' relative expenditure levels.

We discuss each of these topics in more detail below.

I. ARE COMPARISONS OF EDUCATION SPENDING AS A SHARE OF NATIONAL INCOME APPROPRIATE?

In making our comparisons of international spending, we use the most commonly accepted and widely used measure of spending comparisons: expenditures expressed as a percentage of national income (GDP or GNP). Administration officials use this measure of education spending (see "Shortchanging Education", page 2). Roger Porter, the White House Domestic Policy Advisor, remarked in December 1989, that, compared to other countries, U.S. spending for education is "more per capita, more per student, it is more as a share of our gross national product. We spend one-and-a-half percent of GNP more than the Japanese do on education."[1] The only education spending comparisons shown in the UNESCO Statistical Yearbook use this measure, and this comparison of education expenditures is the only one presented in the Statistical Abstract of the United States from the U.S. Census Bureau. In a recent Cato Institute report on comparative education spending, share of national income is the only measure of comparison used. World Bank comparisons of education spending are presented as shares of government budget along with the budget's share of national income. International comparisons of health care expenditures are routinely stated in terms of spending as a percentage of national income, and the CIA compares defense spending between countries by examining expenditures as a share of national income (copies of these reports are attached).

The Department of Education claims that the Organisation for Economic Cooperation and Development (OECD) "commonly uses a [purchasing power parity index] for generating comparative international expenditure statistics." We disagree. For example, the most recent OECD study of international education expenditures,[2] published in 1989, uses expenditures as a percent of national income and per student expenditures as a percent of per capita national income as the methods of comparison (see attached). These are the same two measures of comparative spending that we identify as appropriate. There is no mention of purchasing power parity (PPP) in the book nor any discussion of per pupil expenditures (see below for a further discussion of PPPs).

Expressing expenditures as a percentage of national income gives the most accurate international comparisons. And it is by this measure that we find in 1985, the last year for which data are available, the U.S.' ranked fourteenth out of sixteen industrialized countries in spending on K-12, spending more than only two countries, and less than thirteen.

II. ARE EDUCATION EXPENDITURES PER PUPIL THE BEST MEASURE FOR COMPARING SPENDING AMONG COUNTRIES?

There are two problems with comparisons of education spending per pupil. First, a per pupil expenditure comparison is misleading when the units being compared (countries or states) have different wage and income levels and thus different costs for educational resources (e.g., teachers). Second, spending per pupil comparisons necessarily involve conversions of foreign currency to dollars, leaving the comparisons subject to misleading methodologies.

Consider first the issue of making comparisons independently of wages and costs. Just knowing per pupil expenditures for each country does not tell us how many education resources are actually being purchased. One country may spend more per student, but because costs (prices and wages) are higher, the expenditure may actually purchase less--fewer teachers, fewer schools, fewer books, etc., than a smaller expenditure in a country which has lower costs and is able to purchase more for its money. It is not possible to compare education spending in any meaningful way without simultaneously examining relative costs. But costs generally reflect wages. Countries with higher wages usually have higher costs. Higher wages mean a higher standard of living and higher national income. Therefore we can meaningfully compare expenditures by examining them in relation to national income. This is the measure we (and many others) have chosen to use: expenditures as a share of national income. Examining expenditure figures in isolation from income levels or some measure of costs is misleading. The Department of Education's comparison of spending in Minnesota and Mississippi serves to prove our point.

The Department of Education's Mississippi - Minnesota Example

The Department of Education's January 16 response to "Shortchanging Education" compares education spending in Minnesota and

Mississippi. They describe 1986 spending in the two states using both of the measures we have been considering: per student expenditures ($4180 in Minnesota and $2350 in Mississippi) and expenditures as a percentage of state income (3.7 percent in Minnesota and 3.9 percent in Mississippi). These figures are shown in the table. The measure of spending being supported by the Department of Education, the first of these two, shows Minnesota to far outspend Mississippi, while the other measure (which we use) shows Mississippi to slightly outspend Minnesota. We will use this example to show that a share of income comparison of education spending provides the best insight into the level of educational resources being offered students.

EDUCATION EXPENDITURES IN MINNESOTA AND MISSISSIPPI, 1986.

		Minnesota	Mississippi	Minn/ Miss
	Current Expenditures as a Percent of State Income			
(1)	-as reported in Dept. of Ed. response to "Shortchanging Education"	3.7%	3.9%	
(2)	-actual correct expenditures	3.7%	3.5%	
(3)	-K-12 spending adjusted for Mississippi K-12 attendance	4.2%	3.5%	120%
(4)	Expenditures Per Student Attending School	$4180	$2350	178%
(5)	-corrected for relative teacher wages	$2884	$2350	123%

Sources: National Center for Education Statistics, U.S. Department of Education, Digest of Education Statistics; 1988 and 1989.

(a) Erroneous Data from the Department of Education

First, we must correct the Department of Education's data. In calculating per student expenditures, they use actual 1986 operating expenses. But in the percent-of-state-income calculation, they use estimated 1986 operating expenditures which overstate Mississippi's expenditures by 11.6 percent while the Minnesota estimate is quite close to the actual expenditure. Actual 1986 operating expenditures were 3.5 percent of Mississippi state income and 3.7 percent of Minnesota state income (see row 2 in the table), not 3.9 and 3.7, respectively, as reported by the Department of Education. Also, we must adjust expenditures for Mississippi's higher K-12 attendance, calculated as a percent of the total state population. K-12 attendance in Mississippi is 18.04 percent of the population, while in Minnesota is 16.00 percent. On this basis alone, we would expect Mississippi to spend a larger share of state income on K-12 education than Minnesota. Adjusting Minnesota expenditures to the Mississippi attendance level, as explained in "Shortchanging Education," shows Minnesota to spend 4.2 percent of state income to Mississippi's 3.5 percent, or put another way, Minnesota spends a 20 percent larger share of its income on education than Mississippi.

Per student expenditures are $4180 and $2350 for Minnesota and Mississippi, respectively, indicating that Minnesota spends 78 percent more per pupil than Mississippi. By either measure, Minnesota spends more on education than Mississippi. The important question is, does Minnesota provide 78 percent more educational resources to its students (as the per pupil comparison suggests) or 20 percent more educational resources (as the share of state income comparison suggests)?

(b) Taking Wage Levels into Account

We cannot answer this question until we know how costs and wages in Mississippi compare with those in Minnesota. In fact, costs are far lower in Mississippi reflecting lower incomes and wages. In 1986, the year we are examining, teachers' salaries in Mississippi were 69 percent of those in Minnesota. Construction costs, heating costs and wages are lower in Mississippi than in Minnesota. Using relative teachers' salaries as a indicator of relative costs in education, we estimate that in Minnesota every dollar spent buys only about two-thirds of what a dollar buys in

Mississippi. $4180 spent in Minnesota is equivalent to spending $2884 ($4180 x .69) in Mississippi. Therefore, to compare the actual level of educational services provided in the two states, we must compare spending levels of $2884 (the Minnesota level adjusted for higher wages and costs) and $2350 (in Mississippi). By this comparison, Minnesota still spends 23 percent more per student than does Mississippi. But this is very similar to the relative spending levels shown by our percent-of-state-income comparison (Minnesota outspends Mississippi by 20 percent), and very different from the Department of Education preferred comparison found by comparing per student expenditures uncorrected for wages (Minnesota outspends Mississippi by 78 percent).

The Mississippi and Minnesota example shows that comparisons of per student expenditures are misleading if relative wage, cost or income levels are not factored into the calculation. If we do not know the actual wage and cost levels necessary to adjust expenditure figures, (which is frequently the case, particularly in cross-national studies), accurate comparisons can only be made by examining spending as a percent of state (or national) income.

III. ARE PURCHASING POWER PARITIES APPROPRIATE FOR CONVERTING FOREIGN CURRENCIES TO DOLLARS WHEN COMPARING DIFFERING LEVELS OF EDUCATION RESOURCES PROVIDED TO STUDENTS?

International comparisons based on per pupil expenditures necessarily run into another difficulty -- how to translate each country's spending into a common currency, traditionally the dollar. There are two means by which this conversion could be accomplished. One way is to use actual exchange rates. The Department of Education now agrees with us that this method frequently gives misleading information. The second method of conversion, currently being championed by the Department, uses purchasing power parities (PPPs). This process is equally flawed and should not be used.

As the name suggests, PPPs are <u>hypothetical</u> exchange rates which are constructed to show what the actual exchange rates would have to be in order for goods and services to cost the same in every country. These

PPP rates were designed for comparing standards of living across countries--how many consumer goods and services people can afford to buy. PPP exchange rates do not provide a cross-national comparison of what can be purchased for a given expenditure. They cannot be used to compare educational effort nor compare resources provided to students. PPPs are completely inadequate for the task for which the Department of Education would use them -- to compare expenditures between countries.

An example will illustrate the differences between comparing teachers' living standards (using PPPs) and comparing expenditures for educational services (which cannot be done with PPPs.) In 1985, primary education teachers' salaries in major cities in the U.S. averaged $26,267. In Tokyo, primary school teachers received ¥3,437 thousand for a nine month school year.[3] One could hire a teacher in the U.S. for $26,267 or one could hire a similar teacher in Japan for ¥3,437 thousand. To hire equivalent numbers of primary school teachers, for each dollar spent in the U.S., 131 yen (¥3,437,000/ $26,267) must be spent in Japan. The "exchange rate" necessary to provide equivalent numbers of primary school teachers is 131 yen to the dollar. This is in sharp contrast to the 1985 PPP exchange rate of 222 yen per dollar necessary to equalize teachers' living standards in each country.

To enjoy equivalent standards of living, a Japanese citizen needs an income of ¥222 for every dollar of income received by a U.S. citizen. So a Japanese teacher receiving only ¥131 for every dollar earned in the U.S. will have a living standard below that of the U.S. teacher.[4] However, to hire a teacher in Japan, one need only pay at the ¥131 rate, not the ¥222 rate. PPP exchange rates tell us about relative living standards among countries, (determined by the productivity of workers, abundance of resources such as land and energy, efficiency of markets, etc.), but offer few insights into comparisons of resources provided to students. Remember, the Bush Administration has been linking education spending and student achievement, so the issue is the comparative provision of resources to students.

The Bush Administration's and Department of Education's claims that we spend lavishly on education can be supported only if first, we compare per pupil expenditures without reference to wages, costs or incomes; and secondly, use purchasing power parities to convert the expenditures to dollars. By any other measure the U.S. seriously under-funds education compared to other industrialized nations.

IV. SHOULD THE "OTHER" AND "NOT DISTRIBUTED" CATEGORIES BE INCLUDED IN THE ANALYSIS?

As explained in our report, UNESCO defines the "other" and "not distributed" categories to include operating expenses for "special, adult and other types of education which cannot be classified by level" and "administration for which there is no breakdown by level of education." This is money spent on education, but it is not specifically assigned to K-12 or to higher education. (These are not insignificant amounts of money. For some countries, up to 25 percent of all education spending falls in these two categories.) The U.S. spends money in these areas, but when reporting to UNESCO, assigns these expenditures either to K-12 or to higher education. Therefore, the U.S. lists no expenditures in these two areas. Omitting these foreign expenditures from our comparisons would have decreased the accuracy of our results. Therefore, as explained in Appendix A of our report, for each country we ascribe the expenditures in these two categories to K-12 and higher education in the same proportion as the rest of the country's operating expenses are distributed.

V. IS THE U.S. EXPENDITURE UNDERSTATED DUE TO UNDER-COUNTED PRIVATE SPENDING ON EARLY CHILDHOOD EDUCATION?

We agree with the Department of Education that our study underreports private spending for pre-primary education. This occurs because Department of Education data, which we use, under-reports private pre-primary spending. (U.S. private primary and secondary school spending is fully counted.) A more inclusive accounting of all private spending would raise U.S. expenditures, but only by a small amount. However, we also omit from our comparisons all private spending abroad for all levels of education for all countries except Japan. But as we note in "Shortchanging Education," these amounts are small compared to total education expenditures. Arguably, the omitted foreign private expenditures for K-12 are at least as great as the omitted U.S. private expenditures for early childhood education. We suspect that including all these additional expenditures would have little affect on countries' relative spending levels.

CONCLUSION

We agree with the Department of Education that the improved use of existing resources is an important component of any school improvement regime. However, some desirable education reforms may require spending more money. Implementation of beneficial changes should not be opposed based on the mistaken notion that the U.S. already spends more than most other industrialized countries on K-12 education. In fact, the U.S. spends less than all our major competitors.

ENDNOTES

1. Speech before the National Conference of State Legislators State-Federal Assembly, December 14, 1989, Washington D.C.

2. Organisation for Economic Co-operation and Development. 1989. Education in OECD Countries, 1986-87. Paris: OECD.

3. Barro, Steven M. and Larry Suter. 1988. International Comparisons of Teachers' Salaries. Washington, D.C.: National Center for Education Statistics, U.S. Department of Education. (To compare teachers' annual pay, we must first equalize the length of the work year. The school year is 243 days in Japan and 180 days in the U.S. If Japanese teachers worked 180 days each year instead of 243, they would receive only 180/243 or 74 percent of their usual pay of ¥4,644 thousand, or ¥3,437 thousand.)

4. This is not to imply that U.S. teachers are highly paid compared to their counterparts abroad. Teachers in the U.S. receive a smaller percentage of per capita national income than do teachers in other industrialized countries. The standard of living of U.S. teachers compared to the average U.S. resident, is lower than for teachers in most other industrialized countries (see Barro and Suter).

Representative HAMILTON. The Chair calls on Congressman Obey, because he has not had an opportunity to question yet.

Congressman Obey.

Representative OBEY. Thank you, Mr. Chairman.

Mr. Boskin, I would like to ask a couple of questions about the impact on the economy of what may or may not be a peace dividend, and what may or may not be a significant reduction in military spending.

I have read several comments from a number of congressional sources who have complained loudly that the defense budget this year is more a product of immediate spending considerations and the need to cut the military budget and things like that, than it is a reflection of our long-term strategic planning.

I would like to ask you, in your judgment, what is the proper role for economic variables, such as inflation, interest rates, productivity and savings, in decisions about our defense budget? Do you think it is legitimate to take inflation or recession, or other economic factors, into account, in setting military spending? Or, should we simply look at what is seen as a national security need, irrespective of other factors?

Mr. BOSKIN. I think the primary determinant ought to be our national security needs. In understanding that, obviously, the likely course of inflation will affect what the Defense Department will need to purchase, because that will affect purchasing power. The state of the economy may affect the wage scale for the volunteer army, and things of that sort.

But if the argument is that we ought to be moving defense spending up or down to deal with short-term, cyclical conditions in the economy, I think that's not wise. Spending ought to be set on a long-term strategic basis.

Obviously, in the current situation, where there have been very remarkable, perhaps unprecedented changes occurring very, very rapidly—and no one can be sure how and when that will settle down—it is not an easy thing for Dick Cheney and his people. But they are doing the best they can under the circumstances.

Representative OBEY. Let me ask you this. If we had the same reduction in military spending that we had after the Vietnam war, in terms of the same percentage of GNP reduction, by 1994 our military budget would be cut by about $130 billion. I have no idea whether that is likely to occur. I personally hope it does.

I guess my instinct is that it is probably not going to, given the way this town works. But what I would ask you is this. Can you tell me whether there have been discussions within the administration that you have been involved in, discussions about the proper role of the Federal Government in assisting communities which have been economically impacted by military spending reductions, either through the loss of bases or through loss of major military contracts?

Mr. BOSKIN. There certainly has been some discussion about what has been the impact of previous base closings and things of that sort, and the extent to which those bases have been converted into things like civilian airports and other types of things.

I think that the evidence is that, generically, so long as it is done prudently with some warning, that the impact on the overall economy is likely to be transient. And the economy can probably absorb any sensible adjustment in the military budget.

Specific communities, obviously, differ a great amount in their details, but there have been a variety of situations where the community, after a period of transition, has successfully utilized the military bases for everything from schools to civilian airports.

Representative OBEY. Can I ask you what you think the proper role of the Federal Government is in dealing with the impact of that change on local communities and economies? Do you think that it is appropriate to provide direct adjustment assistance in situations like this? Or, do you think that we ought to let the market determine what happens in situations like this?

Mr. BOSKIN. I would primarily rely on the adaptive capabilities of the market. We do have in place a variety of adjustment programs, for example, unemployment insurance, for people who are working in the private sectors servicing and supplying the military base and who are temporarily unemployed and things of that sort.

Representative OBEY. That will give people cash assistance for the short term, but it will not help redirect the community in terms of its employment opportunities, and it will not help retrain workers who may have to go into another line of work.

I am not trying to argue with your views. I would just like to know what your views are, in terms of whether you think it is appropriate for the Government, the National Government, to get directly involved in eliminating some of the shock that occurs.

Mr. BOSKIN. In addition to the things that are already there, I think any additional measures that might be designed would have to pass an appropriate cost-benefit test, rather than just be a subsidy for a particular region.

I do understand that there can in some cases be substantial regional disruptions that will occur for some time, but I think that in general what has occurred in the past has been a fairly smooth transition to a civilian domestic base.

Representative OBEY. When Chrysler closed a plant in Kenosha, Wisconsin, the district of the chairman of the Armed Services Committee, the Chrysler Corp. pledged to do what it could to move the community into different lines of work, and to help with worker retraining.

I am trying to get at whether or not you feel that the Federal Government has a specific obligation to do the same, or whether you think that primarily the Feds ought to just worry about the national economy, and let market forces eventually reach new equilibriums.

Mr. BOSKIN. Primarily, the latter. But there is a role for the Defense Department to make the transition as smooth as possible. I think they have tried to do that in the past.

Representative OBEY. What I think I hear you saying is that there is no urgent need for the Federal Government to concern itself with additional efforts beyond the routine to assist the local governments. I want to suggest what I think that attitute suggests—I think it is going to result in is a disinclination of a lot of communities to cooperate in the process of decreasing military spending.

I think that if the Federal Government does not recognize that we have a significant need for conversion or reconversion planning at the local level, you are going to create a built-in political resistance to saving money that could otherwise occur.

Mr. Boskin. I appreciate your perspective, and I will take it back to Secretary Cheney and the President. I do know that the Defense Department, as I said, has tried to ease the transition when they have done analogous things in the past.

Representative Obey. What I am suggesting is that I do not see much, frankly, by way of conversion planning being encouraged or supported by the Federal Government. In part, I suppose that is because what has happened in Eastern Europe and the Soviet Union has happened so fast that people have not thought that there was going to be a need for it.

But nonetheless, don't you really think that there is a need for accelerated efforts on the part of the Federal Government, lest we miss an opportunity to save a lot of dollars?

Mr. Boskin. I do think that whatever reduction is possible in light of our national security needs should be done in a manner that is effective and is cost conscious and a smooth transition, in the event that these base closings or other things impact particular local communities. That is one aspect of it. I agree with that.

Representative Obey. One last question. I happen to agree with Congressman Hawkins' interpretation of which evaluation of education spending is most legitimate. Let's discard that for a moment.

The Federal Government has, since 1980, dumped off about $10 billion of the cost of elementary and secondary education onto State and local governments. We have shifted that much back to the State and local governments.

I have almost given up on the ability of the Congress to force the administration into significant new investments in education at the Federal level. I think that whatever improvements in education come are primarily going to be at the local level.

So I would ask you, what would be wrong, economically, with the Federal Government simply taking a piece of the so-called "peace dividend," however large it becomes, and saying, "We are going to return to the local units of government $10 billion that the Federal Government stole from the local units during the 1980's. We will return it, provided that they only use if for property tax relief," so that you reduce the local community anger which has been directed at schools as the Federal Government has walked away from its responsibilities to support elementary and secondary education.

What would be wrong if we did that, provided only that States had in place their own programs to evaluate the programs in each and every school?

Mr. Boskin. I applaud your concern about education and the increased performance evaluations, but I do not have the budget figures before me, and I certainly would not use the phrase "stole." Historically, in the United States this certainly has been a primary responsibility at the elementary and secondary level of State and local governments.

The Federal Government's role has been, has always been, modest in elementary and secondary education.

Representative Obey. A lot more modest than it used to be.

Mr. BOSKIN. Well, perhaps. Our view certainly is that, working with the Nation's Governors, we can set national performance goals and standards, and develop some criteria. We do believe the primary financing ought to be for elementary and secondary schools in our fiscal Federal system.

Representative OBEY. Would you see anything wrong with saying we are going to take $10 billion of that and dedicate it to property tax reduction at the local level, so that local units of government can try to meet up with the demand to support education that is going to be needed?

Mr. BOSKIN. I believe, and I believe that the President believes, that the primary result of any peace dividend would be to decrease the budget deficit to reduce the drain that the Federal Government has on the Nation's saving pool to make more funds available to finance investment.

That would also lower interest rates for local governments, for example, that might wish to finance school expansion.

Representative OBEY. I am sorry, Mr. Chairman, for exceeding my time, but just one comment.

It would seem to me that since local governments, or local taxpayers more accurately, help finance the military buildup by having to endure an increase in the property tax to support education, it would seem to me that now that the requirements of the military buildup have evaporated, that they ought to get some kind of a repayment for past deficits.

Mr. BOSKIN. I appreciate your viewpoint, even if I do not agree with it, sir.

Representative HAMILTON. Congressman Upton.

Representative UPTON. I will make my questions brief.

Mr. Boskin, to repeat my question just briefly that I asked Mr. Schmalensee earlier, based on Secretary Brady's response last week with regard to the family savings plan, what is going to be the economic lure to get people to participate versus the old IRA that was around prior to 1986?

Mr. BOSKIN. The major concern that many people had with the IRA was that you had to tie funds up until retirement. And if you look at the history of who contributed to IRS's, the median participants were their 50's and were close to the age, 59½ when they could get their money out.

I think one of the concerns that many people have is that younger people, people in their 20's and 30's, are saving a much lower share of their income than their parents did at the same age. So it is our view that by having something that is quite a bit more liquid—you only have to tie your funds up for a few years rather than all the way to retirement—that there would be a big advantage to some families in doing so.

Representative UPTON. As you indicated in your report, the deficit as a percentage of GNP has dropped—5.3 percent in 1986, 0.9 percent in 1989. This year it will continue the downward curve. As I recall, the President's budget called for a deficit in the range of about 1 percent as a percent of GNP for 1991. The economy, however, I think all of us would agree, has begun to slow, reflected in your numbers as well as others.

Should we be less concerned about the size of the fiscal deficit as opposed to a year ago, if the economy continues to slow, and it needs some type of stimulus? What would be your recommendation for the appropriate fiscal and monetary policy this government should pursue to get us back on track?

Mr. BOSKIN. First of all, while the economy is going more slowly, we do expect it to rebound as 1990 progresses. We think the first quarter will be more sluggish, and we will get stronger growth as the economy continues.

Fiscal policy, fiscal stimulus has proved to be a pretty unwieldy tool. We do not even really know exactly what went on in the fourth quarter, and we revised those data. You have lags in getting accurate information. Typically, for example, a post-World War II recession has lasted several quarters. So when you try to get a fiscal stimulus, a traditional fiscal stimulus underway, the recession may be over by the time you could do it and get it through Congress.

So we believe that, on the fiscal side, it is cumbersome, as we said earlier. Trying to fine tune the economy in that sense does not make a whole lot of sense. We do not believe that, because no apocalyptic event followed the large budget deficits in the 1980's, that that is any reason to be lulled into complacency. Many people predicted that this would cause a huge increase of inflation, or a sharp recession. Some of the same people predicted both would occur at different times in the 1980's.

Because neither of those events has occurred, in my view this is no reason for us to relax. The major problem with the large budget deficits is that they drain a very scarce supply of private saving in our economy. The effects of that are cumulative, and I think it is very, very important that we continue to make steady progress along the lines of the Gramm-Rudman-Hollings targets in reducing the budget deficits.

I would be very much opposed to any attempt to—and would so recommend, that the President veto any attempt to suspend the Gramm-Rudman-Hollings targets, if the first quarter proved to be under 1 percent growth and we had two quarters under 1 percent growth. That provision in the Gramm-Rudman law is there to prevent superimposing a contraction, a fiscal contraction, on a downturn, and worsening it. And I think it is a sensible provision for that reason.

We are talking about fiscal year 1991, which does not even start until next October, and on through to the following September. And unless we're in a downturn that we expect to last for a very long time, I think it would be unwise to do that.

If you were not expecting the economy to rebound as the year progressed, then maybe it would be a cause to redouble the efforts on the fiscal side to give monetary policy a little elbow room to provide stimulus without igniting inflation. That would be the mix that I would come up with. But only if one thought the economy was going to be very sluggish for a long period of time, which is definitely not what we expect.

Representative HAMILTON. Senator Sarbanes.

Senator SARBANES. Mr. Boskin, I am very interested in the work you are doing in the statistical field, as you know.

Mr. BOSKIN. We have been honored that you have taken that interest. It is enormously important.

Senator SARBANES. I understand we are going to schedule a hearing specifically for that purpose. So I will forbear from asking any questions in that area this morning. But when that occasion comes, I look forward to the opportunity to hear about the work of the working group that you headed up, and take a look at what is or is not in the budget, what your problems may have been with OMB, and so forth.

Representative HAMILTON. We appreciate Mr. Boskin's willingness to come back and testify on that separately.

Mr. BOSKIN. Certainly.

Senator SARBANES. Would you say that the budget deficit is the biggest instance of dissaving that is going on in the economy? When we talk about trying to increase savings, would you put first on the list trying to get down the budget deficit?

Mr. BOSKIN. Yes. Let me be quite clear on that. If one looks at the national savings rate—of households, businesses, and all government units—what they saved in the 1980's relative to previous decades, a large part of the decline has resulted from the decline in private savings, particularly if you look at net savings.

Gross business savings are about flat, but depreciation is up. Household saving has risen recently, but still is below historical norms. But a large part of the decline results from Federal budget deficits.

The surest way to raise national savings, because we know less about our ability to enhance private saving, especially in a manner that would not simultaneously worsen the budget deficit, is to lower the budget deficit.

Senator SARBANES. There are various proposals, and the administration made some, to try to increase private savings—to stimulate private savings, to induce them, to provide incentives for them—and usually through the use of the Tax Code in some way or another.

But that costs money to do and, therefore, you increase the public deficit in this effort to encourage private savings. Now, what is your view, when those two come into conflict with one another?

I take it from what you have just said that, given the primacy you have given to reducing the budget deficit, you would have that prevail over proposals to raise private savings, which would in effect cost money and add to the overall deficit.

Mr. BOSKIN. In general, that is correct. We were very careful, for example, in developing the family savings accounts, to be very aware of the revenue that that would lose, and to make sure that private savings would increase more than public dissavings. And Congressman Upton has left, but that is one of the reasons we are very chary of going back to a front-loaded, tax-deductible IRA, which would lose a lot of revenue up front and worsen the budget deficit.

The family savings account, of course, does not lose you anything up front. It loses the tax on the inside buildup as you go ahead through time. So we believe that it was designed with exactly the concern you raised in mind, and that is why we moved to this more back-loaded system.

Senator SARBANES. You score the capital gains tax cut as producing revenue. It is a wonderful world that we live in, when you give a tax cut, and at the same time you get more revenues out of it, and therefore you can either reduce the deficit or fund these programs. It is just marvelous.

And I do not want to argue——

Mr. BOSKIN. The Joint Tax Committee, also, in the short run scores it that way as well.

Senator SARBANES. Right, but not in the long run.

Mr. BOSKIN. That is correct.

Senator SARBANES. OK. Now, suppose it did not even get scored that way in the short run. Would you still be for it?

Mr. BOSKIN. Yes. I believe that it is not——

Senator SARBANES. You would then be for it, even if it added to the deficit?

Mr. BOSKIN. No, that depends on how much it would add. I just think that the longrun beneficial effects of encouraging greater entrepreneurial activity enhance risk taking in investment, and the longrun benefits——

Senator SARBANES. Now, let's look at that. That in a sense is what Secretary Brady said, that the main point of the capital gains tax cut is to reduce the cost of capital. Is that correct? Do you subscribe to that point of view?

Mr. BOSKIN. Yes. We have talked about it many times, yes.

Senator SARBANES. All right. Now, how much of the capital that is made available to corporations is raised by debt, rather than equity, and therefore not subject to capital gains taxation?

Mr. BOSKIN. Corporations rely somewhere between 35 and 40 percent on debt, and about 60 percent on equity.

Senator SARBANES. And how much of corporate equity is held by institutions not subject to capital gains taxation?

Mr. BOSKIN. A fair amount. But let me——

Senator SARBANES. Half?

Mr. BOSKIN. I do not have the number specifically before me, but I would say——

Senator SARBANES. Would you think the number half is in the ball park?

Mr. BOSKIN. It is a large fraction. It might be one-third, it might be half. It might be outside that range. But it is certainly a large fraction.

Senator SARBANES. All right. So that brings us down now to where we are at 30 percent of the capital to corporations that would be conceivably touched by the capital gains tax. Is that right?

Mr. BOSKIN. Well, you cannot just—the money is fungible. So if we are affecting the willingness of people to supply funds, even if it has its direct impact on a third or half of the funds, it will lower the overall cost of capital as rates of return are equalized.

But more important I think is that the small, new, growing businesses do not have the same kind of access, either to equity or debt markets, as established corporations. I think many people in the small business community and others believe that this is particularly important because the investments there are disproportionately weighted to the potential for increases in the value of the businesses, and these firms do not have the same kind of access to bank lending at the prime rate plus a half, or whatever it happens to be.

So I think that is part of the equation as well, sir.

Senator SARBANES. Well, now, you know, Venture Capital Journal says that 90 percent of the new commitments to venture capital funds in 1986, when you still had a capital gains tax, came from entities other than individual and families who benefited from the exclusion.

And after the capital gains exclusion was repealed in 1987, Venture Capital Journal said that they set a new record for funds raised.

Mr. BOSKIN. I do not dispute those——

Senator SARBANES. And that was without the capital gains exclusion.

Mr. BOSKIN. I do not dispute those figures at all. I think the businesses I am talking about are really much smaller, well before a venture capitalist would ever get interested. We are really talking about the very beginning of this.

Senator SARBANES. Yours are businesses that have traditionally relied on borrowed capital.

Mr. BOSKIN. Borrowed, or giving equity well before you come to the first——

Senator SARBANES. Let me proceed along the line I was following, because we are now down to where 30 percent, only 30 percent of what went in, might be affected.

How much of asset appreciation in the household sector is held until death, in part to avoid any capital gains tax whatever?

Mr. BOSKIN. I do not have that number before me. I will be happy to get it for you, unless you have it in front of you.

Senator SARBANES. Do you think that a 30-percent exclusion will induce many households to forgo the 100-percent exclusion that they realize at death?

Mr. BOSKIN. Some sizable fraction. Especially for those who are not close to death. I think that it will vary by the age and the composition and so on. They may not do their entire——

Senator SARBANES. What fraction?

Mr. BOSKIN. I have not done an analysis of that. Certainly, I believe it is some sizable fraction. I really have not done an analysis, so I would not want to make any imprudent judgment.

Senator SARBANES. Well, if it were half, that would get us down to 15 percent of what goes in that would be affected by this.

Let me ask you this question. Do you think that the size of the budget deficit has an impact on interest rates?

Mr. BOSKIN. Certainly.

Senator SARBANES. And that if we lowered the deficit, you could expect that interest rates would be lowered?

Mr. BOSKIN. Yes. Especially if that was also construed as a signal that future deficits would also be lower.

Senator SARBANES. How much would interest rates have to fall to give the same reduction to the cost of capital as a 30-percent capital gains exclusion?

Mr. BOSKIN. A small amount.

Senator SARBANES. Am I correct that it would have to fall only five-hundredths of 1 percent?

Mr. BOSKIN. I was about to say probably 10 basis points, or something like that, 15.

Senator SARBANES. So that a drop in interest rates from 8 percent to 7.95 percent, would give you the same reduction of the cost of capital as a 30-percent capital gains exclusion?

Mr. BOSKIN. I do not have those numbers before me. But it would be a modest reduction in interest rates. I do not know if it is as small as you are suggesting, but it would be small.

But also, again, we are talking about, in our view, a lot of potential innovation that would not have access to traditional capital markets borrowing at prime, or whatever. Prime plus.

Senator SARBANES. How often do you meet with the President?

Mr. BOSKIN. Frequently. Some weeks, a couple of times a day. Sometimes, not for a week or two, depending on his schedule and mine. Sometimes, by myself, sometimes with other chief economic advisers, sometimes in Cabinet council meetings.

Senator SARBANES. Now, past Chairmen of the Council have talked or written about their role or responsibilities to in effect be educators to the President and the entire administration on economic issues. What issues, what economic issues, do you see yourself as being an educator on?

Mr. BOSKIN. We have tried to do that on a broad range of issues at the Council, and in my own personal interaction with the President and the rest of the Cabinet, ranging from cost-effective ways of dealing with environmental problems, to macroeconomic issues.

Senator SARBANES. I just want to touch on your forecast, very quickly.

Mr. BOSKIN. Good, I thought that we would spend more time on that.

Senator SARBANES. You did not want the morning to go without having that happen.

Mr. BOSKIN. Couldn't dream of it.

Representative HAMILTON. If you did not touch on it, I was going to, Senator.

Senator SARBANES. I have probably used my time.

Representative HAMILTON. Oh, go ahead. No, go ahead, you are doing very well. [Laughter.]

Senator SARBANES. Your forecast on growth is pretty optimistic compared with other forecasters, right?

Mr. BOSKIN. I think, first of all, you have to define what you mean by "compared to other forecasters." Our administration projections are a consistent package with the budget proposals, so they are conditional on the enactment of the budget proposals. For example, the strong fiscal discipline, strengthening Gramm-Rudman, the commitment to reduce the national debt after 1993, we would expect that, for example, to have very favorable expectational impacts on interest rates.

Senator SARBANES. How do you build that into your forecast for 1990, when that will not happen until the last quarter of 1990?

Mr. BOSKIN. Well, first of all, the biggest impact is in 1991. But also, to the extent this occurs and becomes known, it will have an effect early on. You will not have to wait until it actually transpires.

Senator SARBANES. No, but you will not know that until late in 1990.

Mr. BOSKIN. But coming back to the short term—yes, that is why we have an impact, a substantial reduction in interest rates, an additional reduction, in 1991.

In 1990, our forecast for real growth is 2.6 percent.

Senator SARBANES. What is the Blue Chip forecast?

Mr. BOSKIN. The Blue Chip average is, I think, 1.8 percent.

Senator SARBANES. 1.8 percent.

Mr. BOSKIN. 1.8 percent.

Senator SARBANES. Yours is 2.6 percent, correct?

Mr. BOSKIN. On a fourth-over-fourth basis, 2.4 percent.

Senator SARBANES. You are 50 percent higher.

Mr. BOSKIN. Not quite, on a fourth-over-fourth basis. But a couple of other perspectives on it, if I may, Senator. Our forecast is that this year will be 80 percent of an average postwar year. On a year-over-year basis, we are projecting this year will have modest growth, but less than any year since the expansion began.

And for what it is worth, we were more accurate than each and every one of the 52 private, Blue Chip forecasters for 1989, not just the average, but each and every one of them. I hope we might have a year——

Representative HAMILTON. May I interrupt there?

Your forecast that you continually referred to as being more accurate was in fact made in July 1989.

Mr. BOSKIN. And compared to the Blue Chip forecasters it——

Representative HAMILTON. But an economic forecast made for 1989 in the middle of 1989 is not really very helpful to the budget process up here. It gives you a very substantial advantage over the forecasters who are forecasting in the end of 1988.

Mr. BOSKIN. The comparison was made to the same people's forecast in July 1989.

Representative HAMILTON. You accepted the Reagan forecast for your budget proposals last year. And those assumptions were extraordinarily optimistic, too optimistic in almost every regard.

Mr. BOSKIN. I would agree that they are optimistic.

Representative HAMILTON. You accepted those when you came into office. And then, in the middle of 1989, you changed your forecast, as all forecasters do. You made a new forecast. And that forecast, made in the middle of 1989, turned out to be accurate. But that is not the forecast that you used for submission of the budget.

Mr. BOSKIN. To be accurate, Mr. Chairman, we never submitted a budget. We had a difficult choice to make. We could have waited until about April, and gone through the time-consuming process of developing a full forecast and what is involved in pricing everything out. Or, we could go basically with the Reagan forecast, which I agree was optimistic, in order to get the President's proposals quickly before the Congress and before the Nation.

Representative HAMILTON. My point, Mr. Boskin, is that you repeatedly say that the administration's July 1989 forecast was not only accurate, which it was, but that it was more accurate than the private forecasters. That is true. But what you do not say, when you have said that, is that that forecast was made in the middle of 1989.

Mr. BOSKIN. As were the forecasts that we are comparing them to.

Representative HAMILTON. I do not think so.

Mr. BOSKIN. I am correct on this, Mr. Chairman, please. These comparisons were made—each of the private, Blue Chip forecasters does this monthly. Our midsession review forecast which was released in July was compared to their July forecast, not to the forecast at the beginning of the year.

I am sorry if I did not state that clearly in my testimony.

Senator SARBANES. But the essential point here is that it is your forecast now that builds into the budget process.

Mr. BOSKIN. Sure, the early part of it.

Senator SARBANES. Your revision last summer worsened the deficit projections.

Mr. BOSKIN. Yes.

Senator SARBANES. And helped to lead to sequestration. And there is a concern of whether we are not going down the same path again. In other words, you provide this rosy picture now, and then that becomes built into the budget process. And then, you come back in August and you give a very realistic forecast.

I am looking at the Council's own little statement, which comes here at the end of the report.

Mr. BOSKIN. The activities.

Senator SARBANES. Yes, And there is a lot of self-congratulation in here, on page 270. Although you, yourself, make the point, "The forecasts made in the spring serve as the official economic assumptions for the Gramm-Rudman-Hollings baseline for the following fiscal year."

Now, if you give us very optimistic forecasts, and those are incorporated into the budget process, and then you come back in the summer and give a very realistic one, you automatically, as a consequence of that, boost the deficit and heighten the chances of sequestration; do you not?

Mr. BOSKIN. If that were the case——

Senator SARBANES. Isn't that the automatic effect?

Mr. BOSKIN. Let me put it this way. If there is a midsession forecast that projects a larger deficit, that certainly would have that effect. But what I would object to is the characterization of this as "rosy," and what happens subsequently as "realistic."

There are lots of other bases to compare to. And again, let me just say that there is no intention to be rosy. There are many private forecasters that expect the year to be stronger than we do.

Representative HAMILTON. May I interrupt you there? I am not sure that I heard you. There are many forecasters who expect——

Mr. BOSKIN. In the Blue Chip, we are about at the 80th percentile on real growth.

Representative HAMILTON. For which year?

Mr. BOSKIN. 1990.

Representative HAMILTON. And 1991?

Mr. BOSKIN. I do not have those numbers in front of me. The economy may not do as well as we expect. We could do better. For the first time we lay out the alternatives and show the sensitivity, rather than the traditional table that says that, if interest rates are a percentage point higher——

Senator SARBANES. If you were projecting higher real growth, what would you assume would happen to interest rates and inflation? Would you not expect both of them to be higher?

Mr. BOSKIN. It would depend on the state of the economy, and what was causing the higher growth.

Senator SARBANES. You are not troubled by the fact that the Blue Chip forecasts that project real growth up in the range where you are, carry with that higher predictions on both interest rates and inflation than you do?

Mr. BOSKIN. I am not particularly troubled——

Senator SARBANES. I have two questions. One is, you are projecting more real growth than others. You can say that we see it differently. They may prove right, they may prove wrong. These things are not guaranteed.

But then, there is not an inherent logic to it, because the others who are predicting your levels predict higher inflation and higher interest rates. You have it all worked out to a nice scenario, because you predict higher growth. And at the same time, you don't carry with that higher growth either the interest rates or the inflation.

Which is nice. You have high growth, low interest rates, and low inflation.

Mr. BOSKIN. Let me say two things about that, and see if Mr. Taylor would like to make a comment. First of all, there are some people who predict higher growth, whose interest rates are at about the same place ours are.

Representative HAMILTON. Would you give us their names, please?

Mr. TAYLOR. On the Blue Chip, there are forecasters who are forcasting growth around the same level we are or slightly higher, whose forecasts of inflation are comparable.

Representative HAMILTON. And interest rates?

Mr. TAYLOR. Interest rates, also.

Representative HAMILTON. Is there any forecaster who is predicting a 2½ point decline in the 3-month T-bill rates by 1990 in combination with strong growth this year and next, which you are doing?

Mr. TAYLOR. Mr. Chairman——

Representative HAMILTON. Is there any such forecaster?

Mr. TAYLOR. There may well be, and I believe that there are.

Representative HAMILTON. You cannot furnish me the name of one?

Mr. BOSKIN. We will get back to you.

Let me state one additional point. On long-term interest rates, the private forecasters are forecasting corporate bonds, not 10-year Treasury's. So you have to subtract about 1½ points from what they are doing, taking account of the historical differences.

Senator SARBANES. What is your assumption on short-term interest rates in your forecast? Is it 5.4 percent? Is that correct?

Mr. BOSKIN. That is 2 years. This year is 6.7 percent.

Senator SARBANES. It is 5.4 percent for 1991?

Mr. BOSKIN. That is right.

Senator SARBANES. I understand that there is not one forecaster who expects short-term interest rates to come in below 6 percent next year, not one. Is that correct?

Mr. BOSKIN. That may be—I do not have that with me. But do not forget, this is conditional on the very strong fiscal discipline in the President's message. On the President's proposals, I would assume that those people would assign some probability higher than zero to the prospect that the President's proposals will not be enacted.

Mr. TAYLOR. All of those forecasts project fiscal deficits substantially higher than what we are projecting in the budget. Any economic analysis would predict that interest rates would be higher as a result of the higher Federal deficits they are predicting.

Senator SARBANES. Is that because they use the CBO assumptions, and start with $138 billion, instead of your assumptions at $100 billion? Or, is it that they put savings and loans on budget? I was interested in that point.

Mr. Chairman, I know I have overused my time.

Representative HAMILTON. Go right ahead.

Senator SARBANES. When you make the statement in your report about the reduction of deficit as a percent of GNP, how do you treat the money for the savings and loan bailout?

Mr. BOSKIN. As required under Gramm-Rudman.

You mentioned CBO. I might mention, since that is often a group with which we are compared, I have a very great regard for the professionalism of the CBO, which I believe at least some people at CBO share with the CEA.

And it is just instructive I think to recall the CBO's forecasting record. They have been too low on economic growth the last 3 years, they have been too low on inflation the last 3 years. They have been too high on interest rates in the last 9 years.

So I think that this emphasizes, with my deep regard for their professionalism, that economic forecasting is a very inexact science. And we are trying to highlight that by providing three different paths. And every time I have ever discussed the forecast, I stress that we should pay as much attention to the potential variances as to the point estimate.

Representative HAMILTON. The problem, Mr. Boskin, on these optimistic forecasts is that it gets the whole budget process off to a kind of difficult start. You come in with a very optimistic but defensible forecast. And I think, even by your acknowledgment, it is at the high range of the various forecasts that are out there.

Mr. BOSKIN. Certainly.

Representative HAMILTON. The Congress adopts that, because if we come in with a lower forecast, then we have to cut spending more, or increase taxes more. So the whole budget process then is driven by optimistic assumptions. And it just makes the budget process much more difficult.

So, I wonder whether the Nation ought to base its economic policy and its discussion of the budget on these very optimistic forecasts, and whether or not in the end the result of all of that is that we fool ourselves and end up with a deficit much higher than any of us think is advisable, because all of our decisions with regard to the budget have been made on the basis of very optimistic forecasts.

Mr. BOSKIN. If I may briefly respond to that, I certainly share your concern about reducing the budget deficit. Let's take the converse of that in the extreme. Suppose the economy were doing very poorly and was in a downturn. We certainly would not want to superimpose a more draconian deficit reduction. That is why there is the escape clause in Gramm-Rudman. As you may believe——

Representative HAMILTON. That is not the alternative. The alternative is to come in with economic assumptions that are neither highly optimistic or highly pessimistic, but realistic or prudent.

The question I am raising is, is it a wise thing for this nation to develop its budget policy, both in the executive and the legislative branch, on the basis of very optimistic economic assumptions? Is that the prudent thing for us to do as a nation?

Mr. BOSKIN. I would not characterize our estimates and projections as "very optimistic." Under my definition of "very optimistic," I would agree that that is unwise, and I think that there were some cases in the past where that had been done.

But I think it would be equally misleading to have the economic projections in an inconsistent package with the budget proposals. It would lead to a circularity. So I think you have to understand that.

I would certainly agree with——

Senator SARBANES. I missed that statement. What was that statement? To have what?

Mr. BOSKIN. To have the economic projections be inconsistent with the President's budget proposals. They have to be consistent.

Senator SARBANES. Well, shouldn't the budget be consistent with the economic projections?

Mr. BOSKIN. They are. They have to be consistent with each other.

Senator SARBANES. Well, I know. But which goes first here?

Mr. BOSKIN. Well, they have to go together. If you believe, as you have said yourself, sir, that the budget deficit affects the economy, then clearly they have to be done simultaneously. They have to interact with one another. You could not make an economic projection not having any idea of what the proposals would do to the budget deficit, and conversely. So that is why they are done as a consistent package.

Representative HAMILTON. Let me ask you specifically—excuse me, Senator——

Senator SARBANES. I am fine.

Representative HAMILTON. Just on one specific item in the forecast. You are very high on corporate profits. How do you figure that? You come in with corporate profits rising to $360 billion in 1990, while the Blue Chip consensus I think projects a decline. You see a real sudden spurt of profits coming along.

Mr. BOSKIN. Well, let me highlight a few things. First of all, profits plummeted heavily because of the earthquake and Hurricane Hugo, so there is automatically going to be a rebound unless there are disasters that occur again.

Second of all, the fact that we anticipate growth to be higher——

Representative HAMILTON. Did the private forecasters just miss that?

Mr. Boskin. I am going over the reasons that we have projected what we have projected. I am not sure what each private forecaster has done.

Representative Hamilton. I am kind of surprised that they would not figure that out, too.

Mr. Boskin. Well, I am not saying they have not. You asked me why we have our forecast, and I am trying to give it to you. We have stronger growth, and typically, profits would respond quickly to that kind of growth. We believe that inflation expectations will be contained, and hence wage pressure which would squeeze profit margins will be contained. We expect inflationary expectations to be damped as we move through the next 12 months, in part because of the fiscal discipline the President is proposing and the tightening of Gramm-Rudman restrictions. And that also——

Representative Hamilton. You do acknowledge that your profit projection——

Mr. Boskin. Let me—may I finish, sir, please?

Representative Hamilton. Certainly. But you acknowledge that your profit projection is the highest of any of the forecasters?

Mr. Boskin. I have not looked item by item, but I would not be surprised. Because also, if interest rates are falling, then interest costs will be falling, and it is actually the total return to capital that is basically determined in this system. And therefore, the shift between interest and profits would change.

So all of those are reasons why this occurs.

Representative Hamilton. May I ask, do you favor lowering interest rates under present circumstances?

Mr. Boskin. Lowering interest rates?

Representative Hamilton. Yes.

Mr. Boskin. I am not sure exactly what you mean by that. I do not control interest rates. Anybody would like, other things being equal, interest rates to be lower rather than higher. I think the President made it clear. I mean everybody would.

But are you asking, do I believe the Federal Reserve should be making policy? Is that what you are trying to ask?

Representative Hamilton. Yes, that is correct. Under present circumstances, do you favor lower interest rates, does the administration?

Mr. Boskin. Under present circumstances, I believe the Federal Reserve should be looking to what is expected to happen to the economy. And if their forecast is that the economy is going to be very sluggish, then I believe that there is room for interest rates to fall. If they believe that the economy is——

Representative Hamilton. I am not asking you about what the Federal Reserve believes. I am asking about what you believe. Does the administration, under present circumstances, favor lower interest rates?

Mr. Boskin. The administration, as I have tried to say, favors an independent Federal Reserve, looking at the expected future of the economy and designing monetary policy to maximize longrun growth without accelerating inflation.

Representative Hamilton. So you believe that the interest rates ought to be whatever the Federal Reserve sets them to be?

Mr. BOSKIN. Unless we had a major disagreement about the likely course of the economy, sure.

Representative HAMILTON. Well, why did the President's press secretary call upon the Fed to lower interest rates?

Mr. BOSKIN. I cannot give you an explanation of the press secretary's comment.

Representative HAMILTON. Does the press secretary at the White House that you work in have the authority to get up and call upon the Fed to lower interest rates without the direction of the President of the United States?

Mr. BOSKIN. I cannot tell you exactly what went on in that episode. I have been in the press briefing room at the White House. I can tell you, it is a bit like being in a lion's den. I think he was being badgered, and responded to a question with a general answer that people in general prefer to have interest rates lower rather than higher.

Our view is, if that can be done in a manner that does not accelerate inflation, it is desirable. But we are very concerned that we not accelerate inflation.

Representative HAMILTON. Well, you mentioned a moment ago that you meet regularly with the President. When you heard that the press secretary called upon the Fed to lower interest rates, was it your impression that the press secretary was speaking beyond the direction of the President?

Mr. BOSKIN. It was my impression that he had done nothing but make an off-the-cuff response to a comment.

Representative HAMILTON. Was he speaking beyond the direction of the President?

Mr. BOSKIN. Perhaps. I could not give you the answer to that. I believe so, but——

Representative HAMILTON. I know you have been at that table quite a while, and I will try to wrap it up pretty quickly.

Mr. BOSKIN. That is fine.

Representative HAMILTON. You probably noticed the chairman of the Ways and Means Committee's speech yesterday, or perhaps it was in a hearing, in which he basically argued that tax incentives have very little effect on the behavior of American businesses and taxpayers. Then he argued for a strong bias toward the status quo.

Do you agree with the chairman, that tax incentives have very little effect on the behavior of American businesses and American taxpayers?

Mr. BOSKIN. No, with with all due respect to the chairman for whom I have a great regard, I would not agree with that. But I certainly would agree that much of the behavior of American business is determined by factors other than taxes.

Representative HAMILTON. Can you cite for us any economic research that finds that tax incentives have a significant effect on household and business behavior?

Mr. BOSKIN. I am sure there is a very voluminous literature that suggests that, for example, investment incentives have stimulated investment. Many of the investment incentives we have had in the past may also have had offsetting deleterious effects as well as the beneficial effects of stimulating investment. But there is a pretty large——

Representative HAMILTON. We would be interested in seeing such studies. Perhaps you can supply them to us.

Mr. BOSKIN. I would be happy to supply them. They are a very large number.

Representative HAMILTON. All right, let me raise one other question, that relates to trade. You took a position, I think, and the President took a position against managed trade. And I think in general your trade comments are very good. But I am struck by the fact that, even though you inveigh, if that is not too strong a word, against managed trade, you nonetheless in reality follow a lot of practices that are at least sometimes associated with the phrase "managed trade." For steel, we have extended the voluntary restraining agreement for 30 months limiting steel imports. We have done similar things for autos, textiles, semiconductors, machine tools, and quite a few areas in agriculture.

Now, how do you reconcile the strong language with respect to managed trade in your report with the practice in these very significant areas of the economy?

Mr. BOSKIN. I think your point is very well taken. We are hopeful, for example, that the progress in the Uruguay Round will help to sharply reduce this sort of activity here and abroad. Agriculture is a good example. With respect to steel VRA's, an issue in which I was intimately involved, you recall that industry was pressing for a 5-year extension with no liberalization of the quotas, and we ultimately produced an agreement with a date certain of 2½ years with progressive liberalization of the quotas along the way. So relative to what the previous administration had done, this is a liberalization.

The President made a commitment in the campaign to extend them, pending the negotiation of international consensus. And there was some concern that a period as short as 2½ years, cutting the length in half from the previous program, would be unmanageable, that we could not make the negotiations work with our allies for this extension. But as it turned out, the USTR was able to accomplish that in record time.

Representative HAMILTON. Your general direction would be to roll back the restrictions on trade that we have in the economy now?

Mr. BOSKIN. Worldwide, yes

Representative HAMILTON. Worldwide. In addition to the ones I specifically referred to.

Mr. BOSKIN. Yes.

Senator SARBANES. Mr. Chairman, I have to go. I just wanted to make a couple of comments, and perhaps ask a question.

Now, first of all, while I may differ with you on the substance of some of the issues, I must say that I welcome what I perceive to be a reinvigorated role for the Council of Economic Advisers within the executive branch of our government.

Mr. BOSKIN. Thank you, sir.

Representative HAMILTON. May I add to that that we think the quality of this Economic Report is very good. It puts your position forward in a very professional way.

Mr. BOSKIN. Thank you, sir.

Representative HAMILTON. We think it raises the level of discussion on economic issues.

Mr. BOSKIN. Thank you very much, sir.

Senator SARBANES. Second, I am particularly pleased to see the involvement in international economic policies that is detailed in the Council's report, and also the fact that you are now serving as Chairman of the Economic Policy Committee of the OECD.

I, for one, think that, particularly with the developments in Eastern Europe and the changes in the Soviet Union, as you look around for an institution that may suit this moment, that a refocus on the OECD and its potential role is really worth exploring.

Its membership is such that you could draw in some of the eastern countries in a way that does not raise problems with either establishing entirely new institutions or using some of the other international mechanisms. I simply commend that.

Mr. BOSKIN. We have supported, and I have pushed in my role at the OECD, the establishment of an east-west center there. So I think there is some progress in that direction.

Senator SARBANES. Fine. Thank you very much.

Mr. BOSKIN. Thank you for your comments, Senator.

Representative HAMILTON. Thank you very, very much for your appearance, you and Mr. Taylor and Mr. Schmalensee——

Mr. BOSKIN. Schmalensee.

Representative HAMILTON. Schmalensee—I will get that in due time.

We appreciate your appearance, and we stand adjourned.

Mr. BOSKIN. Thank you, sir.

[Whereupon, at 12:54 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1990 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, MARCH 15, 1990

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

The committee met, pursuant to notice, at 10:06 a.m., in room B-352, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Scheuer, Solarz, Snowe, and Upton.

Also present: Joseph J. Minarik, executive director; David R. Malpass, minority staff director; and William Buechner, Susan Lepper, and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

This morning, the Joint Economic Committee is very pleased to welcome Mr. Richard Darman, the Director of the Office of Management and Budget, who is here to testify on the President's budget proposals for fiscal year 1991 and the President's economic policies for this year and next.

The major statutory responsibility, of course, of the Joint Economic Committee is to review the Economic Report of the President and prepare our own report to the Congress in response. This year's Economic Report of the President was a very professional document that recognized a number of challenges that economic policy will have to address in the 1990's—how to reduce the budget deficit, how to stimulate more savings, how to generate more investment by both the private and public sectors in new capital, R&D and human resources, and how to provide a cleaner environment.

The budget is the document that tells us how the President proposes to make these policies work. Mr. Darman's testimony this morning on the fiscal 1991 budget will be of great help to this committee, as it has been to other committees, in evaluating the President's Economic Report.

So, Mr. Darman, we turn to you now for your testimony. You are welcome before the committee, and we look forward to our discussion with you.

STATEMENT OF HON. RICHARD DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DARMAN. Thank you very much, Mr. Chairman. I have a relatively brief opening statement which I would be happy to read if you would allow me to.

Representative HAMILTON. Yes. The statement, of course, will be entered into the record in full. You may proceed as you see fit.

Mr. DARMAN. Yes. Thank you very much. Accompanying this, there is, as you know, an introduction to the budget which I've asked be included as my formal introductory statement. This is a briefer statement.

Chairman Hamilton, distinguished members of the Joint Economic Committee, it is a pleasure to appear before you today.

You have already heard from Secretary Brady and Chairman Boskin. As the third member of the "Troika," I must report that we three are generally in agreement—so I do not have a great deal of new material to offer at this point.

I would respectfully call your attention to the Director's Introduction to the New Budget, which I just mentioned. To the extent that my perspective is a bit idiosyncratic, it is reflected in the introduction. At the same time, the introduction may serve as a useful overview of the President's budget.

Since the introduction was presented, there have been only a few noteworthy developments in fiscal policy. I might mention these: The President's budget has been subject to the regrettable, but now traditional, ritual of instant analysis and partisan criticism. The initial shrill and conventional criticism received its expected early media attention, but quickly quieted. The more subtle virtues of the new budget—especially its increased emphasis on both hidden liabilities and issues of investment—have been noted principally by serious budgeters and other aficionados.

Revised macroeconomic numbers for the fourth quarter of calendar 1989 have come in. If these are not offset, and if reality were otherwise to prove consistent with our forecast, the fiscal year 1991 deficit estimate would be revised upward by $6.2 billion. If global interest rates do not reverse their recent cycle upward, the adverse effects on both growth and the deficit would be worse.

A decision has been made to finance RTC working capital with least-cost financing through the Federal Financing Bank. If this is scored in accordance with current conventions, it would substantially increase the reported deficit for fiscal year 1990, it would have a highly uncertain effect on fiscal year 1991—it would be plus or minus tens of billions of dollars—and it would substantially decrease the reported deficit for the outyears. I should note the obvious: There is an element of absurdity in having such large swings and distortions caused by the application of ordinary accounting conventions to extraordinary working capital transactions or the estimates thereof.

Senator Moynihan's proposal to increase the fiscal year 1991 deficit by $55 billion has been welcomed by some for its possible contribution to enlivened debate, but has generally not been embraced for either its contribution to the Social Security trust fund, the contribution being a large negative number, or its contribution to debt and deficit reduction, the contribution again being a large negative number.

An effort by some to stimulate economic class conflict has gained some attention, but promises to do little either to reduce the deficit or increase economic growth.

Chairman Rostenkowski has shown courage in putting forth a comprehensive deficit reduction plan of his own. The administration's opposition to some of its elements is well known. But, we have taken pains to note that Chairman Rostenkowski's plan, unlike its current congressional competitors, is at least a serious product. We believe it would not contribute satisfactorily to economic growth, and that it is mistaken in proposing to abandon the fail-safe discipline of sequester. But, it is at least a genuinely well-motivated effort worthy of serious attention.

In the face of all this, the two chairmen of the Budget Committees have not yet offered any serious deficit reduction plan at all. We hope they may offer such a plan soon, as the law requires.

I continue to believe that the only way to responsible deficit reduction is through bipartisan agreement. The need for this is no less today than in recent past—although the deficit as a share of GNP has come down substantially.

It is especially regrettable, therefore, that our political system so frequently mires itself in unconstructive partisan posturing when there is important work to be done. I recognize that some are now rationalizing this pattern of partisanship as consistent with the role of a "loyal opposition" in a parliamentary system. What this perspective seems to overlook, however, is an important distinction: In a parliamentary system, when the lively partisan debate is over, the equivalent of the President's budget is generally approved line for line as submitted. In our system, we are more dependent on the parties coming together in order to govern. We, of course, do not expect complete approval of our budget. We do look forward to the period when we may enjoy a somewhat more constructive and productive discussion than our system seems to give us in the early months of the year.

It's in that spirit, Mr. Chairman and members of the committee, that I look forward to trying to respond to your questions. And, again thank you for the opportunity to appear before you.

[Director Darman's introduction to the new budget follows:]

DIRECTOR'S INTRODUCTION TO THE NEW BUDGET

GREEN EYESHADES AND THE COOKIE MONSTER

If anything were meant for viewing through proverbial green eyeshades, it would seem to be the Federal budget. The typeface is small. The text is tedious. Tables are seemingly endless.

The sheer size of the budget makes it seem like a monster. It contains almost 190,000 accounts. At the rate of one per minute, eight hours per day, it would take over a year to reflect upon these! The budget's annual outlays are larger than all countries' economies except those of the United States, Japan, and the Soviet Union. (The Federal budget is roughly the size of the entire West German economy.) Clearly, at some point, green eyeshades must be put aside. Detail must be considered; but the capacity to abstract should not be lost.

Of course, with or without green eyeshades, monsters do not naturally invite examination. Still, if a monster is present, one might address certain threshold questions: Is it threatening or potentially helpful, and how is one to tell? The answers are not always as obvious as the questions.

On "Sesame Street," the children's educational television program, there is a wonderful character known as Cookie Monster. As all monsters are, Cookie Monster is initially intimidating. His manner is gruff. His clumsiness occasionally causes damage.

But quickly, Cookie Monster comes to be seen as benign—indeed, downright friendly. He has a few bad habits. He cannot resist gobbling up anything and everything that might be consumed—especially cookies. And he cannot quite control the way in which he spews forth crumbs. He is the quintessential consumer. Yet clearly, he means no harm.

The budget, for all its intimidating detail, might be seen similarly: as the *Ultimate Cookie Monster*. Its excessive tendencies toward consumption are not exactly ennobling. (It does not ordinarily present itself as seriously concerned with investment.) But at the same time, its underlying motivation is clearly not malevolent. What harm it may cause is largely unintended. Its massive presence might be understood as little more than a compilation of cookies received, cookies crumbled, and crumbs spewed forth.

Yet apt though the Cookie Monster perspective may be, it does not suffice. It is not quite fair to either Cookie Monster or the budget. In reality, a budget is not just a monstrous mass of cookies and crumbs. It is more: an implicit statement of values and expectations for the future. Inescapably, it is headed somewhere—or other. To gain a meaningful sense of the whole, and where it may be headed, one must look beyond green eyeshades and the Cookie Monster. One must frame the budget from several broader (and more serious) perspectives. This introduction tries to help do that.

Among the additional perspectives are these: a global historical perspective; a conventional deficit-estimating perspective; a capital budgeting perspective; a perspective that gives greater weight to future liabilities; another that attends to investment in the future; and finally, a congressional perspective. These are discussed (sequentially) below.

AND THE WALL CAME A'TUMBLIN' DOWN . . .

Looking a bit beyond Cookie Monster to the television news, one is struck with a rare impression: there may be a compelling pattern to the flow of current events. It is not represented in the budget detail by any quantitative "baseline," nor any conventional statistical measure. It was captured visually by a single dramatic symbol, beamed around the world, and etched in the mind of people everywhere: the fall of the Berlin wall.

To put the symbolic fact more clinically: State-centered, command-and-control systems seem to be decomposing. The Soviet Union has been forced to explore the virtues of restructuring, decentralization, and openness. Communist regimes in Eastern Europe have been falling like dominoes. The Iron Curtain has been opened. And the drama has not been confined to Eastern Europe. Just as liberated celebrants have cheered the opening of the Berlin wall and the decline of communist dictators, so too have liberated Panamanians celebrated the fall of the dictator in near-by Panama.

While it would be naively euphoric to consider this pattern "the end of history" (even in the limited Hegelian sense), clearly the sudden and dramatic shift toward pluralist democracy has far more than the ordinary historical significance. The events of 1989, and what they will have unleashed, may one day rise to a place with those of 1688, 1776, or 1789. This is not small stuff. It is another giant leap of the human spirit yearning to breathe free.

Yet this great historical shift has been almost trivialized in its translation into public debate about the budget. The issue has been framed as: "How big is the 'peace dividend'?"—and, in effect, "How can I get mine?" These are issues that the budget and the political system must treat. They are discussed further in the budget. But they are second-order issues at best.

Ahead of them in line, surely, ought to be these points:

- The favorable pattern of recent events has not been caused exclusively by the political and economic bankruptcy of particular state-centered regimes. It has also resulted from U.S. (and allied) military and economic strength. These, in turn, have resulted from market-oriented economic policies and sound public and private investment policies. It would be a highly unfortunate irony if—just as the world were affirming more market-oriented and investment-oriented principles—the United States were to do anything other than strengthen its commitment to these very principles.
- As the world moves away (at whatever pace) from an emphasis on the risk of traditional military superpower conflict, the relative importance of U.S. economic strength only increases. Increased economic strength is essential to inspire and to assist evolving lesser powers. And it is fundamental to success in the global competition with rising economic superpowers.
- Thus, there is a first-order issue for the budget (and the economic policy it represents): How can it best preserve and build on America's strengths, while advancing the American economy toward even greater capacities for leadership and growth? If the "dividend" metaphor must be applied to the budget: How can policy best assure that there is a continuing *growth dividend?*

HOW BIG IS THE DEFICIT?—LET ME COUNT THE WAYS

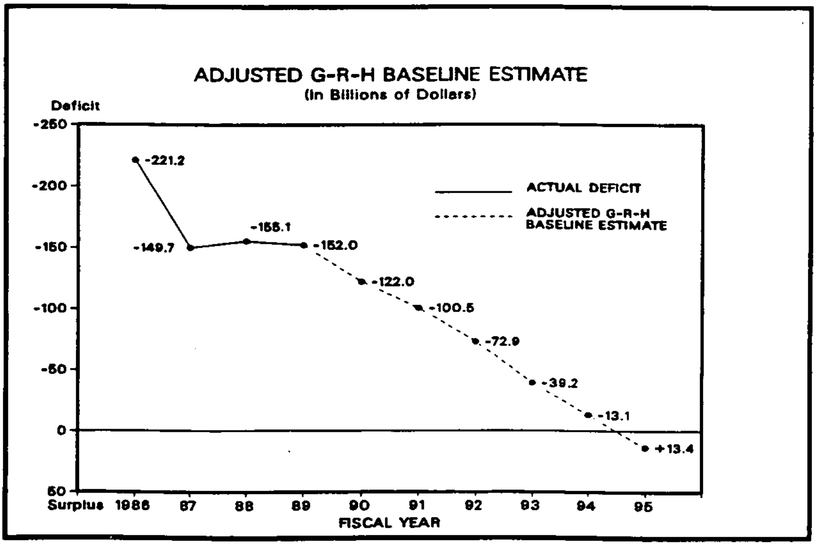
In considering this issue, many traditional analysts turn first to the size of the budget deficit. This is not necessarily as relevant a starting point as many argue. But it is relevant.

Unfortunately, a meaningful answer to the question—How big is the deficit?—is not quite as simple as the question. This budget attempts to answer the question from a wide range of relevant perspectives.

- ***The "Gramm-Rudman-Hollings (G-R-H) Baseline Deficit"***—This perspective is flawed. It biases analysis toward excessive outlay growth. But it is required by law. It constructs an estimate that uses the Administration's economic and technical assumptions; assumes entitlements grow with the beneficiary population and with prescribed benefit changes; and assumes discretionary programs grow with inflation (in effect, treating them as permanent entitlements). It assumes *no change in current law.* From this perspective, the estimated deficit for the current fiscal year (1990) is $122 billion; and for the coming budget year, 1991, it drops to $84.7 billion. It moves to surplus in fiscal year 1994.

- *"Adjusted G-R-H Baseline Deficit"*—The G-R-H baseline, an artificial construct, is used by some for reference purposes. Even for its advocates, it can be misleading. This year, for example, the Food Stamp authorization for appropriations expires. It will almost certainly be extended in some form, but G-R-H does not assume that. Conversely, the decennial census of 1990 will not be repeated in 1991. But G-R-H implicitly assumes that it will be. If one adjusts for these anomalies, the adjusted G-R-H baseline deficit for 1991-95 would be as in the chart below.

This suggests that without major legislative action—but *assuming continued economic growth*—the deficit would move toward surplus in 1995. This would mark a steady, although slow, pattern of correction from the deficit high of $221.2 billion reached in 1986.



- *The "President's Policy Deficit"*—The President's investment-oriented proposals would help assure that the economic growth assumed in the baseline is actually achieved. Other policy proposals would further improve the rate of deficit reduction by reducing spending on low-return programs, reforming selected mandatory programs, and charging appropriate fees. These additional program savings (relative to the G-R-H baseline) are discussed further in Parts V and VII below. Their total contribution is $36.5 billion for 1991, rising to $95.8 billion for 1995.

As a result, the Administration estimates that implementation of the President's budget would meet (and slightly surpass) the legally required G-R-H deficit targets of $64 billion in 1991 and zero in 1993. The President's Policy deficit would be $63.1 billion in 1991, moving to surplus for 1993-95 (even after adjusting to assure Social Security integrity). (See table.)

Overall spending for 1991 would still *increase* by about 3.0 percent. Almost every Department of the government would have higher budget outlays than it did the previous year. But the deficit would be reduced because estimated receipts would increase even more—by $96.8 billion or 9.0 percent (without "ducks"). *This reflects the "flexible freeze" at work:* spending growth is held at a level slightly below the inflation rate: while revenues increase at a higher rate on the strength of economic growth. This is summarized in the table. "President's Policy: Outlays, Receipts, and Deficit Improvement for 1991."

PRESIDENT'S POLICY: OUTLAYS, RECEIPTS, AND DEFICIT IMPROVEMENT FOR 1991

(In billions of dollars)

	1990	1991	Change: Amount	Change: Percent
Outlays:				
Department of Defense	286.8	292.1	+5.4	+1.9%
Non-Department of Defense	910.4	941.2	+30.7	+3.4%
Total Outlays	1,197.2	1,233.3	+36.1	+3.0%
Receipts:				
Current Law	1,072.8	1,156.3	+83.5	+7.8%
New Measures	0.6	13.9	+13.3	+1.2%
Total Receipts	1,073.5	1,170.2	+96.8	+9.0%
Deficit	123.8	63.1	-60.7	-49.0%

- *The Treatment of Social Security*—Current law defines Social Security as "off-budget", but requires its inclusion for purposes of G-R-H deficit calculations. Social Security is also included in traditional "consolidated" or "unified" deficit estimates. There are many good and important reasons to continue to include Social Security in these calculations.

  But in recent years a problem has arisen. The increasing annual Social Security operating surpluses have masked the true size of the underlying non-Social Security operating deficit. In effect, the surpluses have allowed more non-Social Security spending than might otherwise have been the case. If this were long to continue, it would result in an excessive burden of debt for future generations. It would thus undermine the effect of the build-up of reserves intended for retiring baby-boomers.

  To address this problem, without doing violence to the traditional concept of a consolidated budget, the Administration proposes to establish a "Social Security Integrity and Debt Reduction Fund." It would receive each year, as outlays, an amount equivalent to an increasing portion of the projected Social Security operating surplus (reaching 100 percent in 1996). It would be obliged to use these outlays to reduce Federal debt and thus leave a more manageable financing burden for future generations. This Fund would be linked with a continuing obligation to meet a G-R-H deficit target of zero (i.e., a permanent balanced budget) starting in 1993. Thus, the proposal *would effectively prevent the government from spending Social Security receipts on non-Social Security purposes.* The proposal is discussed further in Parts VI-A and VII-A below. Its effects on the deficit are displayed along with the other ways of looking at the deficit in the table: "Deficit/Surplus—Under Selected Definitions."

DEFICIT/SURPLUS—UNDER SELECTED DEFINITIONS

(In billions of dollars)

	1990	1991	1992	1993	1994	1995
"G-R-H Baseline Deficit/Surplus"	-122.0	-84.7	-55.5	-20.1	7.9	36.3
Adjust for outlay anomalies:						
Food Stamps	--	-16.2	-17.0	-17.7	-18.6	-19.5
Census	--	1.0	1.3	1.3	1.5	1.5
Debt service	--	-0.6	-1.7	-2.6	-3.9	-5.0
Total "Adjusted G-R-H Baseline Deficit/Surplus"	-122.0	-100.5	-72.9	-39.2	-13.1	13.4
Adjust for policy recommendations	0.6	36.5	46.9	57.5	75.6	95.8
Adjust for "Social Security Integrity and Debt Reduction Fund"	--	--	--	-14.1	-53.6	-101.8
Total "President's Policy Deficit/Surplus" excluding "gimmicks" (speed-ups)	-121.4	-64.0	-26.0	4.2	8.9	7.4
Adjust for on-off budget:						
Exclude Social Security	-62.0	-80.3	-93.1	-107.4	-124.2	-137.2
Total "On-Budget Policy Deficit/Surplus"	-183.4	-144.3	-119.1	-103.2	-115.3	-129.8
Adjust for G-R-H and speed-ups:						
Include Social Security	62.0	80.3	93.1	107.4	124.2	137.2
Include withholding and other speed-ups	--	1.0	--	--	--	--
Total "President's Policy Deficit/Surplus" including speed-ups	-121.4	-63.0	-26.0	4.2	8.9	7.4
Adjust for "Consolidated Budget":						
Include asset sales	--	1.6	1.6	1.6	1.6	1.6
Include Postal Service	-2.4	-1.7	-0.7	-0.1	0.1	0.4
Remove nondefense spendout adjustment	--	0.1	--	--	--	--
Total "Consolidated Budget Deficit/Surplus"	-123.8	-63.1	-25.1	5.7	10.7	9.4

- ***The Effect of Alternative Economic Scenarios***—In considering the deficit—by whatever definition—it is important to consider its sensitivity to economic variables. For a discussion of these sensitivities, see Section Two, Part I: "Note on Economic Assumptions and Sensitivities." The single most important variable affecting the size of the deficit is probably the real economic growth rate. As a practical matter, the net deficit-reducing effects of economic growth (or its absence) are likely to be far greater than the effects of a so-called peace dividend.

  As a general rule of thumb, a sustained one percent additional increase in real GNP growth—with all else equal—would reduce the deficit by an additional $18 billion in 1991 and an additional $98 billion in 1995. (A sustained one percent lesser increase in real GNP growth—all else equal—would have roughly the equivalent numerical effect, but with the sign changed.) For those seriously interested in either achieving greater deficit reduction or freeing up resources for greater spending, this underlines the importance of pursuing policies likely to maximize the *growth dividend.*

  The economic assumptions used by the Administration are toward the optimistic end of the credible range. But the Administration's assumptions are plausible and achievable.

  The Administration first presented its own economic assumptions in July 1989—at which point they were also judged to be at the optimistic end of the credible range. Intervening performance has, in fact, been highly consistent with the Administration's forecast. But that does not mean either that macroeconomic science has improved substantially, or that the Administration will always be so fortunate as to be correct.

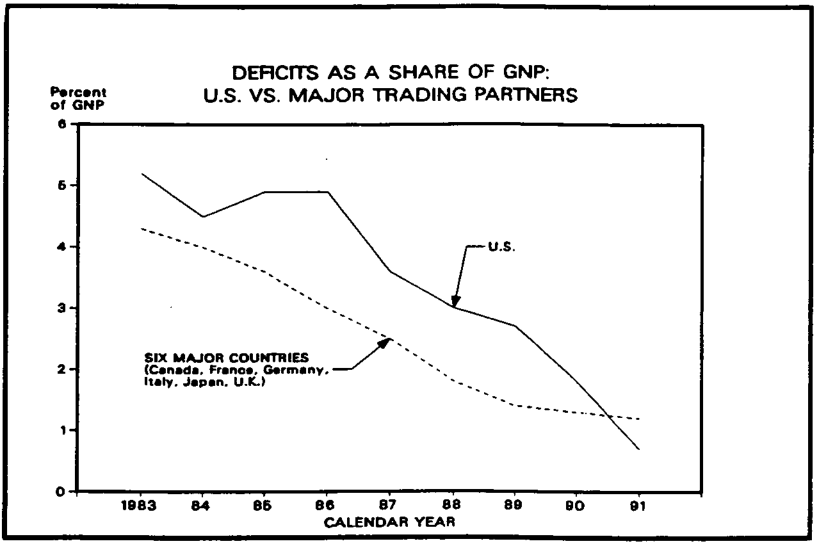
  In developing the budget, the Administration formally considered several alternative economic scenarios. Two of these are discussed in the "Note" in Section Two, Part I. Both of these are also plausible. One is slightly more optimistic, and one more pessimistic, than the scenario actually adopted. These alternative scenarios are specifically described in the Note. If the President's Policy deficit were presented with either the higher growth or the lower growth assumptions, the deficit (or surplus) would appear as follows (after adjusting to assure Social Security integrity).

DEFICIT (–)/SURPLUS (+) UNDER ALTERNATIVE ASSUMPTIONS

(In billions of dollars)

	1991	1992	1993	1994	1995
Higher growth scenario	-54.6	-16.9	+15.1	+24.7	+31.6
Lower growth scenario	-77.5	-48.4	-27.2	-32.9	-42.4

- ***Deficits as a Share of GNP***—Meeting the G-R-H deficit target for 1991, as proposed by the President, would reduce the consolidated deficit to about 1 percent of GNP. The deficit would thus fall clearly within the "normal" range for most of America's major trading partners. In any case, it would mark a significant improvement from the 5.2 percent level of 1983 (6.3 percent for the fiscal year). The pattern is suggested by the chart, "Deficits as a Share of GNP: U.S. *vs.* Major Trading Partners." While the trend is favorable, however, it should not be given excessive weight. The United Kingdom and Japan are both running surpluses—but with very different real growth rates. *As with all measures of the deficit, it is necessary to get beyond this somewhat superficial measure, to an examination of the underlying economic policies and their relation to the future.*



- *Deficit Effects of Capital Budgets*—The current budget concept—essentially a "cash" budget—was developed to conform with the President's Commission on Budget Concepts (1967). The "cash" perspective is especially useful for determining needs for financing in the public debt market. Indeed, it is essential. That is why, regardless of whether trust funds are treated as "on" or "off" budget, there must be some consolidated accounting that shows the total governmental cash position. *But if one is seriously interested in the effects of budget policy on the future, one must get beyond the cash budget frame of reference represented by the G-R-H and consolidated deficit calculations.* One needs a better sense of future liabilities and of the extent to which current income and borrowing are financing investment for the future (as opposed to current consumption and transfers).

With this perspective in view, many have criticized the Federal Government's "cash" budget. Some have argued that the Federal Government should adopt one form or another of capital budget and/or a budget that better distinguishes between trust funds, governmental operating needs, and activities conducted by Government-sponsored enterprises.

In order to begin to address this thoroughly appropriate interest in getting beyond cash budgeting, the President's budget is re-configured as it might appear under the conceptual approach suggested by the General Accounting Office and the approach used by the state of California. These approaches are strictly illustrative—and are presented in Section Two, Part II: "Note on Alternate Approaches to Budget Presentation." They are not intended—now, or in the future—to displace the cash budget; but rather, they are intended to supplement it.

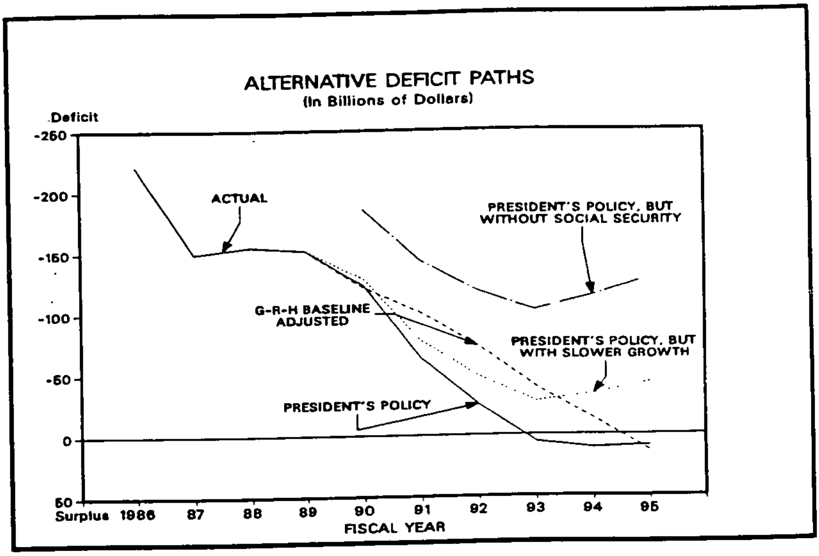
While these additional perspectives are useful, it is clear that they, too, are not fully satisfactory. In going only as far as they do, they tend to do little more than confirm what is now generally accepted wisdom: that the Federal Government invests a relatively small percent of its annual expenditures in capital; and that there is a sharp dichotomy between the operating surpluses in certain trust funds and the operating deficits that characterize the rest of government. They necessarily suggest, but do not satisfactorily settle, many difficult issues of definition as to what is and is not investment. They do not adequately treat "intellectual capital" and "human capital," for example. And they do not provide a dynamic picture of expected future liabilities and future returns.

Stepping back from this surfeit of deficits—all differently conceived and defined—one might summarize where the collection of different deficit pictures suggests things may be, and where they may be headed.

- *First,* by several different deficit measures, *the consolidated Federal deficit seems, at worst, to have stabilized.* If the President's policies were adopted, this pattern of stabilization would obtain, in the near term, even if Social Security were excluded from deficit calculation. *The pattern of continuous erosion that characterized the early- and mid-1980s seems to have been broken.* By many measures, the deficit is headed toward improvement—*assuming that economic growth continues.* Although further progress is not guaranteed, the change in the underlying pattern must be viewed as welcome. See chart: "Alternative Deficit Paths."

  The proviso concerning the necessity for continued economic growth is fundamental, however. The economy is in its eighth consecutive year of growth. This is the second-longest period of continuous growth in America's history. (Post-War Japan has enjoyed two longer periods of growth: one of 20 years, 1953–73 and one of 15 years, 1975 to the present.) There is reason to suggest that the traditional notion of the inevitability of a tight business cycle may be overtaken. But, to underline the obvious: Growth is not automatic. It depends on growth-oriented policies being pursued not only by the Administration, but also by Congress and the Federal Reserve.

- *But second, stabilization of the underlying deficit should not lead to complacency.* Complacency would lead to a loss of fiscal discipline. And even with stabilization, deficits mean rising debt. America's recorded Federal debt is already approaching three trillion dollars. (See Parts III-A and VI-A.) That is not necessarily bad per se. It depends on whether or not the debt is being used in conjunction with policies that will increase future productivity, growth, and capacities for debt service—and whether future hidden liabilities are being kept within reasonable bounds. Here, unfortunately, is where conventional Federal deficit accounting and budget presentation have been woefully inadequate. And here is where there is legitimate cause for concern—as is discussed further below.



HIDDEN PACMEN

The problem with relying solely on the consolidated cash budget—or even on that plus a capital budget—is that it does not give a full picture of the Federal "balance sheet." There is a host of technical reasons why it is not now possible to present a complete and valid Federal balance sheet—not to mention a valid projection of the future balance sheet. But it is possible to do a better job of highlighting potential liabilities, as well as important areas of investment, which have significant future effects. This budget presentation attempts to move in that direction.

One curious thing about future Federal liabilities is that many of them are not yet fully visible. Their particular nature varies. But each is like a hidden PACMAN, waiting to spring forward and consume another line of resource dots in the budget maze. These hidden PACMEN are discussed in some detail in Parts VI-A and VI-B below. A few introductory points may help outline the problem:

- ***Rising Costs of Health Care***—A quarter of a century ago, health care expenditures consumed about 6 percent of America's GNP. Now, that share has almost doubled, to 12 percent. Within the growing Federal budget, the share has risen even more rapidly, from less than 5 percent in 1970 to a projected 15 percent in the early 1990s. Obviously, this is a trend that cannot be sustained forever—or health care costs would drive out all else. There are, nonetheless, increasing demands to assure health insurance coverage for those not now covered, and to provide better financing for long term care. Each of these could entail an additional multi-billion dollar annual bill. Yet the projected health expenditure obligations of current law are not fully covered by projected future receipts. The estimated present value of unfunded liabilities (the actuarial deficiency) for Medicare hospital insurance alone could be over *$250 billion.* (See Parts V and VI-A.)

- *Rising Budgetary Claims of Mandatory Programs*—In President Kennedy's Administration, transfer payments to individuals comprised about a quarter of the Federal budget. Now they consume almost half. So-called "mandatory" programs—selected payments to individuals (entitlements) and other automatic spending programs—have grown from 34 percent of the budget in 1970 to roughly half the 1991 budget—and will reach a projected 57 percent for 1995. (Mandatory programs plus net interest expenditures account for almost 62 percent of the budget.) Since these programs generally have broad-based and well-represented beneficiary populations, they tend to have a powerful claim on resources, and grow faster than the economy as a whole. Yet again: It would seem obvious that this pattern of more rapid growth cannot be extended indefinitely. (See Part V.)
- *Unfunded Retirement Program Liabilities*—There is much talk about the projected build-up of Social Security reserves to cover the anticipated obligations to the baby-boom generation when it reaches retirement. The medium term build-up intended by (and projected under) current law is, indeed, enormous. But even so, over the long term, under some assumptions, the present value of current-law obligations minus projected receipts could be a negative number. This is a speculative matter with a high degree of uncertainty. (See Part VI-A.) Somewhat less speculatively, there are clearly identifiable major shortfalls in unfunded Federal employee retirement programs—although these should be able to be serviced by future contributions. And the Railroad Retirement System, although not fully a Federal responsibility, is substantially underfunded—with a reported actuarial deficiency of *$14 billion.*
- *Obligations to Clean Up Federal Facilities*—For a variety of reasons, the Federal Government historically has not been prompt in attending to environmental clean-up at many of its facilities. For reasons of both law and policy, the pattern of the past is now changing. But the bills are yet to be fully paid. The present-value cost of already-identified future clean-up obligations and waste management improvements at Federal facilities over the next 30 years is on the order of *$140–200 billion.* (See Part VI-C.)
- *Contingent Risks of Federal Credit Programs and Government-sponsored Enterprises (GSEs)*—The Federal Government's direct and indirect credit subsidies are far more extensive than is commonly appreciated. In housing, over a trillion dollars in outstanding mortgages have been guaranteed by Federal agencies or securitized by GSEs. In agriculture, the Farmers Home Administration has accounted for 15 percent of all farm debt outstanding, and the Farm Credit System has financed another 26 percent—for a combined total of about $55 billion. In education, nearly all student loans are Federally guaranteed. The government helps provide credit for export finance, rural utilities, small businesses, and minority-owned businesses. The purposes of all this credit support are generally worthy. But there can be no denying that there is an enormous and increasing Federal exposure—approaching one trillion dollars in direct and federally guaranteed loans alone. This necessarily involves a risk of substantial future claims against the government. These claims are virtually certain to be in the *tens of billions of dollars.* Without continued economic growth, and the credit reforms proposed by the President, the claims would be substantially higher. (See Part VI-B.)
- *Contingent Risks of Federal Insurance Programs*—The Federal Government funds programs that directly insure individuals and firms against many hazards not covered by private insurance. These formal insurance programs cover bank deposits, pensions, veterans life insurance, crops, floods, overseas private investment, nuclear risks, and war risks. The total face value of this insurance coverage (excluding Medicare) exceeds four trillion dollars. Deposit insurance accounts for about 70 per-

cent of this total. But the remainder is still over one *trillion* dollars. Clearly, the Federal Government is not at risk for the entire face value of the insurance. But again: The likely future claims are virtually certain to be in the *tens of billions of dollars*. (See Part VI-B.)

When one adds up all these likely future claims—unfunded health and retirement programs, environmental clean-up obligations, credit risks, and insurance risks—one can produce a rather intimidating total. (See especially Parts VI-A and VI-B.) But it is important to put this, too, in perspective. The claims do not come due all at once. Indeed, they come due over an extended period of time. If one assumed that the likely range of unfunded claims were spread smoothly over the extensive time period in which they are to come due, one would reduce the total to a much less intimidating—indeed, a *manageable*—level.

This is not to say that there is not a built-in shortfall. There is. (See Part VI.) *It is to say, rather, that the "amortized" annual amount of the projected shortfall may be on the order of one-half to one percent of GNP—assuming the problem is managed on an orderly basis.*

Over the long term, there are five ways this shortfall could be handled:

- by reducing the growth of future obligations—through "mandatory" program reforms, credit reforms, and insurance reforms (these are discussed in Parts V, VI-A, and VI-B below);
- by reducing spending on other Federal programs where returns on investment are judged to be of lower relative value (these are discussed in Part VII-B-1 below);
- by increasing the government's managerial integrity and efficiency (this is discussed in Part VII below);
- by pursuing growth-oriented economic and budgetary policies—investing in the future—so that future economic productivity and Federal receipts are higher than otherwise projected (this is the principal area of emphasis in Section One, the Overview, and is discussed especially in Part III below); or
- by increasing the relative burden of debt and/or new taxes (these latter approaches are not a part of the President's program).

INVESTING IN THE FUTURE

As noted, "Investing in the Future" is a theme given special emphasis in the Budget Overview. It was first introduced to the presentation of the budget by the President, last year, in *Building a Better America*.

The emphasis is consistent with three fundamental points: First, a budget must be viewed as more than a static snapshot; it necessarily influences the future, and the nature of that influence must be examined. Second, there is a generally accepted moral obligation to try to leave future generations in a better position than their predecessors. Third, the obligations for future expenditures and debt service are more manageable insofar as current expenditures and tax policy contribute to increased growth. Together, these three points argue compellingly for attention to the extent to which a budget (and its associated economic policy) encourage *investment*—investment in the future.

The President's budget encourages investment in a host of ways that are discussed in greater detail in the Overview. These are outlined here—with references to appropriate Parts of the Overview noted parenthetically:

- ***Deficit reduction***—By reducing the deficit, meeting the G-R-H targets, and then buying down debt, the President's budget policy would improve the U.S. savings rate and reduce the cost of capital. (This is discussed further in Part III-A below.)
- ***Incentives for Private Savings and Long-term Investment***—The President's program would improve the incentives for saving and investment through *Individual Retirement Accounts* (IRAs); create a new all-purpose savings incentive through *Family Savings Accounts*; and encourage growth-oriented, job-creating investment through a new long-term *capital gains incentive*. (These are discussed further in Part III-A below.)

- ***Research and Development***—The President's budget funds initiatives to expand human frontiers in space—NASA would grow 24 percent over 1990 to a record $15.2 billion—and in biotechnology; to advance the development of the superconductive supercollider and to increase investment across the full range of basic research ($12.3 billion—up almost $1 billion); to advance applied research in areas as diverse as defense and health, agriculture and high speed rail transportation, semiconductor development and materials processing. The President also proposes to enact and extend major tax incentives to encourage greater investment in R&D by the private sector. Total proposed governmental expenditures for R&D would exceed $70 billion. (These are discussed in Parts III-B and III-C below.) In the design and implementation of Government programs, the President's budget also recognizes and encourages the innovative role of "States as Laboratories" (discussed in Part IV below).
- ***Investment in Human Capital***—Although Federal money is not the key to solving the nation's serious education problems, the President does propose to increase the discretionary budget authority of the Department of Education by $1.2 billion—bringing the Departmental total to a record $24.6 billion. Program increases are principally in areas of investment that are consistent with the Federal Government's role and responsibilities—reflecting the basic understanding that true solutions must depend heavily on states, localities, parents, and a system that promotes greater innovation, flexibility, and accountability. The budget re-proposes the President's child care initiative—on which the Congress failed to act last year. And the President proposes not only to reauthorize Head Start, but to increase it by half a billion dollars in a single year—bringing Head Start to an unprecedented $1.9 billion. (These and other investments in human capital are discussed in Part III-D below.)
- ***Drug Control Strategy***—Clearly, it makes little sense to invest in human capital only to have drug abuse undermine that investment and, indeed, destroy the very social fabric that makes human growth and investment worthwhile. Drug abuse negates investment. It is fundamentally destructive. It must be stopped. Like education, drug abuse is a problem that cannot be solved by Federal funds alone—or by funds alone whatever their source. Nonetheless, the 1991 budget proposes $10.6 billion in budget authority and $9.7 billion in outlays to combat drug abuse. These levels represent increases of 12 percent in budget authority and $2.8 billion (41 percent) in outlays relative to 1990. They are necessary to advance the next stage of the comprehensive National Drug Control Strategy (and are discussed further in the Strategy, which is published separately, and in Part III-E below).
- ***HOPE and Enterprise Zones***—The problems of economically distressed areas will be alleviated some by the job-creating effects of continued economic growth. The problems will be mitigated also by the President's anti-drug abuse strategy. But more needs to be done to bring hope and opportunity to severely distressed areas. Thus, the President is re-proposing his initiative to stimulate growth through the creation of special incentives for investment and job creation in *Enterprise Zones*—a proposal on which the Congress has failed to act. And he is introducing legislation to advance project HOPE—Homeownership and Opportunity for People Everywhere. (These proposals are discussed further in Part III-H below.)
- ***Transportation Infrastructure***—Improving the U.S. transportation system is essential to economic efficiency and growth. It is a shared responsibility involving the private sector, Federal, state, and local government. The Federal contribution is substantial. For example, the President proposes a record $8.6 billion for aviation in 1991 to help keep the U.S. commercial aviation system the best in the world. Of this, $2.5 billion—an increase of 45 percent—is proposed to modernize the FAA's air traffic control system. (These and related transportation issues are discussed in Part III-G below.)

- *Environmental Protection*—The emphasis on the importance of economic growth must, of course, be accompanied by a responsible concern for the protection and preservation of the environment. The President proposes over $2 billion in new spending to fund: "America the Beautiful," a new program to improve the stewardship of public lands and natural resources, and to promote reforestation; a major increase in the U.S. Global Change Research Program; an acceleration of hazardous waste clean-up; and a 12 percent increase in the EPA operating budget. (These are discussed in Part III-F below.)
- *The American Heritage*—To the extent that investment tends to emphasize rapid technological advance, there is need for a complementary emphasis on aesthetic values, history, and the traditional cultural values that have made America uniquely strong. Although the Federal role in this area must be limited—for important reasons of pluralistic philosophy—it must not be overlooked. America's progress in the future will be the greater for building on its diverse cultural strengths. Thus programs to foster and preserve the American Heritage are treated as themselves an issue of investment. (These are discussed in Part III-J below.)
- *National Security*—None of the foregoing would be worth very much if the budget failed to provide for the protection of U.S. national security. Though responsible analysts may differ about the best means of protecting it, national security holds a fundamental claim on governmental investment. Without adequate investment in national security, ultimately, all that America holds dear could be lost. There is, further, an obligation that America has long championed: the advancement of pluralistic, market-oriented democracy throughout the world. These fundamental interests and obligations are dependent upon U.S. economic growth. But they are also, in some respects, preconditional to it. (They are discussed in Part III-I below.)
- *Management Oversight*—Federal investments in the future will only achieve their objectives if they are effectively managed. Improved returns on investment require a better budget process and more effective management oversight. Americans are entitled to greater assurance that their tax dollars are being invested wisely and managed with efficiency and integrity. Proposals to manage America's government better are discussed in Part VII below.

WONDERLAND REVISITED—THE CURRENT CONGRESSIONAL PATH

In the presentation of the first Bush Administration budget, a critique of "Wonderland" budgeting was offered. It focused on the curious Washington habit (indeed, legal requirement) of "current services baseline" budgeting. Under this system, a "cut" may really be an increase; and a deficit said to be going "down" may really be going up. With "current services'" built-in bias toward increasing expenditures, it should be little wonder that the system has failed to bring the deficit under satisfactory control.

In the Mid-session Review of the Budget, OMB introduced a new budget projection: the "Current Congressional Path." This was done in order to underline what some might think an obvious point. That is, the deficit is not determined, in the end, by either "current services" projections or by mathematical extensions of a "President's Policy." Forecasts based on such projections are almost always bound to be wrong. Budgets are legislated. Congressional action (or inaction) is, therefore, a fundamental determinant of actual deficits. In trying to forecast realistically, it is important to have some sense of the "Current Congressional Path."

Unfortunately, however, the Current Congressional Path is not entirely clear. Indeed, Wonderland seems to be running wild with attractive fantasies, but without yet having established coherent direction. One might consider, for example, the two big games now in play—and a third that is soon to be:

- *The Spend-the-Peace-Dividend-Game*—This is a new game, premised on the assumption of a substantial, near-term "peace dividend." It starts by over-estimating the dividend. Then each player plans to spend the dividend in his or her preferred way. The sum of all such planned expenditures totals about ten times the over-estimated dividend, which is itself perhaps five times the actual dividend. Thus, Washington entertains the notion of spending fifty times a dividend that has not yet definitively materialized—a true Wonderland phenomenon.

In reality, the *near-term* peace dividend is likely to be smaller than is commonly assumed for three reasons: First, the true cost of the previously planned and Congressionally-approved defense program is substantially higher than the current DoD funding levels (and higher than "current services"). Much of the dividend will have to be used just to adjust the previous program downward toward current levels. Second, this adjustment—while politically popular in the abstract—will not be politically popular in all its particulars. Third, any tendency to cut further would likely focus on reducing U.S. troop strength abroad at a more rapid rate than proposed by the President—a more rapid rate than consistent with preserving a strong alliance and negotiating equitable and enforceable agreements with the Soviet Union. Presumably, these countervailing interests will be better appreciated as the debate about the "peace dividend" unfolds.

- *The Cut-Social-Security Game*—This is ordinarily a very dangerous game politically. But in its most recent form, it has started with a superficially attractive proposal: to cut Social Security taxes. Clearly, that would be desirable if it could be done without significant cost to the people paying the taxes and to the economy as a whole. Unfortunately, the most recent proposal to attract significant attention fails that test.

  It is ironic in three respects. First, some of its advocates have argued, until recently, that the government was under-financed (and under-taxed) *not over*-financed. Yet few, in fact, can seriously argue that the government as a whole is over-financed. Second, the emerging conventional wisdom had been that one needed to do more to protect the capacity to pay future Social Security benefits, *not less*. Cutting Social Security taxes now would mean giving up on that objective—giving up on the bipartisan commitment to build up reserves for the future retirement needs of the baby boom generation. Third, and perhaps most telling. Cutting Social Security taxes now would likely hurt the very people it is ostensibly intended to benefit, today's workers. It would either force an increase in their non-Social Security taxes (to compensate for the enormous revenue loss—$55 billion in 1991 alone); or it would force a reduction in their future retirement benefits. (See Part VI-A.)

  The President's proposal to establish a "Social Security Integrity and Debt Reduction Fund" is a responsible way to protect the future interests of today's workers. But Social Security is a notoriously volatile subject when it enters the political domain; and whether rationality will prevail remains to be determined.

- *The Beat-the-Budget Game*—This is the game that begins with the reaction to the President's budget. It has become an annual ritual. At the start, it is predictably partisan. Priorities are judged to be incorrect. Economic assumptions are ridiculed (but later adopted). Gimmicks are scorned (but later outdone). The failure of the budget process is lamented (but ideas for evasion proliferate). The refusal to raise "new taxes" is condemned (as proposals to cut taxes are advanced). Incentives for savings and investment are criticized for their alleged adverse effects on the deficit (as alternative proposals to increase the deficit are advocated). Stalemates are followed by "heroic compromises" that earn the parties self-congratulation, but somehow manage to leave much of the serious job to the future. And the public, understandably, grows more skeptical.

It may be apt to view all this metaphorically as a set of children's games: the Budget as Cookie Monster; its future threatened by hidden PACMEN; its path a journey through Wonderland. But at some point, it is appropriate to put games aside—at least for a while. *At some point, there is an obligation to be serious.* At some point, partisan posturing must yield to the responsibility to govern.

Sooner or later, the American political system will rise to the responsibility to be serious: to complete the job of fiscal policy correction. It may do this in small steps or large. It cannot do it with side-steps.

This year's budget meets the responsibility to be serious. It is seriously presented—giving a more complete and balanced perspective on both the present and the future than has previously been characteristic. Its emphasis on investment and growth-oriented policies and its realistic attention to long-term liabilities should be welcome. Its economic assumptions are not outside the credible range. It meets the Gramm-Rudman-Hollings deficit targets with specific and defensible deficit-reduction measures—and without gimmicks. It seeks to preserve a meaningful consolidated budget, while tightening the budget process. If implemented, it would reach balance in 1993 (as required by law), and would thereafter begin the process of reducing Federal debt.

This, of course, is not to assert that the budget will be treated seriously in the very next round of the Beat-the-Budget game. It is simply to suggest that it should be.

Richard G. Darman
Director,
Office of Management and Budget

Note: This budget is presented in a new, comprehensive, single-volume form. There is no formal record of the number of individuals who may have read, cover-to-cover, the previous seven-volume editions of the budget. (Nor are there epidemiological studies of their fate.) This new single-volume form is provided with the hope that it may be more convenient for the reader; and with the belief that it may actually provide more, not less, useful information. If any reader finds important information to have been dropped, OMB will try to remedy that unintended effect.

Representative HAMILTON. Thank you for your statement, Mr. Darman. We will proceed under the 10-minute rule.

You mentioned, of course, in your statement the Rostenkowski plan. I want to try to get some sense of the extent of your flexibility on it.

You've had some positive things to say about it. You had some positive things to say about it in your statement. You also—you and the President—have commented on it more specifically.

As I look at the elements of the Rostenkowski plan, it seems to me that you've declared your position pretty firmly on most of them. With respect to eliminating the income tax bubble, for example, you are opposed to that. You are not going to change your position on that I presume, are you?

Mr. DARMAN. No. Although, if we are adamantly opposed to the bubble, we would certainly be willing to talk about flattening it at 28 percent.

Representative HAMILTON. But, not by adopting the chairman's suggestion?

Mr. DARMAN. No, sir.

Representative HAMILTON. And, with respect to the increase in the consumption taxes, I presume that comes under your no new tax position?

Mr. DARMAN. Well, it depends on the character. We are not at this point trying to change our own budget, although in my opening statement, and as a realist, I say obviously our budget isn't going to be adopted line for line. And, there will have to be some compromise at some stage.

We have in our own budget proposed an increase, as you know, in the aviation user fee or tax, for example, from 8 to 10 percent. In that case, it's a user fee. We dedicate the resources to improving the aviation infrastructure, and so it passes our test of reasonableness and contribution to economic growth.

Representative HAMILTON. How about the chairman's proposal with respect to consumption taxes on oil and alcohol and tobacco, does that pass your test of reasonableness?

Mr. DARMAN. Well, it's just stated as an abstract proposition. But, as an abstract proposition I would say no.

Representative HAMILTON. Then, he, of course, urges that we reject all tax cut proposals and that runs counter to your stated position.

Mr. DARMAN. Well, at the risk of being properly accused of being too cute, I would say that if you are referring to capital gains it's not necessarily a tax cut. It could be construed as a tax increase.

But, I'm sure we will get a chance to talk about that.

Representative HAMILTON. Yes. But, his view would be to reject all tax cut proposals and that is not your view, I gather?

Mr. DARMAN. What I'm saying is, I think the point of difference would be with respect to capital gains. And, we—to put it directly—continue to believe that our capital gains proposal or some variant thereof should be enacted, that it makes sense from the standpoint of encouraging long-term investment and growth.

Representative HAMILTON. And, of course, Chairman Rostenkowski favors the repeal of Gramm-Rudman, and you've just stated your approval of it.

What emerges to me from all of this is that even though you have indicated that his proposal is a serious one, if you go down the elements of it there does not seem to be much room for bargaining.

Mr. DARMAN. Well, it is a classic question of the glass half empty or half full. I could take—I have his—the Rostenkowski challenge right here before me and go down the elements of it and look at it a different way.

I won't take your time, but just note that obviously there are some things on this spending reduction side which we would approve that you didn't mention. I mean, there is a fair amount——

Representative HAMILTON. Does that include the defense freeze?

Mr. DARMAN. Not as proposed, but again it's how you wish to look at it.

Let's take a look at the defense freeze and the difference. One way to look at it is it's a very significant difference. It is.

His is about $150 billion cut from the baseline. I think ours amounts to about almost $100 billion over 5 years. His starts faster than ours does. We cut initially about $4 billion, and he $10 billion from the baseline.

Thereafter, the rate of decrease is not that different. He is minus 3 percent. We are minus 2 percent. His amounts to minus $10 billion a year. Ours is about minus $8 billion a year.

Now, you could say that's a wide gulf or you could say it's fairly close.

Representative HAMILTON. You described his proposal a moment ago as antigrowth.

Mr. DARMAN. I put it a little more positively.

Representative HAMILTON. But, surely you would agree that letting the deficit roll on is not a progrowth policy? Getting the deficit down is an important part of a growth policy, is it not?

Mr. DARMAN. Yes, it is. I agree completely. But, I would like to add this qualification.

Deficits, per se, would not necessarily be bad if total debt as a percent of GNP were projected to stay within reasonable bounds, and it's arguable what's reasonable. But, that aside, the real key is to make sure that as we accumulate debt in whatever amount we think is reasonable, the debt is being used to finance future growth and capacity to service the debt.

And, I think that we, in the recent past, have fallen victim to a double problem. One is that we are increasing the debt excessively.

Representative HAMILTON. Would you—excuse me. You go ahead and complete your statement.

Mr. DARMAN. Two, we are increasing the debt without adequately investing in the kinds of things that would get us a return in the future that would increase our capacity to service the debt.

Representative HAMILTON. Would you agree that the quickest way to increase savings in the country is to reduce that deficit?

Mr. DARMAN. If you had to pick a single variable to work on, I would say that's the easiest and most obvious.

Representative HAMILTON. I would just like to get your impression on one other aspect of Chairman Rostenkowski's plan, and that was his rejection of the idea of putting incentives in the Tax

Code. As he put it, "Tinkering with the Tax Code is not the solution." You will probably remember that sentence.

Then he goes on to point out that measures that we've enacted, including the 1981 Tax Reduction Act, the reduced marginal tax rates for individuals and corporations, the cut in the capital gains rate to 20 percent, the IRA's that were made available to everyone, the indexing to eliminate bracket creep, the all-saver certificates, that none of these helped in terms of savings.

So, the question for you is: How do you respond to that? Do you just flatly disagree with that?

Mr. DARMAN. No. I don't flatly disagree with that. Some of it is empirically demonstrable or at least it's correct in the abstract that, for a period there where certain incentives were increasing, the personal savings rate was actually declining.

It's my opinion that economists do not understand this phenomenon very well. I could bore you with my own views, but I will spare you.

Representative HAMILTON. But, the point he makes is that with all of these incentives our national savings rate went down and went down rather dramatically.

Mr. DARMAN. We had a lot of things going on simultaneously. What makes it very hard for economic "science" to inform this committee or the public or the President or anyone else is partly that the science is still primitive, but partly it's inherent in the problem of trying to do that kind of science.

You have a single economy with zillions of variables changing at one time simultaneously. And, so you don't have anything remotely like controlled experiments.

So, when you try to isolate what exactly was the effect of a particular change in the IRA or a particular change in the income tax rate or capital gains or any of the others, and you simultaneously have big shocks to the system externally of one sort or another, or a radically changing monetary policy, as we have had, and a number of other changes, you cannot definitively come back and show what the particular effect of anyone of these little changes was.

Representative HAMILTON. So, you are not able to cite then any generally accepted economic research that finds that tax incentives have a significant impact on household saving?

Mr. DARMAN. Oh, no, quite the contrary, Mr. Chairman.

Representative HAMILTON. You are able to?

Mr. DARMAN. I would be happy to submit an annotated bibliography on that point. But, may I just defend myself in advance and say I could also submit an annotated bibliography to rebut it.

The problem is not that there aren't studies. The problem is that the studies conflict with each other.

[The following bibliography was subsequently supplied for the record:]

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Representative HAMILTON. Let me ask you a question I'm sure you have been presented with many times and that's just what is it the administration means when they say no new taxes?

I might say to you that I wrote a letter to the President back on May 22, 1989, asking that the President clarify his position with respect to no new taxes. And, I'm waiting for an answer.

Mr. DARMAN. When was it sent?

Representative HAMILTON. Now, Mr. McClure has been very polite. I've called him a few times and asked him for a response and he has always told me that he's going to get one for me.

So, I thought I would just get it from you this morning. What do you really mean when you say no new taxes?

You obviously have put taxes in. You've just submitted a list of 20 proposed tax increases that will raise $13.9 billion in fiscal year 1991. And, yet when the President is asked on this over and over and over again, he says no new taxes.

So, you have one very confused Congressman up here.

Mr. DARMAN. Mr. Chairman, you are right that I've been asked this before. And, I'm trying to think how in the world to spare you——

Representative HAMILTON. How you answered it last time? [Laughter.]

Mr. DARMAN. Well, I know how I answered it. [Laughter.] What I'm trying to do is spare you the misery that others have gone through. [Laughter.]

When I was being confirmed, 26 years ago it seems, I was foolish enough or smart enough, I'm not sure which, in advance to submit in response to a written question the so-called duck test. That led to 7 hours of inquiry as to the meaning of a duck.

And, we went through every—at least every conceivable to me—hypothetical about what might or might not be a duck. Now, to my knowledge, that's the most complete answer to this question that has been provided. But, it took 7 hours.

And, I wouldn't wish to have you have to go through that. So, could I provide that for the record?

Representative HAMILTON. Well, you certainly may provide it. It won't be very satisfactory I can tell you.

I know that——

Mr. DARMAN. I will tell you one further thing.

Representative HAMILTON [continuing]. This is a question that is kicked around a lot, but it seems to me that when a Member of Congress is trying to think ahead with regard to the requirements of the Nation, and when he or she has to go in and vote with respect to all kinds of fiscal matters, that it's an essential ingredient in all of that to know the President's position with regard to taxes.

All of us understand that if the President doesn't want a new tax, you are not going to have a new tax in this country. We all understand that. And, if the President favors a tax, then there is a chance. So, it becomes an important matter.

As I look at all of these budget proposals, I ask myself over and over again—and I try not to do it in a partisan way—I ask myself over and over again, what can the President accept?

Now, if you take those words on their face, no new taxes, that's very clear—and you don't need 7 hours of testimony and you don't need to redefine duck a 100 times—it's very clear. No new taxes is very clear.

And, that's the President's position.

Mr. DARMAN. But, the problem, Mr. Chairman, is this——

Representative HAMILTON. But, along comes your budget——

Mr. DARMAN. No. Here is the reason that I think that the so-called duck test arose. And, by the way, I should note it has also been put aside. Let me get to that in a minute.

But, the reason it arose is that—the no new taxes statement arose, as we all know, in the context of a national political campaign. And, it was originally—it gained its power as a political statement. It wasn't a statement of—it is a statement of economic policy, but it was—that is not what gave it its force.

What gave it its force was the political context in which it arose and the fact that it was a defining political distinction to the average ordinary American.

Now, the duck test arose because it was a way of saying when asked, how are you going to know whether you violated that test? The answer is by the same political—not economic—test, political test.

When the average American thinks that the policy has been adopted that raises taxes, that will be when there have been new taxes. All the rest is——

Representative HAMILTON. Does it matter what we think in the Congress?

Mr. DARMAN. Oh, sure. But, I was just saying in political terms—if you ask what did it mean in political terms, in political terms the test is with respect to a general public.

And, I think the Congress, individual Congressmen and the Congress collectively, have an excellent sense of when you cross a line and are doing something that appears to be to the general public a tax increase.

Now, could I just go on for a second, because I'm really not trying to be evasive. I hope to clarify something.

Representative HAMILTON. Yes.

Mr. DARMAN. Clearly, even in our first budget revision on February 9 of last year, there were proposals in there which literally could be interpreted as tax increases in the narrow and nonpolitical sense. And, in the same literal sense you can find, as you have done in our budget, a number of proposals which could be construed as "tax increases."

You then get in an endless sophistic debate, and that's what took the 7 hours. It was 7 hours of almost playful sophistry.

Now, Senator Bentsen at the start of this year gave me some advice which was, "If you would like to be constructive this year, put the duck test aside. Don't apply the duck test. I don't want to hear about ducks anymore." So, I've tried to——

Representative HAMILTON. And, then you just brought it up.

Mr. DARMAN. That was a year prior. That was a year prior, and I was just trying to incorporate it in the record because you asked what is the definition. That's the history of the definition.

Representative SOLARZ. Mr. Chairman——

Mr. DARMAN. Could I just finish this?

Representative HAMILTON. Sure.

Mr. DARMAN. It will take one more second. What I've tried to do, and it's actually in this statement here—what I've tried to do is switch the emphasis and say: Look, can't we put that aside for awhile? Let's talk about what helps produce economic growth. Let's apply a growth test.

And. that at least will get us to some extent out of the political vocabulary and into an economic vocabulary. To the extent we are really serious about doing public policy, constructive public policy, work here and not just having a political posturing——

Representative HAMILTON. Does that mean the administration's position is that any tax increase is going to be antigrowth?

Mr. DARMAN. No, because, as you have pointed out—and we could argue about the semantics—there are elements in here. I mentioned one. The aviation user fee or tax increase of 2 percent is not going to hurt growth. It will probably actually help growth.

Representative SOLARZ. Mr. Chairman, would you yield for one question?

Representative HAMILTON. Congressman Solarz.

Representative SOLARZ. Thank you very much, Mr. Chairman. In addition to the duck test, there was one other major ambiguity about the President's pledge, and perhaps you could clarify it on this occasion.

Do you understand his pledge on no new taxes to be applicable to his first year as President, to his first term as President, or to the duration of his presidency, however long it may be?

Mr. DARMAN. Thank you, Congressman Solarz. I realize now that this committee has not had the misfortune of having to deal with me before.

May I tell you about another troublesome thing I've said in response to this question, which I have had many times? I have always answered as follows: When asked for how long does the no new taxes pledge apply? I say: For the time being, forever.

That normally leads to 2 hours' worth of questions.

Representative SOLARZ. For the time being——

Mr. DARMAN. For the time being, forever.

Representative HAMILTON. My time has expired, Mr. Darman. Perhaps I could get you to assure me I will get an answer to my letter.

Do you think you have enough clout to get that done down there?

Mr. DARMAN. I think I could get a letter to you by——

Representative HAMILTON. All right.

Mr. DARMAN [continuing]. Tonight.

Representative HAMILTON. All right. [Laughter.]

Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman. Mr. Darman, I assume that there are a number of reasons why, in terms of economic policy, there is a no tax increase pledge on the part of the President.

And, perhaps you could comment on what the impact would be to increase taxes at this time, especially on the heels of nine-tenths of a percent growth in the last quarter, and I gather we will be getting the figures in April.

And, I would like to hear what your projections are for that growth.

But, we obviously still are very much concerned about what is happening in the economy and what would be the impact of Mr. Rostenkowski's proposal for tax increases, in almost every year, with the exception of corporate tax increases, but consumption, pollution taxes, income tax increases.

Mr. DARMAN. As I suggested in the statement, I do not believe that it would. And, I believe it would marginally hinder economic growth, marginally.

It's not a major drag on economic growth as proposed, but it would be a marginal drag in my opinion.

Representative SNOWE. Why? Is it the kind of taxes?

Mr. DARMAN. Partly because of the kind of taxes, partly because we have a $5.5 trillion economy roughly, and we are talking in total of about $29 billion. It's barely half a percent of GNP.

Representative SNOWE. Right. But——

Mr. DARMAN. I'm not saying it's insignificant but it's, in the grand scheme of things, small.

Representative SNOWE. In the overall economy?

Mr. DARMAN. In the overall economy. I mean, as the chairman has pointed out, our own budget does not have 13.9 billion dollars' worth of revenue increase in it. And, Chairman Rostenkowski's is about $29 billion.

So, what you would have to be saying is that that extra $16 billion is, in a $5½ trillion economy, going to be a really significant number. In my opinion, it isn't a really significant number.

It's more these differences: One, that you've referred to, the composition. We think ours is more prosavings and investment than his. We think that increases in income tax rates for a variety of reasons are not progrowth. So, that's one distinction.

And, the second very important one that the chairman has referred to is that Chairman Rostenkowski's plan would abandon Gramm-Rudman. While we think Gramm-Rudman needs to be improved, in that it's highly flawed, we also think there needs to be some continuing discipline in the system.

And, the reason I mention this in the context of your question about taxes is another point the chairman has raised, long-term interest rates, to the extent that long-term interest rates are influenced by people's psychological perception of what future deficits are likely to be and how they are going to be financed.

If people, sophisticated analysts in the long bond markets, think that the Congress has just enacted a tax increase that is not, in fact, ultimately going to contribute to deficit reduction because the restraint on spending has been abandoned, then you would have an adverse effect from that as well.

And, so it's for this variety of reasons that I think that it's not progrowth.

Representative SNOWE. Well, I recall back in 1983, I think it was, when former President Reagan made an agreement with the legislative leadership in Congress that for every $1 raised in taxes there would be $3 in spending reductions. Well, we got the $1 increase in taxes but we didn't get the $3 spending reduction.

I've been around here for the last 10 years, and it's almost as if we don't get serious about deficit reduction unless we are all willing to agree on a tax increase, when, in fact, the revenues have doubled in this last decade by over $500 billion.

We expect revenues to increase this year over last year by $96 billion. In Rostenkowski's plan, there is significant automatic growth in revenues as well as automatic growth in spending over and above what he is also recommending.

I think that we haven't become serious in that respect in terms of deficit reduction over the last 10 years, so now we are trying to make up for lost time.

And, if we were to repeal Gramm-Rudman, I would agree with you that that would be a very serious setback because at least we have been able to control spending under Gramm-Rudman, whereas before that time we were not able to do that.

Mr. DARMAN. Could I make a general point and ask maybe that if my answer is too long it not count against your time?

Representative SNOWE. That's all right. You can go forward.

Mr. DARMAN. I first worked on a variety of the Rostenkowski plan in I think the summer of 1981 when, as you recall, in the early aftermath of President Reagan's two big economic initiatives, there was discussion within the Congress about a possible fiscal policy correction as soon as that fall in the second, what was then the second, budget resolution. It doesn't exist anymore.

And, there was a bipartisan group interested in something very much like Chairman Rostenkowski's plan. I had some interest in it at that stage. It wasn't of the magnitude that it is now, but the gap was very much smaller then, too.

What I think I've learned in the intervening years is that if there is ever going to be a substantial and meaningful fiscal policy correction, it does have to include some of these boring issues that people don't—that don't have much political heat associated with them, but the public would ultimately benefit from, like serious budget process reform and credit reform, preposterous as that may seem; because, if you look at the long-term problems, substantively you have to get at credit reform. And, politically, you have to get at process reform if you are serious about controlling the deficit.

That's what I think we've learned in a bumbling way in the intervening decade. So, if we ever do get to the comprehensive negotiations that people have been talking about now for a decade, I hope that the end product can include something which is responsible with respect to these other subjects, that don't have anywhere near the political attractiveness.

But, if we are ultimately going to be serious, they have to be part of the equation, which I think is consistent with a point you were perhaps suggesting.

Representative SNOWE. One other question. Concerning Mr. Rostenkowski's proposal, what taxes does the administration find most objectionable besides the income tax? The excise taxes?

Mr. DARMAN. We haven't tried to—we haven't thought it constructive to go through and point out line by line the negatives. All of our positions on these things are so well known that I don't think——

Representative SNOWE. The reason why——

Mr. DARMAN [continuing]. There is a lot of mystery. What we have been trying to do is at least get people to realize this is a serious proposal, and it is in radical contrast with other things that we've been offered to date.

And, to be more particular, it's in radical contrast, if I may say in some frustration, with the approach taken by those who in sessions less polite than this one blast the administration for its failure to appreciate the seriousness of the deficit problem, and that it is really two, three, four, five times as large as we say, and then propose to increase the deficit by $55 billion.

You don't—it's absolutely baffling what you are supposed to do in a situation like that. Or, to pick another approach, both Chairman Sasser and Chairman Panetta have budget process reform bills of their own. And, they start with the same premise, that the deficit is much larger, that our economic assumptions are not appropriate, so on and so on and so on.

And, the implication of all of that is that you need to be more serious about deficit reduction. And, then in Chairman Sasser's approach, he proposes $13 billion in deficit reduction. And, in Chairman Panetta's, $30 billion.

Now, even CBO says ours is more than $30 billion. And, so it's a bit frustrating at times.

Representative SNOWE. Thank you.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman. Mr. Darman, it's a pleasure to have you here today. It's always intellectually challenging and stimulating to discuss these matters with you.

You and I have spoken in the last couple of days privately, and I regret having to go over some of these things again but I will, because I think my questions and your answers are both important enough to put in the record.

It seems to me that many of the assumptions that were cranked into your budget process 60 days ago or 90 days ago have almost become obsolete now. There has been such a breathtaking change in the world situation that if cranked into the process would free up enormous amounts of expenses in the budget.

You heard Robert McNamara recently talk about a recommendation of reducing our defense budget by 50 percent over a 10-year period, and that would be at the rate of presumably $30 billion a year. Mr. Webster testified on the Hill a couple of weeks ago that he felt that many, if not most, of the changes that had taken place in the Soviet Union and Eastern Europe were probably irreversible.

I think if you had Mr. Webster here sitting next to you at that table, he would say just in view of what has happened in the last 48 or 72 hours that they are even more irreversible.

Mr. Gorbachev has now, according to the elections we heard about yesterday, received a 5-year term in a much more powerful presidency. His chief opponent on the right, Mr. Ligachev, has validated his policies of doing it my way, letting him go. Mr. Ligachev said that the answer to Lithuania's problem is not tanks. Tanks are not the solution, he said.

So, here we see the continuing systematic disintegration of the Eastern bloc. The Warsaw Pact, to all intents and purposes, doesn't exist as a serious factor. You've seen the bitter Soviet criticism of Mr. Castro, who has been a constant thorn in the side of Mr. Gorbachev. You've seen the change in Nicaragua. And, it seems to me that there will be a lot less Soviet arms flowing to Nicaragua—none to Nicaragua and a very much reduced flow to Cuba.

In terms of the regional instability of the Middle East, you've had not only a cessation of aid from the Eastern European countries that were such great supporters of the PLO and the Arab States, but now Poland, Hungary, Czechoslovakia, and Romania have recognized Israel, as have eight African States.

And, I think in the new era there will be a lot less arms material flowing from the Soviet Union to the Middle East, to Syria, for example, a lot less help from the Eastern European States that were the prime suppliers of training of military intelligence of all kinds, of funding, of training camps in their own countries for PLO and other terrorist groups.

So, it seems to me that the question of a serious Soviet threat and the real diminution in regional insecurity means that there are awesome possibilities of reduction in the military budget.

Now, to add on to this emerging trend of the Secretary of Defense McNamara, the CIA Director, Mr. Webster, now we have four-star General Andrew Goodpaster coming down here a few days ago, Commander of the European Theater. He spent his whole life in strategic analysis, his whole professional life in the Army.

And, he tells us that we ought to be—and I use his exact words—"on a structured, downward glide path that would reduce our defense budget 50 percent in 5 years." Now, you are talking about $30 billion a year for 5 years to cut the $300 billion defense budget down to $150 billion.

Now, admittedly, the impact in the first year will be very small, in the second year modest, but by the time the third and fourth year rolls around you have a lot of savings cranked into that pipeline from all kinds of downsizing of our military capability.

And, of course, he would be the first to recommend, and I guess I would be the second—Lee Hamilton and I would be second and third—that if by any chance there could be, might be a change in that situation, this downsizing would have to be quickly reversible. But, we know from the fact that the Warsaw Pact doesn't exist, that the time that we would have, the warning that we have, would be several months instead of perhaps several weeks.

So, you would have time to change that course and to reverse course if necessary.

Now, I want to assure you that I'm not being partisan, because if I were President Bush I would think the opportunity to put $30 billion into the economy in improving our education system so that he would be the education President, in improving our health care system and including 31 million Americans who are excluded now would make him the health President, spending money on environment reform, on global warming and acid rain, all of the things that concern Americans, that would make President Bush the environment President.

To have that order of magnitude of resources to work with in the last year or two of his administration, of this 4-year term, to me would provide the most incredible political credits for him. I say this with some tinge of regret as a Democrat.

But, in terms of our country it would be glorious, and I suppose if the President can, and should, take credit, so be it. He's entitled.

All of this is such a breathtaking prospect that I can't understand why there has been no serious consideration of reductions in our defense capability that have been validated in the last few days, since Mr. Gorbachev has consolidated his position for 5 years, since Mr. Ligachev has shown himself to be not a strident opponent of this devolution of Soviet power and the gradual unraveling of the Eastern bloc.

This has to come, of course, from the President and the National Security Council. It would be the National Security Council that would spell out the kind of considerations that I've just mentioned, the reduction in the Soviet threat, the reduction in the problems of regional instability in the Middle East and the Caribbean, the reduction and likelihood of terrorism since the arms master for terrorism has now changed that perception.

Isn't there any hope that the kind of thinking that McNamara and Webster and General Goodpaster have evidenced will be cranked into the process?

And, I just have to say again, that to me it would present the most extraordinary political opportunity for President Bush to make changes in this American economy and to meet our vast unmet needs, educating a competent, competitive work force for the next generation of global competition. It seems to me the political rewards are so obvious that they beg a description.

Are we going to hear some encouraging words on a major plan, structured plan, for downsizing the military over a 5- or 10-year period with all the implications that has for the economy and for our society?

Mr. DARMAN. Thank you, Congressman Scheuer. I think you are certainly right, and it's trite of me even to observe that the changes are, of course, dramatic and more rapid I think than anyone that I know who is a professional in the business of analyzing these issues, more rapid than anyone expected.

It was widely expected that there would be an acceleration of change within the Soviet Union due to their economic troubles and other considerations. It was expected somewhat less widely that there would be a hesitancy of the Soviet Union to enforce the Brezhnev doctrine by force.

What I think no one that I know of—certainly if there is someone, he is a very lonely character, what no one expected was that you would see this domino effect in Eastern Europe so rapidly. There were people who thought it might be over 5 years, 7 years, 10 years. I don't know anyone who thought you would see in a matter of months the kind of change that we've seen.

So, I agree with your premise about the rapidity and significance of the change. I think the part that makes it "irreversible"—I think that's too strong a word, but the part that makes it more significant from the standpoint of planning for defense purposes is this very last part, the part that has to do with the Warsaw Pact's decomposition.

Representative SCHEUER. What I'm asking is, is the administration going to respond to that whole new open window of opportunity?

Mr. DARMAN. Yes. I believe that you—that we were fortunate in putting the budget together, that this extraordinary set of events took place before we submitted the budget.

And, so for the first time, you have a President proposing 5 straight years of negative growth for defense. No President has done that before, minus 2 percent a year in real terms.

That's not insignificant. And, if I—I know it doesn't fully satisfy you, but it is a "structured downward glide path," if that's what General Goodpaster said.

Representative SCHEUER. General Goodpaster proposed 10 percent a year for 5 years. It's——

Mr. DARMAN. Well, I didn't——

Representative SCHEUER [continuing]. A big gap there.

Mr. DARMAN. I didn't——

Representative SCHEUER. Rostenkowski used 3 percent, you were 2 percent, Goodpaster is 10 percent. And, that includes a whole new perception. And, it may have flowed from some of the things that have happened only in the last week or 10 days, admittedly.

Mr. DARMAN. I don't—I didn't unfortunately see or read General Goodpaster's testimony. He and I used to be office mates at the Woodrow Wilson Center years ago, and I have great respect for him. But, I haven't seen his testimony, and so I apologize for that. But, may I just mention a few facts about our own and then a couple of complications?

Our proposal translates into, as I suggested before, about $100 billion measured against the baseline over 5 years, against the CBO baseline, in reduction. That's not insignificant.

And, it grows in the outyears. It grows up toward—I have it here—roughly $40 billion a year. That's a very significant number.

You could say that it could be even more significant, but that's not insignificant. That's substantial.

The second point is this: The baseline does not fully price the previous defense program. If you fully, fairly, accurately price the previous—what I call Before the Wall Fell Down—program the savings would be probably more on the order of $230 billion.

So, something significant is going on in the restructuring that is involved in our budget. It is not as if $230 billion relative to the correctly priced version of the previous program, it's not as if that's nothing.

If we were looking at what is happening in the first year in defense the same way we look at, say, Medicare in budgeting, we would say that it's a $22 billion cut in the first year. Now, we have a double standard in the way we look at these things.

We don't measure defense against the full pricing of the previous program, which is what we do in Medicare. We measure it against an artifical baseline.

So, anyhow, for all of these reasons, I think that a case can be made that there is—you are talking about very substantial reductions even in the President's program—very, very substantial ones.

Now, when I said a couple of complications, yes, it is undoubtedly the case that there is a major shift with respect to planning for a European war. But, unfortunately that isn't all there is to the world, as you know every bit as well or better than I.

I disagree with something you said, or maybe I shouldn't say I disagree. You said something in passing about a reduction in terrorism, and I think you qualified it, and I would agree with the qualification.

There may be, we don't know yet, but there may be a reduction in terrorism that would be sponsored by the Soviets. But, that isn't the only source of terrorism in the world.

And, as you and I have discussed privately, as you suggested, there is a terrible problem that is a natural outgrowth of technological advance which is that you can pack more and more destructive capacity into smaller and smaller packages. And, as you can pack more and more destructive capacity into smaller and smaller packages, undetectable packages, you create more and more opportunities for what we might call third party, nonbig power, mischief that would border on radical terrorism.

Now, what do we do about that? We have a world in which we are going to have to pay increasing attention to that.

I'm not pretending that that means that you have to have five more divisions in the Army. It's going to mean entirely different things. And, we have to think through exactly what it would mean.

Or, for example, we have states that previously you would not have thought likely to be able to launch ballistic missiles in your planning horizon that are now going to have the capability, or states that wouldn't previously have had the capacity to put satellites in orbit that themselves have potential destabilizing effects. What are you going to do about that?

I'm not saying that these argue necessarily for an enormous defense structure. But, they do argue against a rush to reorient defense as if the only thing that happened in the world—the only thing that mattered in the world were the prospects for conflict within the short term in the European theater.

There are two further points. One is the issue of new roles for the military or a change in the mix. An awful lot of people in Congress have been asking—in previous years it was the Pentagon that was resisting; that's not so now—that the Pentagon play a larger role in drug interdiction.

Representative SCHEUER. I've been one of them.

Mr. DARMAN. Right. And, of course, you have to have helicopters and ships and men and fuel and things that cost money to do that.

And, so even though they may not be on their way to a European war, they may be of some real social value if they could be used in a way that would, for example, stem the flow of drugs into the country.

So, I think that has to be in some way factored into the equation.

And then, one other way: To the extent that we think of defense as an instrument of national security protection and the advancement of American interests, you correctly point out that we could take some of the savings and allocate them in ways that would increase U.S. competitiveness, which is going to be increasingly important in a world where military conflict among superpowers has decreasing relative importance. I agree with that.

We've tried to make some of that, a modest shift in that direction in our budget.

But, in addition, there probably has to be a shift of resources to more economic assistance in the foreign policy domain. It's wonderful that Panama and Nicaragua have moved in democratic directions, but now it's going to take a lot of economic assistance to help assure that they can benefit from the political change.

And so, all I'm noting is what you already know. It's a bit more complicated equation that just—I think at least—taking an arbitrary number and say: Well, it can be half as large, what's the percentage that gets us there, and let's just do it, boom.

Representative SCHEUER. Thank you.

Representative HAMILTON. Congressman Upton.

Representative UPTON. Thank you, Mr. Chairman. And, Mr. Darman, welcome. I apologize for being a little bit late this morning.

As a former OMB aide, I was used to David Stockman, Joe Wright, and Jim Miller all being about a half hour late. And, I understand you were on time. Your testimony arrived 48 hours ago. Our testimony always arrived hot when we arrived. [Laughter.] Remarkable changes. Congratulations.

I have not seen Chairman Rostenkowski this week on the House floor. Certainly, we've talked a little bit about his proposal this morning and there have been a number of newspaper articles over the last couple of days as well.

I would be very interested in your comments with regards to the Social Security COLA freeze for 1 year. Many would say that that's political suicide.

I note that Chairman Rostenkowski is unopposed, so I guess you can't label it that way.

What were your thoughts with regard to the COLA freeze for Social Security as a component of its overall pattern?

Mr. DARMAN. Well, first, thank you for noting the important changes to OMB. [Laughter.]

Representative UPTON. I note you have some of the same staff as well.

Mr. DARMAN. Well, maybe we have a controlled experiment to allow us to account for the change in the delivery of the testimony. [Laughter.]

We have proposed, as you know, in our budget a COLA freeze on retirement programs other than Social Security with an exemption for certain disabled people.

And, I think I would probably have to say in fairness, and it wouldn't surprise you, that one reason that we did not propose to extend it to Social Security was political. It did not seem to us to be achievable, given the political history on this subject.

It is somewhat awkward to explain the inconsistency in the treatment. And, while you can explain it, full disclosure requires confession of there being a political element in the judgment that you ought not to extend it to Social Security.

There is another reason, which is that if you look at Social Security as an independent system that is supposed to be actuarially sound, if you reduce the benefits you ought also to have some offsetting reduction in the receipts. And, if that's the way you were to manage this, then you wouldn't actually have it contribute to deficit reduction at least not over the long term.

So, we followed a different approach. We achieve through other mandatory program changes that we recommend about the same amount of savings, actually a little bit more than Chairman Rostenkowski would, without touching the Social Security COLA.

It was our judgment that these other program changes we recommend—also some of them politically difficult—were all clearly defensible on the merits, and that would be the better way to go. That continues to be our position.

Representative UPTON. You indicated in your testimony earlier and in the questions with Congresswoman Snowe that you thought that Gramm-Rudman was highly flawed, that you throught that we needed some serious debate in both budget reform as well as credit reform.

I would be very interested to know some of your thoughts, specifically with regard to Gramm-Rudman. Do we need a second snapshot versus the one that occurs in the call for sequestration?

Or, do you think that the present timeline that we have leading to a balanced budget by 1993 is reasonable? Should we look at perhaps stretching that out and look at some of the things that Senator Moynihan has suggested with regards to the Social Security trust fund surplus?

What are some of your thoughts and recommendations that you would make with regard to budget reform as we look at perhaps a comprehensive package?

Mr. DARMAN. I think the——

Representative HAMILTON. We have a vote——

Representative UPTON. We have to vote. Can the gentlemen finish?

Representative HAMILTON. Yes.

Mr. DARMAN. Go ahead. I'm more than——

Representative UPTON. Keep going. Go ahead.

Mr. DARMAN. I will be more than happy to wait.

Representative UPTON. To pass? [Laughter.]

Mr. DARMAN. No. Well, I can answer your question quickly.

Yes, we think there should be a second snapshot. I think that this existing Gramm-Rudman loophole is just ridiculous. It makes a mockery of the whole system.

And, if we are going to try to be serious about a system that has a fail-safe discipline, it can't be one that says it applies until October 15 and thereafter it's irrelevant or you can waive it with a self-executing rule in the House and have no consequences. I mean, that is just phony squared or cubed.

And, I mean, the perfect case is this situation I just mentioned with the RTC financing. We can come along now and say we are going to do RTC financing through the Federal Financing Bank.

Maybe it will be—who knows—$40 billion more. We don't know yet. But, it's going to be a very large number this year, increase the deficit, the fiscal year 1990 deficit, by that amount, and then there is absolutely nothing in the system that even pauses to care.

So, the discipline associated with it is nonexistent as long as that loophole exists in the form it currently exists. So, I put very high priority on fixing that element.

On changing the targets, I think it would be a mistake to change the targets at the start of any such process. If you had a really serious and responsible package that programmatically addressed the deficit problem first, and that were agreed to, then I think the people who just agreed to that—if we should ever reach such a happy day—should lock themselves in a room and stay there until they also agree on process reforms.

But, if they do it the other way around, if they start with process reforms, we have an outstanding change of ducking all the substance by concentrating on the process and that alone.

Representative UPTON. Let me just ask one other question if I may.

Representative HAMILTON. Sure. Or, you can have time when you come back if you are able to come back.

Representative UPTON. Why don't I do that?

Representative HAMILTON. All right. Mr. Darman, we have to vote, so we will take about a 15-minute break.

Mr. DARMAN. Yes, sir. Thank you.

[Whereupon, the hearing was recessed at 11:10 a.m., to reconvene at 11:25 a.m., this same day.]

Representative HAMILTON. The committee will come to order.

Congressman Upton.

Representative UPTON. Thank you. I was probably, like all Americans, very disappointed to see the real GNP growth rate, 0.9 percent for the last quarter, as they were released.

How is this number now going to affect the administration's budget projections? What is your timetable, and what are your thoughts with regard to that likelihood of sequestration?

What point, in other words, are you going to be addressing these newer, lower growth projections?

Mr. DARMAN. Well, we don't—we are not obliged to reflect the changes in economics until July, as you know, at which point we will be able to incorporate three quarters of information, three calendar quarters of information, that was not available when we put out the budget in January.

And, right now we've only one of those three quarters. So, I can't tell you what the revisions will be in July, since two out of the three quarters are unknown.

It appears that the quarter we are in now shows signs of some rebound. Whether it will be enough over the course of these quarters to get us back on the path that we have forecast in January, I just can't say.

If, as I suggested earlier before you arrived, Congressman Upton, we were to get back exactly on course right away, there would still be an adverse effect of $6.2 billion roughly in the July estimate of the 1991 deficit.

If we were to get back on course just by smoothing the curve back, not just leaping back, the effect would be probably more like $12 to $15 billion, adverse effect, on fiscal year 1991.

So, it's going to be quite important to see how the economy actually performs before we do the reestimates. When you say chances of sequester, there are three very large variables influencing the probability of sequester, all three of which unfortunately are unknown at the moment.

One of them is the one you've touched on, what happens with the economy. A second is what will happen with respect to the RTC, where, as I suggested earlier, it could be anywhere from plus $20 billion to minus $20 billion.

It's not inconceivable you could have financing for the RTC turn out in a perverse way to offset the adverse effects of slower economic growth. That's exactly why the RTC scoring convention is absurd.

And, of course, also very importantly, the third element is what the political system is going to do, whether we will, in fact, have any substantial deficit reduction agreement. Right now, you would have to say the odds on a large sequester are very high.

But, that's today. A lot can change, as we all know, before you actually get there in October.

Representative UPTON. What is the impact of the highway trust fund on the deficit?

Earlier last week, Secretary Skinner testified on the administration's transportation plan before the House Public Works Committee. One of the things that he had indicated was that expenditures, in fact, exceeded the revenue into the trust fund, if you did not count the interest toward that the last couple of years.

And, he indicated a willingness to spend down the trust fund to help the infrastructure if, in fact, we could get some resolution in terms of what the overall plan would look like.

How does that jive with your thinking at OMB?

Mr. DARMAN. Well, it is the case I believe—I'm just looking at the numbers here—that for 1991 we would propose to expend about $14 billion from the highway trust fund, and we would receive tax receipts to the fund of $13.76 billion. So, Secretary Skinner's point is correct.

We would be, on a cash basis, spending more than we received. That, by the way, is a misconception about this trust fund and many other trust funds, as I know you know, that over the past many years on a cash basis the trust funds are not accumulating surpluses.

On the question of whether the trust fund should be spent down, I didn't see exactly what Secretary Skinner said, so I would hope I'm not in disagreement with him.

There is, as you know, the Byrd amendment which limits the extent to which trust fund balances, highway trust fund balances, can be spent down. And, it limits them to that year's obligations plus the next 2. Excuse me. That's right.

The trust fund—excuse me, I've stated it incorrectly. The trust fund balance plus the next 2 years' expected receipts have to be less than or equal to the obligations.

That's sort of rule of prudence. And, I think it's not an unreasonable rule.

Right now, for example, I think the trust fund balance is on the order of $10½ or $11 billion. I'm going from memory. And, the obligations are on the order of $30-some-odd billion.

And, so to say that you ought to have "on hand" in balance a third of what it's already known that you are committed to have to pay isn't imprudent. It strikes me as prudent.

To put it the other way around, what it's really saying is if you shut the highway program down and you followed this policy, you would still need to continue the gasoline tax for at least 2 more years in order to pay for what you are already committed to. That strikes me as a fairly prudent rule.

Representative UPTON. Let me ask one more question, and I will yield back to the chairman.

In your introduction to the budget, you noted some of the various budget baseline concepts in use. As you know, in this city, that oftentimes any reduction in the size of a projected budget increase is considered a budget cut, which is pretty hard to explain outside of the beltway.

What is your estimation of the best way to measure the level of Federal outlays vis-a-vis the previous year? Current services?

Mr. DARMAN. No, just that way. If you will pardon my saying, you answered your own question.

If you are going to measure against the previous year, the best way is against the previous year. It's about that straightforward.

Representative UPTON. I yield back.

Representative HAMILTON. I would like to get your impression of some of the CBO studies that have come out with respect to the shifting burden of taxes and the general question of fairness.

To refresh your recollection, let me say that the studies have found that the percent of income paid in taxes by the richest 5 percent of Americans fell from 29.5 percent in 1980 to an estimated 26.7 percent for 1990. At the same time, the tax burden for the poorest, next to poorest and middle fifths of the population have all gone up.

And, the reason for that, the CBO said, was the increased reliance on Social Security payroll taxes which, of course, are levied only on earnings and only below a maximum amount.

Now, I'm interested in your reaction to that. Are you comfortable with this shift from income to payroll taxes as sources of Federal revenue? That's the first question.

Mr. DARMAN. Mr. Chairman, I think that the shift has to be viewed in conjunction with another very important shift, which is the shift in the pattern of payments by the Federal Government. You are talking about the receipt side where there is a heavier burden borne by social insurance taxes.

If you look at the outlay side, you will see that on the outlay side of the budget there is also a corresponding increase in the proportion of the budget that is going to social insurance payments.

And, so I would answer your question this way: I would say, as long as there is a fair correspondence between the increase in the burden on the way in and the increase in the expenditure on the way out, I would think that sound.

Representative HAMILTON. You think that balance exists today, and you are not disturbed by the trends?

Mr. DARMAN. Let me—I'm not sure you can see, but I think you can see the pattern.

[The witness is referring to a document he is displaying.]

Representative HAMILTON. I can see it. Yes.

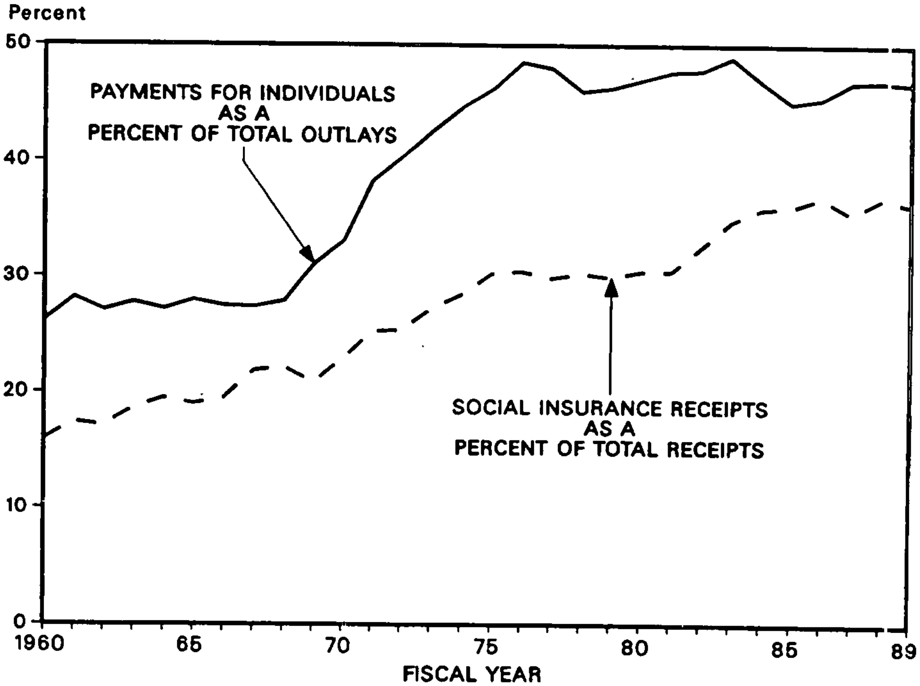
Mr. DARMAN. This——

Representative HAMILTON. Without objection, we will make that chart a part of the record. I presume that's all right with you?

Mr. DARMAN. Yes, it is. Thank you.

[The chart follows:]

PAYMENTS FOR INDIVIDUALS AS A PERCENT OF TOTAL OUTLAYS,
SOCIAL INSURANCE RECEIPTS AS A PERCENT OF TOTAL RECEIPTS



Mr. DARMAN. This line is showing what has happened to social insurance receipts as a percent of total receipts, this lower line. And, as your question suggests, it is going up from something that looks like around 17 percent to something that is around 35, 34 percent, something like that, roughly double.

And, this line—the higher line is what has happened to payments to individuals as a percent of total outlays. And, it goes from roughly 25 percent of the budget up toward close to 50 percent.

So, they both double. And, I would say that relationship is the right one to look at and is roughly fair.

Representative HAMILTON. And, so the thrust of these studies, then, you think are not cause for concern—I guess that's the way I would put it— because of the payments figure?

Mr. DARMAN. No. I mean, it depends on what—I think it depends on what one is trying to do with them.

I think that if you look at these two in conjunction—which is what I think is the fair way to look at them—you then have to ask yourself though, are you comfortable with such a large share of the Federal budget going out in the form of payments to individuals? Do you want that trend to increase? Do you want it to get over 50 percent, which is where it's headed?

If the answer to that is no, then consistent with the point I'm making, you should also not want the trend in social insurance receipts to continue to rise. You should want it also to flatten.

And, if you were to ask me, I would like them both to flatten. So, to that extent, I think that it's useful data to look at.

Representative HAMILTON. So, if I understand you, in sum, you are saying to me that you are comfortable with the shift from income to payroll taxes, because it's offset by the benefit payments?

Mr. DARMAN. That's roughly right. There have to be other considerations, though, two others that—one I mentioned, which is the percent of the total budget. You don't want it to just keep going up.

Representative HAMILTON. I understand.

Mr. DARMAN. And, the second one, which I haven't mentioned, is that you don't want there to be an excessive burden—and it's again judgmental—on the cost of labor or you are going to have an adverse effect on employment. And, from the employee's standpoint, you don't want that tax to rise excessively at the low end of the income scale to where it's a disincentive to work.

Representative HAMILTON. All right. Now, tax as a percentage of income, according to these studies, has declined for the wealthiest 5 percent and risen for all the other groups, the poorest, the next to poorest and the middle fifths of the population.

How do you react to that now?

Mr. DARMAN. I would like if I could, Mr. Chairman, to submit for the record today actually our own and CEA's analysis of these studies you are referring to, the CBO-Ways and Means study is what I think you are referring to. We have an analysis of the same data under the heading "Progressivity."

And, what our analysis suggests is that those studies seriously overstate the changes for several reasons. The most significant I may say, meaning not too much disrespect to the authors, is something you wouldn't accept in an eighth or ninth grade math class.

They take little percentage changes and then compare the percentage change of the percentage change, or the percentage of a percentage. And, that's why you get these highly exaggerated changes. That's one of the problems.

The other is, they carefully pick the base period—or so it would seem—to prove a point. If, for example, you change the base period to 1977 as opposed to 1980, which is the base period they use, you get a different conclusion.

If you were to include transfer payments, you would get an actually reversed conclusion.

Representative HAMILTON. Well, the sum of what you are saying to me, I think, is that you fundamentally disagree with the conclusions that say, in effect, that there has been a sharp increase in income inequality?

Mr. DARMAN. Yes.

Representative HAMILTON. The study you made, of course, will be made part of the record if you will submit that to us.

[The following study was subsequently supplied for the record:]

PROGRESSIVITY:

AN ANALYSIS OF THE WAYS AND MEANS/ CONGRESSIONAL BUDGET OFFICE STUDY

Prepared by the staffs of the Council of Economic Advisers
and the Office of Management and Budget

February 1990

SUMMARY

The staff of the House Ways and Means Committee recently prepared a background paper, based on tables compiled by the Congressional Budget Office (CBO), arguing that the U.S. tax system has become significantly more regressive. A striking result of their study, however, is that high-income families are bearing an increasing share of the tax burden. Also, the study has numerous serious conceptual problems and methodological flaws.

- o An important method for analyzing fairness is to examine how much of the overall tax burden is carried by each income class, rather than tax rates. Even using the Ways and Means tables, despite their flaws, **the share of taxes paid by the highest income quintile of the population is projected to rise between 1980 and 1990 for every tax studied--social insurance taxes, individual income taxes, corporation income taxes, and excise taxes.**

  - The share paid by the highest income quintile of total Federal taxes is projected to rise from 55.7 percent to 58.1 percent, and of social insurance taxes from 38.9 percent to 41.4 percent.

  - For other taxpayers the share of taxes is projected to fall for nearly every other quintile and tax studied. The sole exception is the share of excise taxes paid by the lowest income quintile, which is projected to rise 0.3 percentage points, or roughly $5 per household.

The Ways and Means staff study is incomplete by its nature:

- o The study focuses only on taxes, ignoring Government transfer payments. This incomplete view overlooks the highly progressive nature of the Government's tax and transfer system as a whole. The bottom 40 percent of households receive far more in income transfers than they pay in taxes. The tax and transfer system increases the share of income going to the lowest quintile by 3.7 percentage points, and decreases the share of the highest quintile by 6.6 percentage points.

- o Increases in Social Security taxes are the primary source of the alleged decrease in progressivity. Yet, even if one were to accept the questionable Ways and Means assumption that workers pay the employer part of the payroll tax, the Social Security program is highly progressive. When taxes are netted against Social Security benefits, Social Security is highly progressive, whether measured for any year, across generations, or for any single generation of beneficiaries.

- The United States relies far less on payroll and sales taxes than do other large industrial nations. If the United States were to collect taxes in the same manner as most of these other countries, the distribution of income would probably become less equal.

The methodological flaws in the Ways and Means study include:

- The Ways and Means staff chose a poor base year--1980--for its comparison. Largely as a result of inflation-induced bracket creep, 1980 had unusually high effective income tax rates, particularly on middle and high income individuals. The tax rate reductions of the 1980s were partly a response to these unlegislated increases in tax rates.

- The 1990 figures are estimates based on a projection. To arrive at this projection, CBO had to estimate the effects of the dramatic Tax Reform Act of 1986, since no data yet exist reflecting its full implementation. A more accurate comparison would not extend beyond the most recent year for which data are available (currently 1987).

- The study computes **percent** changes in effective tax rates that are already expressed in percentage terms, a method that is well known to be flawed because it places undue significance on small changes. The Ways and Means study acknowledges this bias only when the movement is toward **increased** progressivity.

  - For example, the effective excise tax rate for the top 5 percent of the population is projected to have decreased 11.7 percent from 1980 to 1990, even though the rate is reported as 0.4 percent in both years. The estimated effective tax rate must have changed by only hundredths of a percentage point.

  - In the same table, the effective individual income tax rate for the lowest quintile is projected to fall from -0.4 to -1.5 percent. Using the same questionable methodology this is a decrease of 275 percent, yet the Ways and Means staff does not report it.

INTRODUCTION

Using tables prepared by the Congressional Budget Office (CBO), the staff of the House Ways and Means Committee has prepared a background paper arguing that the U.S. tax system became significantly more regressive during the 1980s. According to this study, the essential source of the reduced progressivity was increases in payroll taxes for social insurance.

The study has many shortcomings that lead one to doubt the basic conclusion. There are methodological flaws in the construction of the tables, and even more in the interpretation of the tables by the Committee staff. The study is too narrowly focused. It concentrates on changes in effective tax rates despite the fact that their own tables show that the share of taxes paid by higher income taxpayers rose in the 1980s while the share paid by lower income taxpayers fell. Most importantly, it fails to integrate Federal transfer payments with Federal taxes. A complete analysis of how the Government affects income distribution must consider the entire set of tax and transfer programs. Any such analysis reveals that the full set of Federal Government taxes and transfers is highly progressive and has remained so even as increased incomes for retired Americans have moved Social Security recipients higher on the income scale.

METHODOLOGICAL PROBLEMS WITH THE WAYS AND MEANS STUDY

Base Year Choice

The first problem is that the base year chosen for comparison by the Ways and Means staff, 1980, is a poor choice. Largely as a result of inflation-induced bracket creep, 1980 had unusually high effective income tax rates, particularly on middle and high income individuals. During the late 1970s, high inflation overwhelmed the practice of legislating periodic inflation corrections to the tax code. The result was increased tax rates for most taxpayers. From 1977 to 1981, the average marginal tax rate faced by individuals rose from 28.1 percent to 32.5 percent (using shares of adjusted gross income as weights). Reflecting this bracket creep, average income taxes also rose. In fiscal year 1980, individual income taxes were 9.1 percent of GNP compared with 8.2 percent on average for fiscal years 1971 through 1979.

These increases in tax rates did not represent deliberate policy changes. Indeed, these factors were a major impetus for the tax reforms of the 1980s. Income tax rates were lowered in 1981 and inflation-indexed beginning in 1985 precisely to offset this bracket creep. In the 1986 Tax Reform Act, the standard deduction and personal exemption were increased and 4.3 million low income taxpayers were removed from the tax rolls.

Mixing Fact with Projection

A second problem with the study is the mix of actual data with projections concerning the future path of effective tax rates. The 1990 figures cited in the Ways and Means tables are based on a forecast. Like most economic forecasts, these are subject to uncertainty. This forecast, however, is especially problematic. To produce the forecast, CBO estimated the effects of the dramatic Tax Reform Act of 1986. There are, as yet, no data that reflect full implementation of tax reform, so the forecast reflects a judgment of how the reform will work out.

Correctly measuring the impact of the 1986 reform is particularly important for judging the progressivity of the tax system. The reform made the tax system more progressive by removing 4.3 million taxpayers from the tax rolls, expanding the alternative minimum tax, and increasing the corporate tax burden. The latter falls more heavily on upper income groups. The Ways and Means tables show a shift towards more progressivity between 1985 and 1990, but given the uncertainties, the shift could be larger or smaller than anticipated in the tables.

It would be far preferable simply to restrict the analysis to actual data. If it is desired to show how tax burdens have changed over a 10-year interval, it would be better to compare 1977 with 1987--the most recent year with complete data--than 1980 with projected 1990.

Importance of Endpoints

The tables in the Ways and Means study show how sensitive comparisons are to the choice of endpoints. Table 1 demonstrates that between 1977 and 1980, as also between 1985 and 1990, taxes became more progressive.

Table 1

Percentage Point Changes in Effective Tax Rates for All Families between Selected Years

Quintile	Actual 1977-1980	Projected 1980-1990	Projected 1985-1990
Lowest	-1.1	1.3	-0.9
Second	0.1	1.0	0.6
Third	0.4	0.3	1.0
Fourth	1.1	-0.5	0.8
Highest	0.2	-1.5	1.8

Source: Ways and Means (1990)

Identifying the Rich

Another difficulty is that the highest income quintile is hardly "super rich"-- it begins at a family income of just $50,400. A finer breakdown of the upper income category would be needed to identify the taxes paid by those who might be thought of as truly wealthy.

Quintile	1988 Family Income		
1st	0	to	$10,370
2nd	$10,370	to	$20,530
3rd	$20,530	to	$32,580
4th	$32,580	to	$50,400
5th		above	$50,400

Source: CBO (1987)

Incidence Assumptions

In order to measure income and taxes paid, CBO must make assumptions about the "incidence" of each tax and, in effect, allocate the taxes paid to families' incomes. The most important incidence assumption in the study is that all payroll taxes are paid by workers. This assumption is the root source of much of the alleged change in progressivity. It is controversial. The Social Security payroll tax is divided evenly between employees and employers, with each paying one-half of the tax. CBO assumes that the employer half is borne by employees in the form of lower wages. The employer component could instead be borne by the businesses paying the tax--or capital more generally--or passed on to consumers via higher prices. CBO itself estimates that for any reasonable change in the incidence assumption, the effective tax rate for higher income families would be raised. If the Social Security payroll tax were more progressive than shown in the tables, then the increase in payroll taxes since 1977 would have contributed a much smaller reduction in the progressivity of the tax system.

A second incidence issue concerns the corporation income tax. The Ways and Means study allocates corporate income taxes equally to labor earnings and capital income. Although much-debated, there is no firm consensus on the incidence of the corporate income tax. Many people believe that the tax is almost exclusively borne by shareholders of corporations, or by owners of capital more generally. The use of this more standard assumption would lead to increased progressivity of the tax system.

Percents of Percents

Another set of methodological issues concerns the presentation of the results in the Ways and Means study. Computing **percent** changes in effective tax rates (that are already expressed in percentage terms) places undue significance on small changes. For example, the effective excise tax rate for the top 5 percent of the population is shown to have decreased 11.7 percent from 1980 to 1990, even though it was reported as 0.4 percent in both years. The reported 11.7 percent decrease is highly misleading. In fact, the effective tax rate must have changed by only hundredths of a percentage point.

In addition, these questionable methods are used selectively. In the same table, the effective individual income tax rate for the lowest quintile falls from -0.4 to -1.5. Using the same questionable methodology, this is a decrease of 275 percent. Instead of reporting this number, the Ways and Means staff states, "since the denominator for this calculation is very close to zero, this figure is meaningless." They fail to note that the denominator for the calculated decline in the effective excise tax rate is just as close to zero.

A more conventional approach would simply compare percentage point changes in effective tax rates (as in Table 1 of this report).

A Flawed Income Measure

Flaws in the measure of income used by CBO likely lead to an understatement of the progressivity of the tax system each year (the effect on the estimated change in progressivity between two years is uncertain). First, the CBO measure does not include non-cash income, thus excluding such important government transfers as Medicare, Medicaid, Food Stamps, and public housing and employer-provided nonwage compensation such as health and life insurance. Non-cash government transfers are heavily progressive. Neglecting them leads to an understatement of low incomes, an overstatement of effective tax rates for lower incomes, and biases the results against progressivity.

In addition, the CBO measure of cash income excludes losses due to partnerships and rentals--ostensibly to eliminate tax-induced paper losses, but some real economic losses are excluded as well--leading to overstated higher incomes where these losses are concentrated. Further, the cash income measure includes an imputed value for realized capital gains that suffers from two problems. First, although realized capital gains are part of the tax base, they bear little relation to the change in the value of assets, but rather reflect a change in the composition of assets. A better way to measure income for this purpose would be to allocate both corporate income taxes (as CBO does) and retained corporate profits to households directly. Further, CBO imputes realizations as a fixed share of national income, apparently to mitigate tax-induced bunching of realizations. For the years in the tables, however, realizations varied greatly as a share of national income without any changes in the tax treatment of capital gains from the previous year. In these ways, the CBO cash income likely overstates high incomes, understating the effective tax rate, and again biases down the measured progressivity.

ALTERNATIVE WAYS OF VIEWING PROGRESSIVITY

Effective tax rates are difficult to measure correctly and are not the only way or the best way to evaluate the fairness of the tax system. Indeed, one of the main goals of the 1981 tax changes was to lower inefficiently high marginal tax rates that were costing the Government revenue by encouraging high income taxpayers to shelter their incomes to avoid taxes.

<u>Share of Taxes Paid</u>

Another way to look at fairness is to examine how much of the overall tax burden is carried by the different income classes. **By this measure, the tax system has become more progressive.** Other tables in the Ways and Means study show that the <u>share</u> of taxes paid by the highest income quintile of the population is projected to rise between 1980 and 1990 for <u>every</u> tax studied: individual income taxes, corporation income taxes, social insurance taxes, and excise taxes. The share of total federal taxes paid by the highest income quintile rose by 2.4 percentage points, while their share of social insurance taxes rose by 2.5 percentage points (see Tables 2 and 3).

For other taxpayers, the share of taxes is projected to fall for nearly every other quintile and tax studied. The sole exception is the share of excise taxes paid by the lowest income quintile, which is projected to rise by a slight 0.3 percentage points, an increase of roughly $5 in 1990.

<u>International Comparisons</u>

The attention devoted to payroll taxes in the U.S. tax structure may leave the impression that payroll taxes are unusually high in the United States. In fact, the United States relies far less on payroll and sales taxes to finance Government programs than do other large industrialized nations except Japan (see Table 4). If the United States were to collect taxes in the same manner

Table 2

Share of Taxes Paid by All Families
(in percent)

	Actual 1980	Projected 1990
Lowest 20 Percent	1.6	1.6
Second 20 Percent	7.0	6.6
Third 20 Percent	13.4	12.6
Fourth 20 Percent	22.2	21.0
Highest 20 Percent	55.7	58.1
Total	100.0	100.0

Table 3

Share of Social Insurance Taxes Paid by All Families
(in percent)

	Actual 1980	Projected 1990
Lowest 20 Percent	3.4	3.3
Second 20 Percent	11.5	10.8
Third 20 Percent	18.8	17.9
Fourth 20 Percent	27.2	26.5
Highest 20 Percent	38.9	41.4
Total	100.0	100.0

Source: Ways and Means (1990)

as most of these other countries, the distribution of income would probably become less equal.

Table 4

[illegible]

(in percent)

	Personal, Corporate, and Property Taxes	Social Security Contributions, Sales, and Payroll Taxes
Japan	58.2	41.5
U.S.	54.5	45.5
U.K.	50.9	49.5
Italy	39.4	60.7
W. Germany	37.2	62.7
France	22.6	74.2

Source: H. Aaron, Wall Street Journal, February 14, 1990.

LOOKING AT THE WHOLE PICTURE: TAXES AND TRANSFERS

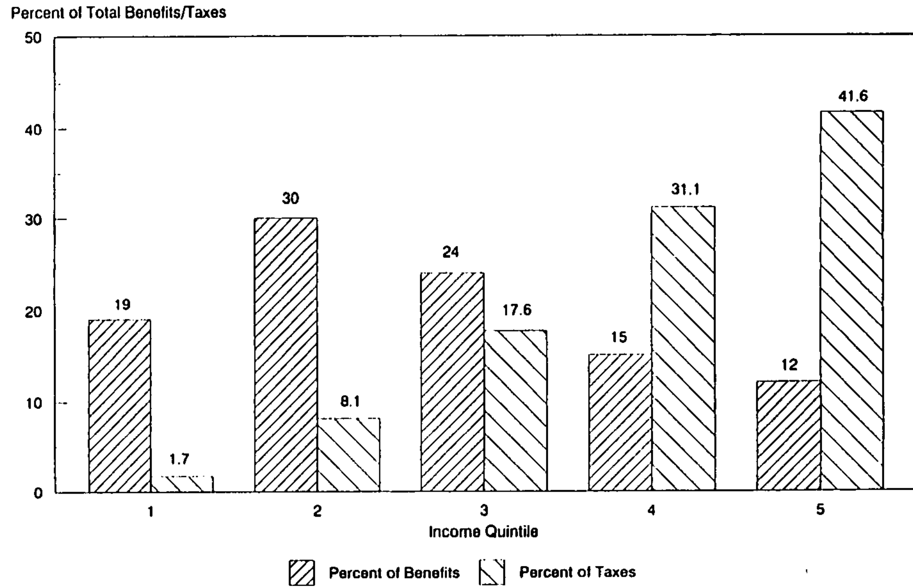
The Ways and Means study not only has significant flaws in design and execution, it is by nature incomplete. Its myopic focus on the tax system ignores the highly progressive nature of the Government's tax and transfer system taken as a whole.

Progressivity of Social Security

When the overall structure of payroll taxes and benefits is examined, Social Security is found to be one of the most progressive of Government programs. Chart 1 shows the highly progressive nature of Social Security when payroll taxes are netted against Social Security benefits. (The chart shows taxes and benefits by income group, not taxes and benefits for individual

CHART 1

Share of Social Security Benefits Received and Taxes Paid by Income Quintile
1987



Source: Social Security Administration

Notes: (1) Quintiles are based on Census money income and are not directly comparable to CBO quintiles .

(2) Benefits and taxes are shown for quintiles and do not necessarily represent payments and receipts for each family.

families.) At any point in time, lower income groups receive much more back in benefits than they pay out, while the reverse is true at the upper end of the spectrum.

For individuals, as opposed to income groups, Social Security is also progressive because low-income individuals receive proportionally more Social Security benefits relative to their contributions than do high-income beneficiaries. Also, historically Social Security has provided benefits that have permitted older generations to share in the growth of real incomes occurring after their retirement, producing a progressive impact across generations.

Growth of Government Transfers

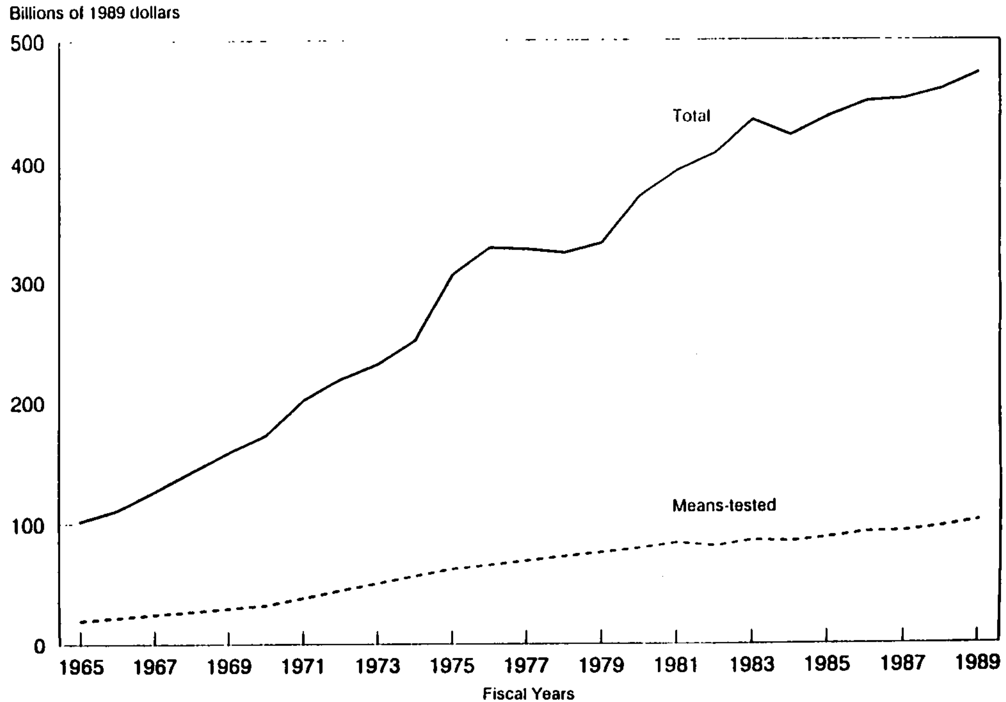
The role of Government transfers extends far beyond Social Security. Substantial growth in the size of Government transfer payments continued during the 1980s, raising living standards of low-income families. As shown in Chart 2, the real value of Federal transfer payments–both total and means-tested--rose 28 percent between 1980 and 1989.

Overall Progressivity of Taxes and Transfers

The Federal tax and transfer system is highly progressive. The total effect of taxes and transfers in 1987 was to reduce overall income inequality substantially, as measured by the most commonly used index of income

CHART 2

Real Federal Transfer Payments



Source: Office of Management and Budget.

concentration. For the lowest quintile, taxes and transfers increased their share of total cash and noncash income by 3.7 percentage points, from 1.0 percent to 4.7 percent (Table 5). For the top quintile, taxes and transfers reduced their income share by 6.6 percentage points. While income and payroll taxes reduce income inequality, Government transfers have produced the bulk of the reduction in income inequality, again measured using the most common index of income inequality.

While it would be useful to compare 1987 with earlier years to gauge how the tax and transfer system has affected the income distribution over time, data are not published in a comparable form for all noncash transfers in years prior to 1986. Even if it were possible to extend the comparisons, year-to-year variations in the measured progressivity of the tax and transfer system should be viewed with caution. These changes are not necessarily the result of changes in policy, but also reflect the influences of recessions, changing family structures, inflation, and other factors. In general, in recent years, **changes** in the distributional effect of the Federal Government tax and transfer system have been negligible compared with the large, progressive nature of the basic system itself.

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Table 5

Income Distribution Before and After Taxes and Transfers 1987

Income Quintile[a]	(1) Income Excluding Transfers[b]	(2) Income After Taxes[c]	(3) After-Tax Income plus Transfers[d]	(4) Net Impact[e]
	-------- percent	--------	--------	percentage points
1	1.0	1.2	4.7	3.7
2	7.6	8.5	10.6	3.0
3	15.2	15.8	16.1	0.9
4	24.3	24.8	23.2	-1.1
5	52.0	48.5	45.4	-6.6

[a] Quintiles of households, defined using income definition in each column.
[b] Money income plus capital gains and health insurance, less government transfers.
[c] Income as in b, less Federal and state income taxes and employee social security payroll taxes.
[d] Income as in c, plus cash and non-cash government transfers.
[e] Net impact of taxes and transfers on the share of after-tax income; column (3) minus column (1).

Source: Bureau of the Census (1989).

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H. Aaron, Wall Street Journal, February 14, 1990.

Committee on Ways and Means, U.S. House of Representatives, Background Materials on Federal Budget and Tax Policy for Fiscal Year 1991 and Beyond, February 1990.

Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987.

Congressional Budget Office, The Changing Distribution of Federal Taxes: A Closer Look at 1980, July 1988.

Mr. DARMAN. In fact, Mr. Chairman, the curious thing about America is, I think, that if you look over a really extended period of time, the whole postwar period, no matter what you do with tax policy, the income distribution and differences tends to be relatively constant.

And, an even more curious thing is this: Unlike most other societies where there is a high degree of stability—in other words, if you are in a lower income level at the start of your life, that's probably where you are at the end; and, if your parents were, that's where you probably were in most countries—in ours, you have tremendous fluidity. And, you have people moving way up and other people who start up moving way down. And, you have all kinds of tax and other policy changes going on.

And, if you look at it for a 50-year period, notwithstanding all of this policy change and all of this upward and downward mobility, the distribution by income class stays relatively constant.

Representative HAMILTON. Let me move on to some other topics. I know you've indicated your desire to leave at 12 noon or a little after, and I appreciate that.

And, you may know, we have the President coming up here today for lunch for St. Patrick's Day.

Mr. DARMAN. Yes.

Representative HAMILTON. We have to be sure to be present for that.

On your economic assumptions, the long-term Treasury rates now have risen from a range of 7.8 to 7.9 percent in December to around 8.5 percent recently. What does that do to your budget projections?

Even if that movement were reversed, won't the debt service cost remain such higher because of the fact that we've already issued some of the debt?

Mr. DARMAN. That's right. That's why I said that if you take into account all the changes that have taken place since we submitted the budget, it's a combination of factors including that that is essentially irreversible.

In other words, if we bounced back in all other respects to our same forecast, we would still pay a price for being wrong in the last quarter.

Representative HAMILTON. Do you have any——

Mr. DARMAN. It's about $6.2 billion total.

Representative HAMILTON [continuing]. Judgment now as to what the sum of all these factors are with respect to your budget projections?

Mr. DARMAN. No. I only can say that I think it's at a minimum. If everything were to bounce back, it's at a minimum $6 billion. If things went back smoothly, it's probably $15 billion negative. If things turn out better than we forecast, obviously it would counterbalance that.

Representative HAMILTON. You have——

Mr. DARMAN. I was just speaking not just to the interest rate effect though, but the combination of the interest, inflation, and the real growth.

Representative HAMILTON. You project higher growth than CBO. You project higher growth than the Blue Chip consensus.

But, you don't foresee higher inflation or higher interest rates than they do or even much lower unemployment. So, you have this unusual projection into the future, where you have a forecast for real growth that differs rather sharply from CBO and from the Blue Chip, but it doesn't seem, so far as your projections are concerned, to have any consequences for inflation or interest rates.

Mr. DARMAN. Well, of course, in the experience of the 1980's, we've had real growth rising and inflation and interest rates falling. And, people before thought that that wasn't likely to happen in that combination.

Representative HAMILTON. You anticipate that same combination to continue?

Mr. DARMAN. Well, could I clarify one thing, Mr. Chairman? Let me make two quick comments.

One, we had this exact same discussion in July when we made such a forecast. And, people said it was preposterous, and it turned out we were exactly right.

Representative HAMILTON. On growth?

Mr. DARMAN. No, on all of these.

Representative HAMILTON. On all of them?

Mr. DARMAN. On all of them. They said—this is your exact question.

Representative HAMILTON. Yes.

Mr. DARMAN. Your growth is higher than the Blue Chip. Your interest rates are coming down faster, and your inflation is coming down faster. How can that be?

And, it turned out that we were right on all of them and more right than anyone of the 52 Blue Chip economists. Now, I'm not saying that's going to happen again.

This is my second point.

Representative HAMILTON. How did you do on the deficit projections?

Mr. DARMAN. That's what I was about to say. I think a good protion of our being right was luck. I am not about to claim that we have macroeconomic scientific wisdom where the rest of the world doesn't.

It's a highly fallible science, and there is an outstanding chance that we and 51 of the 52 Blue Chip economists are going to be wrong.

Representative HAMILTON. Your deficit projections were not so good, were they? Or, have not been so good?

Mr. DARMAN. No. And, I would like to submit one other thing for the record, Mr. Chairman, since I know we are running out of time. But, I hope you find this interesting.

Representative HAMILTON. I hope you are not going to submit all the materials in that folder? [Laughter.]

Mr. DARMAN. No. But, this is a chart that really—I take this liberty only because I know you are a serious student of these things.

If you take a look at our forecasts and CBO's for any number of variables—GNP, nominal, real, the deflator—I have it for all kinds of other things—they all have the same pattern which is this: All these little lines in here, the nonbold lines, those are OMB, CBO, and Blue Chip. This big black line that wanders all over the place in entirely different directions from those lines, that's reality. That's what reality did.

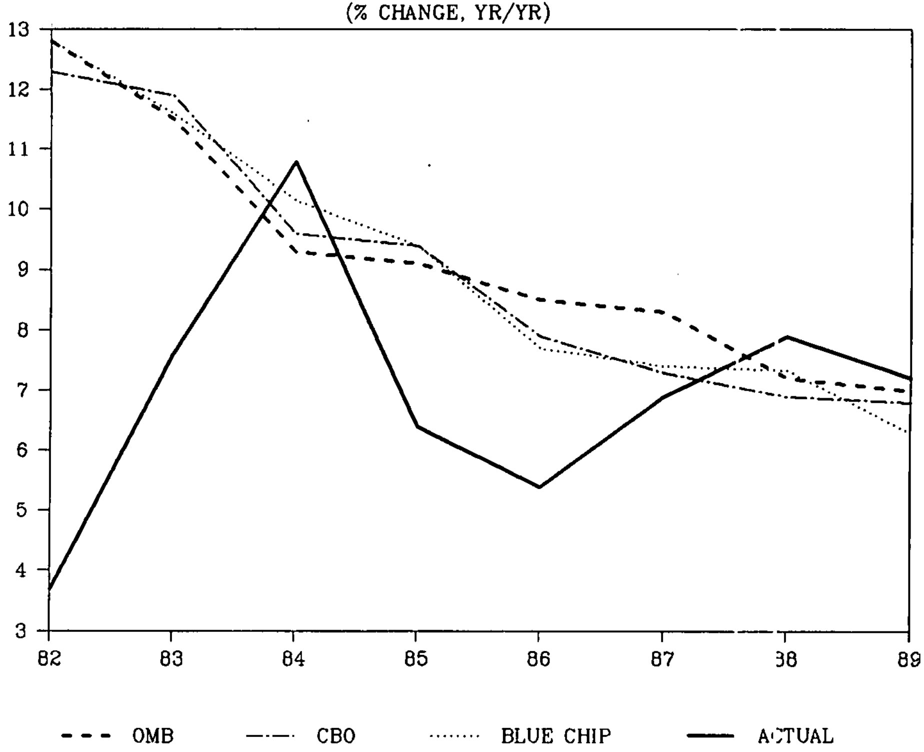
Now, consistently over the decade, the whole decade, we, CBO, and Blue Chip were far closer to each other than to being right. I mean, this is a very important point.

It is the flip side of the point that macroeconomic science is absolutely, fundamentally fallible.

Representative HAMILTON. The charts, of course, will be made part of the record, too. We will be glad to have any of those charts that you want to submit to us.

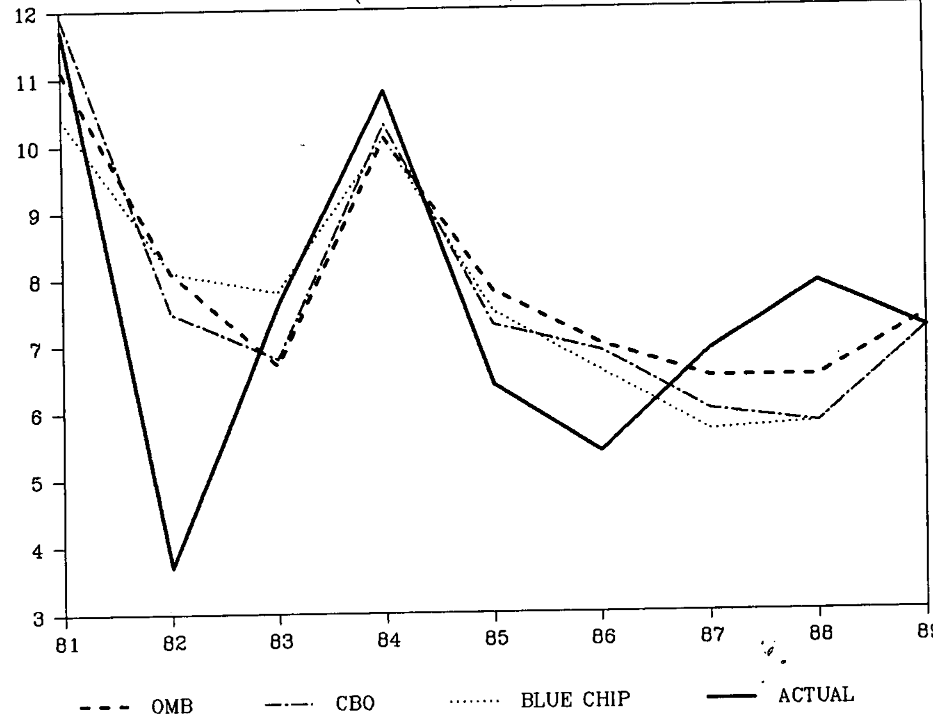
[The charts follow:]

YEAR AHEAD FORECAST FOR NOMINAL GNP



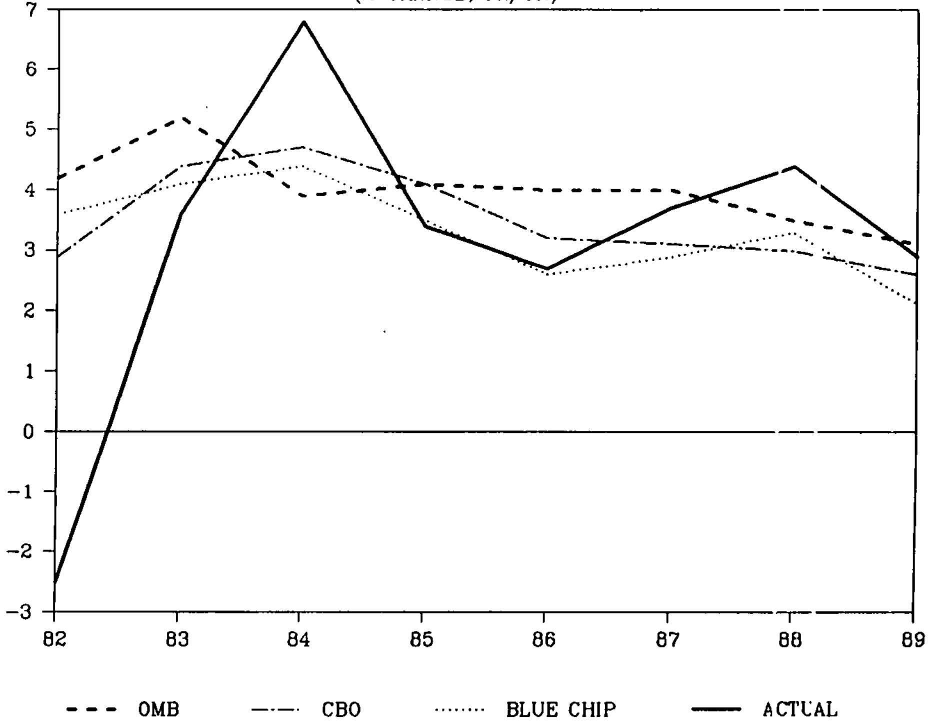
CURRENT YEAR FORECAST FOR NOMINAL GNP

(% CHANGE, YR/YR)



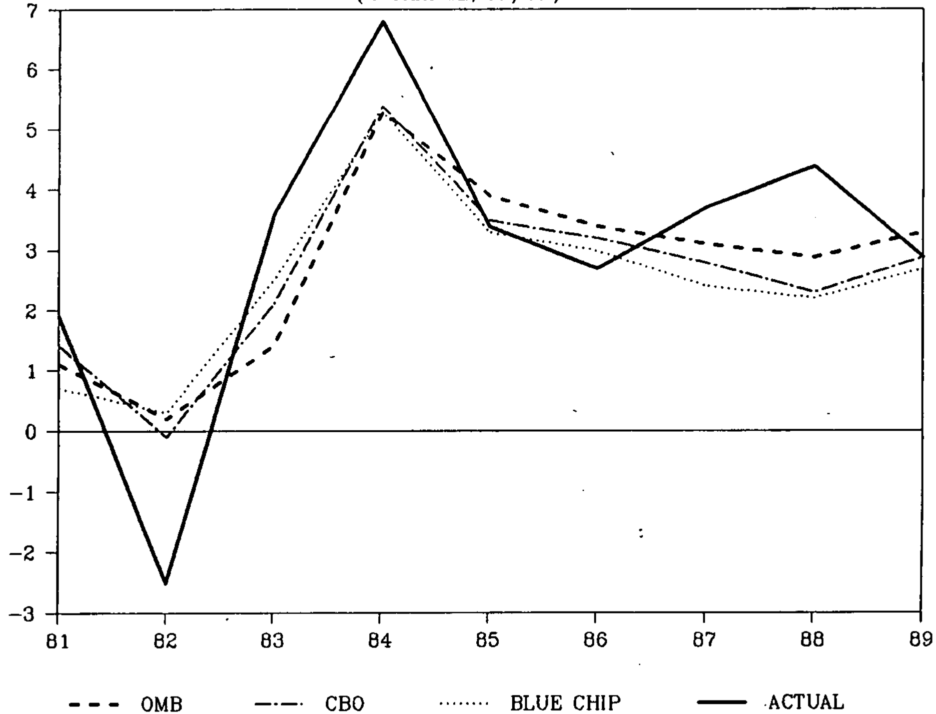
YEAR AHEAD FORECAST FOR REAL GNP

(% CHANGE, YR/YR)

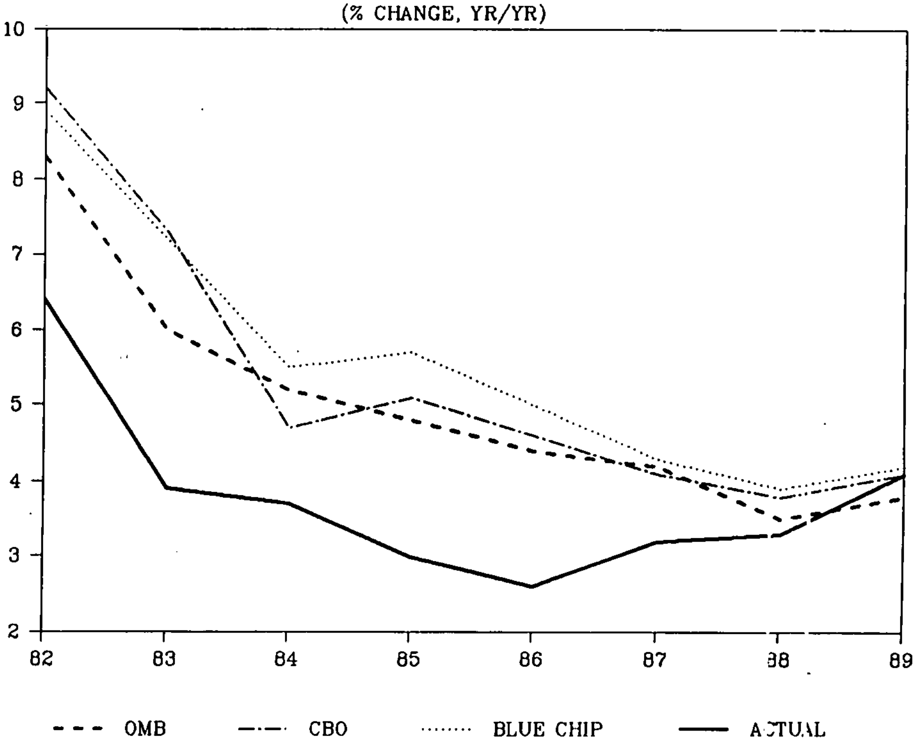


CURRENT YEAR FORECAST FOR REAL GNP

(% CHANGE, YR/YR)

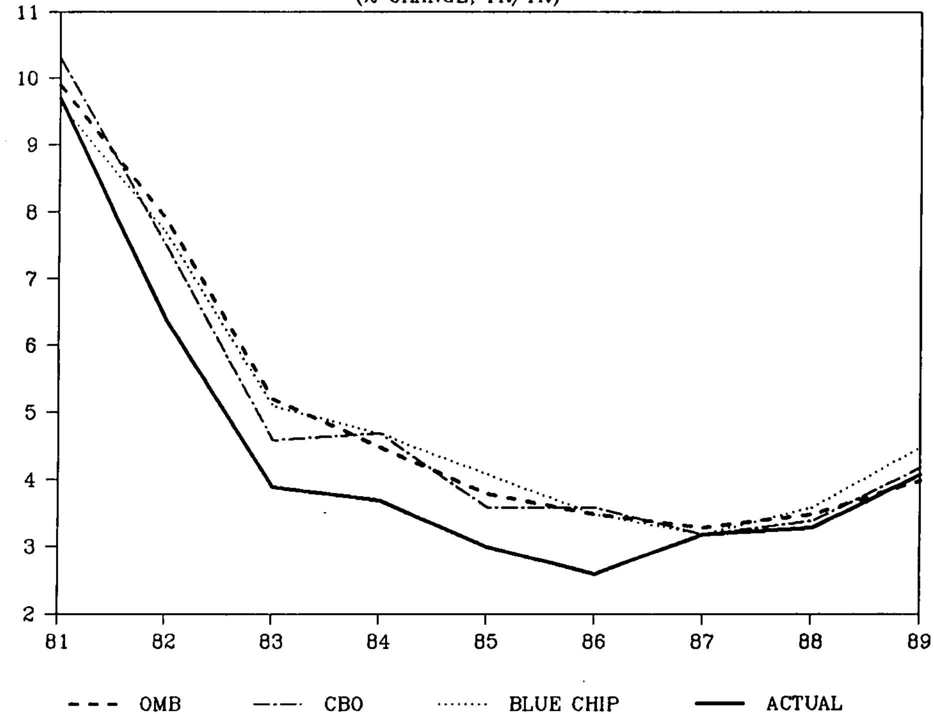


YEAR AHEAD FORECAST FOR THE GNP DEFLATOR



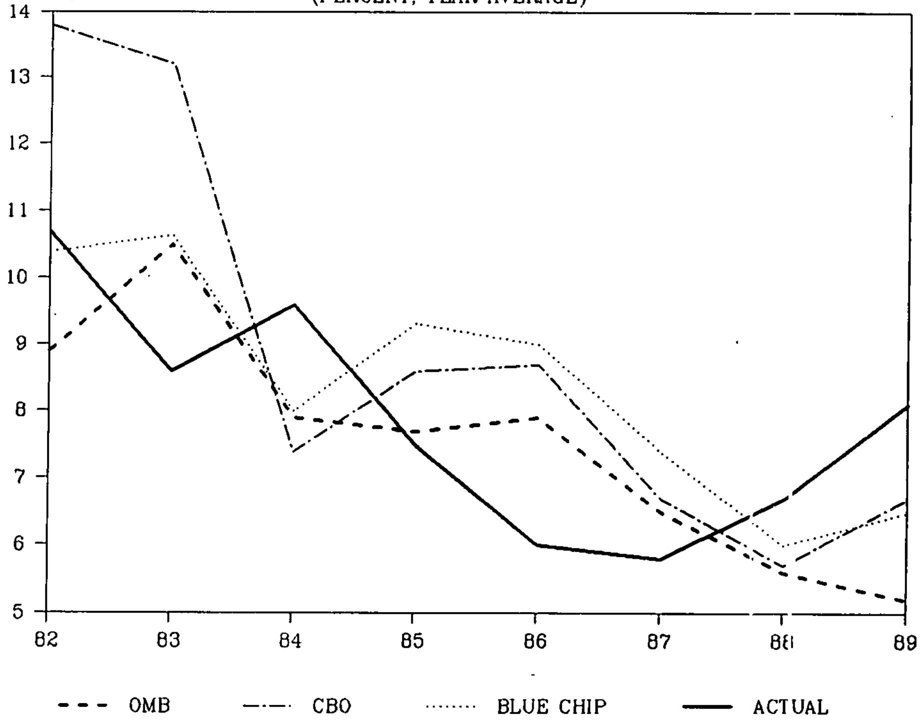
CURRENT YEAR FORECAST FOR GNP DEFLATOR

(% CHANGE, YR/YR)



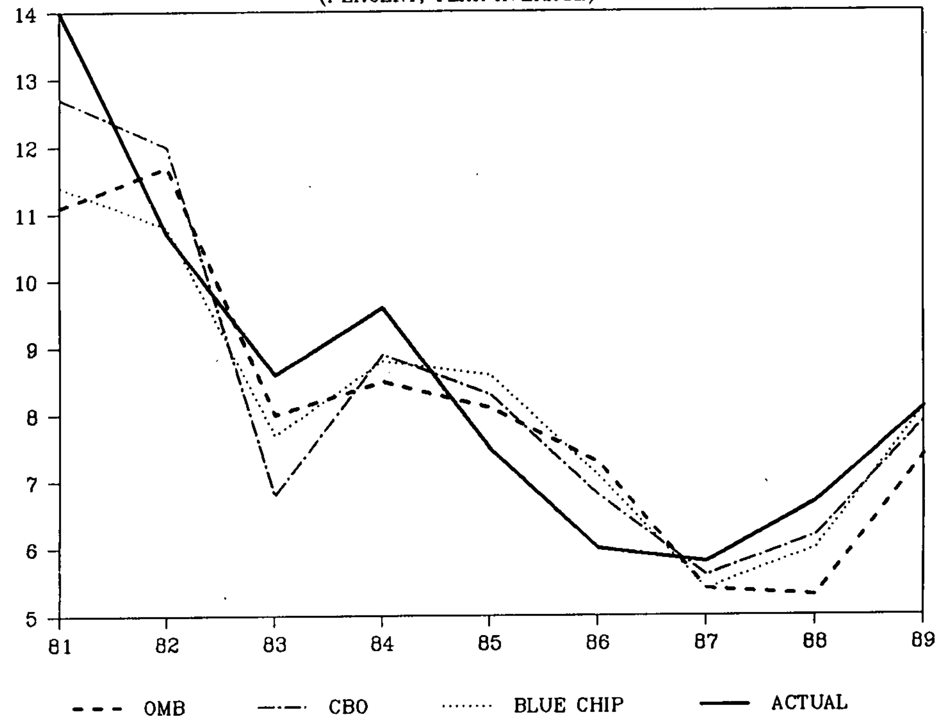
YEAR AHEAD FORECAST FOR 3 MONTH T-BILL

(PERCENT, YEAR AVERAGE)



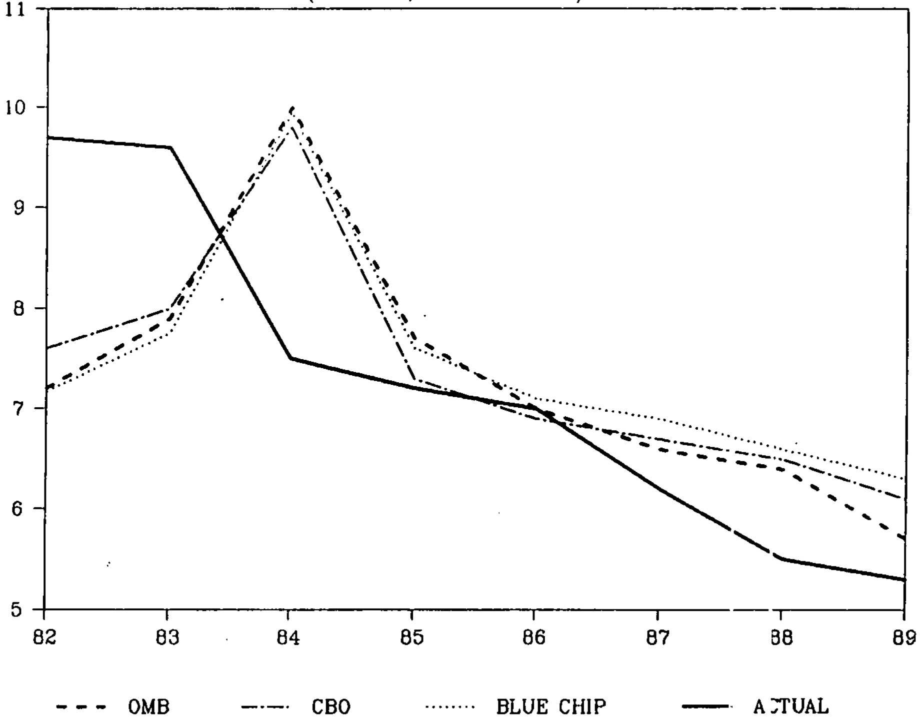
CURRENT YEAR FORECAST FOR 3 MONTH T-BILL

(PERCENT, YEAR AVERAGE)



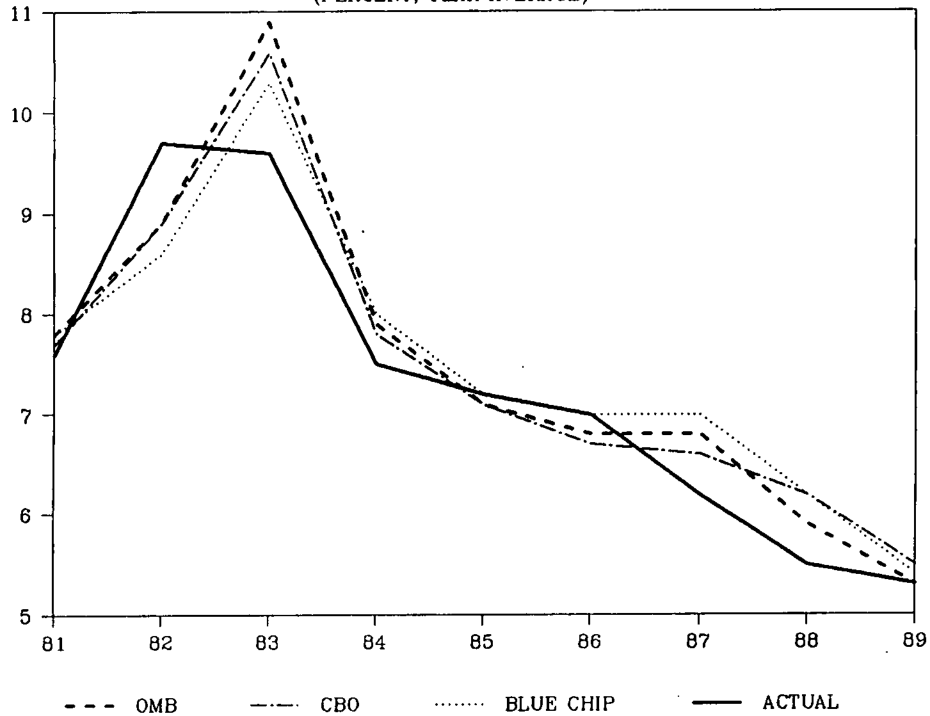
YEAR AHEAD FORECAST FOR
THE CIVILIAN UNEMPLOYMENT RATE

(PERCENT, YEAR AVERAGE)



CURRENT YEAR FORECAST FOR THE CIVILIAN UNEMPLOYMENT RATE

(PERCENT, YEAR AVERAGE)



Representative HAMILTON. Concerning your corporate profits forecast, you've had a 13-percent decline in corporate profits tax receipts in the first 4 months of this fiscal year, 1990, compared with the year earlier.

You have a very optimistic corporate profits tax.

Mr. DARMAN. I think it's too optimistic.

Representative HAMILTON. Too optimistic?

Mr. DARMAN. I think so. But, that's my personal view and obviously the Chairman of CEA has to—you know, you can't hold the position I do about macroeconomic science, which is that it's fundamentally fallible, and then fight to the death over particular estimates.

Representative HAMILTON. Now, let me read some editorials to you. They are editorials that go to the point of the seriousness of credibility of the budget.

I want to say at the outset that you can probably give me a number of editorials with respect to the congressional budget as well. What I don't want to get into here is you charging the Congress with a phony budget and the Congress charging you with a phony budget.

The point I want to make is more fundamental than that. I may do some submitting for the record myself at this point.

The Philadelphia Inquirer: "It's a timid plan riddled with bogus assumptions, financial gimmicks, false economies, wasteful spending."

Mr. DARMAN. What is the date of that, Mr. Chairman?

Representative HAMILTON. I don't have the date. I can furnish you with it.

Mr. DARMAN. One thing, if I might note, which is not a criticism of the Congress, I tend to find those dates are very close to January 29. And, we submitted a 1,600 page document and it's really amazing how quickly people can get through it.

Representative HAMILTON. Well, these are all plans with respect to your budget. But, even that really does not go to the point I want to make here in a moment. So, I will just continue to read some of them if I may.

The Milwaukee Journal: "The President, like his predecessor, resorts to transparent accounting gimmicks that should fool nobody. The budget is misleading in so many ways that it may not be taken very seriously by Congress."

The Chicago Tribune: "Its revenues seem to be mainly daydreams."

The Los Angeles Times: "The budget mentions by name one serious problem after another yet makes clear that most of them will be around long after Washington spends the $1.23 trillion."

The Washington Post: You would anticipate this one, I'm sure. "The President's budget has become less an effort to start the annual debate than an effort to skip responsibility and make Congress take the heat for any unpleasantness."

Business Week: "On paper, the budget would reduce the deficit to $64 billion in 1991, but no one in Washington or Wall Street believes that."

The Baltimore Sun: "Mr. Darman is wrong, and he must know it, when he claims his administration is serious."

The Minneapolis Star and Tribune: "His $1.2 trillion proposal relies on old gimmicks."

The Burlington, Vermont, Free Press, the same thing.

The Boston Globe: "The administration again buried the truth in the fine print."

The Dallas Morning News: I've tried to cite newspapers that are not just Democratic newspapers. I've brought them from all over. "Many economists . . ." says the Dallas Morning News, "say hitting the target will take tens of billions of dollars more in spending cuts or tax increases than Mr. Bush says it will."

Now, my guess is you could write the same editorials with respect to the congressional budget resolutions. The serious thing here, it seems to me, is that a wide variety of opinion in this country, based on editorials—and that's only one judge of what opinion is—but a very wide variety of opinion in this country doesn't take your budget seriously and doesn't take the budget of the U.S. Congress seriously.

And, so maybe the most serious consequence of all of these deficits that we have run year after year after year, despite these marvelous projections we come out with, superb projections on those fancy charts showing a steady decline in the deficit—the fact is the deficit is pretty stable, $150 billion, 3 years in a row.

The key point is that we, you, I, all of us, have lost credibility. And, maybe that's the most serious consequence of this long period of deficits. We've lost credibility and we've lost public trust.

So when you and the President, and when the congressional committees, make what we think is a serious effort, nobody believes us.

First of all, do you think they are all wrong? How do you react to those criticisms?

Mr. DARMAN. As you were reading, I was thinking I should not ever run for office. There didn't seem to be much of a base of support out there. [Laughter.]

More seriously, I think that the issue of credibility is extremely important. But, I would differ with you a little bit about the history.

The deficit has actually come down as a percent of GNP, which is probably the most significant way to measure it. And, debt, as a percent of GNP, has, in fact, stabilized, which is probably the most sigificant way to look at that.

I'm not saying we don't have a problem. I take pains in that introduction to say we have a large problem.

Representative HAMILTON. But, we are also sucking up a lot more of the savings in the country.

Mr. DARMAN. And, part of the criticism of me that shows up in those editorials and elsewhere is that I define a problem but don't adequately address the solution of the problem. I think I can't fairly be criticized for having failed to identify the problem.

In any case, what I think the credibility problem stems from though, if you look at measures of public confidence in public officials is really a Vietnam and Watergate phenomenon, that it's starting right back then that you see this plummet in people's confidence in their elected officials.

And, the deficit really, and our treatment of it, is not that much to blame. It's a serious problem for a democracy for all the obvious reasons.

It's essential that the public be able to have confidence in its own elected officials and institutions. And, I would like to use that as one more reason to try to get something responsible done on this. So, I'm not trying to put it aside.

I'm just saying that I think the public's general lack of confidence in all of us has been earned in more ways than just this one. I think we have been fortunate over this period to have been—some in the system—wrong about what would happen to economic growth.

Starting in 1982, people were saying that if we didn't have the major fiscal policy correction within the year, we would within a year have a recession. And, of course, we are now about to enter what may be the longest period of growth in America's history. We are already at the second longest.

So, we were wrong in some favorable ways as well. My personal judgment is——

Representative HAMILTON. What bothers me a little bit thus far about your response is that you don't seem to be much worried about it.

Mr. DARMAN. About which part? I am worried about the fact——

Representative HAMILTON. About the fact that nobody thinks we are doing a credible job on the budget, that they all think we are playing games with the budget. I'm not just talking about the administration. I'm talking about both of us, the executive and the Congress.

Mr. DARMAN. Right. It does bother me. And, I would like to see us do what we all ought to do, which is get together, as my opening statement suggests, on a bipartisan basis and do a comprehensive job seriously.

And, as I've tried to suggest this morning, I think comprehensive actually goes beyond Chairman Rostenkowski. And the only thing I would say is, if we did that we would still not have public confidence and respect unless the subsequent performance were consistent with what we promised.

Representative HAMILTON. Well, one of the things that makes it so difficult to put together a solution to the problem, it seems to me, is that once we put it together I'm not sure people are going to have any confidence in it because of this track record that I was referring to.

I have come to the view that this credibility problem is one that is very pervasive in government today. I agree with your observation that it probably began with Vietnam and Watergate and on noneconomic matters.

But, I may disagree at this point. My sense is that the sense of suspicion and cynicism and lack of public confidence and trust in politicians generally and those who work on behalf of the President and those who work on behalf of the Congress is very deep seated now principally because of the way we deal with the budget. That has become a major part of it.

The States complain a lot about mandates. They complain a lot about mandates without commensurate funding from the Federal Government.

How do you respond to that frequently heard criticism, particularly in view of the fact, for example, that your national transportation policy would shift a very major portion of highway funding, for example, to the States?

Mr. DARMAN. I think you have to be sympathetic to the States. Another area in which they have complained tends to run in the opposite direction of the sentiment in the Congress, for example, and that's Medicaid.

In the case of Medicaid, the Governors feel extremely strong that increased Federal benefits mandated upon the States, where the States have to pick up 50 percent of the burden, are unfair to the States. They are driven to tax increases in order to fund the preference of the Federal level.

And, so having asked for an increase for certain benefits to 130 percent of the poverty level in Medicaid last year and the Congress delivering 133 percent, we didn't go further this year in large measure in response to the Governors' request on that issue.

On transportation, it's a little bit different issue. There is a very big job to be done. And, the Federal contribution I believe will increase but the Federal share may not.

And, because the job ahead is very large, the burden on States and localities is going to be large, especially as we get beyond the completion of the Interstate System and on to the question of what's the continuing Federal role with respect to the Interstate Highway System which has the burden of——

Representative HAMILTON. Do you see that burden being picked up largely by the States?

Mr. DARMAN. No. I think that the Federal—of course, this has all got to be reviewed in the course of the hearings that are going on this year in reauthorization of the bill.

But, I express my personal view, which is that there will definitely have to be a continuing Federal role in the maintenance of the Interstate Highway System.

Representative HAMILTON. But, a declining role?

Mr. DARMAN. Well, here's the problem, sir.

Representative HAMILTON. Percentagewise anyway?

Mr. DARMAN. Yes, I think so for this reason, because something unanticipated has happened with the Interstate Highway System. And, that is that ring roads, which are technically part of the Interstate Highway System, have become the principal local transportation arteries.

And, the congestion problem on ring roads, which is enormous and bothers a whole lot of people—a lot of the studies show it's 70 percent local traffic. And, why people in a rural area of America should pay a high gasoline tax in order to reduce the congestion for—say, me, when I take my child to a basketball game 2 miles up the road but I take a 10-mile trip because it's faster, because I get on the interstate, why they should subsidize that is not clear to me.

So, I think we have to have a shift for this special problem of ring roads as part of the Interstate System where the localities would have to pay more.

Representative HAMILTON. You have 30 States now that are in the position of cutting spending and raising taxes to solve their budget problems. If you put this kind of a burden on them, you are going to be putting an enormous additional burden on States, particularly tax burdens.

Mr. DARMAN. Well, we don't know—we haven't decided what size the burden is. At least, I——

Representative HAMILTON. Yes, but it's going to be huge.

Mr. DARMAN. I think it's going to be manageable.

Representative HAMILTON. Both things can be true.

Mr. DARMAN. Yes, that's true. But, I—but, it's—OK, maybe we should leave it at that. It's certainly not going to be prohibitive.

Representative HAMILTON. On the Medicaid issue you mentioned a moment ago, now that really is a sensitive one. There are these service standards that the Federal Government, as I understand, mandates the States to fulfill.

But, there is no commensurate increase in funding when the costs go up. Can it be expected that Medicaid costs will continue to rise rapidly?

And, if so, are we going to be sharing any of that burden? Or, are the States going to have to pick that up, too?

Mr. DARMAN. Well, we do share the burden on average about 50 percent.

Representative HAMILTON. Yes.

Mr. DARMAN. But, unfortunately if we don't have a serious, as yet unsatisfactorily defined, reform of our health care system, health care costs are going to continue to rise faster than inflation and faster than the economy. And that, over the long term, is not sustainable for us or the States or anybody else.

I mean, somebody has to pay the costs somewhere, and it can't continue to grow at 2½ times the rate of growth of the economy, which is what has been happening.

Representative HAMILTON. What is the administration working on with regard to this problem of the uninsured on health care?

Mr. DARMAN. Well, we have, obviously, the report of the Pepper Commission now which, as you know, did not propose to finance; it just proposed to cover everybody essentially in the way that it's done in Massachusetts.

We have a task force within HHS that has its own options under review. We have a commission chaired by Deborah Steelman, but it's an outside commission, that is also looking at the same question.

I think it's scheduled to report in June. And, I think Secretary Sullivan is scheduled to have his review completed by October.

So, in the course of this year we will have done our own analysis, reviewed all the significant outside analyses, and have a more definitive position available.

Representative HAMILTON. Does that mean that you would anticipate by the end of this year or early next year that the administration would come forward with significant proposals in health care?

Mr. DARMAN. I shouldn't prejudge that.

Obviously, we all know that as a matter of public policy we would like to see increased coverage for the 30 million plus who are not now insured. But, we want to do that in a way that (*a*) is financed and (*b*) doesn't itself contribute to further acceleration in the cost of health care for everyone else.

And, that's a tough problem. Every time we have tried in the past with a massive expansion, as you know, we've started out with 5 years of failure and sometimes 25 years.

Representative HAMILTON. Well, Mr. Darman, we still have a large number of questions. You've been here a long time and have other things to do.

What I would like to do is submit some written questions to you.

Mr. DARMAN. Thank you very much, Mr. Chairman. I would be happy to respond.

Representative HAMILTON. And, I want you to go right back to the office and draft that letter to me. [Laughter.] Thank you very much for your testimony.

Mr. DARMAN. Thank you for having me.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

[The following written questions were posed to OMB Director Richard Darman by the committee, but he had not responded at the time the hearing went to press. His responses may be obtained from the committee when they are received.]

March 20, 1990

WRITTEN QUESTIONS POSED TO HON. RICHARD DARMAN

I. Budget Targets and Budget Process

A. You have noted the anomalies that could be created by scoring "extraordinary" RTC working capital as normal budget outlays (or offsetting receipts when the assets are sold). What would be your view of an amendment to the Gramm-Rudman deficit reduction law to exclude extraordinary working capital from the budget for purposes of the sequestration trigger? If it would be impossible to define extraordinary working capital unambiguously, what would be your view of excluding all RTC transactions except interest?

B. You have referred to the need for reform in budgeting of credit programs. What is your opinion of the Panetta proposal?

C. You suggested that one of your concerns about the Rostenkowski proposal is the possible adverse effects on financial markets of the proposed repeal of Gramm-Rudman. We understand that some financial analysts with major securities traders believe that serious likelihood of enactment of the Rostenkowski plan as a package would have a very favorable effect on bond prices, because of the direct and explicit deficit reduction called for. Would you comment, please?

II. FY1991 Budget: Economic Assumptions and Deficit Reduction Proposals

A. Administration officials have made a major point that their economic forecast and projections assume implementation of all of their policy proposals. Assuming that all of your proposals are implemented, how much of an effect could they have, realistically, on economic expansion and other developments in 1990 and early 1991?

B. Assuming that a major channel of this effect would be through interest rates, it seems reasonable to compare the interest rate assumptions used for the Budget with the expectations of analysts before the Budget was submitted (when forecasters may have been extrapolating a policy much like last year's, and when the capital market effects from Germany were not foreseen). Such a comparison with the Blue Chip January consensus shows that the Administration's forecast for short-term Treasury bill rates in 1991 is 1.8 percentage points lower than the consensus and for long-term rates is about one percentage point lower than the consensus. This difference seems to violate the well known rule of thumb frequently used in the mid-1980s by former Federal Reserve Chairman Paul Volcker -- that is, that $50 billion of deficit reduction would lower interest rates by one percentage point. The Administration's deficit reduction proposals do not reach the $50 billion level until 1993, and even then would be only about two-thirds as large relative to GNP as the Volcker target for achieving a one percentage point reduction in interest rates. How do you explain this discrepancy?

C. Achieving economic effects from the Administration's program quickly requires that the program be credible and the legislative portion quickly enacted. Yet you admit that some of the proposals are "politically difficult."

- How many of the deficit reducing measures in the budget have been proposed before? What is the dollar total for these proposals?

- Do you believe that there is any greater chance of success this year in achieving spending cuts and tax increases that have been proposed unsuccessfully many times before and have received support from neither party in the Congress -- the bipartisan nonstarters? If so, why?

- If not, what is the budget strategy behind making such proposals? Don't they reduce the credibility of deficit reduction in the minds of the public?

III. Federalism or "Buck Passing"?

A. The Budget notes "by almost any measure the extremes among the States have narrowed. Those concerned about the segments of our population who have been left behind need no longer turn to Washington as the only source of redress." However, in Connecticut, per capita personal income in 1988 was 140 percent of the U.S. average and in the District of Columbia it was 130 percent, while in Mississippi it was 67 percent and in West Virginia it was 71 percent. In view of these disparities, how realistic is it to expect State and local governments to pick up increasing burdens for social services and maintenance of infrastructure?

B. In the case of Medicaid, even a fixed matching rate with the federal government leaves states under increasing burdens because of the rapidly rising costs.

- Is it possible that future Medicare cost-containment efforts, like those of the past, will raise patients' costs through changes in cost-sharing? If so, should this be allowed to increase the Medicaid burden of States for elderly who are eligible for both programs (it would without specific legislation to reverse this effect)?

- Differences in State incomes that are allowed for in determining Medicaid matching rates do not fully reflect the relative burdens that exist owing to intra-State concentrations of poverty in some states and to geographical concentrations of AIDS victims. What should the federal government do about this problem?

C. In the case of transportation, the proposal to allow States to charge tolls and user fees on national highways can most reasonably assist urban areas with high local traffic congestion to finance an increased share of highway maintenance and construction. For other areas, it seems likely that maintenance of the interstate network with a larger state share of funding will merely substitute more state borrowing for more federal borrowing and, ultimately, higher state fuel taxes for higher federal taxes. Why is this efficient?

D. As a general matter, do you believe that State and local taxes have less adverse effects on incentives and economic growth than federal taxes? How do your views on this issue take into account the consequences of competition among States to attract business, and the effects on the Nation when people take their education and health status with them as they move around this mobile society?

IV. The Budget and Investment

A. You have indicated that a major problem of the 1980s was not the Federal Government deficits as such, but rather that they were not accompanied by increased investment in productive capacity to service them. Why were there not sustainable increases in investment -- other than increased foreign investment which, of course, requires payment of the profits or interest to other countries?

B. Are the President's budget proposals really adequate to solve this problem? Are the capital gains tax cut and Family Savings plan really likely to generate substantial net increases in National saving, adequate to finance higher investment at lower interest rates? Do you agree that higher saving and lower interest rates are necessary to achieve the income growth and deficit reduction that are projected in the President's budget?

C. The Budget contains an analysis of saving and investment, including public investment, that is a very important and commendable contribution to the dialogue about National priorities. It is disturbing, however, that growth of nondefense public investment, as implied in the table on page 39, merely keeps up with the GNP growth that you expect in the near term. Do you believe this is satisfactory? If you were to extend this table to cover the budget planning period, what growth rate (or ratio to GNP) of public nondefense investment in R&D, human capital and physical capital (excluding inventories) would be implied by the President's proposals?

D. Has the Administration done an overall saving and investment balance consistent with its budget and economic projections? What are the ratios to GNP of total private saving, and domestically financed private investment? How do these compare, on average, to those of the past three decades?

V. Fairness

A. In your comments on the CBO/Ways and Means study you suggested that the conclusions were significantly affected by the choice of base year. However, the tables in the Committee print show both 1977 and 1980 as alternative base years. From both of these years,

- the share of pre-tax income going to the highest quintile of families has risen while the share of income going to all other quintiles has fallen. Is this acceptable? Is this pattern likely to change? If so, why?

- the share of total federal taxes paid by the highest quintile of families has risen, in percentage points, by only slightly more than half as much as the rise in their share of income received. Is this acceptable? Is it deliberate, or desirable policy? If so, why?

B. Total Federal effective tax rates for the highest quintile of all families have fallen from either 1977 or 1980, while the effective federal tax rates for the second and third quintiles are up slightly.

- Is this acceptable? desirable?

- A frequently used defense for this pattern is the observation that the share of Social Security payroll taxes in total federal revenues is rising but the Social Security system as a whole (considering both benefits and taxes) is progressive. Is this defense valid when Social Security surpluses are being used to finance deficits in the rest of the budget?

C. You have stated that you would like to see a flattening in the trajectory of transfer payments as a percent of total budget outlays. How would you propose to accomplish this objective?

VI. Tax Policy

A. Capital gains tax cuts have a high priority in the President's policy agenda. It is argued that they would enhance long-term investment incentives, shifting the emphasis of investors away from quick turnover speculation. At the same time, it is claimed that "static" revenue estimates (assuming no increases in economic growth) show a revenue gain because of faster realization of accrued gains -- in some instances, realization of gains that would have been held until death. How do you explain this contradiction, with simultaneous assumptions of slower turnover of assets and more rapid turnover of assets?

B. It is argued that the Family Savings Accounts will add to net national saving -- that is, they will induce more private saving than they lose in revenue.

- Can the Administration explain why taxpayers who are still allowed fully deductible IRAs have apparently reduced their contributions? Does the Administration believe that the new, nondeductible plan will be more attractive to them? If not, who is expected to use the new accounts and why would their overall saving be affected?

- Is it possible that an education program reminding the bulk of taxpayers -- who are eligible -- about deductible IRAs would be more effective and much cheaper?

- Can the Administration justify the reintroduction of a saving incentive when saving rates declined over virtually the entire period of universal IRAs, and have increased since universal IRAs were restricted? How much additional net saving can reasonably be expected from the Family Savings Account, and how much of the shortfall of current savings relative to the average of the 1960s and the 1970s would that replace?

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