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S. Hrg. 101-1201

THE ECONOMIC OUTLOOK AT MIDYEAR

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

JULY 12, AUGUST 2, AND SEPTEMBER 19, 1990

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

38-140 WASHINGTON : 1991

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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[Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.]

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THE ECONOMIC OUTLOOK AT MIDYEAR

THURSDAY, JULY 12, 1990

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

The committee met, pursuant to notice, at 9:35 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Obey, and Wylie; and Senators Sarbanes and Mack.

Also present: Joseph J. Minarik, executive director; William Buechner, Susan Lepper, and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. This morning, the Joint Economic Committee begins a series of hearings to examine the economic and budget outlook at midyear.

Our first witness will be Robert Reischauer, Director of the Congressional Budget Office, who will discuss the CBO's latest economic and budget projections.

Mr. Reischauer will be followed by a panel of private economic forecasters—Allen Sinai, chief economist for the Boston Co., and Lawrence Kudlow, senior managing director and chief economist for Bear, Stearns & Co.—who will present their views on the economic outlook and the appropriate economic policies for the coming year.

The committee will continue these hearings on Thursday, August 2, when the Chairman of the Council of Economic Advisers, Michael Boskin, and his colleagues on the Council will testify on the administration's midyear forecast and its latest economic policy proposals.

Senator Mack has requested that his opening statement be placed in the hearing record. Without objection, it will be placed in the hearing record at this point.

[The written opening statement follows:]

WRITTEN OPENING STATEMENT OF SENATOR MACK

MR. CHAIRMAN, I'D LIKE TO JOIN IN WELCOMING THE WITNESSES BEFORE US TODAY.

THE PERFORMANCE OF THE ECONOMY IS OBVIOUSLY AN IMPORTANT INFLUENCE ON THE FEDERAL BUDGET. THOUGH THE CBO ECONOMIC FORECAST IS NOT CENTRAL TO THE BUDGET PROCESS UNDER GRAMM-RUDMAN, IT DOES PROVIDE ONE ESTIMATE OF HOW CHANGING ECONOMIC CONDITIONS MAY AFFECT THE BUDGET IN THE FUTURE.

THERE ARE ALSO POLICIES UNDER CONSIDERATION IN CONGRESS WHICH CAN AFFECT THE ECONOMY AND BUDGET. FOR EXAMPLE, A CUT IN THE CAPITAL GAINS TAX RATE WOULD IMPROVE THE INCENTIVES FOR ENTREPRENEURSHIP, RISK-TAKING, AND INVESTMENT. FURTHERMORE, IT WOULD RAISE FEDERAL REVENUES BOTH IN THE SHORT AND IN THE LONG RUN.

I WOULD LIKE TO TAKE THIS OPPORTUNITY TO NOTE THAT DR. SINAI WILL BE RELEASING A NEW STUDY LATER TODAY ON THE POSITIVE IMPACT OF THE CAPITAL GAINS TAX. HE DESERVES A LOT OF CREDIT FOR HIS PATHBREAKING WORK IN THIS AREA.

ANOTHER POLICY OPTION UNDER CONSIDERATION IS TO RAISE TAXES. THIS WOULD HAVE A NEGATIVE EFFECT ON THE ECONOMY, POSSIBLY CHOKING OFF THE LONGEST PEACETIME EXPANSION IN AMERICAN HISTORY. A TAX INCREASE WILL NOT ONLY UNDERMINE THE ECONOMY, BUT EVERY DOLLAR OF TAX INCREASE WILL ONLY ENCOURAGE MORE THAN A DOLLAR OF NEW CONGRESSIONAL SPENDING. EVEN NOW, AMIDST A SUPPOSED BUDGET CRISIS, CONGRESSIONAL SPENDING SPIRALS UPWARD.

WE HAVE THE OPPORTUNITY TO ADOPT POSITIVE POLICIES TO IMPROVE ECONOMIC CONDITIONS, OR DESTRUCTIVE POLICIES WHICH WILL HURT OUR ECONOMY. I HOPE CONGRESS MAKES THE RIGHT CHOICES IN THE MONTHS AHEAD.

Representative HAMILTON. We are very pleased to welcome Mr. Reischauer. We will turn to you now, sir, for your statement.

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. REISCHAUER. Thank you, Mr. Chairman. I am pleased to be here.

With your permission, I will submit my prepared statement for the record of the hearing and will confine any remarks to a brief summary of CBO's new economic forecast and our new baseline budget projections.

Representative HAMILTON. Without objection, your prepared statement will be entered into the record in full.

Mr. REISCHAUER. This new economic forecast and our baseline budget projections are elaborated in some detail in a report that CBO released yesterday, "The Economic and Budget Outlook: An Update."

Let me start by saying a few words about the assumptions that underlie our new economic forecast. At the request of the negotiators at the budget summit, CBO's new economic forecast is premised on an assumption that a significant multiyear deficit reduction package is enacted some time this year, precisely some time this summer.

We have assumed that this balanced deficit reduction package will reduce the baseline deficit by somewhere between $40 billion and $60 billion in 1991 and between $120 billion and $180 billion in fiscal year 1995.

A deficit reduction of this magnitude would tighten fiscal policy significantly. If nothing else were done, the cuts could reduce economic growth and possibly could push the economy into a recession.

However, the CBO forecast does not expect that the deficit cuts that we have assumed will push the economy into a recession because we expect interest rates and the dollar to fall. While government and consumer spending will be lower, this will be offset by higher investment spending and higher net exports.

Interest rates are expected to fall because the Federal Reserve is assumed to loosen monetary policy somewhat and because the budget deficit will be placing reduced pressure on credit markets. Furthermore, we have assumed that the deficit reduction package will be sufficiently credible to convince financial markets that long-term interest rates will fall.

Together, these factors are sufficient to offset the temporary weakening in economic growth that deficit reduction would otherwise imply.

Real GNP is expected to grow between 2 and 2½ percent in 1990 and 1991 in CBO's forecast. The unemployeent rate is projected to remain close to its 1989 average of 5.3 percent. Inflation rates should remain relatively steady over the forecast period.

There will be a modest pickup in the rate of inflation for 1990, of course, but that largely reflects the runup in prices that occurred during the first quarter of this year.

Short-term interest rates should fall from about 7.6 percent in 1990 to 6.9 percent in 1991, and long-term interest rates should fall from 8.5 percent in the current year to 7.8 percent in 1991.

For 1991, the CBO forecasts for real GNP, unemployment, and inflation are similar to those of other forecasters. The CBO interest rates for 1991 and lower than of most other forecasters.

This difference is largely attributable to the fact that we have assumed significant deficit reduction activity this year. It's worth noting that CBO's current forecast for 1991 is relatively close to the forecast that was released by the administration in late June.

This is significant because it means that the budget summit will not have to struggle over how to resolve large differences in economic assumptions, at least for the first year of the deficit reduction package.

I should note that a good deal of uncertainty surrounds CBO's new forecast. Financial markets may not view the package of deficit cuts as credible and long-term interest rates, therefore, may not fall enough to offset the contractionary effects of the cuts.

The Federal Reserve could do too little to stimulate growth, which could lead to a recession, or it could do too much, which could lead to a temporary increase in inflation.

Let me turn from the short-term outlook to our medium-term projections, which incorporate the economic benefits that should be reaped from the enactment of a large and credible multiyear deficit reduction package. These benefits include stronger economic growth, an improved balance of payment position, lower interest rates, and higher national wealth and future standards of living.

CBO's economic projections for the years 1992 through 1995 entail a pickup of economic growth to rates of about 2.6 percent a year. This is close to half a percentage point higher than would exist if we had no major deficit reduction package. These rates of growth are modestly higher than the rates that we have been projecting in the past when we have assumed a return to historical trends.

Long-term interest rates are projected to decline to about 7 percent by 1995, while the rate of inflation is projected to decline slightly, and unemployment rates are expected to remain about where they are now.

CBO's medium-term projections are not as optimistic as those of the administration's. While CBO is projecting a growth rate of around 2.6 percent, as I noted, the administration is projecting growth rates over the 1992 to 1995 period that are about half a percent point higher.

The administration also projects generally lower nominal interest rates. This reflects their different assumptions for inflation as well as their different expections about real interest rates.

The difference in the economic assumptions between CBO and the administration cause the estimates of these two agencies to differ with respect to the baseline budget deficit by almost $100 billion by 1995. So the importance of different economic assumptions for the outyears remains a very significant problem, even though this problem seems to have been resolved for fiscal year 1991.

Let me conclude by saying a few words about CBO's updated baseline budget projections. We now expect that the fiscal year

1990 deficit will total about $195 billion, which is $36 billion above the estimate that we released in early March and some $95 billion above the Gramm-Rudman-Hollings target for fiscal year 1990.

The major reason the deficit picture has worsened since March is that revenues are likely to fall some $23 billion short of our earlier estimate.

For 1991 and thereafter, the budgetary picture is complicated by the savings and loan bailout. It appears that RTC will exhaust the $50 billion that was provided to it through FIRREA some time early in fiscal year 1991.

Therefore, the RTC will need additional resources to close or subsidize the sale of the 700-odd insolvent institutions that will remain in its caseload after the end of this fiscal year.

CBO estimates that the additional RTC spending needs with the associated debt service cost will add some $68 billion to the deficit in 1991, $81 billion to the deficit in 1992, and $33 billion in 1993. Including this additional spending, the Federal deficit would reach $232 billion in 1991 and $239 billion in 1992 before slipping once again below $200 billion in 1993, the year which, under Gramm-Rudman-Hollings, we are supposed to have a balanced budget.

These deficit figures are obviously far above the Balanced Budget Act targets. If sequestration were applied to the $232 billion figure for the deficit that I gave for fiscal year 1991, the sequestration cuts would be of mind-boggling proportions.

Specifically, they would involve a 42-percent cut in defense programs and a 64-percent cut in nondefense programs. Clearly, Gramm-Rudman-Hollings will have to undergo some major surgery between now and the beginning of the next fiscal year.

Let me close with a word of caution. As dismal as these budget projections may be, they could prove to be too optimistic.

They are based, as I noted, on an economic forecast that assumes a significant multiyear deficit reduction package that is enacted some time this summer. If only a token amount of deficit reduction is enacted this year, the deficit for 1995 could be somewhere between $40 billion and $50 billion higher than the numbers that I have provided for you.

The concludes my statement. I will be happy to answer any questions.

[The prepared statement of Mr. Reischauer follows:]

PREPARED STATEMENT OF ROBERT D. REISCHAUER

Mr. Chairman, I am pleased to appear again before this Committee. In my statement I will summarize CBO's new economic forecast and baseline budget projections. These are elaborated in CBO's summer report, *The Economic and Budget Outlook: An Update*, which has just been released.

THE ECONOMIC FORECAST AND PROJECTIONS

Two major developments have affected the outlook for the economy since CBO's last forecast in January. First, interest rates have risen sharply, reflecting in large part financial developments abroad. Some of the events of the last six months have been breathtaking: the Germanys have become unified economically, and a new Europe is emerging. These events, together with tightening monetary policies abroad and extraordinary turbulence in the Japanese stock market, have contributed to a run-up in interest rates around the world. The second development is the possibility of large, multiyear cuts to the U.S. budget deficit arising from the current budget summit. Although the outcome of the budget summit is far from certain, such reductions to the deficit, if enacted, would make political history, and would help to reduce interest rates.

Nonetheless, the economic outlook is roughly as CBO expected. Growth has slowed from the 3 percent rate of early 1989 to about 2 percent. Inflation, abstracting from the temporary price rises in the first quarter, remains relatively steady. Although higher interest rates raise some concern that economic growth could slow further, the economy appears to be balanced between recessionary and inflationary pressures.

At the request of the negotiators at the budget summit, CBO has developed a new forecast that assumes significant cuts to the deficit. These cuts are big: $40 billion to $60 billion is eliminated from the baseline budget deficit in fiscal year 1991. And they get bigger: by 1995, they rise to $120 billion to $180 billion. The deficit reductions we have assumed are balanced between cuts in defense, entitlement, and nondefense discretionary spending and increases in personal and business taxes.

Such deficit reduction would tighten fiscal policy significantly. If nothing else happened, the cuts could reduce economic growth, possibly leading to a recession. Cutbacks in government purchases of goods and services reduce final demand for output, and higher taxes or lower transfer payments reduce the spending power of consumers. In the past, recessions have sometimes occurred soon after large deficit cuts, though in most cases other factors--such as tight monetary policy or sharp increases in the price of imported oil--contributed to the decline.

<u>The CBO Short-Term Forecast</u>

The CBO forecast, however, does not expect that deficit cuts will push the economy into a recession, because interest rates and the dollar are expected to fall. In turn, business investment will become more attractive and U.S. exports will become more competitive. By offsetting the lower spending by government and consumers, higher spending on investment and net exports will keep the economy growing at a modest pace.

Interest rates are expected to fall for two reasons. First, the Federal Reserve is assumed to meet the dramatic change in fiscal policy with some loosening of monetary policy. Second, cutting the budget deficit reduces pressure on credit markets substantially. Moreover, the deficit reduction package developed by the President and the Congress is assumed to be sufficiently credible to convince financial markets that long-term interest rates should fall. Together, these factors are sufficient to offset the temporary weakening in economic growth that deficit reduction would otherwise imply.

These assumptions are the driving forces behind the CBO short-term forecast (see Table 1). Real gross national product (GNP) is expected to grow between 2 percent and 2 1/2 percent in 1990 and 1991, while the rate

TABLE 1. COMPARISON OF CBO, ADMINISTRATION, AND *BLUE CHIP* ECONOMIC ASSUMPTIONS, CALENDAR YEARS 1990-1995

	1990	1991	1992	1993	1994	1995
Real GNP (Percentage change, year over year)						
CBO Summer	2.0	2.5	2.6	2.6	2.6	2.6
Administration June	2.0	2.8	3.2	3.2	3.1	3.0
Blue Chip	1.9	2.3	2.8	2.7	2.4	2.6
CBO Winter	1.7	2.4	2.5	2.5	2.4	2.4
Implicit GNP Deflator (Percentage change, year over year)						
CBO Summer	4.1	4.0	3.9	3.8	3.8	3.8
Administration June	4.2	4.2	4.0	3.7	3.4	3.1
Blue Chip	4.2	4.1	3.8	3.9	3.8	3.8
CBO Winter	4.0	4.0	4.0	4.0	4.0	4.0
Consumer Price Index[a] (Percentage change, year over year)						
CBO Summer	4.8	4.2	4.2	4.0	4.0	4.0
Administration June	4.8	4.1	4.0	3.7	3.4	3.0
Blue Chip	4.8	4.3	4.0	4.1	4.0	4.0
CBO Winter	4.0	4.3	4.3	4.3	4.3	4.3
Unemployment Rate[b]						
CBO Summer	5.3	5.4	5.4	5.5	5.5	5.5
Administration June	5.4	5.6	5.5	5.4	5.3	5.2
Blue Chip	5.4	5.5	5.6	5.5	5.4	5.3
CBO Winter	5.6	5.5	5.5	5.5	5.5	5.5
Three-Month Treasury Bill Rate (Percent)						
CBO Summer	7.6	6.9	6.7	6.2	5.6	5.4
Administration June	7.7	6.8	5.8	5.1	4.8	4.4
Blue Chip	7.7	7.5	7.0	7.0	6.9	6.7
CBO Winter	6.9	7.2	6.9	6.5	6.1	5.8
Ten-Year Government Note Rate (Percent)						
CBO Summer	8.5	7.8	7.4	7.2	6.9	6.8
Administration June	8.5	7.9	7.0	6.1	5.8	5.4
Blue Chip[c]	8.5	8.3	8.0	7.8	7.8	7.8
CBO Winter	7.8	7.7	7.6	7.5	7.4	7.3

SOURCES: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators.*

NOTE: The *Blue Chip* forecasts through 1991 are based on a survey of 50 private forecasters, published on June 11, 1990. The *Blue Chip* projections from 1992 through 1995 are based on a survey of 41 forecasters, published on March 10, 1990.

a. Consumer price index for all urban consumers (CPI-U) for CBO and the *Blue Chip*; consumer price index for urban wage earners and clerical workers (CPI-W) for the Administration.

b. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

c. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year government notes.

of unemployment is projected to remain close to its 1989 average of 5.3 percent. Inflation rates remain relatively steady over the forecast; the modest pickup in the rate of inflation in 1990 largely reflects the run-up in prices during the first quarter. Short-term interest rates fall from 7.6 percent in 1990 to 6.9 percent in 1991, and long-term interest rates fall from 8.5 percent in 1990 to 7.8 percent in 1991.

Comparison with Other Forecasts. The CBO forecasts for real GNP, unemployment, and inflation in 1991 are similar to those of other forecasters. But the CBO forecast for interest rates in 1991 is not, largely because of the assumed deficit cuts. Interest rates in the CBO forecast are considerably lower than what CBO predicted in January and what the *Blue Chip* survey is predicting now. But neither the earlier CBO forecast nor the *Blue Chip* forecasts assumed such large cuts to the deficit. In contrast, the CBO forecast is relatively close to the Administration's summer forecast, which also assumes significant deficit reduction.

The Risks to the Forecast. The current CBO forecast carries a substantial amount of uncertainty. Financial markets may not view the package of deficit cuts as credible, and long-term interest rates may not fall enough to offset the contractionary effect of the cuts. The Federal Reserve could do too little to stimulate growth, which could lead to a recession, or too much, which could lead to temporarily higher inflation.

But the current state of the economy appears strong enough to withstand such budget cuts, and the rate of inflation appears relatively stable. Statistical indicators do not suggest that the probability of recession is high, and CBO expects that to the extent that deficit reduction is anticipated and incorporated into private decisions, the risk of a recession can be reduced. Furthermore, the monetary stimulus assumed in the forecast is not so large as to raise the risk of higher inflation by much: the growth of M2 remains within the target range set by the Federal Reserve for 1990, and its growth slows to a moderate pace in 1991.

<u>The Role of Credibility</u>. The assumption that the deficit reduction package is credible, and that its effects are anticipated by financial markets, is crucial to the economic forecast and projections. Economic theory suggests that while large unanticipated cuts in the deficit could reduce growth in the short run, such a slowdown can be attenuated if the deficit cuts are fully anticipated and incorporated into private decisions.

Developing a credible package of deficit cuts obviously requires more than simply revising or restating deficit targets. It requires a package that specifies not only the policies required to cut next year's deficit, but also the additional policy changes required to keep the deficit on a steep downward path in subsequent years. Accounting changes or one-time savings would not affect expectations about the course of deficits. Only if the budget agreement involves substantive and permanent changes in policy could such changes be realized. Bipartisan cooperation is clearly essential to the process in order to reassure financial markets that the major issues in budget policy that have divided the nation for the past decade are settled and are unlikely to be revisited in the near future.

A substantial delay in the enactment of the budget legislation would make the Federal Reserve's task more difficult. If the legislation to cut the deficit in fiscal year 1991 is not passed until a lame-duck session of Congress at the end of 1990, the Federal Reserve would most likely be unable to begin its monetary relaxation in time to offset the fiscal contraction fully.

The CBO Medium-Term Projections

CBO projects that enactment of a large and credible multiyear deficit reduction package will bring substantial economic benefits in the medium term. These benefits include stronger economic growth, a lower deficit in the balance of payments, lower interest rates, and higher national wealth and future standards of living. CBO's economic projections for the years 1992 through 1995 entail a pickup of economic growth to rates of 2.6 percent a year--modestly above the growth rates that had previously been projected on the basis of historical trends alone. Long-term interest rates are projected to decline to about 7 percent by 1995, while the rate of inflation is projected to decline slightly, and unemployment is expected to remain near current rates.

Methodology of Medium-Term Projections. CBO does not try to forecast short-term fluctuations in the economy more than two years into the future. Beyond that point, only trends of the major economic variables are projected. The current projection differs from those in the past, however, because it embodies estimates of how much the trends would be affected by significant reductions in the deficit.

The medium-term projection of real GNP uses an economic growth model that incorporates the effects of federal deficits, rates of private saving, rates of growth in labor input, and rates of technological progress. Economic growth picks up in the medium term largely because of higher rates of national saving--arising from cuts to the deficit as well as increases in private saving. The growth in the labor force is assumed to follow the Bureau of

Labor Statistics' midrange projections, and technological progress is assumed to proceed at its average rate since 1960.

The projected decline in long-term interest rates between 1991 and 1995 has been guided by treating as historical norms the real interest rates and increases in national wealth that existed during the 1960s. During that decade, real long-term interest rates averaged about 2.3 percent, while about 7.3 percent of real GNP was devoted to increases in wealth. CBO projects that deficit reduction will raise the growth of national wealth in the 1990s toward the rate that existed during the 1960s. As a result, CBO projects that the real long-term interest rate will also move toward its rate of the 1960s by about the same proportion.

It is not easy to find a similarly compelling norm for the yield spread between short-term and long-term interest rates. In the 1960s, the yield spread averaged about 70 basis points. For a number of reasons, however, it has rarely been so low in the 1980s. In the CBO projections, the spread is assumed to average almost one and one-half percentage points. This spread is equal to the average experienced since the early 1970s, when exchange rate controls were dismantled and U.S. interest rates became more clearly linked with those of other nations.

Comparison with the Administration's Projections. Over the 1992-1995 period, CBO projects that the economy will grow at a 2.6 percent rate, while the Administration projects a growth rate of slightly more than 3 percent. The Administration's growth rate projections primarily reflect a more optimistic view of the likely growth of labor productivity. The Administration also projects generally lower short-term and long-term nominal interest rates than does CBO, reflecting different assumptions for inflation as well as real interest rates. Since both the Administration and CBO assume fiscal policies that substantially reduce the deficit, the Administration's lower projections apparently reflect different views of the other factors that determine interest rates. Together, these differences in economic assumptions cause the Administration's and CBO's estimates of the 1995 budget deficit to differ by almost $100 billion.

THE BUDGET OUTLOOK

CBO has updated its baseline budget projections to reflect its new economic assumptions and other recent developments (see Table 2). We now expect that the fiscal year 1990 deficit will total $195 billion, which is $36 billion above the estimate that we released in early March. The major reason the deficit picture has worsened is that revenues are likely to fall $23 billion short of our earlier estimate. In relation to the size of the economy, the deficit is

TABLE 2. CBO BASELINE, REVENUES, OUTLAYS, AND DEFICIT (By fiscal year)

	1990	1991	1992	1993	1994	1995
	In Billions of Dollars					
Baseline Revenues	1,044	1,123	1,188	1,260	1,337	1,417
Baseline Outlays	1,238	1,287	1,346	1,422	1,496	1,559
Baseline Deficit	195	164	158	162	160	142
Additional RTC Spending Needs[a]	0	68	81	33	-13	-3
Baseline Deficit with Additional RTC[a]	195	232	239	194	146	138
	As a Percentage of GNP					
Baseline Revenues	19.1	19.3	19.1	19.0	19.0	18.9
Baseline Outlays	22.6	22.1	21.7	21.5	21.2	20.7
Baseline Deficit	3.6	2.8	2.5	2.4	2.3	1.9
Baseline Deficit with Additional RTC[a]	3.6	4.0	3.8	2.9	2.1	1.8
Reference: GNP (In billions of dollars)	5,472	5,832	6,215	6,620	7,053	7,514

SOURCE: Congressional Budget Office.

NOTE: The budget figures include Social Security, which is off-budget but is counted for purposes of the Balanced Budget Act targets. For comparability with the targets, the projections exclude the Postal Service, which is also off-budget.

a. Includes debt service costs resulting from additional Resolution Trust Corporation (RTC) spending.

projected to rise from 2.9 percent of GNP in 1989 to 3.6 percent of GNP in 1990.

For 1991 and thereafter, the budgetary picture is complicated by the savings and loan bailout. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provided the Resolution Trust Corporation (RTC) with $50 billion to close or subsidize the sale of hundreds of insolvent thrift institutions. The $50 billion was intended to pay for deposit insurance losses that would never be recovered. It now appears, however, that RTC will exhaust its $50 billion early in fiscal year 1991. If RTC were actually allowed to run out of money, the baseline deficit would fall to $164 billion in 1991 and remain near $160 billion through 1994. In that event, however, almost 700 insolvent thrifts would be left unresolved.

Clearly, RTC must be given more resources. CBO estimates that additional RTC spending needs, with associated debt service costs, would add $68 billion to the deficit in 1991, $81 billion in 1992, and $33 billion in 1993. Including the additional spending needs of the RTC, the federal deficit would reach $232 billion in 1991 and $239 billion in 1992, before slipping under $200 billion again in 1993. These deficit figures are far above the Balanced Budget Act targets of $64 billion in 1991, $28 billion in 1992, and zero in 1993.

If sequestration were to apply to the 1991 deficit estimates shown in Table 2, the cuts would boggle the mind. Excluding the additional RTC spending from the calculation, defense would be cut by 25 percent, and nondefense programs would be slashed by 38 percent. Including RTC's spending needs, the required cuts would be 42 percent for defense and 64 percent for nondefense programs.

Let me close with a word of caution. As dismal as these budget projections may be, they could prove to be optimistic. They are based on an economic forecast that assumes that a significant, multiyear deficit reduction package is enacted soon. If only a token amount of deficit reduction is enacted each year, the 1995 deficit could be $40 billion to $50 billion higher than these estimates suggest.

Representative HAMILTON. OK, Mr. Reischauer, thank you very much.

I wanted to first get clear on these deficit projections. Your 1990 deficit is $195 billion, 1991 is $232 billion, 1992 is $239 billion, 1993 is $194 billion, 1994 is $146 billion, 1995 is $138 billion.

Do those projections assume the enactment of a credible deficit reduction package along the lines that you began your testimony on, of $40 to $60 billion?

Mr. REISCHAUER. The economic projection which underlies those estimates does assume that. The actual deficit reduction amounts are not included in these numbers.

So, if we had a $50 billion deficit reduction package in 1991, you would subtract that from the $232 billion number for 1991 that you just read. If the deficit reduction package grew to $150 billion in the fifth year, by 1995, you would subtract $150 billion from the $138 billion deficit estimate that you read.

So we would have a surplus of $12 billion in the final year. These numbers assume, as I said in my oral statement, that Congress enacts legislation providing RTC with substantial amounts of new resources some time before the beginning of the next fiscal year.

Otherwise, RTC basically grinds to a halt some time in the early part of the fiscal year, although the S&L problem is still left festering.

Representative HAMILTON. Is the RTC problem included in these deficit projection figures?

Mr. REISCHAUER. Yes.

Representative HAMILTON. OK.

Mr. REISCHAUER. We have added those in because we believe that deposit insurance is a mandatory spending item that we, as a nation, cannot avoid. If we delay resolving the problem, we only increase the longrun costs which the American taxpayers will be facing.

Representative HAMILTON. Now, many economists are arguing that this deficit reduction package of $50 billion or so will, in fact, bring on or precipitate a recession. You specifically say just the opposite.

How do you respond to the view that the reduction would precipitate a recession?

As I recall your testimony, you said it's going to bring about growth and improvement in the balance of payments, a higher standard of living, and lower interest rates. That's euphoria. You are right there with all those predictions.

Mr. REISCHAUER. Well, as you know, we have——

Representative HAMILTON. So, on the one hand, we have these economists telling us there will be a recession. On the other hand, we have you saying we are approaching paradise.

Now, how do you argue these things?

Mr. REISCHAUER. CBO is not an institution that has been known for its unbridled optimism, as you know.

Representative HAMILTON. Yes.

Mr. REISCHAUER. The proper way to address that question is to distinguish between the shortrun and longrun effects. Sharp fiscal contraction could push an economy that is growing very slowly, as the American economy is now, into a recession in the short run.

In the long run, however, deficit reduction will lead to significant increases in growth, in living standards, in national savings, and in investment.

But, how do you get to paradise without going through hell first? If a deficit reduction package is enacted early—not in a lameduck session but something this summer—affected individuals, businesses, and institutions in America will have some warning that this fiscal contraction is going to occur, and the Federal Reserve will have some time to react. Then, the Federal Reserve can ease monetary policy sufficiently, while remaining within its current growth targets for the money supply, to offset that contraction.

This also requires participants in private financial markets to look at this package and say, "Yes, it involves substantial changes in tax laws, substantial changes in entitlement programs. It looks like it is real, it's permanent. It won't be overturned by future actions of the Congress.

"National savings is going to increase. Interest rates are likely to fall." And then we will have a tapering off of real long-term interest rates.

On the one hand, we are constraining the consumer and reducing government expenditures. That is clearly contractionary.

On the other hand, lower interest rates will spur investment and also will lead to a weakening of the dollar, which should spur net exports. Under CBO's scenario these forces will balance out.

Representative HAMILTON. Your testimony is that a $50 billion package of tax increases and spending cuts or some kind of a mix will not cause a recession either this year or next. And, your testimony is that that is the broadly supported position of economists?

Mr. REISCHAUER. I think the right way to phrase this is to say that it need not cause a recession if the Federal Reserve reacts to this package.

Representative HAMILTON. And, if they do not react?

Mr. REISCHAUER. It may not, that's true.

Representative HAMILTON. If they do not react, what happens?

Mr. REISCHAUER. The package may be such that financial markets don't view it as particularly credible. And, that could stall things out.

Representative HAMILTON. So, the package has to be credible?

Mr. REISCHAUER. It has to be credible.

Representative HAMILTON. What does credible mean in this context? Credible to whom?

We don't have any credibility with the American people in reducing deficits. Let's assume that the negotiators announce a package. They are bound to announce a package down the road here. And, they are bound to say it's successful. They are bound to say that, "Our goals have been achieved." We have been saying that for 10 years.

The American people out here have no more reason to think the package in 1990 is going to be any more effective than it was in the past 10 years. So, what does credibility mean in this circumstance?

Mr. REISCHAUER. OK. The announcement means very little, given the track record of the past that you have just pointed out.

Legislation has to be passed that raises taxes, changes authorizing legislation, or changes entitlement programs in such a way as to reduce the Government deficit. And, it has to be perceived as being permanent, in the sense that other legislation would have to be enacted, which a President could veto, to undo these tax increases or these spending cuts.

Setting out targets doesn't really do very much. Making promises to hold down discretionary spending in the future doesn't do a whole lot. What really matters is changing the fundamental legislation.

Representative HAMILTON. So, it's performance?

Mr. REISCHAUER. It's performance, absolutely.

Representative HAMILTON. The judge of performance initially will be what? The financial markets?

Mr. REISCHAUER. And the Federal Reserve.

Representative HAMILTON. And the Federal Reserve.

Mr. REISCHAUER. Though I think you will have some early indication of performance by how much howling you hear from your constituents.

Representative HAMILTON. How much pain?

Mr. REISCHAUER. How much pain, yes. We have enacted, as you know, deficit reduction packages in the past that have had a nice big sticker price on them. But, in fact, nobody felt they had been stuck. And, there wasn't much pain inflicted.

Representative HAMILTON. What about the composition of this package? Does that make a lot of difference, whether it's one-third tax increase and two-thirds spending cuts or vice versa?

Mr. REISCHAUER. I think that's a secondary——

Representative HAMILTON. It's a secondary issue.

Mr. REISCHAUER. It's a secondary issue.

Representative HAMILTON. The major thing is the overall impact?

Mr. REISCHAUER. The major thing is the overall impact. What we have assumed is a balanced package.

Representative HAMILTON. One to one?

Mr. REISCHAUER. Well, we are purposely vague on that and have been asked to be by the summiteers. Having sat through the sessions of the summit—the interminable sessions of the summit, I might add—I think there is no question at all that what will come out of that group will be balanced.

It will involve cuts in government purchases, reductions in transfers, increased revenues, and increased fees. And, so I don't think we need to ask ourselves, "What would happen if it relied 90 percent on revenues or 90 percent on spending cuts," because that just isn't in the cards.

Representative HAMILTON. Well, I have a lot of questions for you, Mr. Reischauer. First, I will turn to my colleagues.

Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman. I am pleased to welcome you to the panel this morning, Mr. Reischauer.

I have an opening statement, which expresses my own view, and I might like your comment on that. I understand that you have to be discreet as to how the budget summit package or the summiteers are shaping up as far as their proposals are concerned.

But, my opening statement would be an observation along these lines, which I would like for you to comment on when I finish, and you can see where I am coming from, I think.

The economic outlook is a major influence on budget trends and budget policy. The current economic slowdown makes the economy especially vulnerable to policy errors.

And, I personally feel that one such error would be the imposition of higher taxes on the struggling American economy.

The Federal Treasury is already collecting more revenue than ever before. In 1991, Federal revenues are projected to exceed $1.1 trillion. Another $300 billion is expected to be added to this revenue base by 1995.

Under current law, revenues are projected to rise an average of $75 billion annually during the first half of this decade.

Instead of relying on tax increases, we need to restrain Federal spending growth. Federal spending will continue to generate budget problems as long as its growth is not kept well within the bounds of projected revenues.

The economy may well be at a turning point. Employment growth is weak. Investment is slowing. And, business profits are down.

And, we must be careful not to adopt any policy initiative which runs the risk of undercutting the economy and making the deficit even larger than it already is. And, that is what I think might happen if we do impose higher taxes.

Do you care to comment?

Mr. REISCHAUER. I think the most important thing is to bring down the deficit for the longrun health of the economy. And, it's a secondary issue whether that is achieved through higher taxes, lower spending, or a combination of both.

The division is really more a matter of politics than anything else, as you are well aware. There will be an attempt, and I think a successful attempt, to restrain spending growth.

But, at the same time, there are, as you know, emerging priorities that the administration is interested in as well as various Members of the Congress. We obviously can engage in types of tax increases that might be detrimental to growth. We can engage in types of spending cutbacks also that would be detrimental to growth.

Our longrun objective, of course, is to improve growth in living standards in the future. So, it would be stupid in the short run to shoot ourselves in the foot by adopting those specific types of policies that would be detrimental to growth.

And, I think the people involved in the summit are very much aware of those concerns.

Representative WYLIE. That's a pretty good answer. I still didn't get too much indication as to the shape or manner of the package. But, that comes pretty close to——

Mr. REISCHAUER. Yes, it was a good answer. [Laughter.]

Representative WYLIE. In your statement, you emphasize that sequestration in the amount needed to cover the 1991 deficit would boggle the mind. Would you find tax increases of a similar magnitude mind boggling?

Do you think that budget policy will be determined by the 1991 deficit level or by some other lesser amount?

Mr. REISCHAUER. No. We will not engage in deficit reduction of $100 billion or $150 billion.

That would be really unwise, not only for the economy but programmatically, too. For managers and recipients of various government programs, it would be extremely disruptive.

The President announced near the beginning of the summit that he thought deficit reduction on the order of magnitude of 1 percent of GNP in 1991 was appropriate. The participants in the summit have focused on that amount, meaning somewhere between $50 billion and $60 billion in the first year.

Let me just say, even that—which is less than half of what would be required under the Gramm-Rudman procedures—would be a monumental achievement.

If you look at the permanent deficit reduction that has been achieved by the various efforts of the Congress and the administration over the last few years, the largest first-year number we have ever achieved in the form of permanent deficit reduction, as opposed to one-time savings or gimmicks, is $25 billion. So, the $50 billion goal is twice the maximum.

The maximum was achieved after financial markets collapsed by 23 percent in 1987. So, we had an impetus then that we hope we will not have this year.

If one looks at the record for last year, where we started out with an executive-congressional summit that promised a savings of somewhere around $28 billion, the bottom line for permanent deficit reduction from all the actions that were taken for fiscal year 1990 was $2 billion. So, we are talking about achieving something that is 25 times larger than what was achieved last year.

Representative WYLIE. In your opinion, how important is a summit agreement?

Mr. REISCHAUER. I think it's extremely important. We have climbed out on a limb now, and a lot is at stake here—credibility, for one. Both the executive branch and the congressional budget leaders have created expectations that something will be done. If we walk away from this and say, "No, we can't do it," we face a big void.

What do we do then? We have a Gramm-Rudman law. The cuts required by the Gramm-Rudman law are clearly too large for the economy to sustain. They are also too large to get around through gimmicks, one-shot devices, or phoniness.

So, we are really between a rock and a hard place here. Some major change has to take place in budget policy between now and the end of October.

Representative WYLIE. By the end of October?

Mr. REISCHAUER. And, we will be signaling markets. If we climb up to the summit and then decide, "Well, we really can't take the difficult steps," we will be sending a message to the world that the budget deficit in the United States is not going to be reduced over the next few years.

We are going to continue to absorb capital from the rest of the world. Real interest rates are going to remain relatively high.

Representative WYLIE. I think a budget summit agreement could have a strong psychological, positive effect on our economy, too. I agree with that.

What is CBO's view of the revenue impact of a capital gains cut? I think maybe you have been quoted as saying that you feel it might be a revenue loser.

Is that accurate?

Mr. REISCHAUER. That is true. The revenue estimates that we use are, by law, done by the Joint Tax Committee. They believe that it will be a revenue gainer in the first year and then lose small amounts of money in the ensuing years, and our own analyses support that position.

Representative WYLIE. OK. The so-called Fed fund rate has fallen from 8.58 percent earlier this month to around 8 percent just this week. Do you feel the Fed can be counted on to ease monetary policy if fiscal policy becomes more deflationary?

Mr. REISCHAUER. That is certainly our assumption and our hope. I wouldn't want to——

Representative WYLIE. You wouldn't want to speculate as to what the Federal Reserve might do?

Mr. REISCHAUER [continuing]. Speculate.

Representative WYLIE. OK. All right.

Mr. REISCHAUER. Well, I will speculate.

Representative WYLIE. Good.

Mr. REISCHAUER. The Fed is obviously interested in bringing down inflation. The inflation rate that we have now is somewhere between 4 and 5 percent. It is higher than we should want over the long run. However, if we manage to achieve a major deficit reduction package, I think that the Fed would want to reward that behavior by having monetary policy do what it can to sustain economic growth. It would be a terrible lesson for this country—for the folks in Des Moines or Peoria—if finally the Congress and the administration got together and took the difficult step of significantly reducing the deficit and then the economy went into the tank, unemployment rose, and we had a recession. I think everybody would want to avoid that possibility.

Representative WYLIE. Thank you for your speculation. That is a fascinating answer. I appreciate it.

Thank you, Mr. Chairman.

Representative HAMILTON. Senator Mack.

Senator MACK. Thank you, Mr. Chairman. Mr. Reischauer, welcome.

Mr. REISCHAUER. Thank you.

Senator MACK. You mentioned October 1987. I remember that date, October 19, 1987, really kind of from two points of view.

Believe it or not, I was making the announcement in Florida that I was running for the U.S. Senate on that date.

Mr. REISCHAUER. I've heard some people speculate that that was the cause. [Laughter.]

Senator MACK. I had been actually carrying that weight around for the last several years until yesterday. We had a meeting of the Senate Banking Committee in which there was discussion about stock index futures. And, I found out from one of the individuals testifying yesterday that I needn't worry anymore, that really it was the failure to control the margin on stock index futures that caused the market to crash.

But, the reason that I start with that date is because I really want to kind of raise this question with you as to whether there really is any hope that there is going to be a meaningful budget deficit plan put together because, as you recall, from the discussions after October 19, 1987, Washington was just awash with the words and the ideas of a $60 to $70 billion deficit reduction plan, which came down on the surface $30 billion. I think you mentioned $25 billion in real deficit reduction. I would argue that it was a lot less than that when you look at the different aspects of it.

Mr. REISCHAUER. Well, it was a 2-year plan. The second year, shall we say, evaporated.

Senator MACK. Yes. OK. So, we are really saying that not much was done in 1987. And, I think most people agree with that.

What gives you the feeling now that something—I mean, what we have is a situation of impending doom. That is what has been implied, I think, by the people who say that we have to have this. If we don't, then the economy is about to go off the cliff. And, so, therefore, it's important for us to act.

Two years ago, what we had was——

Mr. REISCHAUER. An economy off the cliff.

Senator MACK. Well, at least a market off the cliff.

Mr. REISCHAUER. Right.

Senator MACK. And, we didn't act then. What makes you think it is going to happen now?

Mr. REISCHAUER. That's a good question. The answer is twofold. I think there is a different attitude on the part of the administration.

I am certainly not here predicting success or failure for this summit. There has been, I think, a very constructive 2-week period for the negotiators in which there has been a lot of serious discussion. Proposals have been put forward. There hasn't been partisan wrangling.

And, it would lead a person involved to be modestly optimistic. On the one hand, as you note, if one looks at the record of the past, one has to be still somewhat cynical and pessimistic.

But, on the other hand—and I think this is different from 1987—there does appear to be a genuine interest in major deficit reduction on the part of the administration.

We've had 2 more years of experience on the part of the congressional negotiators. I think everybody is sick to death of this problem.

The deficit has constrained the activity of the Congress and the ability of the Congress to address emerging needs. It has infected the debate on almost every issue.

Before one even gets to the merits of a program or a policy that is being suggested, you have to answer the question, "How are you going to pay for it?" Or, "What does it cost?"

This has affected the response of the Congress. So, I get a feeling that there is genuine desire on the part of everybody involved in this summit to resolve this issue once and for all.

Senator MACK. OK. I want to talk a moment or two about the tax——

Mr. REISCHAUER. Could I just add one more thing?

Senator MACK. Sure.

Mr. REISCHAUER. I think the real difficulty faced by the negotiators is that the economy isn't off the cliff nor is there an expectation that, if nothing is done, it will fall off the cliff. We seem to have developed the driving skills necessary to drive right along the rim. Sometimes a wheel gets over to the edge and the car gets a little rocky, but then we get back on.

Unfortunately, we can probably manage with high real interest rates, relatively slow economic growth, and higher inflation than we would like for a number of years. The damage that is being done is slow, insidious, and will be visited in large part upon our children and grandchildren.

Senator MACK. That suggests, I think, that the—the analogy that you used suggests that what we end up doing is the—choices that we end up making are rather significant as to how they would impact economic activity. So, I would like to focus just a couple of minutes on the tax side of this.

In one of the responses to Congressman Wylie's question, I kind of got the impression that the decision about whether we do taxes or we do spending is really a political issue. And, I would suggest that you probably meant more than that.

I mean, clearly, the choices that we make about taxing or spending is more than political. It would have an economic consequence if we make the wrong choice.

I think you did imply this, if we make the wrong choice. And, again, let me stick with the taxing side for a minute. That could have a negative impact on the economy, the types of choices that we would make.

I think you then went further to say that there are some taxes that would have an impact on growth. I wonder if you would indicate to us the areas where you have concern?

Mr. REISCHAUER. Well, I don't want to be too specific about this. So, I'm going to be more general than you would like.

If we are raising a fixed amount of revenue, it's generally better to spread that increase out through broad-based taxes than to narrow in on specific sectors or segments of society and smack them with huge increases in taxes.

Senator MACK. Are there some tax changes that we could make that would increase the level of economic activity?

Mr. REISCHAUER. We could get into a debate on the desirability of broad-based consumption taxes. If we, as a nation, relied more heavily on broad-based consumption taxes, it is likely that there would be marginally higher savings in this country, higher investment, and stronger growth.

Senator MACK. Let me switch to capital gains for a minute, which I guess you probably figured I was going to get there.

Mr. REISCHAUER. I suspected it.

Senator MACK. Do you believe—let me go back to one other comment that you made, again, with respect to a question that Congressman Wylie raised. The implication that you gave in your response about capital gains was, "Having to use the figures from the Joint Tax Committee, this is the conclusion that I have come to."

Do you disagree with——

Mr. REISCHAUER. No. I'm sorry if I left you with that impression. I said that the numbers that CBO includes in our deficit reduction book, in our estimates that we provide to the Congress by law, are those of the Joint Tax Committee.

We also have done our own independent estimates, which are virtually identical.

You have to remember that the Joint Tax Committee relies on us for certain economic inputs, like realizations of capital gains and levels of GNP for its revenue estimates.

Senator MACK. The interesting thing about the debate on capital gains and whether it is going to produce revenues or whether it's not is how similar it sounds to the debate that took place in 1977. I remember reading from testimony, Secretary Blumenthal indicating that if there were a reduction in the capital gains rate in 1977 that there would be a loss of revenue to the Federal Government as a result of that. I think he estimated something like a 25-percent drop in the capital gains revenue.

Again, when you go back and look at what happened since 1977, you just see a steady increase in the revenues to the Federal Government. I think a lot of that has to do with the fact that capital gains is a voluntary tax.

If you think the tax rate is too high relative to other taxes, if you think that your return on the investment is not significant enough to sell the assets, you don't sell the asset. And, if you don't sell it, I don't care what the tax rate is, there isn't any income to the Federal Government.

So, it seems like there are many people out there that use kind of the static approach to making their forecasts. It's very difficult for me to look at the evidence anyway and come to the conclusion and agree with your conclusion that there would be no increase to the Federal Government in the revenues.

Mr. REISCHAUER. Remember, when you give a preferential rate to capital gains, people then try to transform ordinary income into capital gains.

Senator MACK. What you are suggesting there is a loss of revenue then in other parts of——

Mr. REISCHAUER. In other parts, yes. So, it's not an easy thing to disentangle.

One thing worth noting is that both the gain expected by the administration in the outyears and the loss predicted by the Congressional Budget Office, the Joint Tax Committee, and the vast majority of private economists are relatively small.

We are talking about several billion dollars. We aren't talking about losses or gains of $20 billion or $30 billion.

Senator MACK. I am aware of at least a couple of studies out there that indicate that $30 billion to $40 billion over a 5-year period——

Mr. REISCHAUER. You are talking about the sum over a longer period of time. I am talking about an individual year.

We are facing a budget deficit of $232 billion in 1991 and one of $138 billion in 1995. The administration is saying that a reduction in capital gains taxation might increase revenues by a couple of billion dollars in 1995, and the Joint Tax Committee is saying it might lower numbers by a couple of billion dollars.

Neither of those numbers is going to get you appreciably closer or further away from a balanced budget.

Senator MACK. Let me just ask you one more question with respect to the capital gains issue. Do you sense that there is any relationship between a lower capital gains rate and the formation of capital?

In other words, do you think that the lower capital gains rate would increase the accumulation of capital for investment in the country?

Mr. REISCHAUER. Marginally. Several econometric studies suggest that the answer might be yes. But, we are talking about very tiny changes over very long periods of time.

Senator MACK. OK. Thank you.

Representative HAMILTON. We will begin a new round of questioning. I will go back to the recession question.

If we do not enact a deficit reduction package, do we raise the possibility of a recession?

Mr. REISCHAUER. Not appreciably.

Representative HAMILTON. We are still going to be on the cliff but not over it?

Mr. REISCHAUER. Yes. The economy is growing slowly. It's not out of balance in any particular way.

Recessions generally aren't brought about by the old age of recovery but rather by misguided policy. The failure to reach a summit agreement and the failure to reduce the deficit significantly might increase the Fed's resolve to lower inflation.

Representative HAMILTON. Now, one of the things that strikes me as I look at your projections into the future is that neither inflation nor unemployment seem to be a major problem under your projections or under the administration's projections as well, right?

You are not worried about it? You are not worried about those items?

Mr. REISCHAUER. We have to ask what is a problem with respect to inflation. Many people would regard persistent 4 percent inflation as undesirable.

Representative HAMILTON. Well, it doesn't push us over the cliff though, does it?

Mr. REISCHAUER. No.

Representative HAMILTON. And, unemployment staying around 5½ percent, inflation somewhere around 4 percent, a little under. Those are manageable, right?

Unemployment, that's a pretty good performance; inflation, manageable. Right?

In other words, neither one of these areas, unemployment and inflation, look to you as if alarm bells are going to go off here on either of those problems, unemployment and inflation; is that right?

Mr. REISCHAUER. That's correct. But, remember, we have the CBO forecast assuming major fiscal policy adjustments.

Inflation might be a little bit higher under a scenario in which there were no actions taken to reduce the deficit.

Representative HAMILTON. Now, you are expecting a decline in interest rates that is faster than the slowing of inflation; is that correct, in your projections?

Mr. REISCHAUER. Yes. I mean, we have real interest rates——

Representative HAMILTON. And, that is going to stimulate housing, and it's going to stimulate business investments and foreign trade, all of those things, right?

Mr. REISCHAUER. Yes.

Representative HAMILTON. You've raised the level of interest rates for 1990 as a whole, both short and long term, correct?

Mr. REISCHAUER. Yes. That's really a reflection of history. CBO did not anticipate in its January forecast the events that were going to take place in the world that pushed up interest rates in the first 6 months of this year.

Representative HAMILTON. And, at the same time, you have raised your forecast for GNP growth, both this year and next. So you have increased growth, increased interest rates, in your projections?

Mr. REISCHAUER. Yes.

Representative HAMILTON. Now, why is inflation going to be slowing?

Mr. REISCHAUER. Inflation is going to be slowing because national saving is going to go up. We are going to be adding to the capital stock; productivity is going to improve.

This is one of the dividends one gets from deficit reduction. However, because of the weakness of the dollar, all that dividend can't be translated into lower inflation, because we are going to face higher prices for imports.

Representative HAMILTON. If you look at your growth projections and compare them with the administration's growth projections, they are very, very close in—well, they are the same in 1990. They are quite close in 1991.

But, then farther out, you are not as optimistic as the administration.

Mr. REISCHAUER. No. They——

Representative HAMILTON. They are at least a half a point above you, maybe more, for those outyears. What is the difference there is your view and the administration's view?

Mr. REISCHAUER. Well, I certainly can't speak for Mike Boskin, but I think the fundamental disagreement here is the rate of increase in productivity. The CBO forecast has multifactor productivity improving at about the average of the postwar period. The administration forecast has labor productivity increasing at a pretty hefty rate.

We both have roughly the same growths in the labor force. Labor force growth, remember, is slowing down.

Representative HAMILTON. If you look at these productivity figures, the administration projects productivity growth at 1.9 percent. And, you are at 1.5 percent.

Now, during the past 3 years, we have had productivity of 1.3 percent. And, it fell the first part of this year.

Why are you as optimistic as you are about productivity? And, why is the administration even more optimistic?

Mr. REISCHAUER. You will have to ask the administration why they are even more optimistic. Remember, what we are assuming that there will be a surge in investment and that the capital stock per worker rises. Workers then become more productive. We've gone through a decade or so of rather low investment, and we are expecting that to turn around.

Representative HAMILTON. So, the increased investment will bring about an increase in the productivity growth?

Mr. REISCHAUER. Right.

Representative HAMILTON. And, not an increase in the labor force?

Mr. REISCHAUER. The labor force is basically constrained by the number of individuals who are of a working age and their participation rate. The surge in the participation rate among women is slowing down because it has reached its maximum levels. Male participation, as you know, has been declining.

Representative HAMILTON. Now how realistic, how prudent is the administration's projection that the economy is going to grow at 3 percent a year from 1992 on to 1995?

Mr. REISCHAUER. I would characterize it as extremely optimistic but not impossible. My view is——

Representative HAMILTON. If it is optimistic but not impossible, is it, therefore, a good basis for making budget projections?

Mr. REISCHAUER. I was going to say that, when you are forecasting the economy for use in the budget and you have a dismal track record, you should err on the side of prudence.

Representative HAMILTON. And, that is what you think you have done with your projection; is that correct?

Mr. REISCHAUER. Well, our normal economic forecast would be more prudent because it would not assume that a major deficit reduction takes place. But, as I explained, the request to CBO by the summit was to presume in our economic assumptions that the summit was, in fact, successful.

Representative HAMILTON. If you were criticizing the administration's economic projections that are set forth, I guess, in your testimony, what stands out to you?

Mr. REISCHAUER. What stands out to me are two things. One is the rapid rate of real growth, particularly in the outyears. The second is the fall in real long-term interest rates.

Representative HAMILTON. And, would you characterize that position of the administration, as you did a moment ago, possible but not probable or words to that effect?

Mr. REISCHAUER. Yes.

Representative HAMILTON. But not prudent?

Mr. REISCHAUER. But not prudent, without my dictionary to decide the fine meanings of these words.

Representative HAMILTON. Well, you would agree that one of the reasons we have ourselves in the mess we have is because we have used very greatly, too greatly, optimistic assumptions throughout.

Mr. REISCHAUER. Yes.

Representative HAMILTON. We all understand the political pressures that bring about that, on both the administration and the Congress. And, yet, it's a major flaw in the process, correct? And, a flaw that we hope will be addressed and corrected in this package that is forthcoming.

Is that correct?

[Mr. Reischauer nodded in the affirmative.]

Representative HAMILTON. Now, I wanted to ask about monetary policy. Mr. Boskin said that he thought it would be "irresponsible"—that's his word—if the Fed did not offset the fiscal contraction from a deficit accord.

Would you think it's irresponsible by the monetary authorities if they didn't offset it?

Mr. REISCHAUER. I wouldn't want to characterize their behavior because there are other things on which the Fed has to keep its eye. It is constrained.

Representative HAMILTON. Some administration officials have said they hope the Fed will respond to a budget deal by cutting short-term interest rates by 1½ percentage points.

Do you think that is about right?

Mr. REISCHAUER. CBO's forecast assumes that the Fed will cut short-term interest rates by slightly over 1 percent but not as much as 1½ percent. But this is well within the range of——

Representative HAMILTON. Now, administration officials have also argued that the Fed should begin cutting interest rates before the budget accord because of the long-lag problem.

How about timing situation? How do you feel about that?

Mr. REISCHAUER. Well, the timing is very important. That's why I tried to stress that one of the assumptions underlying our forecast is that this package is put together and enacted, signed by the President, and completed before the beginning of the fiscal year.

So, the Fed has a few months in which it can begin easing monetary policy before the fiscal teeth begin to bite.

Representative HAMILTON. Should the Fed do that now?

Mr. REISCHAUER. That would be equivalent to giving the child the dessert before he has eaten his broccoli. [Laughter.]

Representative HAMILTON. So, it should not?

Mr. REISCHAUER. No, it should not.

Representative HAMILTON. It should wait until the package is in place, a credible package is in place?

Mr. REISCHAUER. In place, yes. Or is moving through the Congress in such a way as to assure that it will be enacted.

Representative HAMILTON. Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman. That was a great answer on the dessert before the broccoli. I compliment you for it.

Mr. REISCHAUER. I didn't mean it as a partisan remark either. [Laughter.]

Representative WYLIE. Oh, I didn't take it that way at all, of course. Mrs. Bush likes broccoli and I like broccoli. [Laughter.]

Mr. Darman has said that the budget deficit will top $150 billion for fiscal year 1991. In your statement, you said something along the lines of $232 billion in the prepared statement that you submitted for the record.

During your testimony, I thought you mentioned $195 billion. I wrote that down.

What is the figure?

Mr. REISCHAUER. Let me go through this a little. The 1990 number, this current fiscal year, we have——

Representative WYLIE. I am asking for 1991 now, though. That is what we are working on.

Mr. REISCHAUER. The $195 billion is the 1990 estimate. For 1991, the CBO estimate is $232 billion if the Congress provides the RTC with the additional resources it will need to continue resolving the thrift problem.

When the administration releases its midsession report, it will have precise estimates. But, as of right now, the administration has not released anything more than a range for what it thinks the additional RTC spending will be for fiscal year 1991.

Representative WYLIE. OK.

Mr. REISCHAUER. So, the number that you are referring to is the number that Dick Darman gave out to the summit of what the deficit would be, excluding the savings and loan problem in 1991. And, his number was $159 billion.

Representative WYLIE. OK.

Mr. REISCHAUER. Our equivalent number is $162 billion, although we include some interest spending that he doesn't——

Representative WYLIE. So, the difference isn't $60 billion between your figures?

Mr. REISCHAUER. No. In fact, he has also said publicly in the last week that his $159 billion estimate will be revised upward slightly.

So, it is conceivable that the administration number might even be a tad higher than ours, excluding the RTC amounts.

Representative WYLIE. It is a significantly large number. And, do you——

Mr. REISCHAUER. There is no real disagreement both for the 1990 deficit and the 1991 deficit, if we abstract from the RTC. The RTC is really such a wild card.

Representative WYLIE. That clears it up for me. I don't want to get into that. I had another question.

But, before that, do you think Gramm-Rudman cuts could trigger a recession?

Mr. REISCHAUER. Gramm-Rudman cuts of the order of magnitude that would be required under the existing law would stand a very good chance of triggering a recession.

We would be talking about reductions of well over $100 billion, well over 2 percent of GNP.

Representative WYLIE. OK.

Mr. REISCHAUER. I think it would also be tremendously disruptive for the program structure of this country. For example, the FAA would have to reduce its flight controllers by two-thirds.

Representative WYLIE. Well, I agree that——

Mr. REISCHAUER. Not to mention the CBO staff.

Representative WYLIE. We need to avoid that. The CBO staff, now you are talking real concern. [Laughter.]

I would like to stimulate my own thinking on another subject. I am on the House Banking Committee, and the Resolution Trust Corporation activities are under constant surveillance by us.

And, because of the nature of the beast, they have a considerable number of real estate holdings. And, you have mentioned the possible impact on the deficit as far as the Resolution Trust Corporation activities are concerned.

Could RTC spending help prevent a recession? Could it have a favorable impact? I know it could add to the deficit, but RTC has a lot of real estate in its portfolio and other assets which it seems to me might stimulate the economy if properly sold in the marketplace.

Do you understand the thrust of my question?

Mr. REISCHAUER. Yes. No, I don't think it would have really much impact at all.

Representative WYLIE. Well, I'm getting back to——

Mr. REISCHAUER. A lot of people have argued just the opposite. That's why I thought I was going to have a question on that—that is, if the RTC sold its assets rapidly, might it depress local real estate markets to such an extent that in some areas they became chaotic?

I have skepticism on whether that would be the case because everybody is quite aware of this overhang and the uncertainty associated with when and how these assets are going to be sold. Everybody in the affected areas knows that they will be sold.

But, the uncertainty probably depresses markets and expectations as much as the auctioning of this property off at a fairly rapid pace.

Representative WYLIE. There is a large chunk of money there though that has come into the—a large amount of assets which have a monetary value of—we don't know for sure exactly how much, but $100 billion, $400 billion and——

Mr. REISCHAUER. Well, we have——

Representative WYLIE. And, the point that I would make is that if we could sell some of those—if RTC could sell some of those, they could bring some revenue back into the system.

Mr. REISCHAUER. Let me just give you what we have in our forecast for proceeds from asset sales by the RTC. In 1991, we have them receiving $9 billion from asset sales; in 1992, $24 billion; in 1993, $34 billion; in 1994, $34 billion; and, in 1995, $21 billion.

And, so we are expecting them to be selling these assets. These figures are all in CBO's latest report.

Representative WYLIE. OK. I will take a look at that. Thank you very much.

Thank you, Mr. Chairman.

Representative HAMILTON. Senator Mack.

Senator MACK. Thank you, Mr. Chairman. I want to maybe just start toward the tail end of those questions.

There always is this implication or the impression created that if there is a reduction in Federal spending, let's say, to the tune of 2 percent that that is going to have a dramatically negative impact on our economy. And, I would make the argument that just because government doesn't spend it doesn't mean it's lost from the economy.

If the determination is that sequestration goes into effect, No. 1, there would be no tax increases. People would keep those funds and they could determine how they are going to spend them or they are going to invest them.

No. 2, I would sugget that the markets would read a reduction of $100 billion in real reductions in spending at the Federal level as a very positive thing.

Interest rates would fall. There would be a greater flexibility to the Federal Reserve as a result of it.

A reduction in interest rates would, in fact, encourage investment, both on the part of industry and entrepreneurs.

So, I would just like to make the statement that just a reduction in Federal spending doesn't mean that all of this potential goes away.

Mr. REISCHAUER. Correct. I am not going to argue with your basic premise.

But, the issue here is compared with what? In one scenario, you are borrowing money to maintain this spending. And, in the other, you are reducing the spending.

Now, if you were comparing that with raising taxes or cutting programs and raising taxes in a package that the Congress enacted instead of an automatic across-the-board process, then I don't think there would be much of a difference.

But, the real issue is how rapidly can you pull the rug out from underneath the economy. When you cut these programs, you are reducing the purchasing power of people who benefit from government programs.

There will be unemployed congressional staff. There will be unemployed highway contractors, who were depending on Federal moneys to build highways.

This will depress the economy.

And, the question is, how rapidly and how effectively could the monetary policy authorities ease their policy to offset this?

Senator MACK. I would just suggest that there is a great deal more flexibility of $100 billion of real reductions in the role of the Federal Government. There is more flexibility in the markets. There is more flexibility in the Fed. There is more flexibility on the part of investors, entrepreneurs.

Mr. REISCHAUER. This is a question about which we can debate because we haven't experienced something of this order of magnitude occurring the way a sequestration would occur.

If you announced today that a year from now all of these cuts were going to take place, there would be an opportunity for businesses, individuals, and the Fed to prepare for this situation. But sequestration takes place at the beginning of a fiscal year. That makes it very hard for institutions and people to respond.

Senator MACK. I understand. I am just trying to make the point that there, in fact, will be free market responses that——

Mr. REISCHAUER. Interest rates certainly will fall.

Senator MACK. The second point I want to raise has to do with—well, let me follow up on that, because again when you start talking about a $5-plus-trillion economy and saying that a $50 or $60 billion dollar package would be perceived as very positive, yet a $100 billion dollar reduction in spending would have a negative impact, I mean, you are talking about three-tenths, four-tenths, or five-tenths of a percent.

Mr. REISCHAUER. It depends on how fast the economy is chugging along to begin with. On the one hand, if we were dealing with an economy that was perking along at 4 percent growth, we would be a lot more sanguine about taking a big hit out of the Government sector.

On the other hand, when we are only somewhere between 1 and 2 percent growth, we are a lot closer to the edge of the cliff, and it's harder to drive the vehicle.

Senator MACK. Let me just again touch on the taxing and spending issue for a second, because again one of the messages that has been constantly delivered in Washington for years is that the only way to solve the deficit problem is to raise taxes.

And, there seems to be the feeling that there haven't been any tax increases since 1981. I wonder—I don't have any numbers with me. There certainly have been tax increases since 1981—gas tax, Social Security, payroll taxes, et cetera.

But, yet we are still talking about—you mentioned a deficit number of somewhere between $192 and $232 billion or something like that. I mean, if we are going to solve the deficit problem by raising taxes, it would seem to me that the evidence is pretty plain that raising taxes doesn't solve it, that it just encourages more spending.

Mr. REISCHAUER. Well, we are in a semantic problem here of what do we regard as a tax increase.

Senator MACK. I think a duck is about this tall and they quack and they——

Mr. REISCHAUER. It quacks. [Laughter.]

Senator MACK. Right.

Mr. REISCHAUER. One definition of a tax increase is something that changes the structure of the Tax Code in such a way as to raise more revenue than it would raise otherwise. And, if we define it that way, it has been pretty clear that we have had large tax cuts over the last decade. That is just one definition.

Another definition would be what fraction of GNP or personal income is taken from revenues? What do revenues constitute as a percent of GNP?

Under that definition, taxes have remained about constant, maybe drifted up a little. Maybe we have had a little tax increase.

Senator MACK. I would conclude from that then that the problem is on the spending side. Let me just make my last point, because I think we have another member that has arrived that may want to ask you some questions.

And, that has to do with Fed policy, because again the impression was given that the Fed can just, at their whim, decide whether interest rates are going to go up or going to go down. And, I would just say look at December 1989 when the Fed, in fact, decided to lower the Federal fund rate roughly a one-fourth of a point, from 8½ to 8¼ percent.

And, the opposite occurred. We saw long-term interest rates rise by 100 to 150 basis points.

So, I would again suggest that the market is going to be the one that is going to make a determination about whether interest rates can fall or whether they can't. And, it's not some magical thing that——

Mr. REISCHAUER. Certainly when we are talking about long-term interest rates, I think you are right. That's why I emphasized that one key assumption in CBO's forecast is that financial markets regard this package as credible and expect long-term interest rates to begin falling.

Senator MACK. Thank you.

Representative HAMILTON. Congressman Obey.

Representative OBEY. Thank you, Mr. Chairman. I don't have a lot of questions. I came in late, and I am not sure what has transpired.

I have been reading my new Bible, Mr. Phillips' book, which puts in one place a lot of information produced by the U.S. Government—essentially administration sources over the last 10 years, Census Bureau data, Commerce Department data—some of which was in turn publicized and emphasized and analyzed by this committee a few years ago.

I think it relates to some of the questions I've heard about whether there ought to be action at the budget summit and, if so, what kind.

Let me ask first just a boilerplate question. You know, we have had a lot of years of growth. The country on the surface is reasonably well off.

Why shouldn't we allow sequestration to take place? Why should we be searching for a bigger deal at this summit?

What's in it for working people?

Mr. REISCHAUER. I think sequestration is actually a bigger deal, about twice as big a deal as a $50 billion first-year package. So, if we are just looking at this as a first-year effect, sequestration would involve over 100 billion dollars' worth of spending cuts and a package will involve, my expectations are, somewhere between 50 billion and 60 billion dollars' worth of more balanced——

Representative OBEY. What I mean by "big deal," is that I understand they are talking at the summit about a multiyear agreement.

Mr. REISCHAUER. The second issue is that sequestration is for 1 year. Then you have to revisit it in the next years. The deal is over a longer period.

But, of more importance, sequestration is a mindless way of setting policy. It is mechanical. It does not comport with the relative priorities of the Congress, the executive branch, or the American people. It cuts all programs by an equal percentage.

I don't think anybody would argue that that's a sensible way of going about making reductions that might be regarded as necessary.

Representative OBEY. Well, what is so terrible with——

Mr. REISCHAUER. Plus, many of the people that you suggest have been affected adversely over the last decade would be hit adversely again.

Representative OBEY. What so terrible would happen? Why should the average working family be concerned about the effect of sequestration of that magnitude on the economy?

Mr. REISCHAUER. The average American family benefits from the Government's programs, whether those programs provide grants to the local school district in which their children go to school or whether they assure the safety and quality of the food that they have in their refrigerator. All of those would be affected.

Representative OBEY. But, what about the economic effect of a sequestration of that magnitude?

Mr. REISCHAUER. Well, we are getting back to Senator Mack's question there. I said that if we tried to reduce the deficit by sequestration from $232 billion down to $64 billion, we would be dealing with roughly a $150 billion reduction in government spending and that that would likely push the economy into a recession.

Representative OBEY. You know, there are some politicans in this town who are declaring "never more" when it comes to touching the bubble which protects the highest income people in America. I guess their goal is not just to protect the country club set at this point but to protect the presidents of the country clubs.

And, as you know, we have also been told that one of the ways to deal with the deficit is to deal with capital gains and provide another sweetener for them-who-already-have through that.

Would you quarrel with the numbers that Mr. Phillips cites from a Federal Reserve study which indicate that the richest 2 percent of families in this country own 30 percent of all liquid assets, 50 percent of all corporate stock, 39 percent of corporate and government bonds, 71 percent of tax-exempt municipals?

Mr. REISCHAUER. Would I quarrel with those numbers?

Representative OBEY. Yes.

Mr. REISCHAUER. No. I think that those numbers are from the basic survey of wealth that all of us rely on.

Representative OBEY. Would you quarrel with his statement that income from property is up 116 percent since 1978 and income from labor is up 66 percent?

Mr. REISCHAUER. I confess to not having read the Bible yet. But, we have numbers of our own on that. I'm not even sure that those aren't ours. I think they are roughly comparable.

The same patterns that have been reported in Kevin Phillips' book are the ones that various CBO studies and Joint Economic Committee studies have unveiled as well.

Representative OBEY. Mr. Phillips points out that there has been a shift of $80 billion in revenues collected from the progressive income tax to the regressive payroll tax, the Social Security tax.

Would you agree that those are roughly the numbers?

Mr. REISCHAUER. Once again, I'm not sure. My guess is that his calculator works about the same as ours.

But the important thing to remember is that the payroll tax increases that we have enacted over the past decade have been used to shore up the Social Security system, the benefits from which are progressive.

One has to ask, "What would the alternative have been in 1983 had we not made changes to the Social Security taxes?"

Representative OBEY. I don't think he is arguing, and I don't think we are, that that action shouldn't have taken place. But, I do think it's important to note what the effect has been.

Mr. Phillips says that, since 1977, the 90 percent of families below the top 10 percent—all but the top 10 percent—have wound up, in effect, paying higher effective tax rates than they were paying before, while the richest 10 percent is the only club in town or in the country that is, in effect, paying lower tax rates than before.

Do you have any information to dispute that?

Mr. REISCHAUER. We have a study that deals with the same issue. It classifies families a little bit differently from the way they are classified in Phillips' analysis, but it comes to basically the same kind of conclusion.

Representative OBEY. I think you have laid out clearly why we do need an agreement at the summit. I think the numbers, with the help of Mr. Phillips concentrating them in one place, also help focus attention on what might be done at the budget summit to redress some of the imbalances cited.

Thank you for your time.

Representative HAMILTON. Mr. Reischauer, let me just ask a couple of questions quickly. And, there may be a followup question or two.

But, we want to get Mr. Sinai and Mr. Kudlow on here fairly quickly.

Should the Gramm-Rudman deficit reduction targets be suspended because of the current weaknesses in the economy?

Mr. REISCHAUER. No.

Representative HAMILTON. They should not be suspended; why?

Mr. REISCHAUER. Because we have within the Gramm-Rudman law a definition for the conditions which Congress thought would be the appropriate ones to suspend the targets, and those have not been achieved.

We have not had two consecutive quarters of less than 1 percent real growth. Nor does the administration or CBO forecast that that will occur.

Representative HAMILTON. All right. And, should they be suspended if the economy weakens further?

Mr. REISCHAUER. Well, if there was substantial weakening in the economy, we should rethink how much deficit reduction would be appropriate for the summit to agree upon.

Representative HAMILTON. All right.

Mr. REISCHAUER. But, remember, the summit clearly is not going to stick to the deficit targets laid out in the Gramm-Rudman law. That would require bringing the deficit down to $64 billion for 1991.

So, this issue is really being taken care of by the people negotiating——

Representative HAMILTON. Revised figures?

Mr. REISCHAUER. Yes. We will have revised figures.

Representative HAMILTON. Now, your testimony here would be to the average American family that the projected increase in living standards that they are going to get because of the impact of this package on the economy is going to outweigh the increased taxes they are going to have to pay and any benefit they lose from a reduction in spending; is that right?

Mr. REISCHAUER. Well, there is no such thing as a free lunch. It's going to take a long time to get into that situation.

Representative HAMILTON. How long?

Mr. REISCHAUER. We are going to have to tighten our belts for the next 5 to 10 years before——

Representative HAMILTON. Yes, but you do this thing for a purpose. And, the purpose is to get growth in the economy.

Mr. REISCHAUER. The purpose is to have higher standards of living in the long run.

Representative HAMILTON. Your testimony is that in a few years time, living standards are going to go up sufficiently to outweigh the increased taxes and the reduction in benefits that they might get from government spending, right?

That's the thrust of what you are telling us this morning.

Mr. REISCHAUER. I would not want to hold out the prospect to the American people for that occurring in the next 2, 3, or 4 years.

Representative HAMILTON. That's going to be tough for a politician to sell, isn't it?

Mr. REISCHAUER. Well, that's true.

Representative HAMILTON. If your testimony is that these benefits are not going to come for 5 years—and that is apparently your testimony——

Mr. REISCHAUER. Longer.

Representative HAMILTON. Excuse me.

Mr. REISCHAUER. Longer probably.

Representative HAMILTON. It's going to take longer than that?

Mr. REISCHAUER. Initially, standards of living of individual American families will be reduced. They are going to benefit less from government programs because government programs will be cut back. Their taxes might be higher, if taxes are part of the package. That's going to reduce their disposable income.

Representative HAMILTON. But, it's all worthwhile, because 5 years from now their standard of livng is going to go up. Is that what you are telling us?

Mr. REISCHAUER. Five years, I think, is too early. What I was going to say is that they will immediately begin to benefit from the fact that interest rates will be lower, so their car payments might be lower, their mortgage payments, if they have an adjustable rate, might be lower. The cost of those things that they buy on credit would be lower.

Now, remember, there is a chunk of the population who benefits from high interest rates.

Representative HAMILTON. When is their standard of living going to go up? You have said it's going to go up. So, the question is when?

Mr. REISCHAUER. I think 10 years. I mean, the question is not when is it going to go up. It's when is it going to be higher than it would have been otherwise?

The answer is that it will take 5 to 10 years.

Representative HAMILTON. It will take quite a while to play out.

Mr. REISCHAUER. It takes a long time to play out. We have engaged in overconsumption now for a long time. It's like piling up debt on your credit card for a whole decade and then are telling the holder of that credit card, "You are going to have to begin paying off some of this debt."

Representative HAMILTON. All right. The last question I have relates to the composition of the package. You said it was a secondary issue to the amount of reduction.

What composition of deficit reduction is going to yield the best gain in your view?

Mr. REISCHAUER. I don't think I am in a position to give you a particular breakdown—this much in consumption taxes, that much in income taxes, so much in reduced government spending. We would have to get into a discussion of specific government programs——

Representative HAMILTON. Well, let's put it in very broad terms. There is clearly a view here in this town that the best package would be strictly spending cuts.

Mr. REISCHAUER. On programs from which I do not benefit.

Representative HAMILTON. OK. But, the best package would be a spending cut package. There may be some in this town—I haven't heard it, but maybe the view is that the best package would be a tax increase by itself.

And, there is another position, for some kind of a split between spending cuts and tax increases.

Which kind of package, recognizing that it's a secondary question, gives us the best gain?

Mr. REISCHAUER. Well, I am going to avoid answering that question simply because——

Representative HAMILTON. OK.

Mr. REISCHAUER [continuing]. I think the important issue is, if you go from one extreme to the other, you change the political possibility of enacting a package. A balanced package is much more likely to be enacted from the political standpoint.

Representative HAMILTON. I am not asking you to make a political judgment. I am asking you to make an economic judgment.

Mr. REISCHAUER. To worry about marginal changes——

Representative HAMILTON. I am asking about economic judgment.

Mr. REISCHAUER. To put out on the table marginal changes——

Representative HAMILTON. Forget the politics for a minute. You are an economist. I am a politician and you are an economist.

From an economic standpoint——

Mr. REISCHAUER. I am an economist that serves politicians. [Laughter.]

Representative HAMILTON. I am a politician that asks a lot of questions of economists. [Laughter.] But, the point is, from an economic standpoint, does it make any difference what the composition of that package is? Forget the politics.

Mr. REISCHAUER. It would be marginally better to have the package consist of the elimination of wasteful government spending. [Laughter.]

Representative HAMILTON. OK.

Mr. REISCHAUER. I will leave to you the definition of waste. [Laughter.]

Representative HAMILTON. Well, let me tell you what the impression I have from your testimony on that point is: It doesn't make much difference from an economic standpoint.

I don't want to put words in your mouth, but that's the general impression. Is that right?

[Mr. Reischauer nodded in the affirmative.]

Representative HAMILTON. Well, we put you through a tough morning. We thank you, sir, for your testimony.

Does any other gentleman——

Representative WYLIE. I tried to get an answer from one of my questions earlier, but he is persistent.

Representative HAMILTON. Well, very good. Thank you very much Mr. Reischauer. We appreciate your testimony.

We will ask Mr. Sinai and Mr. Kudlow to come forward, if they would, please.

Gentlemen, thank you very much. We apologize that you have had to wait for a considerable length of time. We look forward to your testimony.

I presume you both have opening comments. I would ask you to keep those opening comments reasonably reduced in time, if you would, so we can turn to questions.

Mr. Sinai, you have been here a little longer, so we will let you start off and let Mr. Kudlow follow up.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST, THE BOSTON CO., AND VISITING FACULTY, SLOAN SCHOOL, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. SINAI. Thank you, Mr. Chairman. I am delighted to be here on an important set of topics.

Let me divide my opening comments. One, I want to look at the economy and what its prospects are, and, two, at the very big issue of deficit reduction and what that might mean, and report to you some empirical analysis that we have done on that subject, with and without any Federal Reserve ease that might occur.

The economy is showing a lot of signs of wear and tear and is growing quite weakly now after a long period of unprecedented peacetime expansion.

We have still high interest rates, slowing growth in purchasing power, lots of debt to be worked off. Jobs are being created more slowly now. Consumer sentiment is weakening. Profits performance has been anemic in the business sector. We have intense competition from overseas.

All of that is contributing to a kind of economic growth malaise. In the aggregate, consumer spending is, I think, recession-like, especially spending on big ticket items like cars and houses. Business spending is being held down, mainly because of an ongoing profit squeeze.

Residential construction is depressed at levels of the recession of 1981 and 1982. And, government at all levels is beginning to cut back.

Only trade, exports, and manufacturing currently are showing any buoyancy and, of course, still most U.S. services economy activities are, especially health care. But, it appears to me that the weakness in the economy is considerably more widespread now than it was 6 months ago or a year ago.

Now, in the prepared statement is a table showing our forecast for the next year or two. Let me summarize those.

We expect the economy to be in a slow growth——

Representative HAMILTON. What table is that?

Mr. SINAI. That is table 1.

Representative HAMILTON. Thank you.

Mr. SINAI. We expect the economy to be in a slow growth mode of between 1 and 2 percent real growth through the rest of this year and 1991 with anemic performance in most areas of the economy except for trade.

In the forecast, we see consumption spending rising at the lower end of its historical ranges and the consumer retrenching on durable goods spending, retrenching and bringing down debt, saving more, but certainly spending less and probably for at least another year.

Residential construction will be hard put to pick up much from current levels without households returning to a home ownership mentality or without interest rates dropping sharply from current levels.

Business capital spending, without good growth in sales, better spending by consumers or spending on housing and with profits growing only at a 4- or 5-percent rate, will continue to be cautious. And, so we don't expect much real growth in capital spending, on the order of anywhere from 1 percent to 3 percent at an annual rate.

In the government sector, both at the Federal, State, and local levels, it's clear that fiscal restraint is increasing. We have 40 States that are running operating budget deficits. A significant number of them are running down balances as a percent of outlays and having to cut back.

Tax increases have occurred in numerous States and in localities. Spending is being cut back and employment reduced. The regional economic effects of the emerging bigger restraint at the State and local level have yet to show up in the aggregate economy.

The anatomy of the economy shows up with some areas in recession or slow growth and only a few showing good health. We would call construction and manufacturing in recession. We would call retail trade, finance, insurance, and real estate, those areas of the services economy, probably in some sort of a downturn.

Wholesale trade, public utilities, and transportation are solid. The health care sector is booming. But, even now the services economy, which was the mainstay of our growth for so long, is to us showing signs of wear and tear. For sure, the bright spot is in trade. There is every reason to expect exports and trade to continue to do well, because overseas economies are booming and a lower dollar is going to help.

For the rest of this year to 1992, those factors that might give us a good-sized revival in growth to 2 or 3 percent do not seem in prospect.

Inflation is improving but still entrenched at high levels, especially from the labor cost side.

Interest rates are hardly likely to fall very much unless in response to a major deficit reduction program. It is hard for the central bank to stimulate the economy and to move to easy credit with inflation running at an underlying rate of 4 to 4½ percent.

Certainly, fiscal stimulus can't be used. The fiscal picture is going the other way. We will get fiscal restraint out of deficit reduction.

There is a deficit and debt overhang of the 1980's in the private, public, and international sectors that has to be worked out.

There is just really nothing going on now or on the horizon that should make one think that we could get a pickup in growth.

More likely, if we do not grow in a 1- to 2-percent channel, we will, I think, slip into a full-fledged recession.

Now, given the cyclical outlook, there are some distrubing long-run trends and problems for our economy. I mentioned the overhang of deficits and debt, which will take years to unwind and work out, heavy debt burdens in the private sector, low savings and low productivity growth, a deteriorating infrastructure. There are a whole host of them.

But, chief among the problems is the swelling budget deficit now lately showing up in the data, soaring to unprecedented levels and requiring major action, and I think, soon in Washington. It was good to hear someone close to the budget negotiations sound so optimistic that there will be a package that will come from those discussions.

The budget has deteriorated over the past 3 or 4 months—or I should say the budget outlook—in what looks to people outside of Washington, I think, in a shocking way. When we came into the year, as we looked at the unified budget deficits for 1990 and 1991, our estimates were around $150 to $160 billion.

At that time, those were very pessimistic estimates. Now, for fiscal year 1990, we would agree almost to the decimal point with the CBO projection, $195.2 billion.

For fiscal year 1991, we are more pessimistic than the CBO, expecting, even with a $50 billion deficit reduction program, a deficit of approximately $212 billion.

Now, these figures do include the RTC financing which, in our estimates, add about $70-some-odd billion, so that the fiscal year 1991 budget deficit, that is, RTC and thrift bailout problem is more like $135 billion.

Nevertheless, on the stated numbers and on current services budget deficit estimations, it is clear that major deficit reduction has to be applied or the sword of the Gramm-Rudman-Hollings sequester falls and the amount of cuts, the magnitude and the composition of them, are totally unthinkable, because $100 billion plus of cuts ordered by the Gramm-Rudman-Hollings legislation, if nothing is done, would, I believe, move us fully into recession.

And, second, the nature of the across-the-board cuts that would be applied would be for sure politically unpalatable to the American people and obviously down here in Washington.

So, given those horrible and deteriorating numbers in the budget deficit, as the months have passed, the last few months, I have been encouraged in thinking that we will get major deficit reduction this year, because the alternative is just not thinkable.

Now, the kind of program and the effect of any deficit reduction on the economy and on this set of projections that I have mentioned, we have tried to analyze in some preliminary work using a large-scale econometric model of the U.S. economy, which models fairly extensively the impacts of deficits and various factors on financial markets and the expectations of financial market participants.

Without going through the details in my prepared statement, let me summarize a program that we have simulated. This is a guess for illustrative purposes and because we have to make a forecast to make these guesses. This is a guess of what may come out of the process.

I am now assuming that with about a 95-percent probability there will be a $50 to $55 billion deficit reduction coming out of Washington. There is no other choice.

The other choice is twice as much, and that is twice as much pain on the economy. It just isn't going to happen.

A $50 billion program—and this is now a guess and a forecast of a political process that hasn't yet run to its conclusion. This is not a suggestion of what I might say is the optimal way to do the program. It is only what we have examined and simulated.

And, it involves about $24 billion for fiscal year 1991 of increased taxes; $4 billion comes from removing the notch effect, raising that 28 percent rate for income earners over $200,000 or so to 33 percent. The rest of it is a range of taxes that are mainly excise taxes—gasoline, alcohol, tobacco taxes, and some user fees.

On the spending side, we plug in and assume about $19 billion in defense spending reductions. We think that $13 or $14 billion is already pretty much in the bag from discussions with the Soviet Union and about $5 billion more could come.

And, on the nondefense side, the figure used was $11 billion. Table 12 shows the details of what is guessed at.

What I want to tell you about is what deficit restraint of this magnitude might do to the economy, at least in these examinations that we have made. And, some of this is conventional wisdom and will, I think, be the consensus of what you will hear on the subject from most economists.

Most economists, I think, will tell you, and our model shows, and most models will show, that budget restraint, fiscal changes, have their biggest impact in year 1 after they are applied. And, so in 1991, the mixture of spending, cuts, excise tax increases and a little bit of higher personal income taxes produces almost 1 percentage point less economic growth than would have occurred otherwise.

That does not—since we say 1.8 percent growth or so for 1991—give us a recession by itself. It doesn't mean you might not have a recession. It depends on other factors.

But, just from that amount of deficit reduction, we would not say that we would get a recession. There would be an increased risk of a recession. It could happen. But, by itself it would not.

The lost growth would not really give us much relief on inflation in 1991, because there is a heavy—in this package that was analyzed—element of excise tax increases which we assume are passed forward into prices. So, in 1991, a combination of less growth and higher inflation actually occurs.

The benefits to inflation of the lower growth in 1991 occur in 1992 and 1993. There was a modest improvement on inflation.

Interest rates do go down. The unemployment rate goes up. It is definitely restrictive on the economy.

We do not, if nothing else is done in policy, get back what we lose from this deficit restraint, budget restraint. We do not get it back in the short run or the intermediate run.

I would have to think about whether I might believe we could get it back in 10 years just from deficit restraint alone. I really doubt it.

Now, this means, at least to me, that the Federal Reserve response is critical and monetary policy is critical in any major shift of policy of this nature. And, I think many of us have argued for years that if we do a major budget deficit reduction—and we've argued we should do it, it's the right thing to do for our country in the long run for lots of reasons—that it must be accompanied by offsetting Federal Reserve ease.

And, I would say that now. The same thing is true. I have concern over the state of the economy, the health of the economy with budget deficit reduction, if it is not accompanied by some offsetting ease by the Federal Reserve.

That is a very tricky proposition, because the central bank has to decide, if it were to do this, when, how much, what the lags are and what it wants to achieve for economic growth.

Assuming that the central bank will target economic growth at about 1½ to 2 percent, if the budget restraint takes out 1 percentage point the central bank should give us back 1 percentage point by reducing interest rates appropriately and early enough to return the lost economic growth.

A tighter budget and ease of monetary policy should produce an economy with a lower profile of interest rates, a lower cost of capital, one where we would be more competitive on this ground overseas. It should produce a situation with a lower dollar, which would help our international competitiveness.

The overall rate of growth of output doesn't have to change. The overall jobs picture doesn't have to change.

But, the composition of activity would be altered quite significantly on deficit reduction and offsetting Fed ease. The right role for the Federal Reserve in this, I would say, would be to be cautious and to probably ease a little bit in anticipation of the—once the deficit reduction is agreed upon—ease a little bit in advance of any economic impacts and then feed out more interest rate relief as needed as the deficit reduction bit on the economy and the effects began to show up in the data.

The really concludes my comments. There is a lot in the prepared statement, and it's there for the record and for all of you and, of course, whoever deals with it to take from it what you can.

[The prepared statement of Mr. Sinai follows:]

PREPARED STATEMENT OF ALLEN SINAI*

Prospects for the Economy and Policy at Midyear

The U.S. economy is showing numerous signs of wear and tear, growing quite weakly now after almost eight years of uninterrupted and unprecedented peacetime expansion.

Still high interest rates, diminished real purchasing power, lots of debt to be worked off, less job growth, weakening consumer sentiment, anemic profits performance, and intense competition from overseas in both international and domestic markets all are contributing to the U.S. economic malaise.

While the overall economy itself is not showing up in a full-fledged recession, many sectors and areas are in or near some sort of downturn or barely expanding:

- manufacturing, in general, although with some signs of revival recently. But the latest pick up may only be transitory, principally inventory rebuilding that might not be supported by sustained higher sales;
- construction, both residential and commercial;
- retail trade, especially chain and department stores;
- finance, insurance and real estate;
- business services;
- state and local government.

In the aggregate, consumption spending appears recession-like, especially spending on big-ticket items such as cars and houses. Business spending is being held down, mainly as a consequence of an ongoing profits squeeze. Residential construction is depressed. And, government is beginning to cut back at all levels. Only trade, exports, and manufacturing currently are showing any buoyancy and, still most U.S. services activities, especially health care. The weakness in the economy is more widespread now than a year ago at this time.

The slowdown in the U.S. economy has been long in coming, but now seems to be entrenched. In part, this is due to a conscious effort by the Federal Reserve to bring down inflation from unacceptably high levels. But, it is also a consequence of the long boom of the 1980s and the legacy of massive deficits and debt accumulated during that time.

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A new factor this time around is intense international competition, both overseas and at home, which is operating to keep the economy weak. More-and-more, multinational U.S. companies are finding competition overseas very tough and foreign-owned production facilities set up in the United States have become increasingly competitive. The sluggish economy limits revenue growth and competition reduces market share, a kind of double noose around the neck of the U.S. economy.

There is little prospect of much revival in economic growth for the rest of 1991 and 1992. The "seeds of revival" that normally act to pick up a weak or recessionary economy are not in place. These include much lower inflation, significantly lower interest rates, easy money and easy credit, fiscal stimulus through lower taxes or greater spending, a much lower dollar, or some external source of growth stemming from international or other factors.

Inflation, although improved recently on prices, appears stubbornly entrenched in high labor costs and low productivity growth, propped up by a slow-growing labor force and a surprisingly low unemployment rate, and by anemic performance on productivity.

With inflation high, it is hard for the central bank to reduce interest rates by very much without some help from other arms of policy. Substantial monetary stimulus can hardly be undertaken in an economy with still high utilization of resources, especially in the labor market and where the underlying rate of inflation, as measured by unit labor costs, lies in the 4% to 5% range.

Fiscal stimulus is out of the question, given the swelling budget deficit, which grows worse by the day. Higher taxes and lower government spending are in the pipeline, rather than stimulus.

The deficit and debt overhang of the 1980s, in the private, public and international sectors, must still be worked off. And, although the U.S. economy is benefitting from strong growth overseas, there is a limit to how much the economies in the rest-of-the-world can do for the U.S. as trade and financial flows shift away from this country. A much lower dollar would help, but with effects limited mainly to manufacturing and export businesses, and on a lower dollar posing a threat of higher inflation.

The economy has a cyclical problem superimposed on some longer-run difficulties having to do with deficits, debt, low savings, low productivity growth, a slow-growing potential rate of output, and a relatively weak global competitive position that will keep the business and economic environment difficult for quite some time.

On the bright side, the economic strength of the Pacific Rim-Far East countries and emerging power of a united Europe bode well for the economic future of all countries. Although the outcome of Soviet economic reform remains in question, the Soviet Union and Eastern Europe are bound to join the club of industrialized nations in the world of competitive free markets during the decade of the 1990s. The world also is switching from a wartime footing to a peacetime footing, a very constructive prospect.

How is the economy likely to do in the next year or two? How might budget deficit reduction affect the economic outlook? What role should the central bank play? And, what other policies might be necessary?

These are the main questions addressed below. Briefly.....

- The U.S. economy is growing anemically, with weakness spreading and perhaps cumulating. Real economic growth expected at 1.4% in 1990, fourth quarter-to-fourth quarter, and 1.8% in 1991. Almost all sectors of the economy, except for trade and health care services, are flat to down or only growing slowly.

- Despite the weak growth, prospects for a quick lowering of inflation are not good. High and rising unit labor costs, a consequence of still tight labor markets, new trends in labor force growth, soaring fringe benefit costs, and a dismal performance on productivity growth suggest that the "core" or underlying rate of inflation, unit labor costs, will stay too high to permit a quick unwinding of inflation. A 4% to 4-1/2% inflation rate seems in prospect for the next few quarters, then perhaps lower later.

- The sluggish economy, shortfalls in tax receipts, accumulated debt and high interest rates, and soaring costs of the thrift bailout are swelling the budget deficit, now the most urgent and pressing policy problem confronting the nation. The deterioration of the deficit has been shocking, with the FY1990 deficit now estimated at about $195 billion and $212.5 billion in FY1991, even with a $50 billion deficit reduction program. These figures assume on-budget calculations for the thrift bailout, which is now the biggest source of the soaring deficit. Second is the anemic growth of the economy. Third is the high debt from continuing high deficits and the interest costs arising from the debt.

- The deficit appears out of control, with the kind of restraint suggested by the Gramm-Rudman-Hollings (GRH) legislation unthinkable for FY1991. Well over $100 billion of deficit reduction would be necessary, unthinkable in the current economic environment, and politically unpalatible on the hatchet-like way that programs would be slashed.

- A deficit reduction program of $50 billion to $55 billion is doable, consisting of $25 billion of tax increases, $15 billion of defense spending cuts, and near $10 billion of nondefense spending reductions. Such budget restraint would lessen real economic growth further, principally in 1991, but is not likely by itself to produce a full-fledged recession on current prospects. However, in order to maintain growth, it would be essential for the Federal Reserve to offset the economic effects of budget restraint through easier monetary policy.

- Simulations with the Sinai-Boston Model of the U.S. Economy show approximately a one percentage point reduction in real economic growth in FY1991 from a $55 billion program of budget restraint, consisting of $30 billion in spending cuts and approximately $23 billion of tax increases. This result is produced through an increase in the personal tax rate on high income individuals to 33% from 28%; a $0.10 per gallon gasoline tax, hikes in alcohol and cigarette taxes, and an extension of telephone taxes and imposition of some user fees.

- The gain on inflation of such a program would be modest, however, with inflation at first rising from excise tax increases and then softening. Lower interest rates, by 25 to 50 basis points, would be a consequence.

- Without any offsetting ease by the Federal Reserve, a deficit reduction program of this size would risk recession, although probably not lead to one. Because of lags, easier Fed policy of 50 to 75 basis points, if applied during the period of greatest restraint on the economy from a reduction in the deficit, would lift the economy higher in 1992 and beyond.

- A major factor limiting economic performance in the U.S. is the anemic growth of potential output, now estimated at between 2% and 2-1/2% per year. Policies designed to push up productivity and potential output need to be examined and implemented, as much as any aggregate fiscal or monetary actions. Potential output growth, productivity, and international competitiveness could be more important policy issues than how to run fiscal or monetary policy.

Economic Prospects--1991-92

Table 1 shows the latest Boston Company Economic Advisors forecast of the U.S. economy and financial markets.

The economy is expected to be in a slow growth channel of between 1% and 2% through the rest of this year and 1991, a consequence of anemic performance in almost every area of the economy, except for trade.

Consumption spending rises at the lower end of its historical ranges, a consequence of weak growth in real income, concern by households over jobs and debt, still high interest rates, cautious spending, reduced borrowing and more saving. The spending weakness by households is concentrated in big-ticket items where "stock adjustment" is occurring, with spending postponed as households retrench from the boom in outlays, heavy accumulation of debt, and low personal savings rates of the 1980s.

THE BOSTON COMPANY
Boston Safe Deposit and Trust Company

Economic Advisors, Inc.

(Boston • New York • London • Tokyo)

Table 1
The Boston Company Forecast of the U.S. Economy and Financial Markets
July 12, 1990

	Quarters						Years			
	1989:3	1989:4	1990:1	1990:2	1990:3	1990:4	1988	1989	1990	1991
Gross National Product-1982 Dollars	4162.9	4174.1	4193.4	4214.5	4223.8	4232.5	4024.4	4144.1	4216.0	4284.7
Annual Rate of Change	3.0	1.1	1.9	2.0	0.9	0.8	4.4	3.0	1.7	1.6
Percent Change Year Ago	3.0	2.6	2.1	2.0	1.5	1.4	3.4	2.6	1.4	1.8
Consumption	2690.1	2693.7	2704.3	2706.7	2721.5	2733.7	2598.4	2669.6	2716.6	2768.2
Annual Rate of Change	5.6	0.5	1.6	0.4	2.2	1.8	3.4	2.7	1.8	1.9
Business Fixed Investment	517.9	510.8	520.4	518.4	519.9	516.2	493.8	510.3	518.7	521.3
Annual Rate of Change	5.2	-5.4	7.7	-1.5	1.2	-2.8	8.4	3.3	1.7	0.5
Residential Construction	184.8	184.3	188.6	187.0	186.1	187.1	194.1	188.5	187.2	191.6
Inventory Investment	21.9	22.2	-3.6	13.6	5.3	1.5	27.9	21.9	4.2	1.5
Net Exports	-57.1	-47.2	-33.6	-30.5	-30.7	-28.2	-74.9	-52.6	-30.8	-23.5
Federal Government	336.1	333.3	335.2	335.7	336.5	335.0	328.9	337.1	335.6	333.1
Annual Rate of Change	-8.4	-3.3	2.3	0.6	1.0	-1.8	-3.2	2.5	-0.5	-0.7
State and Local Government	469.2	477.0	482.1	483.6	485.2	487.2	456.2	469.3	484.5	492.7
Annual Rate of Change	2.2	6.8	4.3	1.2	1.4	1.7	3.2	2.9	3.2	1.7
Industrial Production (1977=1.000)	1.081	1.081	1.080	1.092	1.096	1.096	1.054	1.081	1.091	1.111
Annual Rate of Change	-1.2	0.2	-0.4	4.4	1.5	0.1	5.4	2.6	0.9	1.8
Housing Starts (Mils. Units)	1.338	1.348	1.454	1.210	1.240	1.295	1.491	1.387	1.300	1.385
Auto Sales-Total (Mils. Units)	10.8	8.8	9.7	9.6	9.9	9.4	10.6	9.9	9.6	9.7
Unemployment Rate-Civilian (%)	5.3	5.3	5.3	5.3	5.2	5.4	5.5	5.3	5.3	5.6
Federal Budget Surplus										
Unified (Quarterly Rate, NSA, FY)	-46.5	-70.5	-80.3	-11.0	-33.4	-62.9	-155.2	-152.0	-195.2	-212.5
Implicit Price Deflator (%CH)	3.2	3.2	5.4	4.0	4.4	4.0	3.3	4.2	4.2	4.1
CPI- All Urban (%CH)	2.8	4.0	8.1	3.6	4.3	4.1	4.1	4.8	5.0	4.4
PPI-Finished Goods (%CH)	0.0	4.8	9.1	-0.4	4.2	4.0	2.5	5.1	4.2	4.0
Hourly Compensation (%CH)	5.3	6.0	4.1	5.2	5.1	4.8	4.8	5.4	5.1	4.7
Trade-Weighted Exchange Rate	0.928	0.910	0.896	0.897	0.855	0.849	0.880	0.913	0.874	0.856
Annual Rate of Change	1.5	-7.6	-6.0	0.6	-17.5	-2.7	-6.6	3.7	-4.2	-2.1
Merchandise Trade Balance (Bils. $'s)	-111.5	-112.9	-95.5	-87.6	-79.5	-83.5	-118.5	-109.0	-86.5	-74.5
Corporate Profits Aftertax (Bils. $'s)	152.4	156.7	158.5	160.5	160.4	158.7	168.9	161.0	159.5	165.9
Percent Change Year Ago	-12.0	-10.8	-8.7	-0.4	5.2	1.3	18.9	-4.7	-0.9	4.0
Adjusted Profits Aftertax (Bils. $'s)	172.6	168.9	164.9	174.5	174.4	171.9	190.7	171.6	171.4	180.5
Percent Change Year Ago	-9.0	-14.3	-4.1	0.9	1.0	1.8	9.6	-10.0	-0.1	5.3
Real Disposable Income (Bils. $'s)	2919.2	2936.9	2955.4	2964.6	2981.1	2997.3	2793.2	2906.3	2974.6	3038.5
Annual Rate of Change	4.5	2.4	2.5	1.3	2.2	2.2	4.4	4.1	2.3	2.1
Personal Saving Rate (%)	5.1	5.6	5.8	6.2	6.2	6.3	4.2	5.5	6.1	6.5
M2 (Bils. $'s)	3145.7	3201.0	3249.3	3266.6	3304.0	3339.7	3061.8	3201.0	3339.7	3503.3
Annual Rate of Change	7.1	7.2	6.2	2.1	4.7	4.4	5.4	4.5	4.3	4.9
Prime Rate (%)	10.66	10.50	10.03	10.00	10.00	9.50	9.32	10.87	9.88	9.15
Federal Funds Rate (%)	9.06	8.65	8.26	8.25	8.16	7.79	7.57	9.22	8.12	7.31
3-Month Treasury Bills (%)	7.84	7.64	7.77	7.75	7.70	7.28	6.67	8.11	7.63	6.85
10-Year Treasury Note (%)	8.08	7.89	8.41	8.66	8.49	7.96	8.83	8.49	8.38	7.34
30-Year Treasury Bond (%)	8.10	7.92	8.43	8.64	8.51	8.05	8.94	8.44	8.41	7.48
New AAA-Equiv. Corporate Bonds (%)	9.17	8.99	9.28	9.54	9.31	8.88	9.79	9.38	9.25	8.58
Bond Buyer Index (%)	7.07	7.13	7.19	7.32	7.15	6.79	7.69	7.24	7.11	6.43
S&P 500 Index of Common Stocks	341.90	345.56	336.27	349.50	352.99	349.35	265.74	322.87	347.03	368.20
Annual Rate of Change	41.8	4.3	-10.3	16.7	4.1	-4.1	-7.4	21.5	7.5	6.1
Earnings Per Share - S&P 500 ($)	4.85	4.87	5.54	6.05	5.80	5.91	23.80	22.95	23.30	24.58
Percent Change Year Ago	-24.0	-13.3	-17.8	-6.8	19.6	21.4	36.0	-3.6	1.5	5.5
Price-Earnings Ratio - S&P 500	17.6	17.7	15.2	14.4	15.2	14.8	11.2	14.1	14.9	15.0

Residential construction remains at a depressed level, with housing starts at the lowest level since the 1981-82 recession. The weakness in residential housing is part of the retrenchment in home ownership and also occurs in construction as a consequence.

Business capital spending also appears weak, showing only a low rate of increase this year and next, principally the result of cost-cutting and cautiousness on the part of business, weak sales growth, and still high capital costs. The domestic boom in capital spending is over for now, awaiting the next strong upturn in the economy.

The government sector, both federal and state and local, also is headed for retrenchment. At the federal level, cutbacks in spending in order to limit the deficit and reductions in defense outlays growing out of the peacetime thrust all over the world are responsible. However, at the state and local level, where spending has been robust for much of the past year, large operating budget deficits in states, some very large, and with balances running down as a percent of outlays, are requiring less spending and higher taxes (Tables 2,3).

The need to balance the budgets in states like Massachusetts, New York, New Jersey and California will produce weakened regional growth and add to any downturn already in process. State and local government purchases now far exceed those of the federal government, so that cutbacks in this sector could have significant negative effects on the aggregate economy.

Taxes are being raised in numerous states and localities (Table 4), spending cut back, and employment reduced. The regional economic effects of this restraint have yet to show up and will bring another round of weakness in much of the economy.

Much of the economy shows recession or flat growth, with construction and manufacturing of the goods-producing sectors in recession and retail trade, finance, insurance and real estate of the services economy probably in a downturn. Flat growth appears in mining and business services. Wholesale trade, public utilities and transportation, and the health care sector are growing strongly. But, now even the services economy is showing a wearing away at the fringes as the year-long weakness in the goods-producing economy spills over elsewhere.

The bright spot is in trade, especially exports, which have been booming so far this year, both in goods and services. The latter is an area where the U.S. is quite competitive globally, running approximately a $30 billion true services surplus, up from $5 billion five years ago. With booming economies overseas, the opening up of Europe and the Soviet Union, and a lower dollar, exports should keep growing nicely, helping to sustain a positive rate of U.S. economic growth. Inventory accumulation is a swing factor, but businesses will keep inventories low. Any second quarter increase is not likely to last long.

With so sluggish an economy, inflation can be expected to diminish in 1990 and 1991, but the process could be painfully slow.

Table 2

Fiscal Health of the States

	1988	1989	1990	1991
States with outlays in excess of current revenue	13	19	40	27
States with outlays equal to revenues		1	2	10
States with outlays less than current revenue		30	8	13
Aggregate of state revenues less outlays ($ bil.)	1.779	2.795	-4.362	-1.350
States with year end balances less than 5% of outlays*	20	21	30	38
States with operating deficits	9	12	22	18
States in current balance	2	0	2	10
States with operating surpluses	9	9	6	10
Aggregate of year end balances as a percent of outlays	4.2	4.9	3.0	2.7

*Year end balances are the sum of ending balances and budget stabilization funds.

Source: National Governor's Association, National Association of State Budget Officers,
The Boston Company Economic Advisors

Table 3

Alternative Measures of Fiscal Health

	Current revenues less outlays as a percent of revenues				Ending balances plus budget stabilization funds as a percent of expenditures			
	1988	1989	1990	1991	1988	1989	1990	1991
Maine	6.1	1.4	-7.6	-3.6	13.2	12.7	4.0	0.4
New Hampshire	-1.8	-1.2	-1.2	0.8	7.2	5.9	4.5	4.8
Vermont	2.5	-11.4	-1.9	0.0	16.2	4.0	1.8	1.7
Massachusetts	0.0	-6.9	-8.0	0.0	2.0	-2.7	-7.4	0.0
Rhode Island	0.7	-7.8	-1.0	0.1	11.4	3.6	0.1	0.1
Connecticut	-2.4	-0.5	-1.8	0.0	4.1	1.8	0.2	0.2
New York	-0.4	-0.2	0.0	0.0	0.2	0.0	0.0	2.0
New Jersey	0.8	-3.2	-3.6	2.0	9.9	3.6	0.0	2.1
Pennsylvania	-2.5	2.6	-3.3	0.0	1.7	4.5	1.1	1.3
Delaware	-1.1	2.4	-2.9	-1.2	15.3	17.0	12.7	11.0
Maryland	3.9	-0.3	-8.6	-1.0	9.7	8.8	3.0	2.1
Virginia	0.5	-6.0	0.7	-0.6	5.4	0.0	0.7	3.2
West Virginia	0.1	2.1	-3.1	-0.8	2.8	4.5	0.0	0.0
North Carolina	0.5	-3.8	-1.3	-0.9	6.8	2.5	0.9	0.0
South Carolina	3.9	1.4	0.1	0.0	7.6	4.7	4.6	4.6
Georgia	0.4	1.3	-3.2	0.0	8.4	6.0	2.9	3.0
Florida	2.3	-2.1	-0.4	0.0	4.0	2.1	1.1	1.3
Alabama	3.7	-4.0	1.7	-3.2	6.4	2.3	4.3	1.1
Tennessee	1.4	1.8	-2.1	-1.4	4.8	6.7	4.1	2.6
Kentucky	-4.4	0.8	-1.4	1.4	1.0	1.4	0.0	1.5
Mississippi	-1.7	-0.3	-1.9	-2.3	6.8	6.0	3.8	1.2
Louisiana	-1.8	22.3	-1.1	-3.7	-13.4	16.1	14.6	10.0
Arkansas	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Texas	6.6	0.3	-1.0	0.2	1.0	1.2	0.1	0.3
Oklahoma	4.8	1.5	0.1	0.9	8.5	12.1	10.6	11.1
Ohio	0.7	1.6	-0.6	-2.8	5.8	7.6	6.6	3.5
Michigan	0.1	0.6	-0.9	0.1	6.0	6.9	5.4	5.7
Indiana	3.6	3.5	-0.1	-3.9	12.1	13.8	13.5	8.8
Illinois	0.8	2.4	-2.0	0.0	3.1	4.6	2.1	2.0
Wisconsin	-0.7	3.2	-1.3	1.9	3.7	6.9	5.1	6.8
Minnesota	1.8	1.6	-1.9	-4.0	14.7	15.9	12.4	7.7
Iowa	-0.2	1.2	1.3	-2.3	2.6	3.6	4.6	1.9
Missouri	1.2	0.0	-0.1	-4.4	2.7	2.5	2.2	1.7
Kansas	10.7	3.1	-5.3	-8.2	16.0	17.2	10.3	5.2
Nebraska	12.1	10.2	-6.9	-11.1	22.0	34.5	20.0	8.2
South Dakota	1.3	-0.5	-1.4	-6.6	10.3	9.7	7.6	0.5
North Dakota	3.6	-2.1	-2.0	-6.2	10.1	11.9	10.1	4.5
New Mexico	0.0	6.1	4.6	4.9	9.8	6.4	4.9	4.7
Colorado	2.5	1.2	0.4	-1.2	4.7	5.7	5.6	4.2
Wyoming	6.9	-6.9	-7.5	-4.3	36.3	34.6	12.7	3.5
Montana	7.3	6.8	-2.9	-8.5	18.8	17.5	12.7	4.5
Idaho	2.5	9.3	-1.7	-2.8	2.6	12.7	8.8	5.5
Utah	4.0	1.9	-4.5	0.0	9.3	7.9	3.1	0.0
Nevada	6.1	-7.9	-0.1	-0.1	17.9	6.8	6.6	6.1
Arizona	-2.0	-0.1	0.9	0.1	0.2	0.0	0.9	0.9
California	-1.5	2.9	-0.7	1.1	0.6	3.1	2.0	3.1
Oregon	-7.2	8.3	-3.2	-1.8	6.3	15.0	10.1	8.4
Washington	0.2	4.6	-0.5	-4.0	3.5	9.0	7.8	4.5
Alaska	8.6	-2.8	-8.7	0.9	10.8	7.2	1.2	2.2
Hawaii	6.3	6.6	-14.2	-8.0	24.1	28.2	10.8	3.6
United States	0.7	1.1	-1.6	-0.5	4.2	4.9	3.0	2.7
New England	-0.1	-4.1	-4.8	-0.3	4.9	1.0	-2.8	

Sources: National Governor's Association, National Association of State Budget Officers, The Boston Company Economic Advisors

Table 4

Tax Changes for Fiscal 1991
(Millions of dollars)

	Personal Income	Sales	Corporate Income	Tobacco	Motor Fuels	Alcohol	Other	Total	Percent Change
Maine								0.0	0.0
New Hampshire				7.8	10.0	1.9	14.1	33.8	3.9
Vermont	17.2	5.0	3.3	5.0			14.0	44.5	7.3
Massachusetts	740.0	300.0			60.0		12.0	1112.0	14.5
Rhode Island							53.1	53.1	3.6
Connecticut								0.0	0.0
New York	400.0	77.0	178.0	66.0			424.0	1144.0	3.9
New Jersey		1007.0		100.0		52.0	255.0	1414.0	13.3
Pennsylvania								0.0	0.0
Delaware						5.0	2.9	7.9	0.6
Maryland		29.5					4.7	34.2	0.5
Virginia	15.0		29.9			9.1		54.0	0.9
West Virginia								0.0	0.0
North Carolina								0.0	0.0
South Carolina								0.0	0.0
Georgia		-125.0						-125.0	-1.6
Florida				259.3				259.3	2.4
Alabama							55.0	55.0	1.7
Tennessee								0.0	0.0
Kentucky	332.2	83.2	30.2	37.0				482.6	13.2
Mississippi								0.0	0.0
Louisiana							604.0	604.0	16.2
Arkansas								0.0	0.0
Texas								0.0	0.0
Oklahoma	101.4	97.0					5.0	203.4	7.8
Ohio					116.0			116.0	1.0
Michigan								0.0	0.0
Indiana								0.0	0.0
Illinois				80.0			135.0	215.0	1.6
Wisconsin								0.0	0.0
Minnesota								0.0	0.0
Iowa								0.0	0.0
Missouri		5.0						5.0	0.1
Kansas								0.0	0.0
Nebraska								0.0	0.0
South Dakota								0.0	0.0
North Dakota								0.0	0.0
New Mexico		45.7		9.1				54.8	2.9
Colorado								0.0	0.0
Wyoming								0.0	0.0
Montana								0.0	0.0
Idaho								0.0	0.0
Utah								0.0	0.0
Nevada								0.0	0.0
Arizona	69.3		39.3	30.5			30.9	170.0	5.2
California								0.0	0.0
Oregon								0.0	0.0
Washington					130.0			130.0	2.1
Alaska					34.2			34.2	1.4
Hawaii	-64.0						-45.0	-109.0	-4.2
United States	1611.1	1523.6	277.7	595.5	350.2	68.0	1848.7	9994.8	2.1

Sources: National Governor's Association, National Association of State Budget Officers, The Boston Company Economic Advisors

Significant improvement on prices at wholesale and retail, especially commodity prices, has been occurring. But, a still strong services economy, now two-thirds to three-quarters of overall activity, is propping prices. Also, entrenched labor costs are pushing up inflation through cost-push.

The underlying rate of inflation, most correctly thought of as unit labor costs, shows no signs of a significant unwinding soon. A low unemployment rate and sharply rising fringe benefits are holding up wage compensation. Low productivity growth, especially in services, persists. It is hard to see how inflation could quickly or easily diminish, given these considerations.

Superimposed on the cyclical outlook are some disturbing long-term trends and problems for the U.S. economy, including a large overhang of deficits and debt, a need to unwind and work them out, heavy debt burdens in the private sector, low savings and low productivity growth, issues relating to U.S. international competitiveness and business strategy, and a deteriorating infrastructure.

Chief among the current problems is a swelling budget deficit, now threatening to soar to unprecedented levels and requiring major action, and soon, in Washington.

The Shocking Deterioration of the Budget

Table 5 shows the detail of the latest Boston Company Economic Advisors, Inc. budget summary for fiscal years 1990 to 1995.

The unified budget deficit for FY1990 is now estimated at $195.2 billion, considerably higher than the projection at the beginning-of-the-year and some $85 billion above the GRH $110 billion target for the year.

The projection for FY1991, assuming a deficit deficit reduction program of near $50 billion, is indicated at $212.5 billion. This figure, too, is far above earlier estimates for FY1991 which were in the range of $150 billion.

However, it includes near $80 billion of thrift bailout costs, including working capital, some of which could be reversed in later years.

Ex-RTC expenses, the FY1991 estimate is $133.7 billion with a $50 billion program of deficit reduction included.

The necessity of major deficit reduction can be seen in the current services budget deficit, where no changes from current law occur, indicated at $263.3 billion for FY1991, almost $190 billion above the GRH target for FY1991.

The estimates of the deficit have been growing worse almost by the day. Two months ago, the TBCEA unified budget estimate was $190 billion. Three months ago, it was $170 billion.

Table 5

TBCEA Budget Estimates Summary -- July Forecast

(Billions of dollars, fiscal years)	1989	1990	1991	1992	1993	1994	1995
Unified Budget							
Receipts	990.7	1044.6	1127.3	1188.3	1266.6	1353.7	1440.5
Outlays	1142.6	1239.8	1339.8	1403.7	1385.7	1415.5	1474.1
Defense	303.6	296.5	293.0	295.6	298.9	303.1	307.6
Net interest	169.1	182.0	200.4	210.9	216.7	221.4	223.9
Social Security	232.5	248.5	265.4	280.2	296.4	314.6	333.6
Other outlays	437.4	512.8	581.0	617.0	573.7	576.5	609.0
Resolution Trust Corporation		36.2	78.8	74.3	-2.7	-29.7	-19.7
Other		476.6	502.2	542.7	576.4	606.2	628.7
Unified budget deficit	152.0	195.2	212.5	215.4	119.2	61.8	33.7
Percent of GNP	2.9	3.6	3.7	3.5	1.8	0.9	0.4
Social Security surplus	53.7	65.8	77.2	89.5	99.9	112.8	112.8
Deficit without Social Security surplus	205.7	261.0	289.7	304.9	219.1	174.6	146.5
Deficit without RTC	152.0	159.0	133.7	141.1	121.9	91.5	53.4
Deficit w/o RTC or Social Security surplus	205.7	224.8	210.9	230.6	221.8	204.3	166.2
Structural budget deficit (NIPA basis, calander years)	143.5	125.2	113.1	95.0	92.7	71.8	67.1
Treasury financing							
Deficit	152.0	195.2	212.5	215.4	119.2	61.8	33.7
Cash adjustments and other means of finance	-12.9	2.0	1.0	1.0	1.0	1.0	1.0
Total Treasury financing	139.1	197.2	213.5	216.4	120.2	62.8	34.7
Debt held by the public (end of year)	2189.3	2386.5	2600.0	2816.4	2936.6	2999.4	3034.1
Percent of GNP	42.5	43.6	44.8	45.8	44.7	42.8	40.5
Net interest	169.1	182.0	200.4	210.9	216.7	221.4	223.9
Percent of GNP	3.3	3.3	3.5	3.4	3.3	3.2	3.0
Current services budget							
Receipts	990.7	1044.6	1102.3	1162.1	1239.9	1326.9	1413.9
Outlays	1142.6	1239.8	1365.5	1442.7	1438.5	1484.0	1559.9
Defense	303.6	296.5	308.7	319.2	330.6	343.5	357.3
Net interest	169.1	182.0	202.5	217.8	229.3	240.9	251.8
Social Security	232.6	248.5	265.4	280.2	296.4	314.6	333.6
Other outlays	437.4	512.8	589.0	625.6	582.2	584.9	617.3
Resolution Trust Corporation	9.1	36.2	78.8	74.3	-2.7	-29.7	-19.7
Other		476.6	510.2	551.3	584.9	614.6	637.0
Current services deficit	152.0	195.2	263.3	280.6	198.6	157.0	146.0
Percent of GNP	2.9	3.6	4.5	4.6	3.0	2.2	1.9
Deficit without RTC costs	142.9	159.0	184.5	206.3	201.3	186.7	165.7
Economic assumptions (calendar years, except where noted)							
Real GNP (% Chg. 4th Qtr./4th Qtr.)	2.6	1.4	1.8	3.3	2.7	3.1	3.0
GNP deflator (% Chg. 4th Qtr./4th Qtr.)	3.7	4.5	4.2	3.0	4.2	3.5	4.0
Real GNP (% Chg.)	3.0	1.7	1.6	2.7	3.1	2.7	3.0
GNP Deflator (% Chg.)	4.2	4.2	4.1	3.4	3.6	3.9	4.0
Civilian Unemployment Rate (%)	5.3	5.3	5.6	5.6	5.5	5.5	5.5
91-Day Treasury Bill Rate (%)	8.1	7.6	6.9	6.6	7.3	7.4	7.7
10-Year Treasury Note Rate (%)	8.5	8.3	7.3	7.0	7.7	7.8	8.1

Source: The Boston Company Economic Advisors, Office of Management and Budget

The latest CBO estimates (Table 7) show a similar result, although not so high as the TBCEA deficit projections, with or without the thrift bailout costs.

How can deficit prospects have deteriorated so much, so fast?

Table 6 shows a comparison between the current outlook and the original budget submission of the Administration in January.

The shocking deterioration of the budget deficit lies in three areas--weaker economic growth than expected, rising debt and continuing high interest rates, and the growing costs of the thrift bailout.

The differences in economic growth between TBCEA, the CBO and the OMB account for approximately $51 billion of the shortfall in the deficit from what had been expected. Both personal and corporate tax receipts are falling well short of projections.

The TBCEA projections for economic growth in 1990 and 1991 have consistently run at approximately 1-1/2% to a little under 2%. The Administration estimates have been 2.6% and 3.3%, respectively, for these years.

Interest rates, both short-term and long-term, continue to run much higher than Administration estimates, by 0.5 to 1.5 percentage points. This, and the extra debt upon which interest costs are calculated, account for approximately $29 billion of the worsened deficit.

The big surprise and a very disturbing source of budget deterioration has been the thrift bailout and RTC expenses.

Table 8 shows the increasing costs of the thrift bailout. More failure than expected, high interest rates, weak deposit growth, and a large gap between what has been paid for assets and what can be sold are some factors.

As the economy's weakness has spread, interest rates have remained high and the costs of the thrift bailout escalated, the budget deficit has deteriorated month-by-month.

On current prospects and trends, the "cut" job necessary to reach the GRH target ceiling of $74 billion for FY1991 this October would be an unbelievable $125 billion according to TBCEA forecasts, $90 billion according to the CBO, and on the latest figures indicated by OMB Director Richard Darman, some $85 billion. These figures subtract out the thrift bailout costs. Including them would make for deficit reductions of around $195 billion.

Such a reduction in the budget deficit is unthinkable in an economy that might be growing in a 1% to 2% range.

As a rough rule of thumb, $50 billion of deficit reduction would slice nearly one percentage point from real economic growth.

Table 6

TBCEA-OMB Budget Reconciliation

1991 Current services deficit-TBCEA (July, 1990)	263.3
1991 Current services deficit-OMB (January, 1990)	100.3
Difference	163.3
Revenues-OMB	1156.3
Revenues-TBCEA	1102.3
Difference in revenues	54.0
Slower economic growth (TBCEA, 1.6%; OMB, 3.2%)	10.9
Lower inflation (TBCEA, 4.1; OMB, 4.2%)	-0.7
Lower profits as a % of GNP (TBCEA, 5.0%; OMB, 7.0%)	39.4
Other	4.4
Outlays-TBCEA	1365.5
Outlays-OMB	1256.6
Difference in outlays	108.9
Higher RTC outlays (TBCEA, $78.8B; OMB, $7.3B)	71.5
Higher unemployment rate (TBCEA, 5.6%; OMB, 5.4%)	0.6
Higher defense baseline	2.3
Higher interest costs	28.8
Debt level	22.3
Difference in FY1990 deficits	6.8
Difference due to RTC outlays	6.8
Difference in FY1991 deficit ex-RTC	8.5
Interest rates (TBCEA +1.5% on 3 mo. Treasury bills, +0.5% on 10 year Treasury bonds)	6.5
Technical difference on growth in entitlements	5.7

Source: Office of Management and Budget, The Boston Company Economic Advisors

Table 7

Comparison of TBCEA and CBO Current Services Budget Deficit Estimates

(Billions of dollars, fiscal years)	1990	1991	1992	1993	1994	1995
TBCEA current services budget (7/10/90)						
Receipts	1044.6	1102.3	1162.1	1239.9	1326.9	1413.9
Outlays	1239.8	1365.5	1442.7	1438.5	1484.0	1559.9
RTC	36.2	78.8	74.3	-2.7	-29.7	-19.7
Other	1203.6	1286.7	1368.4	1441.2	1513.7	1579.6
Current services deficit	195.2	263.3	280.6	198.6	157.0	146.0
Deficit without RTC	159.0	184.5	206.3	201.3	186.7	165.7
Economic assumptions (calendar years)						
Real GNP (% Chg.)	1.7	1.6	2.7	3.1	2.7	3.0
GNP Deflator (% Chg.)	4.2	4.1	3.4	3.6	3.9	4.0
Civilian Unemployment Rate (%)	5.3	5.6	5.6	5.5	5.5	5.5
91-Day Treasury Bill Rate (%)	7.6	6.9	6.6	7.3	7.4	7.7
10-Year Treasury Note Rate (%)	8.3	7.3	7.0	7.7	7.8	8.1
Congressional Budget Office estimate (July 10,1990)						
Receipts	1044.0	1123.0	1188.0	1260.0	1337.0	1417.0
Outlays	1238.0	1355.0	1427.0	1455.0	1483.0	1556.0
RTC	36.0	70.0	60.0	13.0	-30.0	-18.0
Other	1202.0	1285.0	1367.0	1442.0	1513.0	1574.0
Current services deficit	195.0	232.0	239.0	194.0	146.0	138.0
Deficit without RTC	159.0	162.0	179.0	182.0	177.0	157.0
Economic assumptions (calendar years)						
Real GNP (% Chg.)	2.0	2.5	2.6	2.6	2.6	2.6
GNP Deflator (% Chg.)	4.1	4.0	3.9	3.8	3.8	3.8
Civilian Unemployment Rate (%)	5.3	5.4	5.4	5.5	5.5	5.5
91-Day Treasury Bill Rate (%)	7.6	6.9	6.7	6.2	5.6	5.4
10-Year Treasury Note Rate (%)	8.5	7.8	7.4	7.2	6.9	6.8
Differences in TBCEA and CBO current services deficits						
Receipts	0.6	-20.7	-25.9	-20.1	-10.1	-3.1
Growth and inflation		-6.6	-12.3	-10.4	-8.3	-2.8
Tax rates		-14.1	-13.5	-9.7	-1.7	-0.3
Outlays	1.8	10.5	15.7	-16.5	1.0	3.9
RTC	0.2	8.8	14.3	-15.7	0.3	-1.7
Other	1.6	1.7	1.4	-0.8	0.7	5.6
Growth		0.6	1.2	0.0	-0.1	-1.5
Interest rates		0.1	0.5	1.0	1.0	8.0
Unemployment rate		0.7	1.2	1.3	1.3	-0.4
Inflation		0.3	-1.5	-3.1	-1.5	-0.5
Current services deficit	0.2	31.3	41.6	4.6	11.0	8.0
Deficit without RTC	0.0	22.5	27.3	19.3	9.7	8.7
Economic assumptions (calendar years)						
Real GNP (% Chg.)	-0.3	-0.9	0.1	0.5	0.1	0.4
GNP Deflator (% Chg.)	0.1	0.1	-0.5	-0.2	0.1	0.2
Civilian Unemployment Rate (%)	0.0	0.2	0.2	0.0	0.0	0.0
91-Day Treasury Bill Rate (%)	0.0	0.0	-0.1	1.1	1.8	2.3
10-Year Treasury Note Rate (%)	-0.2	-0.5	-0.4	0.5	0.9	1.3

Source: The Boston Company Economic Advisors, Congressional Budget Office

Table 8

Comparative Estimates on the Cost of the Thrift Bailout 1989-1991:
Expenditures and outlays of the Resolution Trust Corporation

	CBO Budget Estimates								TBCEA Budget Estimates							
	1989	1990	1991	1992	1993	1994	1995	1989-1995	1989	1990	1991	1992	1993	1994	1995	1989-1995
Expenditures	11	65	93	84	47	4	3	305	10.3	65.2	98.8	94.3	32.3	0.3	0.3	301.5
Losses on failed thrifts	1	35	41	32	28	4	3	142	0.8	35.0	50.5	40.0	12.0	0.0	0.0	138.3
Asset acquisitions and advances	10	30	52	52	19	0	0	163	9.5	30.0	48.0	54.0	20.0	0.0	0.0	161.5
Administrative expenses	--	--	--	--	--	--	--	--	--	0.2	0.3	0.3	0.3	0.3	0.3	1.7
Off-budget revenue sources	1	29	23	24	34	34	21	166	1.2	29.0	20.0	20.0	35.0	30.0	20.0	155.2
Original endowment from FHLB	1	--	--	--	--	--	--	1	1.2	--	--	--	--	--		1.2
REFCORP bond sales	--	16	14	--	--	--	--	30	--	16.0	14.0	--	--	--	--	30.0
Asset sales from failed thrifts	--	1	9	24	34	34	21	123	--	1.0	6.0	20.0	35.0	30.0	20.0	112.0
Repayment of advances	--	12	--	--	--	--	--	12	--	12.0	--	--	--	--	--	12.0
Borrowing for working capital*	--	17	43	28	-15	-34	-21	28	--	17.0	42.0	34.0	-15.0	-30.0	-20.0	37.5
Cost to Treasury ex-working capital	10	19	27	32	28	4	3	111	9.1	19.2	36.8	40.3	12.3	0.3	0.3	108.8
Total borrowing for RTC	10	36	70	60	13	-30	-18	139	9.1	36.2	78.8	74.3	-2.7	-29.7	-19.7	146.3

* Working capital is borrowed through the Federal Financing Bank, a division of the Treasury.

Sources: Congressional Budget Office, The Boston Company Economic Advisors

The kind of budget cuts required by GRH would probably push the U.S. economy into a full-fledged downturn. Further, since much of the deficit deterioration resides with the weak economy and is not structural in nature, it would be folly to reduce the budget deficit fully to the GRH target.

The growing costs of the thrift bailout also call into question any attempt to automatically reduce the budget deficit to GRH FY1991 or FY1992 target levels, since the bailout costs represent a one-time special situation.

The kind of deficit reduction that GRH, as currently constituted, requires not only could devastate the economy--it would gut many government programs in a hatchet-like way.

Automatic reductions according to GRH apply to 64% of the defense budget and a minority of nondefense spending, and would lead to a 25% across-the-board reduction in defense spending and 38% on nondefense, cutting into programs such as 1) homelessness, 2) student loans, 3) medicare, 4) massive layoffs in personnel, and 5) no initiatives in education, space or the environment.

<u>The amount and nature of any GRH budget-cutting is unthinkable from an economic or political point of view and would be unacceptable to the American public.</u>

Thus, it is absolutely essential and necessary for the Administration and Congress and the Budget Summiteers to arrive at a more reasonable working out of deficit reduction for FY1991 and beyond, along with redefining what might be included in a restructured GRH legislation.

It makes little sense to cut a budget deficit to legislated targets on account of a weak economy, or to chop spending or raise taxes in order to deal with the thrift bailout. Another issue lies in how to treat the social security surplus, now on-budget. Off-budget treatment would segregate the surplus for its major purposes and give a better idea of the operating budget deficit.

<u>Deficit Reduction and the Impacts--Programs and Possible Economic Effects</u>

Deficit reduction for FY1991 is not only essential--it is absolutely necessary in order to avert chaos in the budget and its potential impacts on the economy or an attempt to completely escape from budget restraint this autumn.

The TBCEA forecast assumes that the Budget Summit produces about a $50 billion program of bona fide deficit reduction, settled no later than October.

Tables 9 to 11 show the possible savings in defense, nondefense, and sources of new tax revenues that might be applied.

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Table 9
Possible Savings in Federal Budget Outlays from Cuts in Military Outlays*
(Billions of Dollars)

	1991	1992	1993	1994	1995	1991-1995
President's proposed Department of Defense savings**	3.2	8.5	16.0	25.7	35.5	88.9
Total possible savings from current Soviet-U.S. talks	1.8	4.3	4.8	5.1	4.8	20.8
Strategic Arms Reduction Talks (START)	0.5	1.2	1.5	1.4	1.0	5.6
Expanded Conventional Forces in Europe Talks (CFE)***	1.3	3.1	3.3	3.7	3.8	15.2
Possible additional cuts from Congress	9.3	16.7	22.0	25.3	27.7	100.8
Strategic Forces						
Reduce R&D expense on the Strategic Defense Initiative	0.9	0.7	0.7	0.5	0.2	3.0
Reduce R&D and procurement on the Stealth (b-2) bomber	1.1	2.6	3.8	4.	4.8	16.7
Cancel procurement of the rail MX	0.5	1.1	1.3	1.1	0.7	4.7
Cuts in conventional weapons are research						
Cancel the C-17 aircraft	0.4	1.4	2.1	2.4	2.6	8.9
Limit payments for independent R&D	1.6	2.0	3.2	3.4	3.5	14.5
Reductions in readiness						
Reduce funding for Operations and Maintenance	2.6	4.4	5.9	7.2	8.4	28.6
Limit funding for support procurement	0.3	0.6	1.0	1.3	1.5	4.7
Reduce drills for noncombat reserve units	0.2	0.3	0.3	0.3	0.3	1.3
Changes in compensation and benefits						
Limit military pay increase	0.6	1.5	2.4	3.4	4.3	12.1
Change compensation for the selected reserve	0.8	0.9	0.9	0.9	1.0	4.5
Reduce funding for school training	0.3	0.4	0.4	0.4	0.4	1.8
Total budget reductions from selected cuts	14.3	29.5	42.8	56.1	68.0	210.5

*Most reductions in military spending are partially offset by higher costs in non-military support programs.

**FY1991 Department of Defense plans call for a 1.8% reduction or 37,600 man cut in active troops: 16,700 from the Army, including 2 of 18 active army divisions; 15,000 from the Air Force; and 6,000 from the Navy, including retirement of 2 of 4 battle ships and 5 attack submarines. An additional 5,000 civilian personnel and 3400 reservist will be cut. By 1995, total personnel is to be cut by roughly 10%, or 300,000. 135,000 of the cuts from the army, for a total of 3 of 18 active divisions and 2 of 10 reserves; 5 of 25 active air force airwings will be cut; cuts in trident submarine forces and retirement of aircraft carriers are likely in the Navy, though specific cuts are not outlined. 70 military bases will be closed or cut back in operations.

***Additional 90,000 troops. The initial 30,000 troop reduction in Europe is imbedded in the President's budget.

Sources: Office of Management and Budget, Congressional Budget Office, The Boston Company Economic Advisors, Inc.

Table 10
Possible Budget Reductions in Entitlement and Mandatory Programs
(Billions of Dollars)

	1991	1992	1993	1994	1995	1991-1995
Extend 1990 Medicare payment restrictions	1.6	2.5	2.9	5.5	7.3	20.0
Accelerate physician payment reform	0.6	1.0	1.1	1.3	1.4	5.5
Cap technical service and support payments	0.3	0.5	0.6	0.6	0.7	2.7
Limit COLAs on federal employee retirement benefits	2.7	4.3	5.0	5.7	6.5	24.2
Federal employee health benefits						
Shift responsibility to the Post Office and D.C.	0.7	0.8	0.9	1.0	1.0	4.4
Reduce federal share of benefit costs	0.9	0.9	1.0	1.0	1.1	4.8
Reduce farm price supports and crop insurance	1.5	2.7	5.0	5.7	6.5	24.2
Improve targeting on child nutrition subsidies	0.7	0.8	0.9	1.0	0.8	4.2
Increase the child care tax credit	-0.2	-1.8	-2.0	-2.1	-2.3	-8.5
Total budget reductions from selected cuts	8.8	12.7	16.4	19.7	23.0	82.3

Sources: Congressional Budget Office, The Boston Company Economic Advisors, Inc.

Table 11
Potential New Source of Revenues
(Billions of Dollars)

	1990	1991	1992	1993	1994	1995	Cumulative
10 cent gas tax	—	10.1	9.7	.5	9.7	9.8	48.8
or 5% tax on energy consumption	—	14.2	15.0	16.0	17.0	18.1	80.2
Double cigarette tax to $.32	—	2.8	2.8	2.8	2.7	2.7	13.8
Double beer and wine taxes	—	1.4	1.5	1.5	1.5	1.5	7.4
Implement a 30% capital gains tax exemption (1)	—	3.2	-4.3	-3.6	-4.3	-3.1	-12.0
or							
Tax capital gains at 15% for all individuals (2)							
"Ex-Post" revenue loss—Sinai-Boston Model (3)	-4.7	-6.8	-4.1	-2.6	-2.7	-1.7	-22.6
Revenues with unlocking—JCT estimate (4)	-1.7	12.1	10.3	12.3	10.7	12.1	55.8
Revenues with unlocking—OTA estimate (4)	-1.9	12.5	14.3	14.4	13.9	15.3	68.5
Add a 33% bracket above the notch	—	3.8	7.6	8.7	10.1	11.7	41.9
Make 75% of Social Security benefits taxable	—	0.8	2.8	3.0	3.5	4.0	14.0
Extend the telephone tax permanently	—	1.5	2.6	2.7	2.9	3.1	12.9
Repeal the automatic aviation tax reduction	—	0.9	1.6	1.7	1.8	2.0	7.9
Extend existing R&E tax advantages	—	-1.3	-1.9	-2.2	-2.2	-2.7	-10.6
All new taxes with 5% energy tax and capital gains taxed at 15% with jct estimate for unlocking	-1.7	36.2	42.3	36.5	48.0	52.5	223.3
All new taxes with 5% energy tax and capital gains taxed at 15% using Sinai-Boston estimate	-4.7	17.3	27.9	31.6	34.6	38.7	144.9
Total new tax revenues with 5% energy tax option and no capital gains legislation	0.0	24.1	32.0	34.2	37.3	40.4	167.5

(1)The revenue effect of the Administrations capital gains proposal as estimated by the Joint Committee on Taxation (JCT).

(2)Reduce marginal tax rate for capital gains to 15% for individuals in the 28% bracket (and the notch) effective April 1, 1990, as simulated by the Sinai-Boston Model of the U.S. Economy. No holding period requirements are assumed.

(3)Ex-post revenues are estimated after feedback of economic behavior in the aggregate economy, financial markets and tax receipts in response to the capital gains tax reduction. No explicit unlocking of existing capital gains is assumed, althougugh additional gains relaizations occur based on increased economic activity, a higher level of transactions, and new capital gains.

(4)Revenues with unlocking includes realizations on existing capital gains as esimated by the JCT and Office of Tax Analysis (OTA) for the Administration's capital gains tax reduction proposal. After 1992, the Presidentěs proposal calls for a 30% capital gains tax exemption for assets held three years or more, a 20% exemption for assets held two years and a 10% exemption for one year. In 1991, the exemption is 30% for two years or more and 20% for one year. The maximum effect of the exemption lower the 28% bracket to 19.6%.
The unlocking effect could be greater than estimated by the JCT and OTA for a reduction in the capital gains tax rate from 28% to 15%.

Source: Congressional Budget Office, The Boston Company Economic Advisors, Inc.

Table 12 shows a plausible program, one simulated as to its economic impacts in the Sinai-Boston Econometric Model of the U.S. Economy.

The program includes about $24 billion of tax increases, mostly excise but nearly $4 billion in a hike on personal income taxes, from 28% to 33% for upper income individuals; a $19 billion reduction in defense spending, appearing high at this time, but not much more than what already is locked in from current negotiations with the Soviet Union; and $11 billion of reductions in entitlement and mandatory programs.

Such a program is not that difficult to attain, especially given the revenue-raising potential for gasoline or energy taxes. Many other taxes could be considered, various kinds of consumption-based taxes, but the program in Table 12 is one that has some plausibility.

Tables 13 to 18 report the results for a series of computer simulations, with and without offsetting Fed ease, done early or late, to examine a few economic impacts from tightening the budget.

The budget restraint itself does not produce a full-fledged recession, however it does risk one, on about a one percentage point reduction in growth for 1991.

The biggest impact of the deficit reduction on the economy occurs in the first year after its implementation. Federal Reserve policy has its biggest impact on the economy in year two after implementation.

The simulations show that in order to maintain economic growth in a direction approaching current Federal Reserve targets, an early easing of monetary policy as an offset to budget restraint would be indicated.

Unfortunately, there is an inflationary impact from the excise tax increases which could limit the room for maneuver in easing monetary policy.

One simulation, shown in tables 15 and 16, where the Federal Reserve acts late in the game, not until mid-1991, produces more economy weakness longer, but also has some beneficial fallout on inflation.

In all cases, the unemployment rate rises in the simulation horizon.

There is one exception, where capital gains tax reduction (Tables 17,18) is included as part of the fiscal restraint program.

The capital gains tax reduction raises growth with very little harm to inflation and is not that costly in terms of lost revenue. If the unlocking effects on unrealized capital gains were included, the capital gains tax reduction would actually produce more revenue, reducing the deficit further but adding to economic growth at the same time.

Table 12
Potential Budget Deficit Reduction Package
(Billions of Dollars)

	Fiscal Years				
	1991	1992	1993	1994	1991-1994
Tax Increases	23.8	27.6	28.7	30.1	110.2
28% to 33% Personal Income	3.8	7.6	8.7	10.1	30.2
Alcohol, Tobacco	4.2	4.3	4.3	4.2	17.0
Gasoline (.10 per gal.)	10.1	9.7	9.5	9.7	39.0
User Fees, Telephone Tax Exten.	5.7	6.0	6.2	6.1	24.0
Reductions in Defense Spending	19.0	19.0	19.0	19.0	76.0
Reductions in Entitlement and Mandatory Programs	11.0	11.0	11.0	11.0	44.0
Total	53.8	57.6	58.7	60.1	230.2

Source: The Boston Company Economic Advisors, Inc., Congressional Budget Office

Table 13
Deficit Reduction: $53 Billion
Economic Effects of Budget Restraint Through Reduced Spending and Higher Taxes*

	1991	1992	1993	1994
Economic Growth (%)	-0.9	-0.1	0.2	-0.1
Inflation-GNP Deflator (%)	0.4	-0.1	-0.2	-0.1
Unemployment Rate (%)	0.2	0.3	0.2	0.2
90-Day T-Bill (%)	-0.11	-0.20	-0.24	-0.36
30-Year Treasury (%)	-0.24	-0.26	-0.27	-0.27
Deficit (NIPA)	53.7	60.3	68.3	73.9

*Program indicated in Table 12.

Table 14
Deficit Reduction: $53 Billion
Economic Effects of Budget Restraint Through Reduced Spending and Higher Taxes--Offset By An Early Fed Easing*

	1991	1992	1993	1994
Economic Growth (%)	-0.8	0.2	0.3	--
Inflation-GNP Deflator (%)	0.4	-0.2	-0.2	--
Unemployment Rate (%)	0.2	0.2	0.1	--
90-Day T-Bill (%)	-0.26	-0.37	-0.40	-0.49
30-Year Treasury (%)	-0.32	-0.32	-0.33	-0.29
Deficit (NIPA)	57.8	69.8	82.7	92.8

*Program indicated in Table 12 and Fed easing of 25 basis points in the federal funds rate, beginning in 1990:3.

Table 15
Deficit Reduction: $53 Billion
Economic Effects of Budget Restraint Through Reduced Spending and Higher Taxes--Offsetting Relatively Early Fed Ease*

	1991	1992	1993	1994
Economic Growth (%)	-0.6	0.4	0.6	0.2
Inflation-GNP Deflator (%)	0.3	-0.2	-0.2	0.1
Unemployment Rate (%)	0.1	0.1	-0.1	-0.2
90-Day T-Bill (%)	-0.45	-0.58	-0.65	-0.72
30-Year Treasury (%)	-0.41	-0.40	-0.41	-0.30
Deficit (NIPA)	64.4	81.9	103.0	119.4

*Program indicated in Table 12 and Fed easing of 50 basis points in the federal funds rate, beginning in 1990:4.

Table 16
Deficit Reduction: $53 Billion
Economic Effects of Budget Restraint Through Reduced Spending and Higher Taxes--Late Offsetting Ease by the Federal Reserve*

	1991	1992	1993	1994
Economic Growth (%)	-0.9	0.4	1.0	0.5
Inflation-GNP Deflator (%)	0.4	-0.2	-0.3	--
Unemployment Rate (%)	0.2	0.2	-0.1	-0.3
90-Day T-Bill (%)	-0.26	-0.74	-0.84	-0.96
30-Year Treasury (%)	-0.32	-0.49	-0.52	-0.48
Deficit (NIPA)	54.9	77.8	105.7	131.3

*Program indicated in Table 12 and Fed easing of 75 basis points in the federal funds rate, in mid-1991.

Table 17
Deficit Reduction: $53 Billion
Economic Effects of Budget Restraint Through Reduced Spending and Higher Taxes--Including Capital Gains Tax Reduction*

	1991	1992	1993	1994
Economic Growth (%)	-0.9	0.1	0.2	-0.1
Inflation-GNP Deflator (%)	0.4	-0.2	-0.2	--
Unemployment Rate (%)	0.2	0.3	0.1	0.1
90-Day T-Bill (%)	-0.08	-0.13	-0.13	-0.32
30-Year Treasury (%)	-0.30	-0.41	-0.33	-0.22
Deficit (NIPA)	44.7	55.6	64.2	63.4

*Program indicated in Table 12, 28% to 15% capital gains tax reduction for individuals, no "unlocking" on revenues.

Table 18
Deficit Reduction: $53 Billion
Economic Effects of Budget Restraint Through Reduced Spending and Higher Taxes--Including Capital Gains Tax Reduction and Offsetting Fed Ease*

	1991	1992	1993	1994
Economic Growth (%)	0.5	0.6	0.7	0.2
Inflation-GNP Deflator (%)	0.3	-0.2	-0.2	0.1
Unemployment Rate (%)	0.1	0.1	-0.2	-0.2
90-Day T-Bill (%)	-0.42	-0.51	-0.55	-0.67
30-Year Treasury (%)	-0.47	-0.57	-0.51	-0.31
Deficit (NIPA)	55.2	77.3	99.4	111.9

*Program indicated in Table 12, 28% to 15% capital gains tax reduction for individuals, no "unlocking" on revenues, and Fed easing of 75 basis points in the federal funds rate, beginning in mid-1991.

The Role of the Federal Reserve

In all of this, the Federal Reserve is key to sustaining economic growth in the face of the deficit reduction.

In theory and probably in practice, the central bank can through any offsetting ease give back to the economy some of the economic growth that budget restraint takes out.

For the central bank, the issue is when and how much to ease in order to time and offset whatever lost growth and extra unemployment might occur, in light of goals on inflation.

Fiscal restraint that did not involve inflationary excise tax increases would make the task of the Federal Reserve easier. However, hikes in personal income taxes simply are not politically feasible and excise tax increases of some sort almost certainly have to occur.

Representative HAMILTON. Thank you, Mr. Sinai. Mr. Kudlow, please proceed.

STATEMENT OF LAWRENCE A. KUDLOW, SENIOR MANAGING DIRECTOR AND CHIEF ECONOMIST, BEAR, STEARNS & CO., INC.

Mr. KUDLOW. Well, there is much of what Allen Sinai said that I agree with, particularly the weakness of the economy. When I appeared before you 6 months ago, the numbers looked better. Today, they look worse.

I would say there is a possibility of recession. I said that 6 months ago, but I think the risks are probably greater now than I thought last January.

For what it's worth, Mr. Chairman, my own estimate for real GNP this year on a fourth over fourth basis is only 1.4 percent. And, that would be the lowest growth rate, I believe, since 1982.

And, this is why I am particularly sensitive to the fiscal and monetary decisions which stand before the Congress and the Federal Reserve. I think it's possible to avoid recession. I want to make that point.

We are not in a recession yet. But, I think policymakers must take great care to choose the right course and send the right signals.

I will skip briefly over the economic part, because I think Allen Sinai covered it well. Retail sales are falling. He mentioned the weakness in the consumer sector, which is unusual.

The only thing I would add is the level of sales are falling, both in nominal and real terms. The level of sales are falling.

That is not a good sign, since that influences the personal consumption expenditures category of the national income accounts and PCE runs about 65 percent of GNP. So, we may have a problem there.

Consumer confidence is slipping. That troubles me. The recent Conference Board surveys show a sharp decline in recent months in consumer confidence.

And, I think the level is 15 percent now, below where it was 1 year ago in July 1989.

Allen Sinai mentioned housing and real estate. And, I agree.

He mentioned the weakness of the employment, payrolls expansion, the rate of job creation. I certainly agree in all areas.

Manufacturing payrolls have declined in 14 of the past 15 months. That's a tough one.

We have also seen, as Allen Sinai indicated, some real weakness in the service area. Again, the retail area is very poor. Retail payrolls have slipped in terms of their monthly expansion.

And, once you take out the Government side, particularly the census workers, we find that the overall services component is much weaker.

Capital goods are weak. That troubles me, because I thought capital goods was the real bright spot when I was here last January.

To be sure, the levels in capital goods are not falling, at least not yet, not sustained. But, the growth rates have come down quite a lot. This was an important area. We were exporting heavily in this area. We still are, but it looks like the domestic side is very weak.

And, as a general matter, business investment spending, including inventories, is really not providing much of a positive contribution. And, the corporate profits area, which is vital to the economy—businesses are not going to expand if the profits are deteriorating—have been deteriorating.

The manufacturing sector was the worst area, all of 1989. There are some signs of stability in manufacturing now, I might want to add that. The picture is not all gloomy.

Profits may have stabilized in manufacturing, even up slightly in the first quarter and maybe the second quarter.

The Purchasing Agents Index, the National Association of Purchasing Managers, shows some slight improvement in the industrial area, not a large improvement but from about 45 percent to about 50 or 52 percent. That's not bad.

At this point, I'm thankful for even small nuggets of optimism out there.

But, the services side is now showing significant deterioration in profits. And, this troubles me a lot, because arguments have been made during the decade that services would carry us. We are really a service economy, and the normal expansion rate of services would keep us out of recession forever.

We are seeing some decay in the service side. In the first quarter, for example, unit labor costs were up 8 percent. I'm sorry, unit labor—yes, were up 8 percent in the first quarter. Prices were only up 6½ percent. Profits in the service area fell by 2½ percent, which is sizable.

It looks to me like there is going to be tremendous cost cutting in the services area. That would be retailing, communications, the media, telephones, various entertainment area, various business sales, and so forth.

I would include the financial services industry, where Allen Sinai and I come from. I think you are going to see a lot of cost cutting. I think the threat of job layoffs is substantial.

And, I think services are going to be a big disappointment to the economy in the next several quarters. I think it's going to keep GNP growth below normal for the whole period, and you may flirt with recession on that side. It's a very disturbing element until we see better profit numbers.

Now, I want to balance this a little bit. Having given you the negative side, there are some positive things going on out there. I mentioned the apparent stability in industry. There are some things that don't look quite so bad.

I am more optimistic than my colleague with respect to the outlook for inflation and interest rates. We have already seen some important declines in the inflation rate, particularly as measured by the Producer Price Index, which has dropped from a year-to-year change of 6 percent a year ago down to only 3.1 percent recently.

The PPI is an important measure of goods prices. And, it looks to me like that is moving in a good trendline.

My own view is PPI inflation is going to be about 2 to 3 percent in the second half of this year and the first part of next year. That is very encouraging.

The CPI has been stickier. I don't like the CPI as an inflation index. I do not—I think it's a lagging indicator distorted by a lot of poor accounting, imputed prices, and also government subsidies.

But, even there, too, the CPI is starting to show some progress. In the last 3 months, the rate has moderated to 3.3 percent. And, I think over time that CPI follows the PPI—the CPI follows the PPI down. And, therefore, I think we are going to be surprised at the extent to which inflation is a plus; that is, lower inflation.

I, myself, like to look at the real world commodity markets, which I think have more information than even the brightest economists. And, on this point I see significant disinflationary pressures.

Oil prices, for example, are soft. Leading metals prices are soft. Gold prices are soft. These are good signs.

Broad commodity indexes have been flat for 2 to 3 years. That's a good sign.

And, as I said earlier, the Producer Price Index is picking this up faster than the CPI is. But, I think we are going to be pleasantly surprised at the inflation decline.

Now, as inflation comes down, people are saving more and borrowing less, which is the behavioral change you would expect to see. There is more saving.

We talked about saving when I was here last January. I said that would depress consumer spending. But, more saving is a plus, I think, on balance in the economy.

My numbers show personal savings has increased by about $150 billion over the last 3 years. The saving rate has risen to nearly 6 percent.

And, on the borrowing side, consumer installment debt has fallen sharply. A growth rate of 10 to 15 percent is now down to under 4 percent. And, by the way, finance company loans to consumers have really collapsed in the last 3 or 4 years. People are staying away from installment debt or personal loans wherever possible.

A lot of this has to do with the 1986 change in disallowing tax deductions for consumer borrowing. A lot of this has to do with a defensiveness in the economy. And, a lot of this has to do with the decline of inflation rate which, frankly, makes it more expensive to borrow.

With spending and borrowing on a decline, the trade deficit is improving. On a national income and product accounts basis, net exports have improved from minus $140 billion in late 1986 to only minus $32 billion through the first quarter of 1990.

I believe I saw a report we are actually running a small surplus with Europe, which is unusual. We are still running a deficit with Japan.

Some time in my lifetime, Mr. Chairman, the New York Yankees are going to win the pennant and we are going to have a surplus with Japan. But, neither is happening soon.

Last, with all of the saving, reduction in borrowing, and an increase in saving, a lot of this is being channeled into financial assets. People are now shifting.

And, we see a big rise in mutual funds. By one estimate, mutual funds have increased $100 billion in the last year. That's a good sign. That's a good sign on the whole. People are willing to make a financial investment.

And, this has helped interest rates to come down. This has helped rates to come down.

None of us ever have enough patience with respect to lower rates, myself included. But, it is worth noting that in the autumn of 1987, long-term bonds, Treasury's, were yielding 10 percent. They got as low as 7.80 percent or we will call it 8 percent a year ago.

As Senator Mack indicated, they did increase to 9 percent briefly this past winter. But, today they are back at about 8½ percent. That is progress on balance, although it happens in fits and starts.

Short-term interest rates, Treasury bill rates, in March 1989 were 9¼ percent. Today, they are about 8 percent.

We have made some progress on the interest rate front. My view is that we are going to make more progress there as inflation comes down. And, I think it's strictly an inflation issue.

I am not impressed with the short-term linkages between the budget deficit and interest rates. The evidence is not strong on it. I have used those arguments. I used them when I was in the Government to try to get some responsible deficit reduction. I occasionally use them out of the Government.

Frankly, if you run the tests through, they are not impressive. I don't want to get off on that tangent, because I, too, want the deficit to come down.

But, I think it's an inflation issue more than it is a deficit issue with respect to rates.

Now, a couple of other points, maybe more to the policy issues that you are dealing with. What bothers me most about the economy today besides the numbers is the fact that I don't see any real animal spirits, entrepreneurship, risk taking going on out there.

Whether it's real estate, finance, heavy industry, capital goods, I think the willingness to take risks is as low as it has been in 5, 7, or 8 years. I cite a number, net business formation. Net business formation, which from about 1981 to 1986, was growing at a 7-percent rate. In the mid-1980's it was growing at about a 5-percent rate. It has fallen off a cliff in the last year, minus 2 to 3 percent.

Net business formation. It's an important entrepreneurial kind of economic indicator. It's not your standard GNP.

But, it's the small businesses in this country that generate the real torque behind the economy. It isn't the GE's and the IBM's and the Coca-Cola's. It's the new companies coming in, companies that have fewer than 200 workers at the beginning.

And, we seem to see a real halt there. And, that, I think, is the principal weakness in the economy. And, that, I think, is an important issue for policymakers.

I have some theories. Other people may have different theories about why these businesses are slowing down. No. 1, I think there is a big worry about taxes.

Allen Sinai mentioned the tight fiscal condition of the State and local governments. I want to underscore that view.

In particular, some of the big, high net-worth and high media visibility States, the bellwether States like New York, New Jersey, and California, are seeing large tax increases there to narrow local budget problems. That's a problem for small business.

We have also had considerable Social Security tax increases in the last few years. I think that's a problem.

We've also had some regulatory legislation proposed which would add business costs. And, I know there are always tradeoffs between environmental concerns and costs and so forth and so on. But, I think small businesses are the ones that bear the burden and the principal brunt of regulatory legislation. The economic impact there is very troubling.

And, finally, of course, there is a lot of uncertainty about Federal taxes. Capital gains tax is up in the air. Income tax is up in the air. Rumors, trial balloons, security transactions tax. It won't help the markets. It won't help the financial services business.

Gasoline tax, BTU taxes, other forms of energy taxes, won't help the energy industries in this country at a time when they are very, very weak.

Other forms of sales taxes—sales are very weak. Retail sales are falling. And, now we want to increase the cost and prices for sales. These things are tough.

I think you said it earlier in your colloquy with Mr. Reischauer. The purpose of fiscal policy is to generate growth in jobs.

Not many people would accuse me of being a Keynesian. But, the fact is that I will draw from Keynes on this point. When he invented an activist fiscal policy of some 60 years ago, it was to stabilize the economy and increase investment consumption and job creation.

My judgment is that an economy on the cusp of recession—and my colleague apparently agrees, and if I heard Mr. Reischauser he agrees the economy is on the cusp of recession or the verge of recession or the threat of recession—is no time to embark on a major tax increase. I see it in those simple terms.

I might look at it more from the supply-production side, the incentive side. But, I dare say, there is an efficiency factor here and there is a psychological factor here that we have to contend with.

And, from my own personal standpoint, again whether it is Keynes or the supply side, I don't think you can tax yourself into better growth or prosperity or more saving or better international competitiveness. This troubles me.

As far as the deficit is concerned, yes, we have lost some ground on the deficit, principally because the economy has softened. I believe the CBO estimates show the biggest problem with the rise in deficit—apart from the savings and loan issue, the biggest economic problem is the shortfall in corporate tax receipts followed by the shortfall in personal tax receipts and some increases in spending.

But, it's mostly a tax receipt problem. And, raising taxes is not going to get us much more economic activity to solve that.

My estimate for the deficit to GNP relationsip, I don't think we are going to run any worse than 3½ percent on that; 5 years ago, it was 6, 6½ percent.

Do I think 3½ percent deficit to GNP is correct in the long run? No. But, do I think we should take abrupt action which might create a recession to solve it in the short run? My answer to that is also no.

And, as far as the Federal debt is concerned, that has been very stable. The debt burden is one of the most overrated issues, I think, as an economic impacter; 42 percent today. It's where it was when Kennedy was President. It's at the low end of the postwar experience. Maybe it will rise to 43 percent if the economy is soft. To me, none of this is a crisis.

Some work that we have done in my shop suggests that rising taxes will reduce economic efficiency and generate higher inflation. There seems to be some important linkages between taxes and inflation.

And, I will throw out one notion on this. You know, the money supply in the 1980's grew faster than it did in the 1970's. But, in the 1980's, the inflation rate was substantially lower than it was in the 1970's. I believe it's because tax rates came down so much in the 1980's that each dollar of money in liquidity the Fed injected became less inflationary.

In other words, you had more money but you were chasing more goods. In the 1970's, we had a lot of money chasing fewer goods. And, that caused inflation.

So, I am quite concerned about the direction of fiscal policy. And, my judgment is, I would think very hard about suspending the Gramm-Rudman targets.

As has been noted by other witnesses, they are going to be liberalized anyway. It's going to be part of the package. I think we ought to start making that explicit.

This, at least, will reduce some of the potential negatives from spending cuts that might be too deep or tax increases that might be damaging.

And, I also feel there are two tax policy areas that deserve consideration. One is a reduction in the capital gains tax rate, which I think will stimulate investment spending in capital formation and would be a revenue gainer.

I think Mr. Sinai has just done a study on this. And, we would all be interested to hear some of his numbers. But, I think $30 to $40 billion over the next 5 years would lower the deficit from higher capital gains generated revenues.

And, the second tax issue, to help the consumer and the working family, the middle and lower income working family, I frankly would like to see the Congress revisit Senator Moynihan's proposals to either freeze or roll back the Social Security tax.

By my estimates, it has been a $21 billion increase by 1990, $51 billion for the 3 years, 1988 to 1990. I think the higher Social Security tax combined with the elimination of various consumer tax deductions has put a big burden, a growing burden, on consumers, on families, in the lower and middle income areas. And, that is something we ought to visit.

And, I think this would help stimulate the economy. It will help stimulate the economy.

Capital gains will help investment. And, lower Social Security will help consumption.

If I sound a wee bit like a Keynesian on this, I plead guilty. But, I will also defend it on incentive oriented grounds. I think both will help work effort and the linkage between work effort and reward. So, to me, there is a dovetailing of interests.

And, as far as the spending side goes, I would be careful here, too, frankly. I would be careful. I agree with Allen Sinai or what I think he was suggesting.

By my estimates—I mean, there is an interesting point here about spending cuts. There is a difference between real cuts and projected cuts, as you know.

I was looking at Mr. Reischauer's numbers. His numbers are pretty close to mine.

The 1991 budget outlays are projected to rise by some $40 billion. That's correct, $45 billion. Call it $40 to $50 billion. So, if you had some kind of sequester-related cutback of, let's say, $50 billion, that would not actually reduce fiscal stimulus from a Keynesian standpoint. That merely takes out the projected increase in the baseline.

In other words, the baseline—it's not real spending we are cutting. We are cutting the projected spending.

Up to $45 or $50 billion, you would still be at last year's level, the 1990 level. Now, as I learned this in graduate school, it's a change in the level of spending that launches the fiscal multiplier. Now, it has been many years and I probably didn't learn it very well then, and I've tried hard to unlearn it in recent years, but even if I take it from that standpoint, it isn't until you actually cut from last year's level that you have to be concerned with some kind of austerity restraint that would diminish GNP and that whole framework.

So, that is something worth thinking about. You might have $40 to $50 billion based on the CBO estimates for last year's baseline. So, I would think about that.

A final point. On the Fed, on this point I am going to disagree with my colleague, Allen Sinai, whom I have known many years and generally think does a pretty darn good job. But, I have to disagree with him on the Fed. And, this won't be the first time that we have disagreed about the Fed.

I don't think we can push the Fed. And, I refer to Senator Mack's point about the December 1989 experience. And, I mentioned that when I testified here last January.

The Fed eased last December and the markets rebelled. Long-bond yields went up 125 basis points. It drove mortgage rates right back up and drove real estate housing right back down. And, we are seeing the effects of that.

The financial markets are unforgiving with respect to inflation sensitivities. And, whether we like it, whether the Fed likes it, whether Alan Greenspan likes it, that's just the reality.

You cannot just push money into the economy and expect interest rates to drop. Yes, the Fed can push the Federal funds rate down. But, from 2 to 3 years out to 30 years, interest rates can rebel.

And, frankly, I think the Fed should do what it has been doing, which is to follow the markets. Follow the markets; don't force the markets. There will be room for ease this year, but the Fed can't drive it themselves. They have to follow the markets, the market prices.

I am sorry if I went on too long. Thank you.

[The prepard statement of Mr. Kudlow follows:]

PREPARED STATEMENT OF LAWRENCE A. KUDLOW

For the first time in 7 1/2 years, there is a serious possibility of economic recession. Real GNP is projected to rise by only 1.4% in 1990, on a fourth quarter over fourth quarter basis. This would be the slowest pace of economic activity since 1982. This is why fiscal and monetary decisions in the period ahead will be crucially important. It may still be possible to avoid recession and preserve the long expansion, but policymakers must take great care to choose the right course and send the right signals.

Incoming data in recent months have not been encouraging:

1) ***Retail sales*** have fallen 3 straight months. Adjusted for inflation, the level of sales has declined by 5 billion, or 4%, since September 1989.

2) ***Consumer confidence*** is also slipping badly. According to the Conference Board survey, the latest reading of 102 on the index is the lowest since June 1987, and stands 15% below the level reached in July 1989.

3) ***Housing*** starts and permits have dropped to their lowest levels since November 1982. From a 1.7 million level in early 1989, starts have dropped to only 1.2 million.

4) Alongside the weak housing picture, ***real estate values*** have declined appreciably in many parts of the country. Buffeted by 1986 tax law changes and recent inflation declines, problems in housing and real estate have taken a toll on wealth expectations and balance sheets.

5) *Employment* growth has slowed markedly over the past 18 months. The growth rate for private employment has sagged from 3.1% in the second half of 1988 to 1.5% in the first half of 1990. Total private employment has eased from an average monthly gain of 229,000 in late 1988 to 112,000 in the first half of 1990. Manufacturing payrolls have declined in 14 of the past 15 months. Retail sector payrolls have slipped from 39,000 new monthly jobs to 17,000. Excluding government workers, private service payroll gains have slowed from nearly 200,000 per month to 135,000.

6) *Nondefense capital goods* shipments have declined 3 months in a row, and orders have dropped 4 of the past 5 months. Since December, orders have fallen $8 billion, and shipments by $1.5 billion.

7) *Corporate profits* over the past 5 quarters have dropped 26.5%. Most of this has occurred in the manufacturing sector, as flattened goods prices have generated major cost-cutting efforts to restore positive margins. To the good, manufacturing profits rose 6% in the first quarter, perhaps signalling an end to the manufacturing recession.

Retailers and the service sector, however, have a long way to go. Unit labor costs in this area rose at an 8% rate in the first quarter, compared to a 6.4% increase in unit labor costs. As a result, service profits fell 2.3%. *Profits of course are the heart of the economy. As go profits, so goes investment returns and business spending decisions. Until profitability is restored, business conditions will remain weak.*

On the brighter side, inflation and interest rates are slowly trending lower. While the demand for real estate and other commodity assets is on the wane, financial asset holdings and savings are on the rise. Under proper tax, budget and monetary policies, these trends can stabilize the economy and enhance prospects for stronger economic growth in 1991.

- *PPI* inflation has declined from 6.1% in May, 1989 to 3.1% in May, 1990, measured over 12 month intervals. Over the past 3 months, the PPI has declined at a 0.5% annual rate.

- *CPI* inflation stands at 4.5% over the past year. However, over the past 3 months this rate has moderated to 3.3%. The commodities component has dropped to 3.3%, but services are rising at a 5.2% pace. However, eroding profits in the services sector will force cost-cutting here.

- *Gold*, which is a key leading inflation indicator, has fallen $70 to $355. Broad commodity indexes have been generally flat for 2 years or more. Crude oil has eased to $16.50.

- As the dollar's buying power continues to improve, people are ***saving more and borrowing less***. Over the past 3 years, personal saving has increased by $147 billion, with the saving rate rising to nearly 6%. Consumer installment debt growth has fallen from 11% in early 1989 to 4% in mid-1990. Finance company loans to consumers have collapsed, from a 27% rate of gain in February '86 to a 3% rate of decline in May 1990.

- With consumer spending and borrowing on the decline, the nation's ***trade deficit*** on a GNP basis (net exports) has improved from -$142 billion in Q3/86 to -$32 billion in Q1/90.

- Much of the added personal saving has been channeled into ***financial assets***. Mutual fund flows have grown by $100 billion in the past year. Along with declining inflation expectations, this has brought Treasury bill rates down from 9 1/4% in March, 1989 to 8.05% currently; Treasury bond yields from 9.2% in March, 1989 to 8.5% presently; and the Dow Jones stock market index has moved from around 2200 in early 1989 to about 2900 currently.

No Animal Spirits

Perhaps the greatest problem with current economic conditions is the lack of risk-taking and entrepreneurship. Instead of animal spirits, businesses and consumers seem possessed by a highly defensive belt-tightening strategy. Nothing illustrates this better than the halt in new business formation. After expanding by roughly 7% per year since 1982, this key measure is now declining at a 2% annual rate. Since early 1989, the level of net business formation has dropped 5%.

This is the backbone of the economy, the torque behind the long expansion. Perhaps the best measure of economic performance and vitality is the creation of new businesses and new jobs, mostly among small firms started by entrepreneurs, people whose work effort and risk-taking depend crucially on incentives and rewards. However, in recent months, these incentives and rewards have been substantially threatened by punitive fiscal policies at the Federal, state and local levels.

- Already, the Social Security tax increases of 1988 and 1990 reduced after-tax take-home pay by $21 billion in 1990 and $51 billion over the last 3 years. Additionally, major state and city tax increases have occurred in highly visible bellwether states such as Massachusetts, New Jersey, New York and California.

- o Making matters worse, proposed regulatory legislation will substantially raise business costs, a development especially painful to small businesses. Cost estimates for the clean air bill, for example, range between $20 billion and $100 billion. Cost burdens will also rise from the disability act, the parental leave bill and implied quotas from the civil rights act. In each case, large established corporations are far better equipped to deal with these costs than newly formed small businesses.

- o What's more, the threat of a major Federal tax increase is growing larger. The income tax could be raised; the capgains tax is up in the air; and there are tax threats in a variety of energy and sales areas, including a securities transaction tax. In response, businesses, consumers and investors are increasingly worried about shifting tax rates and rules. So, all manner of significant commercial and financial decisions have been put on hold until these fiscal decisions are resolved.

Fiscal Expansion, Not Austerity

With the economy standing on the cusp of recession, this is the wrong time for a spate of tax increases. I know of no economic theory which argues that higher taxes are the antidote for a sagging economy, neither Keynesian nor supply-side. Raising taxes this year would be the wrong medicine. It is Hooveresque.

The proper purpose of fiscal policy is to promote economic growth, not austerity. This is what John Maynard Keynes had in mind 60 years ago when he launched an activist approach to government fiscal policy. In the modern postwar period, substantial income tax reduction in the 1960's and the 1980's generated long periods of economic expansion and job creation. Rising tax-rates in the '70s, however, caused stagflation. Indeed, it is worth noting a clear linkage between rising tax-rates and accelerating inflation in the '70s. In contrast, despite more rapid money supply growth in the '80s, lower tax-rates helped to generate far lower inflation rates than experienced in the prior high-tax decade.

With respect to the supply of output, tax-rate reduction created new labor and investment incentives to strengthen the linkage between effort and reward. By taxing these factors less, the supply of these factors increased. And, with increased take-home paychecks, the demand for goods and services was strengthened while labor cost to businesses was reduced.

The wealth of nations has never been sustained through rising tax burdens. We cannot tax ourselves into prosperity, or higher saving, or international competitiveness. Indeed, the current discussion of higher taxes and newly mandated business costs has created an inhibiting effect on numerous commercial and financial decisions. Until these issues are resolved, substantial uncertainty over future tax-rates and tax rules is likely to suppress economic activity in the months ahead. Should the Congress decide to roll back the tax reduction of the 1980's, then the threat of recession will increase.

While it is quite true that lower than expected economic growth will raise the budget deficit in 1990 and 1991, it is not likely that the deficit will exceed a range of 3% to 3 1/2% of GNP. Although weakened economic conditions will prevent any further progress in deficit reduction for the time being, this would still leave the deficit well below its peak level of 6 1/2% of GNP recorded on average between 1983-85.

What's more, Federal debt as a share of GNP has stabilized around 42% in recent years, and is not likely to move much higher unless a deep recession occurs. At 42%, Federal debt is well on the low end of its postwar range. Additionally, Federal spending as a share of GNP is likely to range close to 23% of GNP, well below the 26% share of the early '80s. Taking all this into account, there is no deficit crisis. As well, alleged short-term linkages between deficits, economic performance and the level of interest rates have not withstood numerous quantitative tests.

In order to sustain a ***growth-oriented fiscal policy*** which will lead to significant deficit reduction in the 1990's, I recommend 5 policy actions.

1) In light of the recession threat, the Gramm-Rudman deficit target for 1991 should be temporarily suspended.

2) To stimulate enhanced individual work effort and consumer spending, recent Social Security tax-rate increases should be rolled back. This would be particularly helpful to middle and lower middle-income working families who have been hit hard by the elimination of tax deductions for consumer debt.

3) To stimulate capital formation and business investment spending, a 15% to 20% capital gains tax-rate should be restored. This measure will generate substantially higher revenue levels for deficit reduction purposes.

4) To force government to live within its means, some form of Presidential impoundment authority, or enhanced recission power, or a legislative item veto should be restored.

5) To sustain recent trends of declining inflation and interest rates, the Federal Reserve should be encouraged to continue to employ early warning inflation indicators such as gold, commodities, the exchange rate and the Treasury yield curve to manage the money supply and guide open market operations.

Along with expected reductions in the projected level of defense spending, these policy actions can eliminate the budget deficit by the end of the decade. Lower interest rates can reduce debt servicing expenses by $75 to $100 billion from current estimates. Reduced defense outlay levels could add another $75 billion in savings. Growth-oriented tax policy can provide sufficient revenues to accommodate all reasonable budget priorities. This fiscal plan will provide better government management and restore confidence in the economy. It will enhance U.S. wealth and competitiveness in the new decade and beyond.

BEAR STEARNS ADJUSTED OMB BASELINE FORECAST*

	1989a	1990	1991	1992	1993	1994	1995
REVENUES:	991	1042	1108	1181	1258	1335	1409
OUTLAYS:	1143	1226	1264	1303	1355	1433	1514
DEFICIT:	-152	-184	-156	-122	-97	-98	-105
DEFICIT TARGET:	136	100	64	28	0		
SEQUESTER:			-82	-84	-87		

* Excludes RTC-S&L bailout expenses and adjusts for Bear Stearns economic assumptions.

BEAR STEARNS ECONOMIC FORECAST SUMMARY: JULY 5, 1990

	1989 IVQ Actual	1990 IQ Actual	1990 IIQ Forecast	1990 IIIQ Forecast	1990 IVQ Forecast	Four Quarter Chg. Ending: 1988:4 Actual	1989:4 Actual	1990:4 Forecast	1991:4 Forecast
Nominal GNP	4.6	7.1	4.9	4.3	4.7	7.5	6.4	5.3	5.7
Real GNP	1.1	1.9	1.0	1.1	1.6	3.4	2.6	1.4	2.7
Final Sales	1.1	4.4	0.3	0.7	1.3	4.4	2.5	1.7	2.6
GNP Deflator	3.2	5.4	3.8	3.2	3.0	4.0	3.7	3.9	2.9
Fixed Wgt. Price Index	3.7	6.2	3.5	3.4	3.1	4.5	4.1	4.0	3.0
Consumer Price Index	4.0	8.1	3.6	3.1	3.0	4.3	4.6	4.4	3.0
Producer Price Index	4.8	9.1	-0.2	2.2	2.3	3.4	4.9	3.3	2.5
Industrial Production	0.2	0.9	4.7	0.8	0.7	4.5	1.1	1.8	1.3
Real Disposable Income	2.4	2.5	0.9	1.0	1.0	4.0	3.6	1.4	1.6
Profits Before Tax (Q.R.)	-0.5	3.5	-0.1	1.1	1.6	15.4	-14.1	6.2	6.0
Profits After Tax (Q.R.)	2.9	1.1	-0.0	1.1	0.7	17.9	-10.7	2.9	4.6
Economic Profits (Q.R.)	-2.1	-2.4	2.1	1.1	0.1	8.8	-14.2	0.8	4.4
						------ (Annual Average) ------			
Civ. Unemployment Rate	5.3	5.2	5.4	5.6	6.0	5.5	5.3	5.6	5.9
Federal Funds Rate	8.6	8.3	8.2	7.9	7.3	7.6	9.2	7.9	7.3
91-Day Treasury Bill	7.9	8.0	8.0	7.7	7.1	6.9	8.4	7.7	7.1
30-Year Treasury Bond	7.9	8.4	8.6	8.0	7.3	9.0	8.4	8.1	7.3
DM/Dollar Exchange Rate	1.81	1.69	1.68	1.74	1.78	1.79	1.88	1.72	1.87
Yen/Dollar Exchange Rate	143	148	155	157	160	130	138	155	164

SOURCE: BEAR STEARNS & CO. INC., DEPT. OF COMMERCE, DEPT. OF LABOR & FEDERAL RESERVE BOARD

BEAR STEARNS FORECAST FOR REAL GNP AND COMPONENTS: 1990:2 TO 1991:4

	1989:4	1990:1	1990:2	1990:3	1990:4	--- Growth Rates -- 4th Over 4th Qtr 1989	1990	1991
	Actual	Actual	-------	Forecast	-------	Actual	-- Forecast	--
REAL GROSS NATIONAL PRODUCT	4174.2	4193.5	4203.7	4215.3	4232.2			
PERCENT CHANGE	1.1	1.9	1.0	1.1	1.6	2.6%	1.4%	2.7%
FINAL SALES	4152.0	4197.1	4200.7	4208.3	4222.2			
PERCENT CHANGE	1.1	4.4	0.3	0.7	1.3	2.5	1.7	2.6
PERSONAL CONS. EXPENDITURES	2693.7	2704.3	2702.9	2709.7	2719.1			
PERCENT CHANGE	0.5	1.6	-0.2	1.0	1.4	2.5	0.9	2.1
TOTAL INVESTMENT	717.4	705.5	715.4	720.1	726.1			
PERCENT CHANGE	-3.9	-6.5	5.7	2.6	3.4	1.2	1.2	4.3
BUSINESS FIXED INVESTMENT	510.9	520.5	522.4	524.0	526.6			
PERCENT CHANGE	-5.4	7.7	1.5	1.2	2.0	3.7	3.1	4.1
EQUIPMENT	390.6	397.4	398.4	399.4	401.4			
PERCENT CHANGE	-6.9	7.1	1.0	1.0	2.0	5.2	2.8	4.1
STRUCTURES	120.3	123.1	124.0	124.6	125.2			
PERCENT CHANGE	-0.3	9.6	3.0	2.0	2.0	-0.9	4.1	3.7
RESIDENTIAL INVESTMENT	184.3	188.6	190.0	189.0	189.5			
PERCENT CHANGE	-1.1	9.7	3.0	-2.0	1.0	-7.0	2.8	2.5
BUSINESS INVENTORY CHANGE	22.2	-3.6	3.0	7.0	10.0	$4	($12)	$5
NONFARM	18.0	-7.8	0.0	3.0	6.0	($14)	($12)	$5
FARM	4.2	4.2	3.0	4.0	4.0	$18	($0)	$0
NET EXPORTS OF GOODS & SERV	-47.2	-33.6	-29.4	-28.3	-27.1	$27	$20	$22
GOVERNMENT PURCHASES	810.3	817.3	814.8	813.9	814.1			
PERCENT CHANGE	2.5	3.5	-1.2	-0.4	0.1	0.5	0.5	0.3
FEDERAL GOVT.	333.3	335.2	333.9	331.8	330.8			
PERCENT CHANGE	-3.3	2.3	-1.5	-2.5	-1.2	-3.1	-0.7	-1.3
STATE & LOCAL GOVT.	477.0	482.1	480.9	482.1	483.3			
PERCENT CHANGE	6.8	4.3	-1.0	1.0	1.0	3.1	1.3	1.4

SOURCE: DEPT. OF COMMERCE & BEAR STEARNS & CO. INC.

Representative HAMILTON. Thank you very much, gentlemen. We will begin with questions.

Senator Mack.

Senator MACK. Thank you again, Mr. Chairman. I think I will just start with kind of a broad question first.

I got the impression from listening to Mr. Sinai that there is a lot more that Congress needs to address than just deficit reduction. I guess I would draw that also from an earlier presentation from the standpoint of saying that even if we put the deficit reduction plan together it may be 10 years before we see an increase in the standard of living.

It seems like we do have to address issues like, what do we need to do to be more competitive? What do we need to do to increase savings? What do we need to do to increase investment?

So, maybe, if you would, just address for me some of the other points that we ought to be looking at other than deficit reduction that would increase, I guess, economic growth and produce jobs in the country.

Mr. SINAI. Part of our shortrun cyclical problem is that we are only growing the potential of the economy about 2½ percent a year. It could be a little less than that.

And, what that does is to put policymakers in a straitjacket. If you have inflation of 4 to 5 percent and the economy grows potentially at 2 to 2½ percent, how can the Federal Reserve do anything but try to keep a lid on growth so that that inflation comes down?

It's going to be complicated, because the labor force is growing, is going to grow now at about 1.2 or 1.3 percent a year. That is about half of the rate of growth of our labor force back in the 1960's and the 1970's. And, that is going to take away from potential growth.

Senator MACK. I have seen some figures now indicating that labor growth is as low as a half a percent.

Mr. SINAI. This year?

Senator MACK. Yes.

Mr. SINAI. Yes. I don't think it will stay, since that is kind of an incredibly low number. But, that is going to take away from our potential output.

So, the supply side of the economy and how and what policies one would devise to increase our potential output and productivity I think is going to be more important than the kinds of issues we were talking about today, which have to do with demand-side management and macroeconomic policy from the demand side.

The problem is that we have to get through this macro difficulty first. And, there are some effects of changing the policy mix on our ability to spend on capital and capital formation and productivity.

But the supply side of the economy and how we get our 2½ percent rate a year up to 3 percent or more should be, I think become paramount, and become very, very important in the consideration of Congress.

Now, on that score, the capital gains tax reduction—if you don't ask it now, you are going to ask it sooner or later, so I might as well——

Senator MACK. How did you guess that?

Mr. SINAI [continuing]. Mention that. And, Larry Kudlow mentioned that. You know, there are a lot of dimensions for any tax change in terms of the criteria by which one would judge it.

We have done some work on capital gains tax reduction. And, on the issue of the macroeconomic issues of growth and capital formation and jobs, we are finding that capital gains tax reduction would be very positive.

There is another aspect of that having to do with international competitiveness. I think most research shows that we are not competitive internationally in the cost of capital, and that's part of our deficit vis-a-vis other countries in the amount of spending on capital goods.

The negative on capital gains tax reduction is what Congressman Obey was talking about before. I think it's hard to contradict the income distribution issue that the benefits of capital gains tax reduction do go to the upper income end of the distribution.

It's not to say the ordinary man or woman in the street doesn't benefit because there might be another job. But, on an income distribution issue, capital gains tax reduction I think benefits more upper income people.

But, if I took three or four dimensions, the criteria for judging it, I would say that in terms of—that the productive side of the economy in terms of growth, I think Congress ought to do capital gains tax reduction, because at this particular time in our situation our potential to grow, our ability to compete with very tough foreign competitors to whom we are losing business all the time, which is partly why we are kind of strangling in the economy here, that it would actually help.

It turns out not to be a bad tax on the revenue side because of the unlocking effect of unrealized capital gains. And, this entrepreneurship effect—and I agree with Larry Kudlow—that is something you can hardly measure. It's kind of in the bottle, so to speak.

It's hard to get your hands quantitatively around this risk-taking entrepreneurship factor. But, I agree with him.

It's interesting to me—I was not always a fan of capital gains and I'm not a total fan of it now on income distribution grounds, but it's interesting to me that there was such a burst of entrepreneurial activity between 1981 and 1986 and that there has been some change in that since the tax was changed.

Senator MACK. I think that is an interesting point in light of what Larry Kudlow said, that the new business formation is a negative now, 4 percent or something like that. I mean, if—I'm not an economist, but looking back over the data during this past decade it seems to me that probably the most significant stimulus for the creation of new businesses came from the lower capital gains rate, which I think had a tremendous impact on the availability of venture capital in the country, which is again drawing on my banking experience.

I know that it's very difficult for a new business to go to a commercial bank and obtain the credit to get started. They have to go to venture capital markets. And, it seems to me that the combination of those two things has had or could have a significant impact on business formation.

Mr. Kudlow, maybe you would want to comment on my question in general?

Mr. KUDLOW. Yes. I think that is right. One comment I want to make is that these income distribution numbers should be taken with great care.

You know, economists have debated this question for so many years. We have debated this during the Great Society. We have debated this in the 1980's. Here we go again in the 1990's.

Some experts who know more about this than I do have argued, frankly, that no matter what the policies are, the income distributions don't change very much over time. There is that argument.

As far as numbers that were raised earlier from this book by Phillips and so forth—I haven't read the damn book. I suppose I am going to have to. Friends of mine have told me—and I've read reviews—that a lot of those numbers are just plain wrong.

And, if you are interested in a counterstory to that, I would recommend another book by Mr. Lawrence Lindsey, who was a Harvard professor who, like Allen Sinai, was extremely skeptical of supply-oriented policies and did his research on the tax program in the 1980's and wrote an entire book rebutting many of the factual statistical issues about income distribution, economic growth, work effort, and the like.

I don't know who is right and who is wrong. I don't have enough time. I work as a financial business economist. You need a good academician or you need 20 of them, and even then you may not know. But, I wouldn't go too far on that point.

Other points have been made about capital gains. You know, many older people sell their businesses and sell their homes for retirement purposes, which distorts the data on capital gains realizations. In other words, it artificially inflates their income levels.

If you took out the one-time capital gains on the sale of homes, the sale of stocks and bonds, the sale of businesses, it turns out their income levels are rather low, in the $25,000 to $50,000 range rather than $75,000 to $100,000 and above. And, I think you have to take that into account.

As far as the effects of capital gains on venture capital, I agree. Let me raise another point. I think the capital gains tax affects minority capital, minority business. And, on this point, I have no doubt that—I mean, F. Scott Fitzgerald said this—the rich are different than you and I, they have more money.

The question is for minorities, how do they get the capital? They cannot issue shares into the stock market. The best they can do is go to people with capital and offer them a higher rate of return over time at point of sale over 5 to 10 years.

That higher rate in turn induces a transfer of capital into the minority enterprise. And, this is a point. I've seen polls and so forth that show that minority business people are strong and favor the lower capital gains for this reason. It's the only way they can raise the equity money for friends, relatives, benefactors, and you name it.

The other point I would make is, I think the higher capital gains that was put into place in the 1986 bill has really hurt State and local budgets. From high wealth concentration States, in the Northeast especially, it is not a coincidence that huge revenue misses in the last 2 or 3 years have come from overestimates of personal income taxes, which include capital gains, because the realizations have not been taken at the higher rate despite the fact that the Dow Jones has performed better than any of us dare hoped.

After the October 1987 crash, which took the Dow down to 1750 or some such, now we are at 2950 or some such, people haven't taken those realizations. But, they have been built into budgets. It's not happening.

I think if we had a lower capital gains tax the positive revenue effects at the Federal level would also generate very positive revenue effects at the State and local levels. And, in general, I think it would boost the animal spirits of this economy. And, those animal spirits are lagging.

Senator MACK. So, you do think that there is a connection then between the capital gains and capital formation to new business formation?

Mr. KUDLOW. I surely do. I don't think it's a coincidence.

Senator MACK. Let's go back to your comment about a $50 billion reduction. And, both of you might want to comment on this.

A $50 billion reduction really would bring us back to roughly the same level of Federal spending as 1990; therefore, would not really be a strong negative to the economy. And, I guess the second part of that is, what does that say with respect to Federal Reserve policy?

Does the Federal Reserve then have—should they respond to a—if the deficit reduction package that is put together actually is more spending next year than there is this year, and I would suggest that that probably is going to be the case, why then does the Federal Reserve have to step in and do anything to offset this deficit reduction package?

Mr. KUDLOW. The Fed has no automatic deficit response. This is a problem, because it almost runs counterintuitive.

But, my point about Fed policy is that market interest rates react to inflation and inflation expectations. Now, if you want to argue that a lower deficit path, a permanently lower, creditably lower deficit path, over time reduces inflation expectations and that will help the markets, I say you may be right.

But, from the standpoint of the Fed, I think they have to wait and see it in the market before they go on ahead and try to force rates down. That is why their price targeting is such a valuable adjunct to the normal open market operations and those tactics.

But, as far as the economy goes, I think it would have to depend on the kind of spending changes that were made. In other words, if you have—if the CBO is saying to us, "Spending will grow about $50 billion under current projections, and if you roll that back to last year's level you, therefore, could have a $50 billion saving," I would probably look at that carefully as a way to go.

But, I think it would matter in the kinds of program changes you made. I mean, if the Federal Government is investing less, I might be wary of that. That might hurt the economy.

If you are cutting back on transfer programs or inefficient programs or programs that really no one thinks has much of an economic impact, I would like to see that cleaned up. I think Mr. Reischauer's comments there are correct. But, I do think we have more elbow room on that.

Now, if you are talking about a $100 billion sequester and it all comes on the spending side, that would yield a $50 billion reduction in last year's level, I would be worried about that under present economic conditions. I would be worried about that.

I know that sounds a tad Keynesian, but I wouldn't ignore it altogether.

Senator MACK. You know, you have to be very careful here today. You might be changing the perception.

Mr. Sinai, do you want to comment on that?

Mr. SINAI. I think the amount of $50 or $55 billion just happens to be that kind of number that can't make one go over the edge of the cliff on an expectation of recession. We might not have one. But, we certainly would be closer to it.

And, the way the Fed would respond is a very tricky proposition.

I don't think anybody would disagree that if you raise taxes and/or cut spending or mainly cut spending that the economy is going to go up, even if it's from the projected level, because you are going to have some detriment to growth from what otherwise one would have expected or could have forecasted, right or wrong on the forecast, because of that.

So if the central bank is targeting 1½ or 2 percent growth—that's their expectation for this year and I think targeted and probably will be for next year—and a deficit reduction of a $50 billion cut in spending comes along in the next fiscal year—and almost all the evidence says that is where the biggest impact will be—then I don't think they lose anything, although it breaks the tradition by cutting the Federal fund rate by a quarter of a point and then seeing what happens.

I think it's kind of like an ounce of preventive medicine and little insurance against going off the cliff into a recession. But, that's tricky, because that is against the tradition of the Fed, they perhaps shouldn't make any promises or any guarantees.

But, in a soft economy like we have, I'm not sure—you know, the economy is not linear, so that $50 billion of restraint on top of an economy that is described the way we have described it today, where maybe 35 percent of the economy is in some sort of recession, maybe that's just enough. And, if you don't want a recession—because it does take away revenues and keeps the deficit even higher—then I think the Fed has to do some easing.

What I wouldn't do or advise or argue is that the Fed does a lot of it, and that they should do this very gingerly. You see, the problem is, if they wait until the time when the economy is doing badly off a deficit reduction, if they wait and then start to ease, the lags are so long that you lose a lot of jobs in between.

Senator MACK. There has been some reference to some work that you have done on capital gains. Do you want to go beyond what you have said already with respect to the impact that reduction in capital gains might have?

Mr. SINAI. Well, just as a macromatter, what we are finding is that a capital gains tax reduction would raise economic growth. The results are not big numbers, but do raise economic growth. It would increase capital spending. It would increase capital formation. It would generate a decent number of jobs.

It would, without unlocking, cost money, net. And, then depending on what you plug in in terms of assumptions on unlocked capital gains and realizations upon which taxes are paid at the new lower rate, it could actually more than pay for itself, which I think is what the evidence shows the capital gains tax reductions in the past did.

With unlocking, the capital gains tax reduction in the past—I don't think Larry Kudlow is closer to that research than I am, but that's my impression of the research on that subject.

Senator MACK. The unlocking and then the reinvesting. In other words, the money is not going to be buried in mattresses. Mr. Felstein and I think Mr. Lindsey as well did studies on lower capital gains rate and made some projections as far as revenues were concerned. And, if I remember those numbers, it was like $9 billion in the first year, $10 billion in the second, and $11 billion in the third, roughly $30 billion over a 3-year period.

Are those numbers relatively close?

Mr. SINAI. That's not bad. What we have done, that I guess hasn't been done, is to run this through a macroeconomic model and take a look at it. So, the kind of macrofeedback effects have not been in the work that has been done on the static estimates of the losses in capital gains tax reduction and the unlocking effect which gives back some revenues because of taking these—taking these locked up capital gains.

So, as a macroeconomy matter, we get additional growth, additional capital spending, additional jobs, a lower cost of capital. And, these days, to me, anything that helps us to be more competitive internationally—because in my own hierarchy of what I subjectively think—counts a lot for this country; that is, where we are now. I pay a lot of attention to things that will enhance our international competitiveness.

So, I weigh very heavily any research that I do that tells me we will be more competitive.

Senator MACK. OK. Mr. Chairman, thank you.

Representative HAMILTON. Let's see. I want to get your feelings on this package that all of us assume is going to come out of the summit.

Do you favor that package?

Mr. SINAI. I absolutely favor a $50 to $55 billion deficit reduction package.

Representative HAMILTON. And, the composition of it—assuming the composition is going to be roughly half tax increase and half spending cuts or close to that, that is acceptable to you? That's a step in the right direction?

Mr. SINAI. That's a step in the right direction.

Representative HAMILTON. Mr. Kudlow.

Mr. KUDLOW. I am much less enthused about it. Would we be better off to do nothing? No.

I would like to see some tax reduction. I think the capital gains tax reduction will lower the deficit and stimulate the economy. I think the Social Security rollback will stimulate the economy and in a year or two will lower the deficit.

I do not think this is the time to raise taxes, Mr. Chairman. I think the composition of the package is more important than the package.

I do not think all deficit reduction——

Representative HAMILTON. You don't agree with Mr. Reischauer when he says that's a secondary issue, the composition of the package?

Mr. KUDLOW. I believe it's the principal issue. And, further, my view on fiscal policy is that the purpose of fiscal policy is to stabilize the economy, create jobs, move us toward better growth. I don't think the purpose of fiscal policy is to meet the Gramm-Rudman target.

I think there are a lot of people now, both conservatives and liberals, who don't like Gramm-Rudman for different reasons than they didn't like it a few years ago. I see a lot of switching of positions here for different reasons. And, it fascinates me, the dynamic.

But, what I hear coming out is that Gramm-Rudman is really a secondary issue, maybe a tertiary issue. If the unemployment rate goes up in the next 6 months or maybe—let's see, November I guess is the real end of the year——

Senator MACK. Early November.

Mr. KUDLOW. Early November. No one is going to be happy with that.

Representative HAMILTON. Do you believe the package will avoid a recession?

Mr. SINAI. Well, let me break that into two steps. Suppose we have a deficit reduction package of $50 to $55 billion and nothing else happens in policy? By that, I mean the Fed does nothing. I think we run a very significant risk of a mild recession with that.

Representative HAMILTON. But, you would anticipate the Fed would react?

Mr. SINAI. Yes. I think they would react, because, you know, if that kind of budget deficit reduction—if they do nothing at the start, they wait, they are sooner or later going to see some bad economic numbers and probably some lower inflation rates. And, then they are going to say, "Yes, we can ease."

So that one way or another, they will end up reacting. It's just a question of when they do it.

Representative HAMILTON. I would be interested in your reaction to Mr. Kudlow's program, which he sets out. I don't know if you saw it or not, but I think he has mentioned most of the elements of it during his comments.

He wants to, of course, reduce the capital gains tax but he also wants to reduce the Social Security tax. How do you respond to that combination of proposals?

Mr. SINAI. There are a lot of worthwhile proposals to get a $50 billion deficit reduction. And, you can do it all spending, no taxing. You can do it—from my point of view, I am agreeing with Mr. Reischauer, you can do it with all taxes and no spending changes, though I have a personal preference to do most of it on spending and second on taxes.

But, from the point of view of the deficit and debt problems, which internationally are doing so much damage to us in terms of our standing in the world, I don't care how it happens.

Now, getting beyond that, I then ask a second question of what is the way to do it. A capital gains tax reduction, I think I would put it, I would put in a package. And, I would agree with Larry Kudlow.

And, we did some simulations with that. Because of unlocking, it may actually bring in or net some revenues.

Representative HAMILTON. That was the tax study you did for Charles Walker?

Mr. SINAI. Yes. But, of all the taxes, that one may be the least costly.

Now, the other one, the Social Security, it could be very sensible to raise the tax—forget politics now, but raise the tax on Social Security benefits for that other 50 percent of Social Security.

Representative HAMILTON. What would be the impact of Mr. Kudlow's suggestion that the Social Security tax rate increases should be rolled back?

Mr. SINAI. Cut Social Security?

Representative HAMILTON. Yes. That is your recommendation, Mr. Kudlow, isn't it?

Mr. SINAI. I guess I wouldn't do it.

Representative HAMILTON. You wouldn't agree with that? Why not?

Mr. SINAI. Raising taxes on Social Security benefits or freezing the COLA or delaying the COLA for a quarter or freezing benefits at current levels for a year, those to me are all, aside from the politics of it, perfectly appropriate ways to raise revenues or cut outlays and to lower the deficit.

Representative HAMILTON. I take it Mr. Kudlow deals with the problem of income distribution that you confront when you cut capital gains in part by recommending the reduction in Social Security tax.

How do you deal with that question of income distribution?

Mr. SINAI. I would raise the rate and eliminate the notch and go to 33 percent for——

Representative HAMILTON. You would raise the income tax?

Mr. SINAI. Yes.

Mr. KUDLOW. Can I respond to that, Mr. Chairman?

Representative HAMILTON. Yes.

Mr. KUDLOW. I think all these questions, there is a punitive way to deal with it and there is an expansive way to deal with it. I'm trying to find an expansive way to deal with it, because I think an expansive fiscal policy is the right medicine for a near-recession economy.

Social Security is a perfect example.

Representative HAMILTON. Excuse me. You said an expansionary fiscal policy——

Mr. KUDLOW. Right.

Representative HAMILTON [continuing]. Is the right thing to do now?

Mr. KUDLOW. That is my view. That is correct.

Representative HAMILTON. Regardless of the impact on the deficit. You don't worry about that?

Mr. KUDLOW. Well, in the near term, my view is that the deficit is going up no matter what we do.

Representative HAMILTON. And, you think in the long term you get higher growth and recapture a lot of it? Is that it?

Mr. KUDLOW. Yes, sir. I think—look, here is one way to look at Social Security.

Revenues derived from Social Security are predicated——

Representative HAMILTON. Let me just interrupt you there.

Mr. KUDLOW. I am sorry.

Representative HAMILTON. That has been a very seductive song for the decade of the 1980's. And, the deficit has kept going up.

Mr. KUDLOW. No. I would say actually on balance the deficit has come down. I agree with you they went up until the middle 1980's, and I would argue they are coming down.

Representative HAMILTON. Even with a $195 billion deficit for this year?

Mr. KUDLOW. Well, this year is going to be the worst year since 1986 when it was about $220 billion, if my memory serves me. However, as a share of the economy, we will still be way, way below. I think that is an important way to measure the deficit.

Representative HAMILTON. Isn't it just as important to see to what extent you are taking savings out of the economy with the deficit?

Mr. KUDLOW. Well, sure. I agree with that. But, again, I don't understand how higher taxes—if we tax saving, we are not going to get more saving. What we are going to do is get less economic activity, which will throw off fewer revenues and raise the deficit.

Social Security payrolls, for example, we know—we agree and I think Mr. Reischauer agreed—the employment growth is sloping downward. Employment was growing at 3 to 4 percent for many years in the 1980's. Now, employment is growing less than 2 percent.

That, I think, in part is a function of the increase in Social Security taxes, which raises the cost to businesses of hiring a new worker on the margin and lowers the aftertax return to workers. I think we have to solve that. We have to solve that by raising the aftertax return to workers, which is by bringing that 1 percentage point Social Security hike down and make it cheaper for employers to hire workers.

I believe we will get an expansion of payrolls and throw off more revenues, maybe not in the first year. Timing is tricky. I can do better than 10 years for you on that, though. I believe 1 to 3 years is——

Representative HAMILTON. What do you do about the future of the Social Security system if you don't have surpluses in the system now? And, if you reduce the tax rate increases that we've had in the past on Social Security, you really go to kind of a pay-as-you-go system, it seems to me, and that means when the baby boomers retire you are really going to be socked with very sharp increases, aren't you, in Social Security?

Mr. KUDLOW. Absolutely.

Representative HAMILTON. You accept that, do you?

Mr. KUDLOW. Oh, sure. But, the actuarial assumptions on this look pretty good to me. I mean, this is what I think Senator Moynihan's point was.

We are running, what I call, a surplus-surplus right now. And, so much of this—these were very longrun estimates, of course. We are talking about 50-year-type estimates. So much of this is predicated on the rate of the economic growth and the rate of payroll employment growth.

So, it seems to me, what we should do to protect the integrity of the system in the long run is to be sure that the payrolls grow at the fastest possible rate, which I believe will not be achieved by progressive tax rate increases.

And, I think what Senator Moynihan is saying about the accounting of Social Security is also a key issue. Now, that's more of a longer term issue. It's not a recession-type issue. But, I think he has a point there, too.

Mr. SINAI. I may have misunderstood the question. Your proposal is to reduce the Social Security payroll tax, is that it?

Representative HAMILTON. That's correct.

Mr. SINAI. I was talking more of an expenditure item, which is in terms of cutting the payments of Social Security benefits in order to help reduce the deficit. So, that we do have—it is a regressive tax. It is now a very large proportion of our tax receipts, and it is segregated. And, it is a very large surplus.

So, it's something worth taking a look at in terms of the——

Representative HAMILTON. I just had handed to me a chart. I don't know that I understand it fully. But, let me throw the figures out to you to get your reaction, since it seems to challenge what both of you have said with regard to capital gains.

According to Lawrence Lindsey's own study, he estimated that in capital gains realizations and revenues after the 1986 law was enacted, in 1987 we would lose $7.71 billion. But, the actual result has been that we picked up $4 billion.

Feldstein estimated we were going to lose $18 billion. We picked up $4 billion.

Treasury estimated we were going to lose $14 billion. And we picked up $4 billion.

How do you react to that? I mean, how do you——

Mr. KUDLOW. I think that too puts much significance on 1987 for that. The timing of the changes can reflect a lot of economic factors besides just the tax rate.

I think, however, if we take 1987, 1988, 1989, and 1990 we will see a significant shortfall in receipts from earlier projections.

Representative HAMILTON. Now, 1988 was even further off. Lindsey predicted a $15 billion loss and there was, in fact, an $8 billion increase.

Mr. KUDLOW. From what?

Representative HAMILTON. Well, that's on the basis of his baseline.

Mr. KUDLOW. Well, I am not familiar. I would have to look at his baseline.

Representative HAMILTON. I am interested in this. I guess all of us are. I know I am throwing something at you that you haven't seen here and it was just handed to me.

Well, you all have been here a long time. I don't want to keep you too much longer.

I did want to get your impression on the administration's comments with regard to Fed action. The administration has suggested, as you heard me ask Mr. Reischauer, that the Fed should respond to a budget deal, a package, by cutting short-term interest rates 1 to 1½ percentage points.

Do you think that is about right?

Mr. SINAI. If the Fed were to respond early and respond to a budget deal, I think 1 to 1½ is too high.

Representative HAMILTON. They ought not to do it before the package is in place?

Mr. SINAI. I agree with that.

Representative HAMILTON. You agree with that?

Mr. SINAI. I agree with that, yes.

Representative HAMILTON. OK. And, do you want to comment on that, Mr. Kudlow?

Mr. KUDLOW. Yes. I think the Fed's reaction—the conduct of monetary policy has to focus principally on the question of inflation and inflationary expectations. And, I think that is tricky business with regard to the deficit package. I really do. I don't think there are any automatic rules.

I mean, here is an odd scenario. Supposing the deficit package was $50 billion in tax increases and no spending cuts, a hypothetical. And, suppose that included an income tax hike as well as other tax increases. If the markets look at that and they say a big tax hike reduces economic efficiency and will generate more inflation, then I believe medium- and long-term rates will go up no matter what the Fed does.

Representative HAMILTON. Yes.

Mr. KUDLOW. That's a risk.

Representative HAMILTON. Senator Mack.

Senator MACK. I will try to be brief. I want to touch on two points, one going back to capital gains and there are two points under capital gains, one having to do with the impact on the value of assets and the second having to do with again the income distribution question, because I have also seen some reports that have indicated that when people are looking at who is paying the capital gains tax they, in fact, do include as part of income, as if it were ordinary income, the value or what they receive from the sale of that asset which pushes them up into a much higher income bracket. Therefore, they are part of the wealthy.

The next year, they fall back down below into the $20,000 in income or $15,000 in income.

I just want to get your response to that.

Mr. SINAI. Well, most of what I've seen—I haven't seen all of the studies and all of the qualifications—I think suggests that on the measured numbers that more of the benefits accrue to the upper income end of the distribution.

Now, if I take off my hopefully objective scientific hat, there is no way in the world anyone will ever convince me that the rich don't do relatively better on capital gains tax reduction than the poor. And, if I have some subjective nonscientific, citizen view that makes me think that a more equal income distribution is going to be better for our society, I probably wouldn't change my mind on this income distribution criterion.

What has been persuasive to me in some of—as I say, there are other ways to evaluate capital gains tax reduction and what it means on growth, on capital spending, on how much it costs. And, there is a lot of controversy over how much it costs, how much is unlocked, how much isn't, when the unlocking happens. A lot of it should happen early. Then perhaps there are some negatives later. The JCT and OTA have different numbers on that.

Then there is also something that is even, to me, very important these days, and that is how we compete with the rest of the world. I think we are losing out in terms of our market share in the rest of the world in this part of our difficult business environment.

So, questions of international comparisons on the cost of capital become very important.

Senator MACK. Maybe I am putting on my political hat when I asked that question, because lots of people in Florida who are elderly either have sold a house, a business, or a farm, which is included in an income in a very short period of time and will be looked at—in fact, I would imagine that many of them would react to the fact that only the wealthy are going to get a benefit from the capital gains tax reduction are probably going to react—I hope would react the same way that only the wealthy were going to pay for the catastrophic health insurance plan that went into effect. And, they found out, "Wait a minute. I didn't realize I was wealthy. But, on this one I am."

I would suggest that they are also going to react the same way when the capital gains tax reduction goes through, "I am one of the wealthy. I am going to get some benefit."

I will just ask a second question on capital gains. I have always been under the impression that tax rates do have an impact on value of assets—that as tax rates go up values of assets go down, as tax rates go down values of assets go up.

I wonder if again a lowering of the capital gains tax wouldn't have an impact on, one, real estate, two, our ability to sell properties that we have accumulated with the Resolution Trust Corporation and help solve the problem with respect to the S&L crisis?

Mr. SINAI. It certainly should. It's a subsidy to appreciation of any asset, so that it should push, to some extent, the prices of those assets higher.

In some of the research I've done, we find a pretty significant stock market effect. If one lowers the capital gains tax from 28 percent to 15 percent, there are pretty sizable impacts. We didn't study the effects on real estate prices, but we did on the stock market.

Mr. KUDLOW. Sure. I mean, I don't know that it's a subsidy. I think it's—the theory here is tax capitalization, the impact of taxes on capital values.

If you raise taxes, asset values are going to decline. At the State and local levels, for example, a lot of studies have shown higher State and local taxes have almost an immediate impact on lower real estate values. And, I think that model works here.

But, the point about the distribution, the income distribution, let's suppose I agree for the moment that capital gains tax cut somehow on average would help the wealthier incomes more. Maybe nothing is going to change that income distribution.

The question is, the real test ought to be whether tax policy—with respect to capital gains or other things, whether tax policy is increasing national income and national wealth? So that you may have the same distribution spreads but everybody may have more income and they may be wealthier.

And, I would regard that as a good thing. I don't think the thrust of fiscal policy should be this narrow issue of income redistribution.

And, sometimes I read the papers about this debate. I understand the politics a bit. But, I say, "For heaven's sake, the whole rest of the world, in Europe and Latin America and elsewhere, is moving away from the idea that policies are dominated by distributional effect, and they are moving toward the idea that policy should be dominated by income and wealth type standards. Why is the United States so preoccupied all of a sudden on distributional issues?"

What we want to do is grow the economy. It may be that the spread between the wealthiest person in the economy and someone in the middle and someone at the low end, that may never change. Economists have disagreed about this for decades.

But, if they are all moving up the ladder, they will be happier. And, I daresay, in political terms, that's a good thing for everybody in office whether you are a Democrat or Republican.

Senator MACK. Thank you, Mr. Chairman.

Representative HAMILTON. Mr. Kudlow, how would you have voted on the California proposition to increase the gasoline tax?

Mr. KUDLOW. Oh, dear. If I lived out there, Mr. Chairman, and if I carefully read the covenants and I really believed that these were truly designated taxes and would help me get to work faster——

Representative HAMILTON. Infrastructure.

Mr. KUDLOW. Infrastructure. It's possible I might have voted yes. I hate traffic jams like everybody else. [Laughter].

Representative HAMILTON. Well, I recognize the question was a little off the wall. But, the point is that some tax increases, even in your view, might be progrowth.

Mr. KUDLOW. I agree. I mean, look, we have it in New York. Lord knows, we could do better in the New York infrastructure.

And, I think earmarked, designated taxes, particularly for investment purposes, can help business and commerce, yes. No, I am not a purist on this question.

Representative HAMILTON. Mr. Sinai, how much of a reduction in interest rates would it take to give an equivalent cost of capital reduction as a capital gains tax cut of the size passed by the House Ways and Means Committee last year?

Mr. SINAI. I don't know. I would have to take a look at the House Ways and Means Committee item and think about that one. I can't give you a quick answer.

That's an excellent question, but I can't give you a quick answer.

Representative HAMILTON. Well, we have had you here for a long time. We apologize for keeping you waiting for a while while we heard from Mr. Reischauer.

Thank you very much for your excellent testimony.

Mr. SINAI. Thank you.

Representative HAMILTON. The committee stands adjourned.

[Whereupon, at 12:27 p.m., the committee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record:]

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Robert D. Reischauer
Director

July 26, 1990

Honorable Lee H. Hamilton
Chairman
Joint Economic Committee
Congress of the United States
Washington, DC 20510

Dear Mr. Chairman:

This letter responds to your request of July 11, 1990, that CBO comment on the accuracy of Lawrence Lindsey's predictions of the effect of the Tax Reform Act of 1986 (TRA) on realizations of capital gains and revenue from the capital gains tax. Your letter included a copy of Professor Lindsey's 1987 article and a table comparing Lindsey's predictions with actual data for 1987 and 1988 reported in *Tax Notes*. Comparisons of forecasts and actual realizations cannot definitively resolve the question of whether a capital gains tax cut can increase revenue in the long run. CBO, however, agrees with the *Tax Notes* article's assessment that actual experience seems inconsistent with Lindsey's predictions and with the expectation that cutting capital gains tax rates would be likely to raise revenue.

Estimates from the *Tax Notes* article are reproduced in the attached Table. These estimates show that Lindsey's realization estimates, based on a survey of cross-section econometric studies, understated actual realizations by from 24 to 77 percent in 1988. The *Tax Notes* article argues that this understatement shows that Lindsey's estimates vastly overestimate the response of taxpayers to changes in capital gains tax rates. Though this is a plausible interpretation of the estimates, it is not the only one. The estimates could also be too low for other reasons unrelated to the change in capital gains tax. For example, estimated realizations could also fall short of actual realizations if Lindsey's projections of baseline realizations (i.e., capital gains realizations that would have occurred if the capital gains tax rate had not been increased) were too low. In fact, CBO's estimate of baseline realizations, which is based on actual macroeconomic and stock market data unavailable at the time of Lindsey's forecast, is 27 percent higher than Lindsey's forecast.

Honorable Lee H. Hamilton
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To see whether this possibility could reasonably explain the results, CBO has calculated what the level of baseline realizations would have to be in order for the estimated level to equal the actual level of realizations using Lindsey's methodology. These implied baselines are reported in the Table. At one extreme, the capital gains response estimated by Feldstein, Slemrod, and Yitzhaki would be consistent with actual realizations only if baseline realizations were $830 billion. This is more than three times the CBO baseline estimate. It is also almost five times the level of capital gains realizations in the last year before tax reform, 1985. Such a high level is implausible. On the other hand, the relatively low response attributed to Minarik would be consistent with actual realizations if baseline realizations were $254 billion. This latter figure is only 4 percent higher than CBO's baseline and is plausible.

However, as the *Tax Notes* article points out, this comparison of 1988 data with predictions does not accurately reflect the long-run response to higher rates. The level of realizations in 1988 was probably depressed by the huge sell-off of assets in 1986 before the higher capital gains tax rates took effect. Thus, even the lowest response cited by Lindsey might significantly understate the actual long-run level of realizations.

The Table and the *Tax Notes* article to which you referred all suggest that the evidence on capital gains realization response based on cross-section data is not a good predictor of the response of individuals to capital gains tax changes. I enclose another *Tax Notes* article by Leonard Burman, a member of the CBO staff, which questions the relevance of cross-section evidence on empirical grounds. Both articles are consistent with CBO's reliance on time-series evidence. That evidence, as reported in the 1988 CBO study on capital gains, which is also enclosed, suggests that the increase in capital gains tax rates enacted in 1986 probably raised revenue and any cut in capital gains tax rates from current levels would most likely lose revenue.

If you wish further details, please feel free to contact me or your staff may wish to contact Leonard Burman at 226-3194 or Larry Ozanne at 226-2684 of my staff.

Sincerely,

Robert D. Reischauer
Director

Enclosure

cc: Honorable Paul S. Sarbanes
Vice Chairman

Estimates of Capital Gains Realizations and Implied Baselines--1988

Model	Capital Gains Realizations ($ Billions)	Deviation From Actual Realizations (Percent)	Baseline Consistent With Actual Realizations ($1 Billion)	Deviation From CBO Baseline (Percent)
Lindsey's Baseline	192			
Feldstein, Slemrod, and Yitzhaki	38	-77	830	240
Treasury	57	-65	550	126
Lindsey	86	-47	362	48
Auten and Clotfelter	102	-37	307	26
Minarik	123	-24	254	4
Actual Realizations	162			
CBO Baseline Estimate			244	

Source: Joseph J. Minarik, "One More Round on Data on Capital Gains Tax Revenues," Tax Notes, April 9, 1990, p. 222, and CBO calculations.

viewpoint

WHY CAPITAL GAINS TAX CUTS (PROBABLY) DON'T PAY FOR THEMSELVES

by Leonard E. Burman

Leonard E. Burman is a principal analyst with the Congressional Budget Office. The views expressed are the author's alone and should not be attributed to the Congressional Budget Office.

As one of the coauthors of a study frequently cited as providing evidence in favor of a capital gains tax cut, Burman contends that the inference that such a cut would pay for itself, if not increase Federal revenues, rests on unsupported assumptions. The inference suggests that taxpayers would sell a large percentage of assets that they would otherwise hold until death. Such a behavioral response is inconsistent with both historical evidence and conventional views of financial markets.

The opinions expressed in Viewpoint do not necessarily reflect the opinions of Tax Analysts. Viewpoint is open to any person who wishes to express an opinion on tax or fiscal policy. It is our hope that the opinions expressed in this column will contribute to the development of a sound and administrable system of taxation. Please address submissions to the editor.

An article that I coauthored last year has been frequently cited as evidence of a high degree of responsiveness of taxpayers to capital gains tax changes. In May 1989, the Treasury Department released three studies: a panel study[1] by Jerry Auten, Bill Randolph, and me,[2] a cross-section study by Robert Gillingham, John Greenless, and Kim Zieschang,[3] and a time-series study by Jon Jones.[4] At the time, Treasury's press release stated that the studies provide "additional evidence supporting the Treasury Department estimates that the President's capital gains proposal will increase Federal tax revenues." Since then, those who believe that cutting capital gains tax rates would pay for itself have cited these studies as scientific evidence of their position. It's not that clear-cut.

My interpretation of this research makes me extremely skeptical that cutting capital gains tax rates is an effective way for the government to raise revenue. In particular, the analysis in Auten, Burman, and Randolph (ABR) makes it clear that parameter estimates based on panel and cross-section data cannot be expected *a priori* to reflect the response of individuals to statutory changes in tax rates. "Cross-section estimates. . . will accurately predict responses to tax policy changes only if individuals treat all components of their marginal tax rate in the same way.[5] To explain the point briefly, we know that individuals have some control over their marginal tax rates (for example, through the use of tax shelters or through the timing of realization of gains and losses) and also that tax rates can vary from year to year because of exogenous changes in income. In addition, tax rates vary among individuals because of differences in wealth and demographic factors such as family size and age. In a cross-section data set, these individual differences are the only possible source of variation. In addition, periodically the government changes tax rates. This is the primary source of variation in time series data. Panel data that span tax law changes reflect both sources of variation. However, because there are other time-varying factors that affect capital gains realizations, such as the state of the economy, a panel would have to include many more years than the Treasury panel to isolate the effect of changes in tax law.

If individuals respond the same way to individual-specific changes in tax rates as they do to statutory changes, then cross-section, panel, and time series estimates should be similar. The empirical evidence is that

[1]This is econometric jargon. A *panel* refers to a data set with observations on a number of individuals over time. A *cross-section* data set contains observations for a number of individuals taken at a single point in time. *Time series* data contain aggregate data (for the whole country) over many years. Thus, a panel has both cross-section and time series dimensions. The Treasury panel contains individual income tax return data from approximately 12,000 taxpayers over the five-year period 1979-1983.

[2]Gerald Auten, Leonard Burman, and William Randolph, "Estimation and Interpretation of Capital Gains Realization Behavior: Evidence From Panel Data," *National Tax Journal*, vol. 42, September 1989, pp. 353-374. A preliminary version of this paper was released by Treasury's Office of Tax Analysis as OTA Paper 67, May 1989.

[3]Robert Gillingham, John Greenless, and Kimberly Zieschang, "New Estimates of Capital Gains Realizaton Behavior: Evidence from Pooled Cross-Section Data," OTA Paper 66, May 1989.

[4]Jonathan Jones, "An Analysis of Aggregate Time Series Capital Gains Equations," OTA Paper 65, May 1989.

[5]ABR, p. 357.

they are not. Most cross-section and panel estimates (including ABR) report elasticities[6] of capital gains realizations with respect to tax rates that are greater than one at current tax rates. Most time series estimates of the long run response to tax rate changes (including most of the estimates in the Treasury time series study) are below one. As analyzed by the time series, the historical evidence is not consistent with the predictions of micro-data studies. The consistent divergence in estimates suggests extreme caution in inferring aggregate behavior based on the micro-data studies.

These conclusions are not radical or controversial. The limited applicability of cross-section estimates is a classic problem in econometrics. Edwin Kuh warned in 1959 that "...cross-sections cannot be used successfully to make time series predictions unless a systematic relationship between the cross-section and time series estimates has been firmly established."[7]

ABR argued, after catagloging a host of potential econometric problems in time series estimates, that "the time series estimates under the most optimistic of assumptions reflect a good estimate of...the average effect of statutory tax changes."[8] However, the optimistic assumptions are not supported by the empirical evidence. Time series parameter estimates vary widely, as had been noted by Jon Jones, Alan Auerbach,[9] CBO,[10] and others. All that can be inferred from the time series estimates is that the capital gains realization elasticity is probably less than one, and even that inference depends on the assumption that the sources of bias in time series estimates did not result in a consistent understatement of elasticities, an assumption that cannot be validated empirically. There is no point elasticity estimate that can claim empirical support. The empirical uncertainty surrounding any estimate is very large. At best, the empirical evidence may be used to rule out certain possibilities as relatively unlikely.

This leaves revenue estimators at Treasury and at JCT in a real conundrum. They can't answer policymakers, "we don't know," even though it's true. The econometric results just aren't very helpful. That means that the only recourse is to think about the implications of various estimates and whether those implications are plausible.

Lacking convincing counterevidence from empirical analysis, the congressional estimates of the response of individuals to a capital gains tax cut seem more plausible to me than the Administration's. The Administration's estimates assume that taxpayers would pay more tax in total over the long run at lower tax rates. This is a very surprising result. When tax rates are cut by 30 percent, someone who would have paid $1 million in capital gains taxes over his or her life can save $300,000 by doing nothing different. Would many taxpayers alter their behavior so that they would voluntarily pay back all of the tax savings? Jane Gravelle[11] and Alan Auerbach have pointed out that the only significant long-run source of additional revenues from capital gains is from sales of assets that would otherwise have been held until death or donated to charity and thus escape tax entirely. Any other realization response simply represents a timing change—the government collects revenues now rather than later.[12]

But why would someone sell an asset that they would otherwise hold until death or donate to charity, even at a 20 percent tax rate? If market prices reasonably reflect future earnings (a hypothesis that is generally accepted in the finance literature), any portfolio asset should have the same earnings prospects as any alternative investment after adjusting for risk. Thus, selling an asset, paying capital gains tax now, and reinvesting what's left after tax would result in a smaller bequest or gift. As long as capital gains can escape tax entirely, the penalties to selling assets that would otherwise be held until death or donated to charity are likely to be prohibitive in most cases.[13]

Another possibility is that assets that would have been held until death could be sold for current consumption. A lower capital gains tax rate encourages such behavior since the cost of realizing gains for consumption is directly related to the tax rate. However, those who count on a burst in consumption in place of bequests have cause for concern. This is equivalent to assuming that a lower capital gains tax rate would reduce savings in the long run.

Thus, a long run elasticity of capital gains realizations of greater than one seems very unlikely. Such a high elasticity may seem to have empirical support in cross-section and panel data studies, but the relevance of those studies rests on extremely strong assumptions that are inconsistent with the dichotomy between cross-section and time series estimates. The time series estimates may be relevant (also under strong assumptions), but almost all of those estimates are well below one. As the UCLA econometrician Edward Leamer wrote, "a fragile inference is not worth taking seriously."[14] Given the empirical evidence available to date, a capital gains elasticity of one or more is an extremely fragile inference indeed.

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[6]More jargon. The *capital gains realization* elasticity measures the responsiveness of individual capital gains realizations to changes in the tax rate. For example, an elasticity of 0.5 implies that a 30 percent cut in tax rates would result in a 15 percent (0.5 times 30) increase in realizations. As a very rough rule of thumb, a capital gains tax cut would pay for itself if the capital gains realization elasticity is 1.0 or higher (although that ignores several other factors that affect revenues).

[7]Edwin Kuh, "The Validity of Cross-Sectionally Estimated Behavior Equations in Time-Series Applications," *Econometrica*, vol. 27, April 1959, p. 211.

[8]ABR, p. 357.

[9]Alan Auerbach, "Capital Gains Taxation and Tax Reform," *National Tax Journal*, vol. 42, September 1989, pp. 391-401.

[10]U.S. Congressional Budget Office, "How Capital Gains Tax Rates Affect Revenues: The Historical Evidence," March 1988.

[11]Jane Gravelle, "A Proposal for Raising Revenue by Reducing Capital Gains Taxes," CRS Report 87-562E, June 1987.

[12]Timing does affect the present value of government receipts. However, at moderate rates of inflation, this is a relatively minor effect.

[13]See Charles Holt and John Shelton, "The Lock-In Effect of the Capital Gains Tax," *National Tax Journal*, vol. 15, December 1962, pp. 337-352, for a careful and still very relevant analysis of the lock-in effect caused by the nontaxation of capital gains at death.

[14]Edward Leamer, "Sensitivity Analyses Would Help," *American Economic Review*, vol. 75, June 1985, pp. 308-313. This was an elaboration on Leamer's stinging critique of misapplied econometrics, "Let's Take the Con Out of Econometrics," *American Economic Review*, vol. 73, March 1983, pp. 31-43.

RESPONSES OF ROBERT D. REISCHAUER TO WRITTEN QUESTIONS POSED BY REPRESENTATIVE HAMILTON

QUESTION

I understood you to say that the deficit reduction you had assumed would raise the growth rate of real GNP close to one-half percentage point higher than would occur otherwise. Is that correct? Could you please tell us roughly the amount of additional GNP per capita, in dollars of today's purchasing power, that would imply by 1995?

Answer

The deficit reductions assumed in the CBO projections for 1991 through 1995 would increase the growth rate of real GNP by an estimated average of three-tenths of a percentage point between 1990 and 1995. As a result of this accelerated growth, real GNP and per capita real GNP are nearly 2 percent higher in 1995 than they would be without deficit reduction. This translates into an increase of about $430 per person by 1995, when measured in 1990 dollars.

QUESTION

Between the two broad categories of domestic earnings--wages and salaries and other labor compensation, on the one hand, or profits, interest and rent, on the other hand--would there be any distinguishable difference in growth rates as a result of the faster GNP growth? Would you expect the growth rate for wages and salaries, after adjustment for inflation, to be at least as fast as real GNP through 1995?

Answer

CBO projects a perceptible difference in growth rates of the broad income categories: total labor compensation (wages, salaries, and fringe benefits) and nonwage income (comprising profits, interest, rent, dividends, and proprietors' income). The differences in growth rates stem from three basic characteristics of the deficit reduction forecast: faster GNP growth, lower interest rates, and lower government spending.

Total labor compensation, for example, is projected to grow faster than in the baseline, averaging one-tenth of a percentage point higher growth between 1990 and 1995 than it would have in the absence of deficit reduction. This difference incorporates two effects: faster GNP growth (raised an average of two-tenths of a percentage point), which tends to raise the compensation growth rate; and lower spending on federal wages (an assumption about deficit reduction), which tends to slow the growth of compensation.

In comparison, nonwage income grows more slowly than it does in the baseline; deficit reduction lowers this growth rate by an average of two-tenths of a percentage point during the forecast period relative to the baseline. The main reason for this is that deficit reduction cuts payments of interest on federal debt, an important component of interest income.

When adjusted for inflation, the growth rates for wages and salaries and for total labor compensation are projected to be slightly lower than the growth rate for real GNP, under the assumption of deficit reduction. Real GNP is projected to grow at an average rate of 2.5 percent through 1995. Wages and salaries, as well as total labor compensation, are projected to grow at an average rate of 2.2 percent (a rate higher than in the absence of deficit reduction).

QUESTION

Would most economists project GNP and wages and salaries to remain at higher levels as a result of permanently reduced budget deficits? Would the gains from deficit reduction continue to grow? For how long?

Answer

The theory of long-run economic growth, which is exploited by the model CBO used, predicts permanently higher levels and temporarily higher growth rates of real GNP as a result of deficit reduction. Therefore, after a period of acceleration, real GNP's growth rate would eventually return to the baseline rate, but real GNP would be permanently higher than it would have been in the absence of deficit reduction. The same result would be predicted to hold for wages and salaries.

QUESTION

You have noted that a prompt reduction in short-term interest rates would be a necessary response by the Federal Reserve to prevent fiscal restraint from causing a recession, and that a credible deficit reduction policy would bring down long-term rates as well. Would variable-rate mortgage costs and rates on home equity lines be likely to decline promptly, in pace with Treasury bill rates, and would fixed-rate mortgage rates decline with other longer-term rates? By how much would the carrying cost on a median priced house be reduced for a family that has financed with a typical variable-rate mortgage, and for one financing a new purchase with a fixed-rate mortgage?

Answer

Although CBO does not project interest rates on mortgages or home equity lines of credit (HELCs), it is possible to outline the structure of the relationship between these rates and those that CBO does project. For instance, most HELCs (about three-quarters) are tied to the prime rate, which tends to track short-term interest rates. Given that most HELC rates are adjusted monthly, it is reasonable to expect that they will fall roughly as fast as three-month Treasury bills, which CBO projects to be 70 basis points lower (by 1992) as a result of deficit reduction.

Mortgage interest rates can be expected to move just as quickly. Rates on conventional (fixed-rate) mortgages generally move in step with the 30-year Treasury bond rate, which would be expected to fall with the 10-year Treasury note rate, as CBO projects. Adjustable-rate mortgages (ARMs) are typically tied to one-year Treasury note rates and adjust annually. Rates on new ARMs would fall as Treasury note rates fell, although the national average ARM rate would decline more slowly, as the changes in Treasury note rates slowly passed through to all existing ARMs.

Lower interest rates will reduce the carrying costs of both types of mortgage. To estimate the size of the reduction, consider the following example: the median price of a new home is currently about $130,000 and the average rate for a conventional 30-year mortgage was 10.16 percent this past June. Assuming a 10 percent down payment and that the average mortgage rate would be 70 basis points lower as a result of deficit reduction, then the average monthly payment would be roughly $60 lower under the assumption of deficit reduction. Of course, the full 70-basis-point drop in rates is not projected to occur until 1992, while the median home price would be expected to be higher by then. However, this calculation is indicative of the savings (in 1990 dollars) that would be realized.

The savings for holders of variable-rate mortgages is somewhat more complicated since each person's savings will depend on how long he or she has held the loan, but under conditions similar to those described above, and assuming a three-year-old mortgage, our median homeowner will save about $57 per month as a result of deficit reduction.

QUESTION

Can you give some idea of the role of improvements in the trade sector in the overall job growth that you project over coming years, and would you sketch any notable changes in job characteristics?

Answer

According to CBO projections, both the current-account balance and the merchandise balance of trade will improve as a result of deficit reduction, an that the improvement in the trade balances would lead to improved job growth in the manufacturing sector.

QUESTION

Is it likely that a policy of fiscal restraint coupled with an easier monetary policy in the United States will lead to lower interest rates in international financial markets? Who will be the principal beneficiaries of such rate declines? Can they be of significant help to newly democratizing and developing countries?

Answer

The mix of fiscal and monetary policies assumed in the CBO summer report would probably lead to lower interest rates in other nations' markets. The U.S. financial market is so integrated with other financial markets of the industrialized world that it is appropriate to talk of one global financial market. Thus, a reduction in the world demand for credit--arisingfrom a reduction in the U.S. deficit--canbe expected to reduce the level of world interest rates.

All developing countries, but especially those facing heavy debt burdens, also stand to gain substantially from a drop in global interest rates. A decline in global interest rates could help reduce the debt-service burden of the developing countries, freeing up resources to finance investment and imports of goods and services. About 70 percent of the long-term debt owed by the severely indebted middle-income countries (including Mexico and newly democratic countries such as Brazil, Argentina, and the Philippines) is in the form of variable-interest loans, whose interest rates fluctuate with the London Interbank Offered Rate (LIBOR) for Eurodollars (which in turn fluctuates with domestic U.S. rates). Many of the newly democratizing countries in Eastern Europe--especially Hungary, Poland, and Bulgaria--also suffer from serious debt-service difficulties and would benefit from a fall in global rates.

THE ECONOMIC OUTLOOK AT MIDYEAR

THURSDAY, AUGUST 2, 1990

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

The committee met, pursuant to notice, at 9:37 a.m., in room 2325, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representative Hamilton, Scheuer, and Solarz.

Also present: Joseph J. Minarik, executive director; William Buechner, Susan Lepper, Randall Dodd, and Doug Koopman, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The meeting of the Joint Economic Committee will come to order.

This morning, the committee resumes its hearings on the economic outlook at midyear.

Our witnesses this morning are the Chairman of the President's Council of Economic Advisers, Michael Boskin, and his colleague on the Council, John Taylor.

The purpose of this morning's hearing is to examine the revised economic and budget forecasts that were released earlier this month in the President's midsession review of the budget. The Joint Economic Committee is very pleased to welcome Mr. Boskin and Mr. Taylor to testify on the economic and budget outlook. And we'll turn now to Mr. Boskin for his opening remarks.

We're delighted to have you. Your testimony, of course, will be entered into the record in full, and you may proceed as you see fit.

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY JOHN B. TAYLOR, MEMBER

Mr. BOSKIN. Thank you very much, Mr. Chairman. It's indeed a pleasure to be here once again to testify before the Joint Economic Committee, which I always remember fondly was created simultaneously with the Council of Economic Advisers by the Employment Act of 1946.

I will make some brief opening remarks, and then I'll ask Mr. Taylor to supplement them with some remarks of his own, and questions can be addressed either to myself or to Mr. Taylor.

There have been a number of changes in the U.S. economy since we appeared before this committee in February. The economic expansion continues to set records for durability. The unemployment rate remains around a 16-year low, and our trade deficit has continued to come down. The United States remains the world's most prosperous nation. This is indeed the good news.

Yet, interest rates are higher than we, and most other private forecasters, predicted back in January, and the pace of economic growth is more sluggish than we would like. To be sure, we face serious policy challenges. But, if we meet these challenges and pursue sensible economic policies, I remain optimistic that the economic expansion can continue and the United States can increase its rate of longrun economic growth.

The most important economic challenge is adopting a credible, multiyear, growth-oriented, deficit-reduction package and a monetary policy appropriate to offset any short-term contractionary effects of such deficit reduction.

The administration's revised economic projections, which were reported in the midsession review of the budget, were developed as always by the Council of Economic Advisers, the Treasury, and the Office of Management and Budget, the so-called troika.

The revised projections incorporated data available until June and were made prior to the recent GNP revisions, a point I'll refer to in a moment. The projections reflect our analysis of the views and opinions of many outside economists, both in the public and private sectors. As I've often said, Mr. Chairman, economic forecasting is an imprecise science. Unforeseen events—from unusual weather to foreign political developments—one of the things that I seemed to have forecasted well was that I included foreign political developments in testimony prepared a couple of days ago—make forecasting the course of the economy difficult.

In our view, the projections embody the best available forecasting methods, informed judgment, and basic economic principles. The projections should be viewed as a most-likely scenario. The economy, of course, may well perform better or worse than projected.

Let me briefly review what has happened since I appeared here in February. Long-term interest rates around the world rose significantly very early in 1990. This jump was not forecast by us or most private forecasters. Anticipation of increased demand for capital in Eastern Europe, particularly once it became clear that there may well be a rapid reunification of Germany, was a significant factor in this jump, according to virtually all analysts. A temporary increase in inflation expectations and the financial turbulence in Japan may also have contributed to this increase in interest rates.

Partly as a result of these higher-than-anticipated interest rates earlier this year, the U.S. economy has grown more slowly than we had predicted. For the first half of 1990, real GNP growth averaged 1.5 percent, with modest increases in consumer spending, residential contruction, and business spending on new plant and equipment compared to late 1989. Real exports grew at an average 8 percent rate in the first half, and continue to be a bright spot for the economy.

For the first half of the year, the real net export deficit was at its lowest level since the third quarter of 1983. However, on the down side, there was a noticeable slowdown in overall job creation and declines in the number of jobs in the goods-producing sector. Real GNP grew a modest 1.2 percent in the second quarter, according to the Commerce Department's advance estimates which, as you know, are often revised considerably.

However, consumption growth picked up toward the end of the quarter, and I would caution everyone to realize that very unusual weather and other special factors have made quarterly real growth statistics less representative of underlying economic movements than they may have been at a time when the weather patterns might have been more normal. We had very, very cold weather in late December, which caused lots of problems and unseasonably warm weather in January and February, which boosted construction activity. There were other factors of that type, so it makes sorting out the data a little more difficult.

Despite the slower growth, the unemployment rate has not moved very much in the last 6 months, remaining very near its 16-year low. Jobless rates for individual worker groups have also remained at relatively low historical levels. Recently, the Commerce Department not only released its first estimate of its three successive estimates of second quarter real GNP growth, but also historical revisions to the GNP account for 1987, 1988, and 1989. The revisions confirm that 1987 and 1988 were strong growth years. The growth in 1989 was revised down significantly. Real GNP is now estimated to have grown 1.8 percent in 1989, compared with the previously estimated 2.5 percent, on a fourth over fourth quarter basis. The major factor in this lower GNP growth was a sharp downward revision to consumer spending on services, particularly medical services, for which annual survey data were available for the first time. The fourth quarter of 1989 was particularly weak, posting a very small 0.3 percent annual growth rate.

While the administration's projections were made prior to these revisions and to the advance estimate of second quarter GNP growth, the qualitative picture we had been anticipating since the summer of 1989—slower growth in late 1989 and early 1990, picking up late 1990 and 1991—has not been changed.

We saw a brief spurt of inflation. That inflation was higher in the first quarter 1990 than analysts, including ourselves, had projected late last year, but much of that runup was due to temporary factors. For example, December's cold weather. Energy prices rose sharply. Consumer food prices rose sharply because of the freeze in the agricultural sector in December, and so forth. In the last several months, however, inflation has once again abated.

In summary, the general pattern of inflation during 1990 appears to be fairly similar to that in 1989. You may recall in the first half of 1989, CPI inflation averaged almost 6 percent at an annual rate, again led by unusual energy and food price increases. But energy and food prices abated and we expected them to abate, so we interpreted the first-half increase as a temporary inflation blip. The second half CPI inflation did indeed trail off, to 3.6 percent. In our judgment, the first-quarter 1990 runup in inflation was another temporary blip, and so we remain optimistic about the outlook for inflation.

Let me speak briefly about the projections and about how they affect the budget projections. The administration's projections—both short and long term—are a consistent package with administration's economic policy proposals. Hence, they should be viewed as a conditional forecast. If the policies or their economic equivalent are not implemented, the projections would not be our best judgment of future economic conditions. Most important in this context is the policy goal of credible, multiyear, growth-oriented deficit reduction, with a monetary policy appropriate to offset any short-term contractionary effects of such deficit reduction. In light of the first-half developments, we have revised our economic projections for 1990 through 1995.

We expect that real growth will be somewhat slower in 1990 and 1991 than we had earlier projected, and I'll come back to what we expect on the other variables in one second. The best way to think about that, Mr. Chairman, is that we had been expecting something of a slowdown and then a rebound. Because of the backup in interest rates and some other factors, we now expect that slowdown to stretch out a little longer and the rebound to be a little more gradual and occur a little later. So the qualitative picture remains quite similar, but the exact timing and the period of slower growth is a little longer. That leads us to a real GNP growth of slightly over 2 percent in 1990 and 2.9 percent in 1991, with exports and business spending on new equipment likely to be driving forces behind GNP growth.

In January, we had projected 2.6 and 3.30 percent for those 2 years. The slower projected real GNP growth in the near term may well result in a very slightly higher average unemployment rate in 1991 than had previously been expected.

Inflation is expected to moderate in the second half of the year and moderate further in 1991.

The increase in long-term interest rates through May 1990 caused us to raise our projection of the average level of interest rates for 1990, although we still expect interest rates to decline somewhat. Ten-year Treasury notes are projected to average 8.5 percent in 1990 and 7.9 percent in 1991, and we're projecting that short-term rates on 3-month T-bills will average 7.7 percent in 1990, about where they are now.

With respect to the longer term outlook, labor force growth is expected to slow. As is well known, the generation following the post-war baby boom entering the labor force is much smaller. Labor productivity is assumed to grow at its longrun historical trend. These two factors combine to produce an estimated potential GNP growth rate—when GNP is at its "potential" growth rate—of about 3 percent. GNP growth between 1991 and 1993 is projected to be slightly above 3 percent as the economy rebounds from its current level, which is not fully utilizing all of its resources. Thereafter, growth is expected to stabilize around potential.

Significant progress in devising a growth-oriented Federal deficit reduction strategy and steady reductions in the inflation rate will allow interest rates to decline gradually over this period of time. In our view, a more stable economic environment is likely to wring out some of the uncertainty premium in interest rates.

Let me say a word or two about how we compare to other forecasts. For the next couple of years, the administration's forecast is about in the middle of private opinion on the major aspects of the macroeconomic outlook. For 1990, on a year-over-year basis, the CEA, and I might add, the CBO, call for a 2 percent annual rate of growth in real GNP, about the same as the 1.9 percent average of 52 private forecasters compiled by the Blue Chip—called the Blue Chip Consensus—in July. For 1991, on a year-over-year basis, the administration's forecast of 2.8 percent is slightly higher than the CBO and the Blue Chip Consensus.

On inflation, the administration, the CBO, and the Blue Chip Consensus are essentially the same for 1990 and 1991 with respect to year-over-year percentage changes in the GNP deflator. They differ at most by a tenth of a percent. On interest rates, the administration and the Blue Chip average are the same this year. We're about 60 basis points lower than the average Blue Chip forecast for 1991, although the CBO is about the same as the administration in both years.

I must emphasize that our forecast is conditional on the policy proposals and, hence, they're not strictly comparable to the Blue Chip forecasters, because obviously they are making different policy assumptions than we are. They're making their best judgment about what is likely to happen; we are making ours conditional on the policies being enacted which obviously we hope will occur.

Let me say a word about the economic assumptions and the budget projections. Expected outlays in revenues depend on many factors, not the least important is the state of the economy. The administration's economic assumptions and budget policies are designed as a consistent package. The changes we have made in the economic assumptions since January account for only a small part of the change in the projected deficit of the Federal Government for 1990 and 1991.

Focusing on fiscal year 1991, Mr. Chairman, the projected deficit is about $169 billion, excluding Resolution Trust Corporation spending. This compares with $93 billion in the January budget, excluding RTC spending. Of the resulting $76 billion change in the projected deficit for fiscal 1990-91, $49 billion is due to technical reestimates, $24 billion due to changing economic assumptions. Most of the change due to economic assumptions is related to higher than previously expected outlays because we—as well as most private forecasters—now expect higher interest rates than we expected 6 months ago.

Let me conclude, before turning to Mr. Taylor for a couple of comments, by stating that despite the recent sluggishness and the policy challenges we face, my best judgment is that the economy will continue to grow. As I noted earlier, economic forecasting is an imprecise science, though, and economic growth could be more rapid than I have indicated today, or it could be slower. And we should keep that in mind.

As I have stated elsewhere, economic expansions do not end on their own; they end as a result of external shocks to the economy, economic imbalances that have to be worked off, or inappropriate economic policies. The administration is working hard to ensure that economic growth continues, and that it is not only made more rapid, but also more secure.

We look forward to continuing to work with the Congress to achieve substantial, growth-oriented deficit reduction, which, combined with a quick and full monetary policy accommodation, will set the stage for a continuation of what is already the longest peacetime expansion on record. This will further enhance the long-run growth potential of the economy, while controlling inflation.

If I may, I'd like to have Mr. Taylor say a few words.

[The prepared statement of Mr. Boskin follows:]

PREPARED STATEMENT OF HON. MICHAEL J. BOSKIN

The Administration's Economic Outlook

Chairman Hamilton, Vice Chairman Sarbanes, and other distinguished Members of the Committee, it is a pleasure to appear before you to present the Administration's economic outlook, prepared in conjunction with the Mid-Session Review of the budget.

There have been a number of changes in the U.S. economy since I appeared before this Committee in February. The economic expansion continues to set new records for durability, the unemployment rate remains around its 16-year low, and our trade deficit has continued to come down. The United States remains the world's most prosperous nation. Yet, interest rates are higher than we, and many other forecasters, predicted in January, and the pace of economic growth is more sluggish than we would like. To be sure, we face serious policy challenges. But, if we meet these challenges and pursue sensible economic policies, I remain optimistic that the economic expansion can continue and the United States can increase its rate of long-run economic growth. The most important economic challenge is adopting a credible, multiyear, growth-oriented, deficit-reduction package and a monetary policy appropriate to offset any short-term contractionary effects of such deficit reduction.

The Administration's revised economic projections, reported in the Mid-Session Review of the Budget, were developed by the Council of Economic Advisers, the Treasury, and OMB (the Troika). The revised projections incorporate data available until June and were made prior to the recent GNP revisions. The projections reflect our analysis of the views and opinions of many outside economists, both in the public and private sectors.

Economic forecasting is an imprecise science. Unforeseen events -- from unusual weather to foreign political developments -- make forecasting the course of the economy difficult. In our view, the projections embody the best available forecasting methods, informed judgment, and basic economic principles. The projections should be viewed as a "most likely" scenario. The economy may well perform better or worse than projected.

The Current Situation and Near-Term Outlook: 1990-1991

Long-term interest rates rose significantly around the world in the first part of 1990. This jump was not forecast by us or most private forecasters. Anticipation of increased demand for capital in Eastern Europe, particularly from the rapid reunification of Germany, was a significant factor in this jump. A temporary increase in inflation expectations and the financial turbulence in Japan may also have played a role. Partly as a result of higher than anticipated interest rates earlier this year, the U.S. economy has grown more slowly than we had predicted.

For the first half of 1990, real GNP growth averaged 1.5 percent, with modest increases in real consumer spending, residential construction, and business spending on new plant and equipment compared to the fourth quarter of 1989. Real exports grew at an average 8 percent rate in the first half, and continue to be a bright spot for the economy. For the first half of the year, the real net export deficit was at its lowest level since the third quarter of 1983. However, there was a noticeable slowdown in overall job creation and declines in the number of jobs in the goods-producing sector. Real GNP grew a modest 1.2 percent in the second quarter. (This is the advance estimate, which is often revised considerably.) However, consumption growth picked up toward the end of the quarter. Unusual weather and other special factors have made quarterly real growth statistics less representative of underlying economic movements.

Happily, despite slower growth, the unemployment rate has not moved very much in the last 6 months, remaining very near its 16-year low. Jobless rates for individual worker groups have also remained relatively constant since January, at relatively low levels. The rate for women remains at its lowest annual rate since 1969, while the rate for blacks is at a 16-year low.

Historical revisions to the GNP account for 1987, 1988, and 1989 were also recently released by the Department of Commerce. The revisions confirm that 1987 and 1988 were strong growth years. However, growth in 1989 was revised down significantly. Real GNP is now estimated to have grown 1.8 percent in 1989, compared with the previously estimated 2.6 percent, on a fourth-quarter-to-fourth-quarter basis. The major factor in lower GNP growth was a downward revision to consumer spending on services -- particularly medical services -- for which annual survey data were available for the first time. The fourth quarter of 1989 was particularly weak, posting a 0.3 percent annual growth rate.

While the Administration's economic projections were made prior to these revisions and to the advance estimate of second quarter GNP growth, the qualitative picture we had been anticipating since the summer of 1989 -- slower growth in late 1989 and early 1990, picking up in late 1990 and 1991 -- has not been changed.

Inflation

Measured inflation in the first quarter of 1990 was higher than many analysts had projected late last year, but much of the inflation run-up was due to temporary factors. The effects of last December's cold weather were particularly important:

- o Energy prices rose sharply, with domestic crude oil prices climbing nearly $3 per barrel from the end of November 1989 to early January 1990.
- o Consumer food prices rose at an 11.4 percent annual rate in the first quarter.
- o Food and energy price increases combined to help raise the first-quarter inflation rate to 8.5 percent.

In the last 3 months, however, inflation has once again abated:

- o Overall, consumer prices rose at an annual rate of 3.5 percent.
- o Consumer energy prices fell at a 2 percent annual rate.
- o Food prices rose at only a 2.1 percent annual rate.

In summary, the general pattern of inflation during 1990 appears to be very similar to 1989. In the first half of 1989, CPI inflation averaged 5.7 percent at an annual rate, again led by energy and food price increases. At that time we interpreted the first-half increase as a temporary inflation blip, and second half CPI inflation did indeed trail off, to 3.6 percent. In our judgment, the first-quarter 1990 run-up in inflation was another temporary blip, and so we remain optimistic about the outlook for inflation.

The Projections

The Administration's projections -- both short-term and long-term -- are a consistent package with the Administration's economic policy proposals. Hence, they are a conditional forecast. If the policies or their economic equivalent are not implemented, the projections would not be our best judgment of future economic conditions. Most important in this context is the policy goal of credible, multiyear, growth-oriented deficit reduction, with a monetary policy appropriate to offset any short-term contractionary effects of such deficit reduction. In light of first-half developments, we have revised our economic projections for 1990 through 1995 as follows:

(a) Real GNP Growth

The Administration's forecast for the remainder of this year and 1991 projects continued growth of the U.S. economy. Real GNP is projected to grow 2.2 percent in 1990 and 2.9 percent in 1991. (See Table 1) Exports and business spending on new equipment are likely to be the driving forces behind GNP growth. In January we had projected slightly faster growth: 2.6 percent growth for 1990 and 3.3 percent growth for 1991. Higher interest rates maintained through the first half, led us to reduce the projected growth rates. As with our previous projections, growth is expected to rebound during the second half of this year and into 1991.

(b) Unemployment

The slower projected real GNP growth in the near term is likely to result in a slightly higher average unemployment rate in 1991 than had previously been expected. The unemployment rate is projected to average 5.4 percent in 1990, the same as in the January budget submission, but to rise slightly to 5.6 percent in 1991. In January, we projected a 5.3 percent unemployment rate in 1991.

(c) Inflation

Inflation, as measured by the rate of increase in the GNP implicit price deflator, is projected to be 4.5 percent in 1990 and to fall to 4.2 percent in 1991. For consumer prices, measured by the CPI-U, inflation is expected to be 4.8 percent in 1990 and 4.2 percent in 1991. In January, we predicted 4.2 percent inflation measured by the GNP deflator in 1990 and 4.1 percent inflation in 1991.

(d) Interest Rates

The increase in long-term interest rates through May 1990 caused us to raise our projection of the average level of interest rates for 1990, although we still expect interest rates to decline somewhat. Ten-year Treasury notes are projected to average 8.5 percent in 1990 and 7.9 percent 1991. We are projecting that short-term rates on 3-month Treasury bills will average 7.7 percent in 1990 and fall to 6.8 percent in 1991.

Longer Term Outlook: 1992-1995

Labor force growth is expected to slow as the generation following the postwar baby-boom enters the work force. Labor productivity is assumed to grow at its long-run historical trend. These two factors combine to produce an estimated potential GNP growth rate of about 3 percent. GNP growth between 1991 and 1993 is projected to be above 3 percent as the economy moves toward full utilization of its resources. Thereafter, growth is expected to stabilize around potential. Consistent with GNP approaching long-run potential, the unemployment rate is projected to decline to 5.2 percent in 1995.

Significant progress in devising a growth-oriented Federal deficit reduction strategy and steady reductions in the inflation rate will allow interest rates to decline gradually through 1995. A more stable economic environment is likely to wring out some of the uncertainty premium in interest rates.

Comparison to Other Projections

For the next couple of years, the Administration's forecast is about in the middle of private opinion on the major aspects of the macroeconomic outlook. For 1990, on a year-over-year basis, both the CEA and the CBO call for a 2 percent annual rate of growth in real GNP, about the same as the 1.9 percent average of 52 private forecasts compiled by Blue Chip (the Blue Chip "Consensus") in July. For 1991 on a year-over-year basis, at a 2.8 percent rate of growth, the Administration is slightly higher than the CBO and the Blue Chip "Consensus."

On inflation, the Administration, the CBO and the "Consensus" opinions are essentially the same for 1990 and 1991, using year-over-year percentage increases in the GNP deflator. They differ by at most one-tenth percent. On interest rates, the Administration matches the Blue Chip average this year and is about 60 basis points lower than the average Blue Chip forecast for 1991. The CBO interest rate forecast is about the same as the Administration's in both years.

I must emphasize the Blue Chip forecasters generally make policy assumptions that are different from ours. In this sense, the Administration forecast is not strictly comparable to the average Blue Chip forecast.

The Role of Economic Assumptions in the Budget Projections

Expected outlays and revenues depend on many factors including the state of the economy. The Administration's economic assumptions and budget policies are designed as a consistent package. The changes we have made in our economic assumptions account for only a small part of the change in the projected Federal deficit for 1990 and 1991. In fiscal year 1991, the projected deficit is $168.8 billion excluding Resolution Trust Corporation (RTC) spending. This compares with $93.2 billion in the January budget excluding RTC spending.

Of the resulting $75.7 billion change in the projected deficit for fiscal 1991, $49.3 billion is due to technical re-estimates and $24.2 billion is due to changing economic assumptions. Most of the change due to economic assumptions is related to higher than previously expected outlays because we (as well as most private forecasters) now expect higher interest rates than we expected 6 months ago.

Concluding Remarks

Despite the recent sluggishness and the policy challenges we face, my best judgment is that the economy will continue to grow. As I noted earlier, economic forecasting is an imprecise science, though, and economic growth could be more rapid than I have indicated today, or it could be slower.

As I have stated elsewhere, economic expansions do not end on their own; they end as a result of external shocks, economic imbalances, or inappropriate economic policies. The Administration is working hard to ensure that economic growth continues, and that it is not only made more rapid, but also made more secure.

We look forward to continuing to work with the Congress to achieve substantial, growth-oriented deficit reduction, which, combined with a quick and full monetary policy accommodation, will set the stage for a continuation of what is already the longest peacetime expansion on record, further enhancing the long run growth potential of the economy, while controlling inflation.

Table 1

ADMINISTRATION NEAR-TERM OUTLOOK
(Calendar Years)

	1990	1991
	(Percent Change, 4th Quarter to 4th Quarter)	
Real GNP		
Mid-Session Review	2.2	2.9
January Budget	2.6	3.3
GNP Implicit Price Deflator		
Mid-Session Review	4.5	4.2
January Budget	4.2	4.1
CPI-U		
Mid-Session Review	4.8	4.2
January Budget	4.1	4.0
	(Annual Average)	
Unemployment Rate (Total)		
Mid-Session Review	5.4	5.6
January Budget	5.4	5.3
3-Month Treasury Bill Rate		
Mid-Session Review	7.7	6.8
January Budget	6.7	5.4
10-Year Treasury Note Rate		
Mid-Session Review	8.5	7.9
January Budget	7.7	6.8

Table 2

ADMINISTRATION ECONOMIC PROJECTIONS
(Calendar Years)

	Actual 1989	Projections 1990	1991	1992	1993	1994	199
	(Percent Change, 4th Quarter to 4th Quarter						
Real GNP	1.8						
Mid-Session Review		2.2	2.9	3.3	3.2	3.1	3.
January Budget		2.6	3.3	3.2	3.1	3.0	3.
GNP Implicit Price Deflator	3.7						
Mid-Session Review		4.5	4.2	3.9	3.6	3.3	2.
January Budget		4.2	4.1	3.8	3.5	3.2	2.
CPI-U	4.6						
Mid-Session Review		4.8	4.2	3.9	3.6	3.3	2.
January Budget		4.1	4.0	3.8	3.5	3.2	2.
	(Annual Average)						
Unemployment Rate (Total)	5.2						
Mid-Session Review		5.4	5.6	5.5	5.4	5.3	5.
January Budget		5.4	5.3	5.2	5.1	5.0	5.
3-Month Treasury Bill Rate	8.1						
Mid-Session Review		7.7	6.8	5.8	5.1	4.8	4.
January Budget		6.7	5.4	5.3	5.0	4.7	4.
10-Year Treasury Note Rate	8.5						
Mid-Session Review		8.5	7.9	7.0	6.1	5.8	5.
January Budget		7.7	6.8	6.3	6.0	5.7	5.

Table 3
COMPARISONS OF ECONOMIC PROJECTIONS
(Calendar Years)

Fourth-Quarter-to-Fourth-Quarter Percentage Change

	1990	1991
Real GNP		
Mid-Session Review (7/90)	2.2	2.9
CBO (6/90)	2.3	2.5
Blue Chip Average (7/90)	1.9	2.4
Blue Chip Top 10 (7/90)	-.-	-.-
Blue Chip Bottom 10 (7/90)	-.-	-.-
GNP Deflator		
Mid-Session Review (7/90)	4.5	4.2
CBO (6/90)	4.3	4.0
Blue Chip Average (7/90)	4.3	4.1
Blue Chip Top 10 (7/90)	-.-	-.-
Blue Chip Bottom 10 (7/90)	-.-	-.-
CPI		
Mid-Session Review (7/90)	4.8	4.2
CBO (6/90)	4.8	4.4
Blue Chip Average (7/90)	5.0	4.4
Blue Chip Top 10 (7/90)	-.-	-.-
Blue Chip Bottom 10 (7/90)	-.-	-.-

Year-Over-Year Changes

	1990	1991
Real GNP		
Mid-Session Review (7/90)	2.0	2.8
CBO (6/90)	2.0	2.5
Blue Chip Average (7/90)	1.9	2.2
Blue Chip Top 10 (7/90)	2.3	2.9
Blue Chip Bottom 10 (7/90)	1.4	1.6
GNP Deflator		
Mid-Session Review (7/90)	4.2	4.2
CBO (6/90)	4.1	4.0
Blue Chip Average (7/90)	4.2	4.0
Blue Chip Top 10 (7/90)	4.5	4.5
Blue Chip Bottom 10 (7/90)	3.9	3.5
CPI		
Mid-Session Review (7/90)	4.8	4.1
CBO (6/90)	4.8	4.2
Blue Chip Average (7/90)	4.8	4.2
Blue Chip Top 10 (7/90)	5.1	4.9
Blue Chip Bottom 10 (7/90)	4.4	3.6

Table 3 (cont'd)
COMPARISONS OF ECONOMIC PROJECTIONS
(Calendar Years)

	Annual Averages	
	1990	1991
Unemployment Rate (Total)		
Mid-Session Review (7/90)	5.4	5.6
CBO (6/90)	5.3	5.4
Blue Chip Average[1] (7/90)	5.3	5.4
Blue Chip Top 10[1] (7/90)	5.5	5.8
Blue Chip Bottom 10[1] (7/90)	5.2	5.0
3-Month Treasury Bill Rate		
Mid-Session Review (7/90)	7.7	6.8
CBO (6/90)	7.6	6.9
Blue Chip Average (7/90)	7.7	7.4
Blue Chip Top 10 (7/90)	7.9	8.1
Blue Chip Bottom 10 (7/90)	7.4	6.8
Long-Term Interest Rates		
Mid-Session Review[2] (7/90)	8.5	7.9
CBO[2] (6/90)	8.5	7.8
Blue Chip Average[3] (7/90)	9.2	9.0
Blue Chip Top 10[3] (7/90)	9.5	9.7
Blue Chip Bottom 10[3] (7/90)	9.0	8.4

[1] Blue Chip total unemployment rate, which is the published Blue Chip civilian rate less 0.1 percentage point.

[2] 10-Year Treasury Bond Rate

[3] Corporate Aaa Bond Rate

Representative HAMILTON. Thank you, Mr. Boskin.

Mr. Taylor, please proceed.

Mr. TAYLOR. Thank you, Mr. Chairman.

I'd like to focus my brief remarks on three issues relating to financial markets and international developments in the administration's outlook.

First, regarding corporate——

Representative HAMILTON. Mr. Taylor, do you have a statement?

Mr. TAYLOR. I'll just read it into the record, if that's all right.

Representative HAMILTON. That's fine.

Mr. TAYLOR. Mr. Chairman, first regarding corporate profits. The administration's estimates for profits have been revised down from the January estimates. In January, we projected that before-tax profits would be 6.5 percent as a share of nominal GNP for 1990 and 7 percent as a share of GNP for 1991. Our projection is now for 5.5 percent in 1990 and 6 percent in 1991. This reduction in our forecast for corporate profits reflects the somewhat slower growth in business activity that we have seen. I think our revised profit forecast seems quite reachable at this point, especially in light of the revised estimate for 1989.

It is important to note that before-tax profits for 1989 were revised up by 6 percent, that is, from 5.6 percent of GNP to 5.9 percent of GNP. Note that in percentage terms, the upward revision in profits before tax was larger than the 2 percent downward revision of wages and salaries. It's a significant upward revision.

The second point relates to our forecast for recovery from the period of moderate growth that we have seen at this point. As you know, we are forecasting a pickup in growth for the last two quarters of this year. To see why this makes sense, I think it's helpful to note that growth has been below 2 percent for the last six quarters. And I would note there that we would adjust for the drought in the first quarter of 1989, which gives a growth rate of 1.4 percent in the first quarter of 1989. In other words, growth has been below 2 percent; it has averaged 1.3 percent for this six-quarter period.

Viewed relative to 3 percent potential growth, which we are forecasting, this represents a reduction in the economy's capacity utilization of about 2 percentage points overall. This is the same magnitude that would occur from two quarters of minus 1 percent growth. What this means is that the economy has room to move more quickly from the slow growth that we've experienced recently, much as it has recovered from other periods of more moderate growth. For example, the growth in 1986 was 1.9 percent and rebounded to 5 percent in 1987.

Finally, Mr. Chairman, regarding our forecast for long-term interest rates. As Mr. Boskin indicated, our analysis of the runup in interest rates early this year was related to the increased demand for capital in Eastern Europe. Our view of financial markets is that they are forward looking. Long-term interest rates reflect expectations of the future, especially the path of future short-term rates. The increase in demand for capital in Eastern Europe, especially East Germany, is only now beginning, but its effects on long-term interest rates have largely already occurred. This is why we do not expect any additional increase in long-term interest rates in our forecast, and in fact are forecasting a moderate decline.

Thank you, Mr. Chairman.

Representative HAMILTON. OK, gentlemen. Thank you very much.

Let's begin with the possibility of a recession. One of the things we've noted in testimony by private economists before this committee is that they are more concerned now about a recession than they were some months ago. One of the witnesses talked about the economy being on the cusp of a recession. I'm not just sure what cusp means, but it sounds ominous.

Mr. BOSKIN. As I recall, Mr. Chairman, it's a term mostly derived from astrology, and I hope that we would not be comparing astrologists and economists.

Representative HAMILTON. OK. What's the probability or possibility of a recession within the next year or so?

Mr. BOSKIN. Mr. Chairman, we would put the probability of a recession as low but certainly not zero. One cannot be absolutely 100 percent sure that there will not be a recession, but we think it is just as likely that the economy will rebound more rapidly than we are projecting than that the economy would slow that much.

I think some economists have a slightly more pessimistic view because of the downward revisions in the GNP numbers. If GNP is at a somewhat lower level than we thought, growth is a little bit closer to zero. But we still think that the probability of a recession is low. We don't have a specific point estimate of a probability but I think the best thing to say is that we think it's unlikely; but there are no 100 percent guarantees.

Representative HAMILTON. Now, the budget summit is considering a $50 billion cut in the deficit. Why would not that kind of a cut in the deficit tip us into a recession? I presume you will argue the benefits of that kind of a cut, as indeed you did in your statement. Some would argue just the opposite, as I know you're aware, that that's exactly the wrong move to make.

Why is it not the wrong move to make to cut $50 billion?

Mr. BOSKIN. Well, let me make two points about that, and then ask Mr. Taylor if he'd like to comment.

First, $50 billion is about 1 percent of GNP, and the reduction would occur throughout fiscal year 1991. Were one expecting the economy to be very, very weak at that time, and no accommodation by the Federal Reserve, then you might well get a 1 percent or perhaps even a slightly larger fall from a baseline of wherever the economy was. We expect the economy to be in the 2 percent growth range, rather than in the 1 percent range in 1991. And we also believe the Fed has the capability and willingness to fully offset any fiscal contraction that might occur from a $50 billion deficit reduction package.

You are quite correct that the direct effect of a $50 billion deficit reduction would be to withdraw some purchasing power from the economy. And that would be contractionary. But with the Fed offsetting it, and given where the economy is likely to be, we believe that the path of GNP will be roughly what it would have been.

Also, the summiteers have been discussing a credible and enforceable multiyear package of a much larger magnitude with legislated changes that would lead the public and financial markets to expect that future year savings would occur. If that happened——

Representative HAMILTON. $500 billion, right?

Mr. BOSKIN. That has been a number widely discussed cumulatively over 5 years. So the $50 billion would grow, and then when you add it up over 5 years, it would total perhaps $500 billion. If that occurred, as Mr. Taylor's very direct and nice analysis of long-term interest rates indicated, long-term interest rates should fall quickly because they will anticipate much less of a drain in the future by the Federal Government on private savings pools. There will be more saving available to finance investment in the future, so long-term rates should fall quickly in response to that—if the package is credible and enforceable and widely believed not to be smoke and mirrors. If that occurs, the mortgage rates would eventually come down and housing should rebound—and likewise for other types of activities that are interest sensitive—and investments should expand, and so on. So you'd get some benefits from that as well.

Mr. Taylor, do you want to expound on that?

Mr. TAYLOR. I think that's a very clear explanation. The main thing is we believe if the budget package is multiyear and if it's credible—that is, there are enforcement mechanisms—then these things will happen. There have been many suggestions on the table of ways to increase the probability that a deficit-reduction agreement would actually come about. If those were there and the financial markets understand them and the intentions of both sides are clear, then I think it could have a significant effect on long-term interest rates, and ease any kind of contractionary effects that would otherwise occur.

Second, I think it's important to note that what has been on the table is really a gradual phased-in reduction. All the reduction doesn't occur at once. It's a first year cut, the second year is larger, the third year is larger than that, and so forth. And that's meant to give the financial markets and the rest of the economy sufficient time to adapt. And I think our experience in the economy shows that gradual phased-in reductions of that kind can be done with relative ease in the economy.

Representative HAMILTON. A couple of things impress me when you discuss the $50 billion deficit reduction for 1 year and more over a multiple-year period. In your statement, Mr. Boskin, you frequently used the word "credible." And Mr. Taylor just used it again. So it has to be a credible reduction. What that brings to my mind is that a lot of reductions in the recent past have not been credible. They've not persuaded the financial markets, they've not persuaded the American people that we've really gotten hold of the budget.

The other thing that impressed me about your response is the importance you place on Federal Reserve response to the deficit reduction. And I wanted to explore that just a little bit with you.

I take it, from your testimony, that if the $50 billion deficit reduction package is enacted, then monetary accommodation by the Federal Reserve is crucial?

Mr. BOSKIN. Yes.

Representative HAMILTON. And I think you've gone so far as to say that they'd be irresponsible if they did not respond. Is that correct?

Mr. BOSKIN. I have said that in the past, yes, sir.

Representative HAMILTON. And you say that today, too, do you?

Mr. BOSKIN. Yes. It's not a delicate way of phrasing it, but, yes.

Representative HAMILTON. What, in your judgment, would be not an irresponsible, but a responsible, response by the Fed?

Mr. BOSKIN. If it's a credible multiyear package, the Fed has the ability to offset the short-term contractionary impact of the higher revenues. These higher revenues coupled with the lower government spending directly withdraw purchasing power and demand from the economy. And the Fed has the ability to do that by easing interest rates.

But I think it's important to make two specific points. The ability of the Fed to do that is perhaps somewhat taken for granted. Indeed, there are technical difficulties in the Fed doing that, and they are perhaps underestimated. Monetary policy works with a long and variable lag from everything we know in history, so it is important that this be done as soon and as clearly and as enforceable as possible, so they can have a pretty good idea of what's likely to happen.

Representative HAMILTON. Before or after the enactment of the package?

Mr. BOSKIN. Well, it would depend on the nature of the package and what else was going on in the economy.

Representative HAMILTON. Is it, in your view, the sooner the better?

Mr. BOSKIN. My view is the sooner the package, the better, and that there will be some rather substantial easing. It's difficult to say how much. That will depend heavily on the nature of the package, how large it is, and how enforceable it is and how much long-term interest rates react. The more long-term interest rates come down, the more gradually the Fed will be able to ease. It would depend very much on the timing of the package, so I think it's hard to say.

Representative HAMILTON. How do you react to the fact that the leaders both in the administration and the legislative branches have obviously decided to delay the package from early August to middle September?

Mr. BOSKIN. Well, as you know, sir, the administration was hoping to get an agreement prior to the recess. That seems not to have been possible. And so we will go to the next best thing, which is try to get the best package we can as soon as the recess ends.

Representative HAMILTON. It would have been better if it had been in August, from your point of view?

Mr. BOSKIN. For the economy, if it was a good package and the same package, sure, it would have been better earlier, and would have made it easier.

Representative HAMILTON. I'll turn to my colleague, Congressman Solarz, and Steve, I'm going to run and vote, and get back as quickly as I can.

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

I have the impression that if you look at the economy on a regional basis, it's the Northeast which seems to be in the worst shape at the present time. Would that be a fair statement?

Mr. BOSKIN. The worst shape in the relative sense of where it was. It had a long period of doing better than average in the economy. Many parts of the Northeast start from much better than average level but certainly it has declined more than other parts of the country.

Representative SOLARZ. Why is that?

Mr. BOSKIN. Well, there are a variety of explanations that have been offered. We don't make regional forecasts but there is a sense, partly, that in a time of rapid buildup, people overextrapolate, overbuild. Some of it probably has to do with the fact that there is some dependence—perhaps more than proportional dependence in some of those States—on defense and technology, and other things related to defense; and there is the expectation that some of that spending will grow more slowly or fall in the future. Some of it has to do with the fact that there was a very sharp runup in real estate values in the last few years, and there appears to have been a substantial contraction in real estate in the Northeast.

Representative SOLARZ. Is there a comparable——

Mr. BOSKIN. If I could just add, while the unemployment rates, for example, in many of those States have risen, in many of them, they're still below the national average.

Representative SOLARZ. Has there been a comparable contraction of real estate values in other parts of the country?

Mr. BOSKIN. In some parts, there has; in other parts, not. And it depends a lot on which part of the real estate market you're looking at. As you know, Congressman Solarz, real estate tends to be a very local market phenomenon. If we look at housing values for sort of averaged or lower priced housing, no. At the top end, the very top end of the market, there certainly has been a nationwide contraction.

In California, for example, the top end of the market has been hit hard, but the broad middle part of the market has not.

Representative SOLARZ. I'm puzzled by the fact that, in spite of the decline in the economy in the Northeast—in a number of the States in that part of the Nation—there doesn't seem to have been a rise in the unemployment rate. When you look at what's happening in real estate, I know just in New York, for example, that real estate values seem to be declining. You hear about contraction in Wall Street and in finance and other sectors of the regional economy and yet, the unemployment rate does not seem to have risen.

How does one explain that?

Mr. BOSKIN. Well, there are several explanations. But I would start by saying that I think we're in a little bit of uncharted water here. First is that in some of these areas, for example, in Wall Street, some of the contraction is in incomes, rather than employment. People who were making very high incomes for the last few years in an industry which has heavy bonus and profit-related payments now are still working but making much less.

Second, it is often the case that some rise in the unemployment rate lags the slowdown in the economy. Indeed, we, in our own forecast, project a small increase in the unemployment rate later this year, and next.

Representative SOLARZ. Now, could you tell us what the growth rate has been in the United States over the last year, compared to Japan, West Germany, and the European Community, as a whole, and what you project the growth rate in our own economy to be over the next year, compared to what you expect it to be in Japan, the Federal Republic, and the European Community?

Mr. BOSKIN. In the last couple of years, Europe has had very strong growth, after a long period of much slower growth than the United States. Japan also has had solid growth, had very strong growth in the first quarter. It has had strong growth in the last year, and we've had very modest growth. As Mr. Taylor said, several quarters under 2 percent.

We expect the recovery here to be gradual and for us to grow at around 2.2 percent for the four quarters in 1990; 2.9 percent for 1991. We would expect that Japan and the European Community would grow in the 3's as an average in 1990, and around 3 percent in 1991, and that's roughly what the international organizations project.

Mr. Taylor, can you add any more to that?

Mr. TAYLOR. Just with respect to Japan, our counterpart agency in the Japanese economy, the Economic Planning Agency, is seeing growth of a little over 4 percent the next year.

Representative SOLARZ. Well, would it be fair to conclude, then, that at the present time, the economies of Japan and the European Community seem to be stronger than our own?

Mr. BOSKIN. No. If I could be a little more careful in the phraseology to explain what I mean. We start from a much higher base and until the last year or so, we have been growing for several years, more rapidly, in 1987 and 1988, for example. Right now, there seems to be a more rapid growth there than here. This happens. Economies don't all grow at the same rate, but we start from a higher base so we have a stronger economy than they, but they are growing a little more rapidly than we are now.

Representative SOLARZ. Do you think we've effectively eliminated the business cycle, as it were, in the sense that we no longer need to anticipate the inevitability, at some point, of a recession?

Mr. BOSKIN. Well, first of all, I've never thought there was anything quite so regular about when—and how large—booms and busts occur, that merit the phrase "cycle." But we certainly have periods of booms and busts. It's very unlikely that a historian, many years from now, looking back, will say that we've gone for decades and decades without a recession. But on the other hand, I think it's also likely that we're going to see a period over the next 20 or 30 years where recessions are less frequent than they had been for a variety of reasons. For example, the ability to control inventories will make the kinds of inventory blips, when many industries get inventories built up and have to contract quickly, less likely; and there are a variety of other business practices and, hopefully, sensible policies.

But, no, we may well have some severe external event that shocks the economy, and we may make a mistake in economic policy, and those certainly can bring about a recession.

Representative SOLARZ. What impact on the economy do you expect the recent decision by OPEC to increase the price of oil will have, and what impact on the economy, if any, do you think the Iraqi invasion of Kuwait is likely to have?

Mr. BOSKIN. Well, those are very good questions. And I guess I'd have to start by saying, it would depend a lot on what the resolution of those things are, obviously.

Representative SOLARZ. I doubt Kuwait is going to win. I don't anticipate a counterattack tomorrow which will drive the Iraqi invaders from Kuwaiti territory.

Mr. BOSKIN. I meant on the price of oil, not the military outcome, sir.

Even if the higher price is enforced by ugly means, as in this case, or purely by agreement in the cartel that's enforceable—which previous agreements usually have not been in OPEC—our economy today is much better able to absorb modest price increases than it was in the past. But it would have some deleterious effect on our economy because we're a net importer of oil. It would have a larger deleterious effect on the Japanese economy, for example. But we would see a decline of GNP for a 25 percent price increase in oil that stuck and was continued for some time. We'd see a temporary decline in GNP of a few tenths of a percentage point.

Representative SOLARZ. But it wouldn't be enough, then, to drive us into a recession?

Mr. BOSKIN. In my view, not by itself, not unless it was compounded by policy mistakes, or some other weakening that for some other reason, also occurred.

Representative SOLARZ. Do you think that the Iraqi invasion of Kuwait means that Iraq will now be in a position to singlehandedly determine the price of OPEC oil? And, if so, are they likely to insist on even greater increases?

Mr. BOSKIN. I think that's going to be very, very difficult to forecast those developments. I'm not an expert on Middle Eastern security. We have a National Security Council meeting this morning to discuss these issues. My own view is that, however this particular problem resolves itself, it is more likely that OPEC will decide what to do in a broader context than just in this context. So I don't have a good explanation; I'm not the best person to answer that.

Representative SOLARZ. Let me just ask you, quickly, two brief questions, because I have to get over to the floor for a vote.

You indicated you don't think a $50 billion deficit reduction package will have an adverse impact on the economy. Supposing there is no agreement and sequestration goes into effect, and a $100 billion whack is taken out of the deficit. What impact would that have on the economy?

Mr. BOSKIN. Let me just go back to something I said, earlier, first. I think I sloppily said that we'd have, from the price increase in oil that might occur, we'd have a few tenths of a percent decline in GNP. What I meant to say, and what is correct, is that a few tenths of a percent decline in the growth of GNP. So we don't forecast that it would decline, as my comment about not causing a recession would indicate.

Representative SOLARZ. The impact of sequestration.

Mr. BOSKIN. On the impact of a $100 billion sequestration, it would depend, in my view, on several things. No. 1, how long it occurred; whether it really did go into effect and lasted for the entire year.

Representative SOLARZ. Let's assume that's the case.

Mr. BOSKIN. If that is the case and the Federal Reserve quickly and fully accommodates it, the impact, in principle, could be offset. But, obviously, there would be great uncertainty about how long the sequestration would last, or whether it would be overcome.

So I think that the effect on the aggregate economy would be more of a fiscal contraction, which would put more pressure on the Federal Reserve for a greater monetary accommodation, but that's not to suggest——

Representative SOLARZ. You mean, to lower interest rates?

Mr. BOSKIN. To lower interest rates, sure. But that's not to suggest, of course, that there wouldn't be some very substantial impacts on particular people or particular institutions whose spending levels would be cut a lot.

Representative SOLARZ. If the Fed reduced interest rates, would the net impact be a wash, or would it be positive, or would it be negative?

Mr. BOSKIN. It would depend on how much they reduce interest rates. In principle, they could offset it. But relative to the comments I made earlier, I would just once again state that the clearer the picture the Fed has about what is going to happen, and over what time period and how enforceable it will be, will make it much easier for them to calibrate when and how much to ease.

Representative SOLARZ. And, finally, when you look at the effort to get a deficit reduction package for the next 5 years, in terms of its impact on the economy, would you prefer to see a target of zero for the deficit, or say, a target in which the deficit would be roughly the equivalent of 1 percent of GNP?

Mr. BOSKIN. Well, I would like to see—that's hard to answer in the abstract without knowing what it would take to get it there and what pieces would be in it. Because it's not just how large the deficit reduction is, but how it's done, that can have impacts on the economy. But, in general, I would like to see us moving toward a balanced budget over this 5-year period. Roughly speaking, if the projections had us off by $5 billion or something like that, that would be so trivial relative to the economy. But I think that it's a good target to shoot for.

Representative SOLARZ. Thank you very much.

Why don't we stand in recess until Chairman Hamilton returns. Thank you very much.

Mr. BOSKIN. You've welcome, Congressman Solarz.

[A short recess was taken.]

Representative HAMILTON. OK. The committee will resume its sitting.

I wanted to return to the questions I was pursuing with you, with respect to monetary policy.

You had indicated that you thought it would have been better if the package had been enacted in August, rather than September. With respect to the timing on the Fed action, should that action precede or follow the enactment of a deficit reduction package?

Mr. BOSKIN. It's hard to say in the abstract, because you have to know what the package is likely to be and the timeframe over which the package is likely to occur. I would say that monetary policy does work with some lag. If it was very likely that the fiscal contraction would hit very early, very quickly, then obviously the Fed would need some leadtime to get a monetary policy moving to offset it by the time the lower interest rates could have an impact on the economy.

But if the nature of the package is that it wouldn't, that is if most of the year was past before much of it occurred, then they'd have sufficient time to act at the time it was enacted. So it's hard to say in the abstract. In general, monetary policy does work on the economy with a lag. I know the people at the Federal Reserve well, as I know you do, Mr. Chairman, and they're quite aware of that.

Representative HAMILTON. What would be the economic consequences if we enact the package we've been talking about, but the Fed does not loosen monetary policy?

Mr. BOSKIN. In my view, that would lead to a contraction in the economy from where it otherwise would have been. With our view of the economy growing in the 2's, with no monetary accommodation and that much of a fiscal contraction, you could well get a substantial slowdown. If the economy were still weaker than we were expecting, you could do worse. You could tip it negative if, indeed, the Fed did absolutely nothing.

On the other hand, if it was very credible and clearly believable, the long-term interest rates would come down a lot, so the amount the Fed would have to ease quickly would be very modest, and it wouldn't hurt very much. But they would have to continue easing to justify that fall in the long-term interest rate, which implies that people expect future short-term rates to be lower.

So the basic answer is that it would certainly contract the economy relative to where it otherwise would have been. Our best guess is that the economy will still be growing at a modest rate and that the 1 percent of GNP is unlikely to drive it into a recession. But if the economy were weaker, that could happen. And that, I guess, was the source of my colorful remark about the Fed that you mentioned earlier.

Representative HAMILTON. Now, I'm interested, too, in your understanding of Mr. Greenspan's testimony. Is it your understanding that if Congress and the President agree on a major substantive credible deficit reduction package, that the Fed will act?

Mr. BOSKIN. That is my reading of his testimony, yes. I think that——

Representative HAMILTON. That interests me, too, when you say "his testimony." Do you—by "you," I mean the administration—do you sit down and talk with Mr. Greenspan about these things?

Mr. BOSKIN. Sure. Certainly, Mr. Greenspan and other relevant members of the Federal Reserve Board, but more the Chairman, than others, yes.

Representative HAMILTON. So the Treasury Secretary and you and others responsible for economic policy do meet informally with Mr. Greenspan from time to time?

Mr. BOSKIN. Yes. The Treasury Secretary meets with him weekly. I speak to him almost everyday. The entire Council of Economic Advisers meets with him and his colleagues every few weeks for lunch. Obviously, this is one of the issues that we talk about.

Mr. TAYLOR. There's also a considerable amount of communication at the staff level and other levels. I would say there's technical discussions at all levels.

Representative HAMILTON. And in those discussions, you would get a pretty good idea, would you, of what their response is likely to be in the event such a package is enacted?

Mr. BOSKIN. Well, I would be a bit more cautious than that in the way I would phrase it. I think that we carefully air our views about what is likely to happen in the economy and what appropriate monetary and fiscal policy mixes ought to be. But I think the Fed Chairman and other members give a general qualitative notion of what their views are, but they reserve the right to make monetary policy in private, rather than quasi in public. But those sorts of meetings are quite consistent with what the Chairman said in his testimony.

Representative HAMILTON. The Wall Street Journal reported, for example, and I'm quoting them now, that "privately, administration officials say they hope the Fed would respond to a budget deal by cutting short-term interest rates 1 to 1.5 percentage points." That's from the Journal.

In your discussions, do you get that specific?

Mr. BOSKIN. We talk about, under different scenarios, what kinds of interest rate changes might be reasonable to offset, and a wide range of scenarios has been suggested. And there are differences, as well as agreements, on some matters about how much they should be changed.

So, yes, at times, something is that specific, but there is no agreement or arrangement on exactly what will occur.

Representative HAMILTON. But it would not be unusual, in those conversations, for you to say to the Fed Chairman that you think short-term interest rates should come down a percentage point or point and a half?

Mr. BOSKIN. Well, I don't think I would get it to a tenth of a percentage point, but we have fairly rigorous and detailed technical discussions on the economy which do sometimes get into qualitative discussion of the rough order of magnitude.

Representative HAMILTON. And you're comfortable, at this point, with the Fed's position on timing in response to the cut in the deficit?

Mr. BOSKIN. I think it's beneficial to the economy to have an independent Federal Reserve on balance. And I would make that point as a preamble. But I think that depends heavily not just on the timing of the cut, but on the state of the economy. And I know the people at the Fed, and I know they are looking at where the economy is, and they are not just thinking, in terms of monetary policy, about whether and what type of a budget deal they may have, but also what's likely to happen to the economy whether there's one or not. So they should be forward looking and analyzing where they think the economy is headed and take appropriate monetary policy actions. Given where the economy is, I think that's quite consistent with what would make sense, if and when a budget deal occurred.

Representative HAMILTON. Let me put it this way: Specifically, are you saying to the Fed now, that the Fed ought to begin to ease now?

Mr. BOSKIN. No, I'm not saying that. But, on the other hand, I think there are many private analysts who have come to that conclusion and the Fed is obviously—and I think there are capable people over there—looking at the same signs and signals about the future course of the economy as we are; and I think they will take appropriate action.

Representative HAMILTON. I recollect that Secretary Brady, and perhaps you, as well, were quoted in the press as urging the Fed to ease?

Mr. BOSKIN. That has happened on occasion, yes.

Representative HAMILTON. In both your case and Secretary Brady's case?

Mr. BOSKIN. Yes. Infrequently, but on occasion, it has.

Representative HAMILTON. Another thing that Chairman Greenspan said, with regard to this deficit reduction package, related to the composition of the package. His testimony was, and I quote him, "different types of taxes, different types of program changes, have different types of effects within the economy, but I would suspect that overall it doesn't matter that much. That is, it is the absolute total size of the deficit reduction that is crucial."

In other words, he says that the overall impact is the most important thing, that the composition is of secondary importance, obviously important but of secondary importance. Do you agree with that assessment?

Mr. BOSKIN. I might put greater weight on the composition. I certainly would put great weight on not only the composition but also on the credibility and the enforceability of the multiyear agreement. And I would put that as important as the size. I think it would be better for the economy to have a fully enforceable-by-law, multiyear agreement which was a little smaller, than one which we had to rely every year on the budget process to try to deliver, which, as you noted by inference in your earlier remarks, hadn't worked so well for previous budget summits.

But I do believe the composition of spending and revenues affects the economy substantially. I would not like to see, for example, the bulk of spending cuts come out of public investment relative to public consumption. I think that would be bad for the long-term health of the economy.

Representative HAMILTON. So you, then, would think the composition is as important as the overall impact. Would that be a fair statement?

Mr. BOSKIN. I think they're both very important. I don't know exactly how I'd order them. I can conceive, in an extreme, of a composition which wouldn't benefit the economy very much if there was a large deal, and I can conceive of a composition which would be more beneficial if it was a smaller deal. So that's the best I can do to describe my feelings.

Representative HAMILTON. All right. Mr. Taylor.

Mr. TAYLOR. Mr. Chairman, the process reform part of this—the extent to which there's enforcement mechanisms—I would say, is more important than the composition.

Representative HAMILTON. That goes to the credibility question, obviously.

Mr. TAYLOR. I would put that much higher than the composition, at this point. That's what I would say that we should be worrying about.

Representative HAMILTON. Do you think that's what the financial markets would look at closely?

Mr. BOSKIN. I think the financial markets would look at the credibility closely, but also at the composition. Some of the things that have been suggested in the media and have been loosely talked about could beneficially or adversely affect financial markets because they directly affect the taxation of capital or the income from it, for example.

Representative HAMILTON. Now, another thing I'd like you to do is spell out for us, if you would, the benefits of this package, as you see them. Why is it in the national interest to enact this kind of a package?

Mr. BOSKIN. Well, I'd say they are twofold. First, with respect to the overall economy, this type of fiscal monetary policy switch would sort of keep the baseline GNP about the same in the short run, but by lowering long-term real interest rates, would be beneficial to the economy's long-term growth; it would lower the before-tax cost of capital, in this case, and would lead to a shift in the composition of activity more to investment and away from consumption. This would enhance the economy's long-term growth potential. I also think it would have a very beneficial psychological impact in financial markets, and perhaps on the American people in general, because I think that there has been a very long process of stalemate for many, many years over these issues. And I think the ability to resolve them would be a welcome sign that we were regaining control of the fiscal process.

The second point I would make is, from the overall financial management of the Federal Government as an enterprise, that this, along with some of the process reforms that have been suggested, would hopefully better enable us to manage the Federal Government's financial affairs in a more reasonable, cost-effective, target-effective manner. I think that would be very salutary in restoring some public confidence in the Government.

The major benefit would be, as I noted, the potential benefits on long-term growth.

Representative HAMILTON. If you were talking to an average American, whoever that might be, however you might find——

Mr. BOSKIN. From Indiana?

Representative HAMILTON. From Indiana, yes, how do you explain the fact that they may have to pay higher taxes and that they may have to miss some of the benefits from certain kinds of government spending, and when are they going to see some benefit from it?

Mr. BOSKIN. Well, starting with the latter question, many of them will see a benefit from it rather rapidly if it's a credible multiyear deal, offset by Federal Reserve easing, because we'll see long-term interest rates fall, and people on adjustable rate mortgages will see advantages in that. People purchasing durable items and so on, will see some advantages to that. These things will offset some of the pain inflicted by revenues or spending cuts.

But I would basically argue that it's important that we make this investment in our nation's future. That is, if we run very large deficits continually, we are gradually saving less than our modest level of investment in our economy, and that will gradually drain the economy's long-term growth potential. And while it has not resulted in an economic apocalypse in the 1980's, a soaring of inflation or a deep recession, it does have a cumulative negative impact on the economy; and it's time we stopped it, reversed it, got back in charge of our own affairs, and made that investment in our long-term future.

So I'd sell it to them, in the short term, partly on the basis of their interest costs, and in the long term, a better life for young people when they're older, or middle-aged people for their children.

Representative HAMILTON. If you look at your growth targets, compared to the Federal Reserve's, the Fed expects the economy to grow 1.5 to 2 percent in 1990. I'm talking, now, about the so-called central tendency. And you expect the real GNP to grow at 2.2 percent. And then, in 1991, the central tendency of the FOMC and the FRB presidents, is 1.75 to 2.5 percent growth; you're right under 3 at 2.9 percent.

Why do we have that difference between you? Why are you more optimistic than they are?

Mr. BOSKIN. Well, let me start by saying that this is not a formal target. The Fed doesn't target real GNP growth. This is their central tendency of their estimates of the various parties about how the economy will grow.

I'll note that the Fed central tendencies, as the Blue Chip, the administration, and the CBO, historically has been about as inaccurate as everybody else on real GNP growth. But I guess that we might be a little more optimistic about the prospects for a multiyear budget deal and the Fed accommodating. And I put the emphasis, relative to them, on the prospects for a multiyear enforceable deal. And also we perhaps have a slightly, but not dramatically, higher view than some of those people about the economy's potential.

I would note, also, that these differences of a few tenths of a percentage point are not only very small, compared to typical forecast errors, but are small historically relative to differences between the administration forecasts and the Fed or the CBO.

Representative HAMILTON. You expect, as you testified, quite a pickup in growth in the second half of this year. What sectors of the economy do you see leading that pickup?

Mr. BOSKIN. Well, we expect to see exports continue strong and business investment to pick up. And we've begun to see—it's unclear whether this will continue—at the end of the quarter, the first sizable gain in consumer spending that we had seen all year. Consumer spending had been flat or negative in real terms for the first 5 months. I mean, there was 1 month where it grew one-tenth of a percent. So there are several sectors that have that potential.

But, as I indicated, this is our central tendency, not our absolute judgment.

Representative HAMILTON. So exports and consumers would be the two areas you single out?

Mr. BOSKIN. And some additional investment spending by businesses.

Mr. TAYLOR. Residential investment, if long-term interest rates continue to move down, would also pick up.

Representative HAMILTON. Is it correct to say, then, that exports are becoming very crucial to the economic recovery, in your analysis?

Mr. BOSKIN. Well, they've been a major part of it for the last several quarters. That has been one of the brightest spots in our economy. We've become the world's leading exporter, again. They've been at record highs. And just as the decline in net exports accounted for almost half of the fall in GNP in the 1981–82 recession, fortunately, the export sector has been doing very well for the last couple of years.

Representative HAMILTON. Does your confidence in the pickup in the second half of this year still remain in view of these three new economic reports that came out yesterday, that suggest the economy is rather stagnant? I'm referring now to the Index of Leading Economic Indicators, and Construction Spending, and the National Association of Purchasing Managers, which reported a sharp drop in its index. Those three were all reported yesterday, I believe.

Mr. BOSKIN. That's correct.

Let me start by saying that I do pay some attention to the Purchasing Managers' Index. I think that has some useful information in it. That had had some pretty strong rebounds for a couple of months and then has fallen off a little, as a matter of fact, sizably on both the overall index and on orders. They are unclear whether that's a temporary phenomenon having to do with the timing of some things. For example, the auto industry is building some inventories because they have a labor contract coming up, so they may have been doing some inventory investment at one stage, and then gradually drawing it down. So I noted that with interest, and if that pattern continued, that would give me some concern.

With the Index of Leading Economic Indicators, I have often said that we get on the last day of the month the Index of Leading Indicators for the previous month, which has 11 components, 8 or 9 of which have already been publicly released, so I don't find any useful new information in the Leading Indicators. I mean no disrespect; many people find them useful, but I have never found them to be a particularly useful forecasting tool.

I don't know. Mr. Taylor, maybe you have a comment?

Mr. TAYLOR. I would say that the other third statistic you mentioned, the construction, also reflects decisions made in the past with respect to starts of construction. And this tends to be more of a lagging indicator, anyway. So that shouldn't be added to the list.

Representative HAMILTON. The point of all this is that those three indicators don't disturb your projection for the rest of the year in any appreciable degree?

Mr. TAYLOR. No.

Mr. BOSKIN. No. The trend would have to continue for several months along that path.

Representative HAMILTON. Now, I was looking at your economic assumptions. You'll recall that when you were here on February 8, I questioned you with regard to revenue forecasts. I said that I thought there was a possibility that your revenue forecasts were too high, principally because you had assumed significant increases in corporate profits throughout the 1990–95 period.

Now, I note in your midsession review that you reduce your projected growth for 1990 and 1991 and you also projected reduced revenues because of lower corporate taxes. Is that correct?

Mr. BOSKIN. That's correct.

Representative HAMILTON. But, at the same time that you are lowering your projects for 1990 and 1991, you are raising your growth projections for 1992, 1993, and 1994, modestly, and that, of course, enhances revenue growth in the outyears. So if you look at that total package, what you've done is to reduce your growth estimates in the short term and increase them in the longer term, is that right?

Mr. BOSKIN. Yes, that's exactly the reflection of the pattern I noted earlier; the more sluggish growth of the economy and the higher interest rates in the short run lead to lower quarter profits, because sales are weaker and interest costs are higher, for example. And then as the economy rebounds somewhat later than we had anticipated back in January, they pick up from that.

Representative HAMILTON. Is it correct to say that your longer term economic growth projections are considerably more optimistic than the Blue Chip or other forecasters?

Mr. BOSKIN. I wouldn't use the word, "considerably." The Blue Chip generally looks at long-term growth when they do these. They don't do that monthly. Every once in a while, they ask, and the average seems to be around 2.75 percent. Ours is 3 percent; the CBO is 2.6 percent. I would say that's a reasonably tight cluster. If you look at any 10-year period of American history and compare them, the variance would be much larger than that.

Also, of course, relative to the Blue Chip, we do assume this growth-oriented fiscal change.

Representative HAMILTON. What strikes me when I look at your projections earlier this year, that for every revision you made to those earlier projections, the impact was to raise the budget deficit. Now, let me try to be more specific. One of the reasons the fiscal situation has deteriorated so badly, and the reason you have to have a budget summit, is that we've had a series of multiple disappointments in the way you projected the economy's performance.

In January, you predicted real growth at 2.6 percent; in July, you projected 2.2 percent. That raises the deficit.

In January, you predicted the level of GNP to be—what's that, trillions?—Indiana fellows aren't used to using these big figures—$5.583 trillion, and in July, $5.563 trillion. That raises the deficit.

If you look at corporate profits, which I referred to a little earlier, January, $360 billion; July, $306 billion. That raises deficits.

If you look at interest rates, Treasury bills, 6.7 percent projection in January; 7.7 percent projection in July. That raises deficits.

If you look at longer term Treasury interest rates, 7.7 percent in January; 8.5 percent in July. That raises the deficit.

And if you look at consumer prices, 4.1 percent in January and 4.8 percent in July. That also raises the deficit.

And what then comes through is that in all of these key indicators, we've had a disappointing performance.

Mr. BOSKIN. Well, that's correct, but they're all related. If I could say one word about that, the higher interest rates in the early part of the year, which we attribute heavily to the increased demand for capital in Eastern Europe, were not forecast by anybody. So it's not just us but CBO and private forecasters, as well. That is one of the reasons the economy has slowed. It's one of the reasons corporate profits are lower. So these things are all related.

Now it is true that, if you take the whole package, that they have a net impact on the fiscal year 1991 budget deficit of $24 billion, but that's less than half of the increase in the projected deficit that was due to technical reestimates—for example, the ability of the agencies to forecast outlays from their budget authority, and things of that sort.

Representative HAMILTON. Yes, I want to get to those technical estimates because I really don't understand them very well, in a minute, but I'm still working on these projections a bit.

What distinguishes your projections in January from the projections of other forecasters is that you're optimistic at every point, it seems to me. You're on the high side at every point. You can always compare your projection to another private forecaster, the Blue Chip or whatever, with regard to unemployment or inflation or growth or interest rates or something or other, and say that they're with you on that point, but what distinguishes your projections in January was that you were optimistic across the board.

Mr. BOSKIN. Well, I wouldn't say we were optimistic across the board; we were in about the 75 or 80 percentile, if you arrayed the Blue Chip variable by variable. Also, for the first few months of the year, Blue Chip were raising their forecasts, for example, of real growth. I imagine with the more recent statistics that they'll be lowering them somewhat.

Mr. TAYLOR. There's a reason for the different indicators to have a similar characteristic, and that is that the forecast is meant to be internally consistent. Faster growth would generally be associated with relatively lower interest rates. You call those both relatively optimistic, but what we are able to make sure of is that our forecast holds together internally—it is internally consistent. And I think that's what you're referring to. The numbers seem to have a similar feature to them.

Representative HAMILTON. Now, in the midsession review, you've revised the long-term economic projections relatively little. Is that correct?

Mr. BOSKIN. That's right. The best way to think of those is that we've pushed the rebound in the economy out some and, otherwise, it follows a fairly similar pattern.

Representative HAMILTON. Mr. Reischauer, the head of the CBO, says that your long-term projections of real GNP growth are, in his words, "extremely optimistic but not impossible." How do you respond to that characterization?

Mr. BOSKIN. Unwarranted, unprofessional almost. I think that Mr. Reischauer's long-term growth estimates, for some time, have clearly been way below what the economy has performed at—or not Mr. Reischauer's, but the CBO's. I would not suggest to them, I would not use symmetric or analogous language to them. It is certainly clear that——

Representative HAMILTON. What kind of language?

Mr. BOSKIN. Symmetric. Using the symmetric language which you just quoted him as saying. I assume the quote is accurate.

Representative HAMILTON. Yes.

Mr. BOSKIN. I would not use that same language to describe the CBO's rather pessimistic view of the world. On the other hand, it's also important to understand a big difference between the administration forecast and the CBO. Our administration forecast is made consistent with the budget proposals; the CBO's is not. So, in that sense, the CBO has been assuming a very small amount of deficit reduction per year. And, if there were the kind of credible, multiyear, enforceable deficit reduction that we're talking about here, I think 90 percent of all economists would agree that the economy's long-term growth potential would be enhanced, and it would cause their estimates to be different.

And, indeed, one of the things that happened at the budget summit was that this was pointed out, and they had to go back and show what would happen if such a package were enacted to make them more comparable to what we do. So it's comparing apples and oranges somewhat.

Certainly, if we don't get a multiyear, deficit reduction, growth-oriented package, it is far less likely that the economy will grow as rapidly. I think that's the major source of the disagreement and it's why I think that those comments by Mr. Reischauer are inappropriate.

Representative HAMILTON. From 1991 to 1995, CBO projects an average growth rate for real GNP of 2.6 percent. Now, your projection is 3.15 percent, on average. So there's quite a difference. How do you explain that difference?

Mr. BOSKIN. No. 1, we have the benefits in the outyears of a multiyear enforceable budget deal which is growth oriented, investment oriented.

Representative HAMILTON. And they do not?

Mr. BOSKIN. That's right. They basically assume a baseline which has a small deficit reduction. They have done some reestimates for purposes of the budget summit to try to make their estimates more comparable and I don't know which estimates you happen to be referring to at this time. But, also, I think we differ a little bit on the economy's long-term productivity potential. We tend to look at the last 40 years, which includes the strong years in the 1950's and 1960's, the abysmal years of the 1970's, and the partial rebound in the 1980's; they tend to look at just the more recent performance.

Representative HAMILTON. Mr. Reischauer testified, I don't know whether this is a difference or not, that CBO's growth projections do assume a deficit reduction.

Mr. BOSKIN. Well, they were asked by the budget summit to come up with what their estimates would be if they assumed a budget package in the same way that the administration does, and they produced that; so I don't know which of the two you're referring to.

Mr. TAYLOR. They have changed in the most recent forecast, as you indicated, Mr. Chairman. I believe if you look at what the effect of that change in assumption has been on their forecast, it has largely affected only the very short-term part of the forecast. And that's probably why the CBO and the administration are more related or closer, at this point. In the longer term, I don't think you'll see much of an effect. Therefore, it begs the question, to say that they have really incorporated the budget deficit.

Representative HAMILTON. You don't think there'll be much of an effect on what?

Mr. TAYLOR. I don't think, if you look at the CBO's long-term projections a year ago and now, you'll see much difference. We could do an analysis of that, if you like. Therefore, it begs the question: Is it really incorporating any credible multiyear deficit reduction?

Mr. BOSKIN. Nor do they believe it would be very valuable to the economy.

Representative HAMILTON. The paragraph in the CBO testimony before the Joint Economic Committee, I'll just read it to you.

"At the request of the negotiators at the budget summit, CBO has developed a new forecast that assumes significant cuts to the deficit. These cuts are big: $40 billion to $60 billion is eliminated from the baseline budget deficit in fiscal year 1991. And they get bigger: by 1995, they rise to $120 billion to $180 billion. The deficit reductions we have assumed are balanced between cuts in defense, entitlement, nondefense discretionary spending, and increases in personal and business taxes."

OK, Congressman Scheuer.

Representative SCHEUER. Thank you very much, Mr. Chairman. It's a pleasure to have you back with us, Mr. Boskin.

Mr. BOSKIN. It's good to see you, too, sir.

Representative SCHEUER. You apparently told us a few minutes ago that you don't want spending cuts concentrated in public investment. Is that more or less?

Mr. BOSKIN. I think has to be left open to the negotiators as they try to fashion a package. What I said was, in response to a question from Chairman Hamilton, that I would forecast a different effect on the economy from spending cuts that affected public investment than from other public expenditures.

Representative SCHEUER. OK. Would you elaborate on that, please?

Mr. BOSKIN. Well, I think some public investment, not necessarily anything the Government might invest in, is potentially beneficial for the economy. Government R&D. We, in our own budget, have proposed a big increase in aviation infrastructure investment and so on. So I think that this does help the economy perform better when it's done carefully and effectively and subject to rigorous benefit-cost criteria.

I was just trying to point out an example of where the composition of spending cuts might matter. I would say the same as to the composition of revenues. But I thought I'd give an example on the spending side, since they're mostly on the revenue side when the discussions are held.

Representative SCHEUER. Talking about the cost-benefit calculus, I'm a sponsor, along with Congressman Dale Kildee of Michigan, of a full-funding-for-Head Start bill. The provisions of the bill have been passed by the House; it's in the Senate Labor and Education Committee, and it looks as if it's going to have pretty smooth sailing. Of course, the question will be when it comes to appropriations. The bill leads us in a structured, upward glide path to about $7 to $8 billion in 1994–95, to provide a Head Start slot for every kid at severe education risk, every kid from a disadvantaged family who, when he comes to the school house door at the present time, is just not learning ready.

At the present time, we have a Head Start slot for about 16 percent of the kids at urgent education risk. The President's $500 million request for Head Start funds would bring it up to about 21 percent, but we'd still be excluding 79 percent of the kids from this enriched, preschool experience that is almost their last fair chance to make it in school. When you make it in school, you are one-half as likely to end up on welfare, on drugs, as a client of the criminal justice system. You are twice as likely to graduate from high school, to go to college, and all of those good things.

Now, we've done several cost-benefit analyses of Head Start. And they show that for every dollar invested by government, we get a return of between $7 and $11, which is an incredible cost-benefit calculus. I think the only other government expenditure that compares with that, or that's government mandated, is seatbelts and shoulder harnesses.

Would you advocate a substantial investment in Head Start, sufficient to give every kid in America who comes from an educationally disadvantaged home and who is on the precipice of education failure, would you advocate that we invest in those kids the moneys necessary to help them make it in school? Is that the kind of thing you were talking about?

Mr. BOSKIN. Let me qualitatively agree that while I'm not familiar with all of the studies that you're referring to, I've seen some, and I don't have with me the percentages you're talking about or exactly how you've defined that risk and so on; but let me qualitatively agree that it appears that Head Start, when one looks at effective programs, is an effective program. That's one reason that we have proposed, in our budget, a substantial expansion, obviously not nearly as much as you would like. But qualitatively, I would agree that a well-designed expansion of Head Start is a valuable investment in our future.

Representative SCHEUER. And you have advocated a $500 million additional investment in Head Start that would bring the percentage of kids who urgently need Head Start from about 16 percent to about 21 percent. Would you advocate that we move in a structured, thoughtful way from excluding 79 percent to no exclusion at all, to make sure that the kids who need it, get it?

Mr. BOSKIN. Well, I'd have to go back to how you're defining these percentages. I'm not trying to duck the question; I'm just not currently in possession of enough information to say where the 21 percent is or whether it includes all children or only 4-year-olds.

Representative SCHEUER. Well, 21 percent, plus or minus 5 percent, 10 percent, 15 percent, in that neighborhood. Do we make the national commitment to educating kids, to assuring that these kids from seriously disadvantaged homes—and we're all familiar with what that means—do we give them their last best chance of making it in school?

Mr. BOSKIN. Well, I think it is important that we have an effective Head Start program and that it be expanded in an orderly manner. Whether ours is sufficient, whether you're including 2- and 3-year-olds in this calculation, and the data suggests——

Representative SCHEUER. Nobody advocates including 2-year-olds but I am including 3-, 4-, and 5-year-olds.

Mr. BOSKIN. I think ours was trying to make a major increase in the fraction of 4-year-olds, and I just do not have—I will go back, as befits your comments today, and analyze the studies and how 3-year-olds fit into that picture. But I remember ours was concentrated on 4-year-olds and the percentages we had been using were to increase it to 70 percent or something.

Representative SCHEUER. Right. I'll send you our bill, our proposal——

Mr. BOSKIN. Right, we would like to see them.

Representative SCHEUER [continuing]. I'd appreciate your reaction to it, and I look forward to working with you.

Next question. We saw, just yesterday, the Armed Services Committee of the House making a major cut in military expenditures. They are really moving to downsize the military, far beyond what many of us felt was possible and doable. They are really trying to create a peace dividend.

I don't know if you heard Congressman Les Aspin, chairman of the House Armed Services Committee, endorse a cessation of production of the B–2 bomber at $800 or $900 million a print, as they say, almost a billion dollars a copy.

Now, over the long pull, I think the cut is in the nature of $20 or $25 billion, which is almost the 10 percent a year that Secretary McNamara has advocated that we cut, as others have. General Goodpastor, Andrew Goodpastor, commander of our troops in the European Theater in World War II, advocated the same thing. This isn't quite 10 percent. Ten percent would be $30 billion, but it's a heck of a good start. And we all welcome that. And there are untold possibilities of how we can reinvest that money in our society in much more productive ways, witness the Head Start program.

In the short run, though, the downsizing of the military can be painful. And some of us think that the Government should play a more proactive role in mitigating the consequences to individual workers, large numbers of them, and their families and the communities in which they reside. I'll give you a simple example. I'm a member of the Long Island Caucus. Grumman has 10,000 workers in that community. They're going to be hit very hard by the downsizing of the military. They produce fine Navy fightercraft that they've been producing, model after model, for half a century. But they are going to be hit very hard. The workers are going to be hit, the families are going to be hit, and the economy of Long Island is vulnerable.

Does the CEA have any advice to give this administration on souping up, now that the downsizing is almost a reality, souping up the various programs for mitigating the effects of downsizing on communities in Long Island and elsewhere? Many cities around the country are going to be hit very hard by the loss of jobs, families are going to be hit hard. Have you thought about a prompt souping up of the ability of our States and cities to cope with these painful readjustments and what the Federal Government can do to help?

Mr. BOSKIN. Well, we have analyzed various scenarios and what they'll likely do to the economy. We have a labor force that's about 120 million people. Hopefully, there will be arms agreements and events around the world that will make a national security posture prudent, consistent with a reasonable and hopefully orderly reduction in defense spending. The world would be a safer place, and obviously the resources would be devoted——

Representative SCHEUER. My question is, we're on the way to doing that——

Mr. BOSKIN. I'm getting to the answer, sir.

Representative SCHEUER [continuing]. But it has short-term painful costs.

Mr. BOSKIN. That's correct. But every year in the economy, hundreds of thousands of people change and lose their jobs for many reasons, from shifts in technology to shifts in demand to other things of that sort. And my general qualitative analysis is that a modest, foreseeable, orderly transition to a small military and to smaller military support to industry can be accomplished in a manner which is not terribly disruptive to the economy. That has been the case with much larger builddowns in the past. But I think it is important that there be some predictability and some order to it.

We have a variety of programs that already exist, including how to deal with closing a base, facilitating the productive transfer of the military's land and buildings to the private sector, and educational needs. We also have unemployment insurance and a variety of other benefits of that sort.

But the single most important thing is that people who are no longer employed in the military, or who may not be employed in industries supplying the military, enter into or relocate into a robust growing economy that is flexible enough to create lots of jobs, so they have lots of job opportunities. So I'd say that the most important thing the Government can do is to enact responsible macroeconomic policy.

I'm not prepared at this stage to go beyond that, but I'd be interested in hearing what your proposals are—you said you have thought a lot about this and have various proposals. I'd be interested in seeing them, discussing them with Secretary Cheney and others. I know that the Defense Department is interested in making the transition as smooth for everyone as possible and as prudent and orderly as possible.

Representative SCHEUER. I appreciate that, and I will be in touch with you, Mr. Boskin. I think the consensus is that the military has the legislation and they have the ability to do it, but they don't have the funding to do what I think they would like to do. I think that has been brought out on Long Island with the analysis of the Grumman situation. But I will be in touch with you on that.

Let me ask a related question. The Carnegie Foundation has recently issued a report—I don't know whether you're familiar with it—on the way we treat our non-college-bound youth. Are you at all familiar with that?

Mr. BOSKIN. I'm not familiar with the report, sir.

Representative SCHEUER. Yes. We had some hearings in this committee, that I chaired, on the fashion in which we deal with non-college-bound youth in our country. Our performance doesn't begin to meet the standards of many other developed countries, where they have state-of-the-art vocational education programs. They don't teach their people how to make buggy whips and Stanley Steamers, as we do. They teach them how to acquire skills that are in demand or the state of the art. There's a very close relationship between business and the vocational education system. Business people, plant managers, and engineers serve in the school system for 6 months or a year at a time. And the heads of vocational education departments go over to industry and work for 6 months or a year at a time. So there's a very close relationship, and the transition from the world of education to the world of work is a very easy, comfortable one that takes place almost automatically.

We don't have that tradition in this country. The report is a brilliant report, in the main, authored by a marvelous economist by the name of Marc Tucker, who testified at our hearings, too. Mr. Tucker is brilliant, and the recommendations are very much to the point.

Are you familiar with this study?

Mr. BOSKIN. No, I'm not. I will look forward to receiving it and analyzing it, and getting back to you on it. I would agree that our elementary and secondary education systems are a huge Achilles' heel to the future course of our economy, not just to these individuals. They'll be supplying our labor force of the future, and we need not only supply our future college graduates with skills, we need to supply our entire future labor force not only with the skills they'll need in the future, but with the skills to adapt to changes we can't even begin to foresee now.

So I couldn't agree more that we need some major improvements in our elementary and secondary education system that makes them much more closely related to performance-related outcomes that reflect the skills that will be needed in the future and the ability to learn skills or to adapt skills for things we can't even predict. So on that, we're in agreement, but I don't know the study per se, and I don't know it's recommendations on how to do that. We might have practical or philosophical differences, but on the general problem, I certainly wholeheartedly concur.

Representative SCHEUER. Very good.

Let me ask you a question on our health care system. As you know, we're spending approximately 12 percent of our GNP for health care, about $650 billion at the present time. The average for the OECD countries, the developed countries, is about 8 percent; the Japanese spend 6 percent, which is half of our percentage of GNP, and they have demonstrably superior health outcomes in nfant mortality, life expectation at birth, and by many other neasures.

One reason seems to be that a significant proportion of the ex- enditures we make for health are wasted. Maybe a third, a quar- er to a third, of all the procedures that we engage in—x rays, ests, medications, and operations—are useless, sometimes they ven harm the patient. This seems bizarre, but this was the testi- nony of former Secretary of Health, Education and Welfare, Joe alifano. It was the testimony of Professor Uwe Reinhart of Prince- on University, one of the country's outstanding health economists.

Our business of managing health care is primitive. We can't com- are one hospital to another hospital, or the cost effectiveness of hose hospitals, because they're on different accounting systems. In ur country, we have several times the rate of hysterectomies for vomen than they have abroad, in England and on the continent, et there is no demonstrable difference in health outputs for vomen. Within our own country, we have enormous differences in he frequency of all kinds of operations, between East and West, etween one hospital and another hospital. But we don't seem to nalyze these differences and figure out how to fine tune our ealth care system to eliminate the differences and to save the unds involved.

Uwe Reinhart and Joe Califano estimate that probably close to a uarter of all our expenditures in health care are wasted and could e saved, if we fine tuned our system, if we eliminated some of the hoices. They figure that well over $100 billion, perhaps up to $125 illion of our $650 billion health care annual bill is wasted.

Now, the Rockefeller Commission came out with an analysis of vhat it would cost us to go to a national health program, which lmost everybody seems to think we need, one that we craft, based n our needs, and not a copy of the British system, not a copy of he Canadian system—although there's a lot to learn from the Ca- adian system—but it should be crafted based on the parameters of ur health care assets and our health care needs. They estimated it vould cost maybe $65 or $70 billion extra to provide health care for he 37 or 38 million Americans who are now excluded from our ealth care system, who have no health insurance, and who access ur health care system through the emergency rooms of our hospi- als. They are billed at great cost and treated by highly trained life aving technical personnel, and the ER's are overloaded with eople coming in with a kid that has colic or who has a cold or a ore throat. It's a bizarre misuse and waste of public funds. The act that we haven't included these people in a rational way in our ealth care system leaves them to overload the system at a critical oint in a manner that is absolutely ridiculous.

We have never really addressed the problem of waste, duplica- ion, terrible accounting and bookkeeping practices, in our health are system. Would you have any thought of recommending to the dministration that we make a thoughtful analysis, perhaps over a eriod of a year, of where the waste, where the duplication, where he overlapping, where the misuse comes in our health care ystem, and try and fine tune the system and eliminate many of hese characteristics that everybody has been complaining about for years. Like Mark Twain said in the last century, "everybody complains about the weather but nobody does anything about it."

Would you recommend to the administration that we try to save upward of $100 billion a year in our health care system and make it a cost-effective system, built on our assets, built on our needs, that serves the American people far better than the one we have now?

Mr. BOSKIN. Well, sir, I already have, along with my colleagues, made such a recommendation, and the President has asked Secretary Sullivan at HHS to conduct a comprehensive review, to include a review of the recommendations of the Pepper Commission, which Senator Rockefeller headed, and the Steeleman Commission which will issue a report on health shortly and analyze a variety of things. And I agree that we spend too much as a society and we waste resources, and we have major problems of access for a sizable fraction of people. And they access it in ways that are——

Representative SCHEUER. Overly wasteful. Let me just comment that the Rockefeller Commission report was an excellent report. It showed how we could go into a national health care system and what it would cost. It did not address the very important question of waste, duplication, overlapping, and built-in structured stupidities in our present health care system.

Mr. BOSKIN. I agree with that, and we've been urging HHS to take a look at some of those issues.

Unfortunately, another thing the Pepper or Rockefeller Commission didn't address was how to pay for the large additional expenditures that they were proposing. And I can assure you that the administration will be analyzing that, as well. You may well be right that it can be paid for by reduced waste.

Representative SCHEUER. The saving, the clear potential saving from reducing this foolishness in the system of upward of $100 billion and perhaps as much as $125 billion, is clearly sufficient to pay for the total cost of including these 37 million people into the system, which Pepper and Rockefeller estimate to be in the order of magnitude of $65 or $75 billion. The potential saving is at least 50 percent more than that, and perhaps close to double that.

Mr. BOSKIN. You may well be right. As I wasn't here to hear Mr. Reinhart's testimony, I do tend to agree that there is a substantial amount of duplication and waste, defensive medicine practices that are designed to avoid malpractice suits, rather than improve the health of the patient, and things of that sort. But it will be a comprehensive study and HHS will be looking at these issues, as well.

Representative SCHEUER. And they'll be looking at the issues of waste?

Mr. BOSKIN. They've been instructed to include that, as well.

Representative SCHEUER. I have one last question, Mr. Chairman.

There seems to be a capital shortage globally. If our economy didn't have the availability of Japanese savings and Japanese investment and Japanese loans to us, we'd be in deep sushi. We'd be in real trouble. If the Japanese weren't saving like mad—maybe 18 or 19 percent of individual annual income is put into savings, as against maybe 4 or 5 percent in our country—if they weren't saving at almost four times the rate at which we're saving, we'd be in terrible trouble. It would be nice to think that, over the long pull, Americans could provide their own savings for investment in research and development, new plant and equipment, and all those great things that you need to have a prosperous, expanding, robust economy.

Yet, we don't seem to be able to save. And even you, Mr. Boskin, bemoan the possible reduction in consumer spending. From my point of view—and I suppose there are some who agree with me—we've been engaging in a consumer binge, buying consumer electronics up to our eyeballs and not saving anything out of our individual family incomes to put back into the economy to improve the economy. So we have a desperate capital shortage in this country. And, as I say, we have to rely on foreigners to lend us the wherewithal to grease the machinery here.

Do you have any recommendations to the President as to what we could do to encourage people to save more, to provide incentives for saving and disincentives for spending on consumer items that people really ought to think twice about. In general, how can we encourage a substantial increase in savings in this country that would free us from dependence upon foreign source of finance and would provide the necessary investment capital for our businesses to develop new products, new services, new facilities, new plant and equipment, and enable our economy to be a competitive economy, without the constant need of blood transfusions of needed capital from abroad?

Mr. BOSKIN. Well, I would agree with the fact that we'd be in still better shape, were we saving more as a nation. In the short run, obviously, the savings from abroad that flow into the United States are both some sign of confidence in the economy, they prevent interest rates from rising further than they would otherwise, and are beneficial. Now, over the long run, obviously, when foreigners acquire the assets, the interest in dividends and rents accrue to others, rather than to Americans. So, for a variety of reasons, to help reduce interest rates, to deal with our external balances, and so on, increasing the national savings rate—averaged over periods of fluctuation in the economy—is a very important thing to do.

The surest and safest way to do that is to decrease the Federal Government's budget deficit, which is a drain on the private sector's already modest saving that you've mentioned, and do so in a way that doesn't harm private saving. That was one of the questions Chairman Hamilton asked before, "does it matter how you do it?" If we reduce the budget deficit in a manner that lowered private saving, we would just be transferring part of this problem from too much government borrowing to even less private saving.

So that's the surest and best way. We have made several proposals in our budget to enhance saving, changes in the Tax Code, capital gains, a family saving account to help people save for preretirement objectives which would sharply limit any potential shortrun revenue loss at the Treasury, and so on.

I also think that there are some demographic factors involved here. And, as the baby-boom generation gets more into the peak-earning years, there'll be some increase. But I do believe that we do have a major national saving problem and that the biggest component of it is the persistent Federal budget deficit. So I agree with you on that score, completely.

Mr. Taylor, do you have anything you want to add?

Mr. TAYLOR. We should certainly try to increase our national savings rate, both public and private. And as Mr. Boskin indicated, we have a lot of proposals in the works to do that. The President's budget has many items.

I would say, though, that it might very well be that we'll continue, even if we do raise our savings rate, to receive funds from abroad. After all, the United States is an attractive place to invest and one of the reasons funds come into the United States is because of the attractiveness of the investment. It's not simply to supplant a low-savings rate.

Representative SCHEUER. The safe haven principle.

Mr. TAYLOR. That's exactly right.

Mr. BOSKIN. And the increase in saving, therefore, might lead to a yet higher investment rate, or indeed more American investment overseas.

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

Representative HAMILTON. OK. I'm trying to understand why the projected deficit grew so much. If you look at your projections in January of this year, and compare them with your projections in the midsession review, you have an increase in the deficit of $530 billion over a 5-year period.

Now, how in the world did that happen? A huge increase in our projection of the deficit, what happened there?

Mr. BOSKIN. Some of it is a shifting because of the timing of the rise and then fall of interest rates, sluggish growth and the later pickup, and things of that sort. But let me try to focus on 1991, to give an example.

Originally, the deficit, excluding RTC spending, was projected around $93 or $94 billion. That's now up to $169 billion; $49.3 billion of that increase is due to technical changes. Those things concern how rapidly agencies are spending relative to their budget authority, Treasury reestimates of revenue receipts for any given level of the economy, and things of that sort. That is the largest non-RTC increase.

The second part is from the economic assumptions. In fiscal year 1991, the slower growth and higher interest rates that we've forecasted would add a little less than half of what the technical changes add—about $24 billion.

And then, of course, there is a large increase in RTC spending.

Representative HAMILTON. How did we miss that so far?

Mr. BOSKIN. Well, there are a variety of reasons, Mr. Chairman. I think among the reasons were that, in the earlier presentation of the budget, we laid out some of the scenarios, but we didn't know how rapidly the cases would be resolved, how much working capital would be required, and whether working capital ought to be included in the definition of the deficit, and so on.

Representative HAMILTON. How much did the President include in his budget to take care of the RTC problem in January?

Mr. BOSKIN. I'll have to come back to look at that. I think it was $7 billion.

Representative HAMILTON. What's your estimate it's going to take, now?

Mr. BOSKIN. This is for fiscal year 1991, we have $62 billion.

Representative HAMILTON. How could we be that far off?

Mr. BOSKIN. Well, first of all, there's the issue of working capital. Second of all, there's been a major acceleration of the pace of resolutions. The RTC is planning to do a great deal more than was the case earlier. So, in some sense, these are being moved forward. In some sense, the total resolutions——

Representative HAMILTON. And the expenditures are being moved forward?

Mr. BOSKIN. The expenditures are being moved forward. Also, partly because those are being moved forward and there'll be more resolutions sooner, the RTC needs a lot more working capital than was anticipated sooner. And they will be working that off. And then, at some point in the future, that will be reduced. So there was a $55 billion increase since January.

And we made the statement, if I just may remark, in the midsession that this is a very uncertain estimate. It's highly uncertain. It would depend on new spending authority being granted to the RTC, as was discussed in the Banking Committee a few days ago, so that they're able to resolve many more S&L's quickly. The spending authority will run out well before the fiscal year 1991 gets very far along.

Representative HAMILTON. Well, in looking back at that, shouldn't we have done a better job of estimating the RTC costs?

Mr. BOSKIN. Well, I think hindsight's always very helpful. Except when the Commerce Department has to revise the figures, we do a better job in forecasting the past than the future. But we had made it clear, particularly Secretary Brady had made it clear, even before the passing of FIRREA, that it was very uncertain whether the funds in there were sufficient, and exactly what the time pattern would be, and so on.

Representative HAMILTON. If you take this $530 billion increase in the deficit, my figures suggest that $227 billion of that is due to lower estimated revenues. Is that about right?

Mr. TAYLOR. I think it's helpful to look at it on a year-by-year basis, Mr. Chairman.

Representative HAMILTON. I see.

Mr. TAYLOR. Take 1991, for example.

Mr. BOSKIN. I can say, quite aside from the revenue breakdown, if you added how much was due to changes in economic assumptions, it would be about $120 or $130 billion over 5 years.

Representative HAMILTON. Over that period.

Mr. BOSKIN. Over 1990 to 1995, for the 6 years.

Representative HAMILTON. How much of it is due to increased spending, new spending? I'm talking about new spending because the Congress passed spending bills or something of that sort.

Mr. TAYLOR. In this calculation, very little.

Mr. BOSKIN. Very little. Much of it would be RTC and technical reestimates, both to revenues and to outlays, including the estimated outlays from BA of various agencies. But there are large technical reestimates of revenues, as well.

Representative HAMILTON. OK, that's what I want to get at. Technical reestimates, I don't even understand the phrase. What does technical reestimates mean, anyway, and how can they get to be such huge figures? We have a phrase up here in the Congress, you have a technical amendment, it means a very, very minor adjustment to a bill. Sometimes that word is loosely used, I might say, on technical amendments.

You say technical reestimates, and then you come up with these big, big figures. What are we talking about on technical reestimates?

Mr. BOSKIN. Well, it really refers to the fact that the agencies, OMB on outlays, and Treasury on receipts, have various techniques they use to estimate, for any given set of assumptions about the economy, what receipts are likely to be by component and in the aggregate, and what outlays are likely to be, and they go through various procedures to do that. And sometimes, for example, OMB will get a new survey from HHS or from HCFA, the Health Care Financing Agency about medicare, and then they'll have to adjust what they thought was going to be the outlay.

Sometimes the Treasury will, in trying to figure out what's likely to be the pattern of receipts, realize that they've overestimated or underestimated receipts when they see what actually is happening; and they try to figure out exactly why that has occurred.

We had major tax reform legislation in 1986, and it has made the interpretation in the last 2 or 3 years of revenues more complex, because some of it is due to the normal activity, some of it's due to the transitions and the changes in the tax laws. So when we make adjustments of that sort, that is, holding constant GNP and wages and salaries and profits, we change how much we believe we'll get in receipts. Or with respect to entitlements, determining how much will actually be spent is difficult. Because even if Congress doesn't pass a new law, more people will be eligible when conditions change and the spending will be more, given the current law. Those are technical reestimates, and they're made sometimes on a weekly basis, continually, as new data become available.

Representative HAMILTON. And in this case, in recent months anyway, they've been very, very large.

Mr. BOSKIN. That's correct.

Representative HAMILTON. Robert Samuelson points out, in a Washington Post article this past week, that technical reestimates reduced projected revenues by almost $200 billion in 1990–95. There was also a $185 billion increase in spending over that period, due to technical reestimates.

I don't recall technical estimates being so huge in the recent past. Have they always been this large or have we suddenly gotten into a situation where technical reestimates are ballooning?

Mr. BOSKIN. Well, I think there have been some major changes. For example, there were some rather radical revisions to GNP, as I indicated. And therefore, I think that Treasury, in trying to analyze how much taxes would come as a result, had to change some of their analyses of what was likely to happen, based on those kinds of new data and on their own analysis of what was going on with everything from subchapter S corporations to capital gains.

Representative HAMILTON. Would you anticipate in the future that technical reestimates are going to be in this magnitude?

Mr. BOSKIN. I can't give you a good answer to that, Mr. Chairman. I will try to get an answer back to you. I would point out one thing. That, on an annual basis, they are still large, but not obviously as large as they are cumulatively. But it only takes a very tiny change in the fraction of something as a percentage of GNP, or of wages and salaries, or a tiny change in the rate out of a huge expenditure on a program, to cause large absolute dollar changes.

In 1981, a $49 billion technical change, both summed of outlays and receipts, is still well under 1 percent of GNP. And so these are very large dollar amounts. They're very significant, especially when Congress has to deal with meeting specific dollar figure deficit targets. And I understand the frustration. But you could be off by a very modest amount in your estimate of an effective tax rate or of the nature of Medicare spending.

Representative HAMILTON. Well, the thing that has impressed me and it's just come to my attention more forcefully in the last few months, is the size of these technical estimates. I don't recall them being of that magnitude in the past.

Still on the question of assumptions, JEC staff indicate to me that, on average, over the 10 years from 1980 through 1989, the deficits in the budget resolution underestimated the actual deficits by $40 billion. That's an average.

And the question to you is, do the frequency and the size of these errors, if you would, in forecasting, indicate to you a consistent pattern of underestimating the size of the deficit?

Mr. BOSKIN. Well, I think that there have been a variety of surprises. I think this was particularly bad in the deep recession in the early 1980's. And then I think that what winds up happening is that a law is enacted that winds up, ex post, being a lot less of a deficit reduction than originally anticipated or hoped for.

A good example is the budget summit of 1987, after the stock market crash. After a lot of hard work by a lot of capable and dedicated people in the executive and legislative branches, there was a lot of fanfare, and a set of proposals came out. But by the second year, the amount of spending reductions was only $2 billion. I don't know exactly what the explanation is for that. I don't know if subsequent legislation doesn't live up or that people are being too optimistic, or what.

Representative HAMILTON. Well, when I look at fiscal year 1990, what strikes me is that it has been a recordbreaking year for budget revisions. I just cannot remember a time when we have had such traumatic changes in the budget outlook as we've had in this fiscal year 1990. And, you know, there are always explanations, but if anything was going to go wrong, it went wrong, it seems to me, in 1990.

Mr. BOSKIN. I would agree that some things have gone not as well as expected, and the deficits are now projected to be considerably larger.

By way of historical comparison, I will note a couple of other episodes which were at least qualitatively much worse in their own time. You may recall the difficulty we had—and I mean no partisan statement here—when President Carter proposed his budget in

January 1980. It called for $616 billion of spending and $600 billion of receipts, only a $16 billion deficit. But because we had such horrible inflation at that time, he had to withdraw it because of the hue and cry about not having a balanced budget. So he actually had to withdraw the budget. He resubmitted a budget on the eve of a very sharp, albeit rather brief recession. And those numbers were all submitted, so that problem occurred.

In the early 1980's, we were way off about the economic performance. Everybody was way off about the economic performance because we had a very deep, long-lasting recession in 1982, which was not universally forecast.

Representative HAMILTON. Well, I've talked with you before about this bias that exists for optimistic projections. And my own view is that it's rather a serious matter. It gets us off on the wrong foot for our deliberations on the budget. I really don't attribute that to a Republican or Democratic administration, I think it's inherent in the system. And it's just as much the fault of the Congress as it is the administration because we accept what you do.

Now, there are very, very strong political reasons for us doing that, and for you doing what you do. But it reminds me of the phrase they use on computers, junk-in and junk-out. We put a lot of junk in early on because we're too optimistic, and we get a lot of junk out, as a result of it.

Now, I recognize that's extreme language, but there's a comparison here.

Mr. TAYLOR. Mr. Chairman, if I might add. I think it's very important for our forecasts to be objective and internally consistent, and we aim to do that. Also, I don't think it's really correct to blame all the shortfalls on the forecasts, particularly when you compare the actual evolution of the budget to the forecasts. In fact, in this year, it's certainly not that way. It's a small component.

I think if you look back through these 10 years where your $40 billion average comes out, that a large fraction of that would not be due to economic assumptions, but to other things. And, in fact, I think what's most important is that it's not a growing problem. Whatever bias is there has been relatively stable and the growing problem with deficits can't be traced to this economic assumption.

Representative HAMILTON. Well, I recognize it includes things other than optimistic economic assumptions. It includes things like technical estimates that we were talking about a moment ago that, I must say, still continue to puzzle me.

OK, I want to go to another topic. You've been at this for quite a while, and I don't want to keep you too much longer. But I want to talk a little bit about the distribution of income problem, to get your sense of it.

As you know, that's being much discussed here in Washington and on Capitol Hill. And it's not my intent to get into any extended discussion on statistical matters, but there are some statistics that I will cite here. I think you would agree that the data show that the income gap between the wealthy Americans and other Americans has widened very significantly in recent years. And I'd just like to get your reaction to that, and whether or not the administration believes that we should use government policies to try to improve the fairness of the distribution of income.

Mr. BOSKIN. Well, let me first start with a longer term historical perspective. Which is that, generally speaking, I think, it's recognized that the distribution of income in the United States has been remarkably stable over a long period of time. There are many explanations for that, many competing explanations, but this has occurred in regimes with very different tax and public outlay scenarios. So I'd start with that statement.

Second, I think what is clear is that the most noticeable major change in the income distribution in the last decade or so has been the large increase in the fraction of families with higher incomes, apparently, mostly moving up from the middle class to upper middle class, as opposed to anything else. When I looked at this about a year ago, I think it was with data comparing perhaps 1979 or 1980 with 1987 or 1988, the fraction of American families with a real income over $50,000—and I apologize, I don't remember whether this was 1980 dollars or 1987 dollars—had grown from 16-odd percent to 22 percent. So I think that was the most noticeable major change in the overall distribution.

Representative HAMILTON. Yes, but doesn't that really come about because you have increasingly two people working in the family, or more?

Mr. BOSKIN. No. Some of it does, sir, but if you look at the increase in personal income, and you compare that to the fraction of two-earner families, personal income has grown much more rapidly than two-earner families have grown. And, as a matter of fact, the growth of two-earner families was much greater in the mid-to-late 1970's than it has been in the last 7 or 8 years.

Representative HAMILTON. But the question I want you to address is whether or not the administration believes the situation is at a point where we ought to use government tax policy, or whatever, to improve the distribution of income. That's really my interest.

Mr. BOSKIN. Well, I think we maintain——

Representative HAMILTON. In the President's proposal, for example, on capping the State and local income deduction, there is a feature of progressivity in that, right?

Mr. BOSKIN. There is no formal proposal made of that sort.

Representative HAMILTON. Well, OK, no formal proposal, but whoever put it our there, there is a feature of progressivity in that proposal, isn't there?

Mr. BOSKIN. Yes. But I would compare that in the overall packages that are being discussed, and there is a strong feeling on my part, and more importantly, the President's and the administration, that a capital gains tax differential would be good for the economy. There are many people who feel that, because a disproportionate share of the benefits might accrue to upper income taxpayers, that they would want something to offset that. I think the way to think about the proposal being discussed is that it is part of an overall package, not that there's a feeling that we ought to go separately at the Tax Code to deal with progressivity issues.

As a member of fact, I think there is quite a bit of controversy whether the Tax Code is any less progressive now than it was in the past.

And I'd make two additional points, Mr. Chairman. What really matters is the overall income distribution and the overall impact of all the government's activities, not just the tax side but the spending side of the budget. And, as a practical matter, despite what were nominally very progressive tax rates in earlier years—getting up to 90 percent, even though people didn't really pay the 90 percent rate—the overwhelming bulk of redistribution of income done by the Government units in the United States is on the outlay side of the budget, in Social Security and unemployment insurance benefits, and welfare and things of that sort, and transfer payments.

Representative HAMILTON. I want to tell you how I'm reacting to what you're telling me. I asked you what is the administration's position or attitude toward using government policies to improve the fairness and the distribution of income? And I'm getting the impression from you that your answer is that you don't think the administration ought to use government policy to impact the fairness of the distribution of income.

Mr. BOSKIN. At the present time, our analysis has been that there has been little change in the progressivity, and that in general, this is not something that ought to be a major focus of tax policy.

Representative HAMILTON. Going back a moment to the optimistic assumptions, you're not proposing any change in the process or the pattern of the way we have done these things in the past? That is to say, the President makes a recommendation—those recommendations I think have often been very optimistic—and Congress adopts it. You're satisfied with that procedure and you don't see any reason to change it?

Mr. BOSKIN. Well, I think there are many reasons to change the budget process.

Representative HAMILTON. But that's not an area where you're recommending changes?

Mr. TAYLOR. Well, in the President's budget, there was a suggestion discussed for a second sequester. And in that process of a second sequester, there would have to be a reexamination of the forecast.

Representative HAMILTON. At what point?

Mr. TAYLOR. As a second sequester——

Mr. BOSKIN. Part way through the year.

Mr. TAYLOR [continuing]. Came, halfway through or whatever. It'll be reassessed at that time.

Representative HAMILTON. But there's no suggestion to change the approach initially on economic assumptions?

Mr. BOSKIN. No. I think what has happened, for example, this year, as we look at how the budget summit has progressed, we have been updating our information. The CBO was in the room. We had a lot of discussions about why there were differences, and the differences narrowed somewhat. As the year progressed and new data became available, they raised their estimate a little, we lowered ours, and so on.

But Congress is free to work off of whatever set of economic assumptions they would like to in passing a budget resolution. You are correct that in recent years, they have perhaps found it more convenient to work off the administration's than the CBO.

Representative HAMILTON. Well, that's just the problem. I mean, the political pressures that operate on the President are the same political pressures that operate on the Congress. Those pressures drive us toward not what I would call unrealistic assumptions but what I would call not the most prudent assumptions. And since we do not adopt the most prudent assumptions, then we get ourselves into trouble down the line. That would be my view.

Mr. BOSKIN. Well, I certainly respect that point of view.

Mr. TAYLOR. The second sequester, though, would you bring——

Representative HAMILTON. I understand. That's a good point. Yes, I understand that.

Mr. TAYLOR. When you're in the middle of the year, it's more difficult to be less prudent.

Representative HAMILTON. There are some problems, however, with the second sequester, which I've been reminded of here. It would disrupt programs to correct errors in the forecast, and it would come too late. So there are problems with the second sequester.

Mr. BOSKIN. Mr. Chairman, if I could make one additional point on these forecasts. For the first time, this administration has adopted the procedure for the President and the budget submission, of laying out several different paths the economy might follow, in order to try to highlight, in a way that had not been done previously, the sensitivity of budget outcomes, and also to highlight the fact that economic forecasting is an imprecise science. One might well consider using more of that information, rather than just the point estimates, as we're driven to by law.

Representative HAMILTON. On the technical reestimates problem, does part of that come about because of the inadequacy of data, statistical date?

Mr. BOSKIN. Some of it certainly does. Inadequacy or timing or large revisions.

Representative HAMILTON. I know you're working on that. Can you give us a quick progress report on what your group has done since you testified before us some months ago?

Mr. BOSKIN. Yes, I can. As a matter of fact, the working group on improving the quality of statistics met again, yesterday, and after forming several subgroups, we have very detailed reports on suggested improvements in everything from improving the reliability and joint use of business lists and greater accessibility of the data for the consuming public to improving the quality of our service sector statistics. And we are in the process, in the next couple of weeks, of preparing a report to the Economic Policy Council with recommendations for additional programs to be implemented and additional funding requested to implement those programs.

And I might say that, speaking not just on my own and the administration's behalf, but on behalf of the entire community that relies on quality Federal Government economic statistics, I want to particularly thank the JEC for the role it has played and particularly thank you and Senator Sarbanes for the role you've played last year in assisting us in this regard.

Representative HAMILTON. Thank you.

Mr. BOSKIN. There had been this tendency to cut appropriations below what was requested for statistical agencies.

Representative HAMILTON. Thank you for the comment.

So, will there be a report out later this summer, do you think, or this fall?

Mr. BOSKIN. There'll be a recommendation to the Economic Policy Council which will make a recommendation to the President, and it will be in this budget cycle. There will be a request for a package of proposals to improve the statistics and for the corresponding funding necessary with offsets in other places where savings can be made.

Representative HAMILTON. That'll be in the 1992 budget cycle?

Mr. BOSKIN. That's right.

Representative HAMILTON. Well, thank your very much, gentlemen. We've appreciated your cooperation and your testimony this morning.

And we stand adjourned.

[Whereupon, at 11:56 a.m., the committee adjourned, subject to the call of the Chair.]

THE ECONOMIC OUTLOOK AT MIDYEAR

WEDNESDAY, SEPTEMBER 19, 1990

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

The committee met, pursuant to notice, at 10:16 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

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

Also present: Joseph J. Minarik, executive director; Joe Cobb, minority staff director; and William Buechner and Susan Lepper, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The committee will come to order.

This morning, the Joint Economic Committee resumes its hearings on the economic outlook. Our witness today is the Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan.

In its monetary policy report to Congress on July 18, the members of the Federal Open Market Committee projected continued economic growth this year and next, some further progress on bringing down inflation, and steady unemployment.

Events since then, including the Iraqi invasion of Kuwait, have significantly altered the economic outlook. There is growing concern that the economy is weakening and may be going into a recession, with all that entails, and that rising oil prices have worsened the outlook for inflation.

The Joint Economic Committee has invited Chairman Greenspan here this morning to present his latest views on the economy and the outlook and to discuss how recent developments affect the appropriate conduct of monetary and fiscal policy.

We're very pleased to welcome you, Mr. Greenspan, before the committee, and we turn to you now for your testimony.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman. It's always a pleasure to be here, especially to discuss the state of the economy in such a period. And I'd like to, of course, also touch upon the appropriate course of policy in such an unusual situation.

When I presented the Federal Reserve's semiannual report on monetary policy to the Congress in July, I noted that the pace of economic activity had slowed considerably this year. Real GNP rose at only a 1½ percent annual rate, on average, in the first half, and the available indicators suggest that real growth remained slow during the summer. Private employment has been flat over the past 2 months, and the unemployment rate, which had fluctuated narrowly for several quarters, has edged up since midyear.

Despite the general sluggishness in business activity this year, the underlying trend in inflation has not improved. In fact, the core rate of inflation in consumer prices may have crept higher. Moreover, the chance of a significant break soon in the inflation trend would seem to have diminished in view of the additional pressures from oil prices.

In my July testimony, I noted that the Board members and Reserve Bank presidents expected the economy to expand at a moderate pace over the ensuing year and a half, while prices were anticipated to rise less rapidly than they had earlier this year. Most private forecasters shared that assessment. Regrettably, events in the Middle East have introduced new and substantial risks to the outlook. The higher oil prices already have added to overall price pressures and may have begun to restrain real activity. In addition to the effects of the higher oil prices per se, just the enormous uncertainty about how and when the tensions in the Persian Gulf will be resolved undoubtedly is affecting the economy in a negative way.

If we knew how oil prices were going to move in coming months, it would be feasible—at least in principle—to trace out the effects of the 1990 "oil shock" on the U.S. economy. Economic theory supplies an analytical framework, and empirical analyses of past experience provide rough indications of the likely direction and size of the impacts.

Admittedly, even the most sophisticated econometric models are simplified, almost crude, representations of economic reality. They vary in their readings of history and cannot capture completely the scope and complexity of the economy's interrelationships or changes in its structure over time. Moreover, they cannot take into account the political and military unknowns in the current situation. Nonetheless, such models can be employed to identify the directions, and rough orders of magnitude, of the average effects of changes in oil prices. This is certainly a useful first step in policy analysis.

Suppose, for example, that crude oil prices were to average something under $30 per barrel over the next year—roughly in line with what is suggested by current transactions in the spot and futures markets. Representative models suggest that such a $10 per barrel increase in the price of oil would add 1½ to 2 percent to the level of overall consumer prices over the next year. Much of the increase in the overall price level reflects the passthrough of higher costs of crude oil into prices of domestically consumed petroleum products. These direct effects typically appear relatively quickly; indeed, such effects already were evident in yesterday's report on the CPI for August and undoubtedly will remain sizable in the September figures as well. Other, less direct, effects will build over time. Prices for competing energy products will be bid up, and those of goods and services that use energy as an input will rise more rapidly than they otherwise would have. A sustained higher oil price also would tend to feed through—with some lag—to wages, as workers seek to offset losses in their real income.

The effects on economic activity work through several channels and are more difficult to sort out. The range of empirical estimates is doubtless wider than for prices, but a representative figure is that a sustained increase of $10 per barrel of oil would reduce the level of real GNP by roughly 1 percent within a year. Much of this loss in output arises because—to the extent that the United States is a net importer of oil—a hike in oil prices drains away purchasing power from American energy users to foreign oil producers. Indeed, with imports of petroleum and products currently averaging about 8½ million barrels per day, a $10 per barrel rise in the oil price adds roughly $30 billion to our annual import bill.

Specifically, the higher consumer prices that result from the oil shock cut into the real disposable income of households, which in turn can be expected to reduce their spending. The weaker path for consumption subsequently can be presumed to spill over to business investment as many firms—their profit margins already squeezed by higher energy costs—lower capital spending in response to the reduced demand for their output.

Over time, the oil-producing countries may increase their purchases of U.S.-produced goods and services. In the current situation, the recent fall in the dollar may also provide some stimulus to our exports and restrain our imports. But, in total, the increment to U.S. GNP from higher net exports probably will be smaller than the drop in domestic demand—particularly in the short run. In addition, the weaker dollar adds upward pressure to U.S. import prices and hence raises further concern about inflation and instability.

Domestic energy producers, like their foreign counterparts, benefit from higher oil prices. At least to some extent, they likely will increase spending on exploration and drilling, or other types of investment. Nonetheless, this offset, too, probably will be relatively small in the near term, as producers—not knowing whether the higher oil prices will be sustained—are likely to be reluctant to undertake major projects.

Turning from the abstract to the current reality, hard data on the output of goods and services in the period since the invasion of Kuwait are limited, and it is difficult to distinguish the effects of higher oil prices from developments that would have occurred anyway. Clearly, growth is, at best, sluggish. Nonetheless, judging from both hard data and more anecdotal reports, we are not—at least as yet—witnessing a cumulative unwinding of economic activity.

Outlays on new cars and light trucks should be sensitive to the uncertainty shock that the Persian Gulf crisis has imparted, yet they have softened only moderately from the pace of earlier in the summer. In addition, the advance estimates for August suggest that retail sales of other items were about the same in real terms as in the preceding few months. Nonetheless, prospects for consumer demand are highly uncertain, especially in light of the sharp deterioration in consumer sentiment recorded in a variety of surveys since the Middle East crisis began. For example, the indexes complied by the Survey Research Center at the University of Michigan and by the Conference Board both plummeted in August to their lowest levels since 1983.

As yet, there is no statistical evidence on how prospects for business investment may have changed as a consequence of the oil shock. But the available anecdotal information clearly has taken on a more pessimistic tone over the past several weeks. Notably, the latest information provided to the Federal Reserve Banks by businesses and other contacts suggests a greater caution on the part of firms in the acquisition of capital goods, in some cases because of increased uncertainty. The reports from the District Banks are summarized in the so-called "Beige Book," which will be released later today.

It would be surprising if the recent developments did not give rise to some pullback by consumers and businesses. But the paucity of hard data makes it difficult to assess the extent of any cutbacks in spending or production that may be underway. It is also difficult to put the information in perspective. For example, the sharp drop in consumer attitudes may be largely a reflexive response to bad news, rather than an objective assessment of the outlook for income and employment. If so, attitudes, and spending in turn, may improve, once the initial shock effect wears off. On the other hand, the surveys may be signaling a more basic weakness in demand that will not be eased by the mere passage of time. The prospects for weakness cascading throughout the economy do not as yet appear compelling, in part because of the tight rein that businesses have been keeping on inventories. Nonetheless, we must remain alert to the possibility of such a development.

Whether an efficacious policy response to current developments would seek higher, lower, or unchanged interest rates will depend on the specifics of the situation, which are shifting day by day. In framing policy, however, we must not lose sight of the fact that there is no policy initiative that can in the end prevent the transfer of wealth, and cut in our standard of living, that stems from higher prices for imported oil. In addition, we must take into account the policy problems that already were present before the oil shock. For example, as I reported to the Congress in July, we made an adjustment to policy at that time in response to evidence, including Federal Reserve surveys, that banks—along with other lenders—had tightened credit. Data since that time have validated the earlier assessment, and, of course, we shall continue to evaluate all of the evidence relating to credit conditions.

Another key issue one must address is how much of any change in short-term rates would carry over to the crucially important long-term rates, given the concern in financial markets about prospects for inflation and about future economic developments. It is lower long-term rates, rather than short rates, that can do the most to foster the investment activity that is critical for the future health of the economy. Specifically, lower mortgage rates clearly would be useful in containing the current erosion of real estate markets. Policy actions that are not perceived to be consistent with a stable, noninflationary economic environment could easily be counterproductive over the long haul.

It is the responsibility of monetary policy to look through the uncertainty of the near term and to provide the stable financial environment that is consistent with our longer run objectives. We shall want, for example, to make sure that money and credit remain on appropriate growth tracks, with due allowance for the special influences affecting the demand for money and its velocity; among those influences are the credit developments to which I referred a moment ago. Indeed, one could argue that the restrained stance of monetary policy over the past few years may have reduced the odds of the oil shock igniting a more general acceleration of prices and a sharp escalation of bond yields.

In any event, the surest way to bring down real long-term interest rates is to reduce the Federal budget deficit. As you know, some have expressed concern in recent weeks that a large cut in the fiscal year 1991 budget—coming on top of the oil shock—would risk tipping the economy into recession. Such fears are understandable; however, they must be balanced against the benefits that will flow from reducing the Federal Government's claim on the Nation's limited pool of saving. Because the Government has been borrowing so much and for so long, it is well past time to scale back its draw on credit markets and to free up more resources for enhancing investment and production by the private sector.

The participants in the budget summit are endeavoring to craft a package of sizable deficit reductions. If they succeed and the Congress does enact a credible, long-term, enforceable budget agreement, I would expect long-term interest rates to decline.

In that context, I would presume that the Federal Reserve would move toward ease to accommodate those changes in the capitol markets. What adjustment might be necessary, and how it might be timed, cannot be spelled out before the fact. The actions required will depend on current economic conditions, the nature and magnitude of the fiscal package, and the likely timing of its effects.

In the final analysis, no one can guarantee that real growth will proceed smoothly, without a hitch on a quarter-to-quarter basis. I can only offer the assurance that the Federal Reserve will seek, as we have in the past, to foster economic stability and sustainable growth, in the context of continued progress over time toward price stability.

Representative HAMILTON. Thank you very much, Mr. Chairman. We'll proceed under a 10-minute rule for questions. I want to begin with the topic you ended on.

I assume by your statement—I think it's clear, but I want to be sure—when you refer to the Federal budget deficit package, that you still think such a package is urgently necessary.

Mr. GREENSPAN. I most certainly do, Mr. Chairman.

Representative HAMILTON. And are you in general accord with the targets that have been roughly stated, at least a $50 billion reduction for this fiscal year and a $500 billion reduction over the 5-year period?

Mr. GREENSPAN. Yes, Mr. Chairman.

Representative HAMILTON. Do you think that's enough?

Mr. GREENSPAN. I think it is an appropriate response to the current situation.

Representative HAMILTON. The General Accounting Office came out this week with a report saying it really ought to be $750 billion over the 5-year period.

Would you feel more comfortable with $750 billion, rather than $500 billion?

Mr. GREENSPAN. I would feel comfortable with $500 billion which I knew was enforceable and behind us. We could always worry later about whether or not it is enough. The major problem at this stage is to get started in a significant manner.

Representative HAMILTON. Now, in reading your statement, I was asking myself, is the Chairman of the Fed more worried about recession or inflation?

What worries you the most?

Mr. GREENSPAN. Well, regrettably, Mr. Chairman, both at the moment, because, as I've indicated, what has occurred in recent weeks is inflationary pressures have increased concurrently with a weakening of the economy.

So, in a sense, the answer is both. The outlook for both has deteriorated. And that's the reason why I stipulate that there is a real loss of resources that occurs as a consequence of this shock, and there is no policy which can be implemented which can reverse that. And, in a sense, it acts as a wedge which has effectively increased the risk both of recession and of inflation.

Representative HAMILTON. In my opening statement, I referred to the FOMC's July 18 projections for the economy. Since that time, the private forecasters, at least, have rather substantially revised their projections.

How would you revise those projections of July 18 at this time particularly with regard to growth and inflation?

Mr. GREENSPAN. Well, my impression is, without obviously having polled the Governors or the Presidents of the Reserve Banks, that the median would show presumably somewhat higher inflation and somewhat lower growth.

How those numbers would tally out, I frankly cannot indicate to you because I assume there will be revisions—in some cases, significant revisions—among the participants in that survey which we take, and that will not be compiled until early next year.

Representative HAMILTON. If the FOMC members have not had a chance to revise their figures, have you changed your own forecast? And if so, to what extent can you share that with us?

Mr. GREENSPAN. Well, it's obvious that the short-term outlook in physical volume terms is weaker. I think, as I indicate in my remarks, we are still growing at this particular stage very slowly. I don't see as yet any hard evidence on an immediate day-by-day basis that we have tilted over into any significant deterioration.

Representative HAMILTON. We are not in a recession today.

Mr. GREENSPAN. I would say that is a correct statement, and I would say that that is probably especially correct if we use the broader definition of recession, which I think is the appropriate one—namely, a cumulative process of deterioration in which events feed on each other and induce the economy into a cumulative decline.

That is clearly not the state of play at this stage. But it's also obvious that the economy is slowing down, that the layoff rate is gradually rising. But if one is reporting as distinct from forecasting, I would say as of now, or at least as of last week when we had data which are reasonably useful for this purpose, we have not tilted down. But I want to emphasize that is as of last week, and I would not want to assure you that that will go on indefinitely.

Representative HAMILTON. The news this morning is not very encouraging with regard to either inflation or the trade deficit.

Mr. GREENSPAN. Most certainly not.

Representative HAMILTON. The Blue Chip forecast is for virtually no growth in the rest of the year.

Do you think that that's a reasonable forecast under current circumstances?

Mr. GREENSPAN. Well, it's certainly consistent with the type of impact that I indicated in my remarks—namely, essentially lopping 1 percentage point off, on average, the general growth rate. And that, for most forecasts would leave them close to a very small increase or a very small decrease.

But I would hasten to add, Mr. Chairman, that we have to be cautious about reading too much into these types of numbers. I would merely answer your question by saying, not that the forecasts are reasonable, but they are not unreasonable.

Representative HAMILTON. A very cautious statement, Mr. Chairman. [Laughter.]

Mr. GREENSPAN. I've learned how to do that over the years. [Laughter.]

Representative HAMILTON. Of course, I'm accustomed to cautious statements from you. As they should be, may I say.

What is your current view on the probability of a recession?

Mr. GREENSPAN. It has clearly risen with the onset of the crisis in the gulf and the oil shock. It's hard to characterize the magnitude of it, but it has gone up. Whether or not it's greater than 50–50, I think it's actually too soon to indicate.

Representative HAMILTON. Have you been conducting monetary policy in a manner in the last few months to prevent a recession, or has that not been a factor?

Mr. GREENSPAN. I would say our policy over the past few months has been one in which we are endeavoring to project longer term stability. But, clearly, as I have indicated on numerous occasions before this committee and others, we have moved rates down. Specifically, in July, out of concern with what we perceived to be a tightening of credit markets independently of Fed action, we responded again.

So, in that sense, we were clearly moving in the direction to try to maintain the moderate growth path which occurred through the first half of this year, a growth path which I must say to you was less than we had earlier projected. But, in part, we ran into an extraordinary circumstance, that is, a rather dramatic slowing down in the labor force, only part of which is the result of economic activity. Sociological and demographic forces are a substantial factor as best we can judge. How permanent that is, we don't know, but it clearly has had an effect on the growth rate of the economy.

Representative HAMILTON. Do I understand correctly that your actions with regard to monetary policy were taken, not with respect to concern about recession, but with respect to concern about the credit markets?

Mr. GREENSPAN. For the actions taken in July, the answer is yes. I would, however, obviously not want to dissociate the credit markets from the economy as a whole.

We are also concerned, as we have indicated on many occasions, that we have to be very careful not to allow inflationary pressures to build up because if we wanted to guarantee a significant economic contraction, a buildup of inflationary pressures would almost be the quickest way of achieving that.

And, as a consequence, in our overall view, which is to try to maintain economic stability, we perceive the issue of keeping inflation under control, not as a tradeoff between inflation or unemployment, but as a necessary condition for long-term sustainable growth.

Representative HAMILTON. I saw in one of the papers this morning, that economists now are predicting a mild recession—a majority of economists, at least according to this article.

I suppose, then, it is not an unreasonable forecast, to use your terminology, to expect a recession soon?

Mr. GREENSPAN. Well, I think we have to distinguish between what in many respects has become the conventional definition of a recession and one which I think is a little more appropriate to policy.

The conventional definition of recession is a period in which two consecutive quarters of real GNP decline. That probably does encompass a broad range of actual economic declines. But by using that type of definition one can very readily find oneself believing that you are in a recession, and 3 years later, when the Department of Commerce gets its basic data revised, you will find out that you really weren't in that situation because it's very easy to revise the data by several percentage points, as, indeed, we have seen.

Representative HAMILTON. Yes.

Mr. GREENSPAN. A process in which the economy is deteriorating in a cumulative, interactive manner, in my judgment, never gets revised. That is a true recession. That is the process which we try to fend off. And, in that sense, I'm not certain how many of those who have, in effect, been forecasting a recession are doing it on the first definition or the second. My suspicion is the large majority are using the first, not the second.

Representative HAMILTON. But, in any event, it is not unreasonable to make a forecast at this point that a recession would occur soon.

Mr. GREENSPAN. No, it is not. Of the whole range of potential forecasts, it's clearly not an outlier.

Representative HAMILTON. Congressman Upton.

Representative UPTON. Thank you. Earlier this year, when you came and testified before our committee, you had indicated that you thought that there was less of a chance of a recession this year than you had thought the previous year.

As I recall from my days at OMB, the word on the street was that if we got into a recession, in fact, it would add to the deficit of about $100 billion each year, almost overnight.

Is that your thoughts as well, if we end up getting into a recession, that it will in fact increase the deficit by $100 billion?

Mr. GREENSPAN. Well, obviously, it will increase the deficit, and I say that the extent to which it will increase it will be very closely related to the degree of recession, were it to occur. It will also depend on whether or not corporate profits fall far more than, say, personal income as a share of the GNP, because the marginal tax rates do differ, as you know. It will also depend, to an extent, on what happens to unemployment insurance and a variety of related items on the expenditure side of the budget.

But I think it is fairly clear that when you're dealing with receipts and expenditures in the trillion-dollar range, you don't have to engender very much change in the combination of either to add rather significantly to the actual deficit.

Representative UPTON. I'm concerned about sluggish growth rates, as you've indicated in your testimony as well. And you draw a good parallel with regard to the gulf crisis and what it will do, in fact, if it's prolonged to reduce our growth rates.

Larry Kudlow, who, of course, is the chief economist for Bear, Stearns, when he testified again in the spring, indicated that if he saw a capital gains package enacted by the Congress, he thought that he would revise almost overnight his growth forecast by at least a half percent, maybe more.

How important is it to the Fed that in any budget agreement that may be reached in the next short-time period here, that we in fact accept and pass a capital gains package that would create jobs, lower the cost of capital, and obviously spur investment?

How important a factor is that to you in terms of revising your growth rates, not only for this year, but next year, too?

Mr. GREENSPAN. Well, it's difficult to make an estimate. I will say that our position basically is, as a Board, to stay away from recommendations for specific elements within this budget package.

I have personally testified, and do believe, as I've said innumerable times before the Congress, that a capital gains tax cut would be a positive element in the economy, and I would certainly say, especially in the context of weak real estate markets, a significant cut would be a positive element on values in the stock of real estate.

But I don't think it is appropriate for us to be involved in the political tradeoffs that are being discussed in the summit and, as a consequence, I have in past responses to questions about specific details of the summit, decided, along with my colleagues, merely to indicate that we believe that a large reduction in the budget deficit is a very positive element in the economic outlook.

Representative UPTON. You had indicated in your response to Congressman Hamilton, following up a little bit here, that you thought that the real budget deficit decline of $500 billion with enforcement was the key to reducing long-term interest rates and spurring growth.

The importance of a real budget deal I think is key to all of us here. And it does seem, at least for the moment, that the budget talks have stalled. There seems to be no real agreement on entitlement reform. There seems to be no agreement on domestic spending levels. There doesn't seem to be any agreement on enforcement or real budget reform. And there doesn't seem to be any agreement on revenues, either.

And it appears as though we're going to be coming to a show-down at the sequester corral beginning really in another week.

How important is it to the Fed that we make a deal that has real meaningful reform along the lines that you've indicated before—$500 billion with enforcement—within the next 30 days, versus if it's pushed off until after the November election?

What type of signal do you think that that would send?

Mr. GREENSPAN. Well, I don't think the issue is whether it is important to the Federal Reserve or not. I think it's very important for the country and for the economy.

Over the years, I have argued that the budget deficit affects the economy in a corrosive manner. In other words, it absorbs domestic saving, reduces investment, and gradually reduces growth and standards of living. It is not as though we're hitting a stone wall.

I'm not sure that position is going to be appropriate indefinitely into the future. We may be getting to the point where urgency of resolving this issue is increasing, whereas I don't think that was the case a year ago, certainly not 2 or 3 years ago.

It has always been a problem. The nature of the problem has always been, I think, unambiguous. What concerned me particularly about the slowdown in economic activity and economic potential in the first half of the year is that it may be, at least in part, the result of this long-term drain on savings and levels of net investment which I think are less than we need.

As a consequence, I am somewhat disturbed by the fact that this process seems to go on without resolution, and I would suggest that we may no longer be in a position or have the luxury to put it on the back burner again and hope it will get resolved at some later date.

Representative UPTON. So you would be in favor, then, of seeing some agreement reached in the short term.

Mr. GREENSPAN. Most certainly.

Representative UPTON. You touched on the part about savings. Do you think that there's sufficient savings being generated by the U.S. economy now, and what type of steps do you think we should take to improve that?

Mr. GREENSPAN. No, I don't think that there is adequate savings, Congressman Upton. I think that, fortunately, we have been obtaining significant amounts of foreign investment to augment our domestic savings to finance our domestic investment. But even before the poor July trade balance data that ratio of savings had been declining, that is, the foreign available savings. And we can't count on it indefinitely in the future.

I would argue, therefore, that we have to find ways to increase total domestic savings. And since I can't honestly say to you that many of the various different tools we've endeavored to employ in recent years have worked as well as I would like to see them work, I've concluded that, at a minimum, we should bring the Federal budget deficit down and reduce its drain on the available lower level of savings which it, in fact, has been imparting.

Representative UPTON. I have to go vote.

Representative HAMILTON. Senator Sarbanes.

Senator SARBANES. Chairman Greenspan, I am absolutely transfixed—indeed, the term might almost be mezmerized—by this sentence in your statement. And I'm going to read it to you:

Whether an efficacious policy response to current developments would seek higher, lower, or unchanged interest rates will depend upon the specifics of the situation, which are shifting day by day.

Mr. GREENSPAN. You certainly can't argue with that statement.

Senator SARBANES. No, I certainly can't. [Laughter.]

I want to give the Obfuscation Award of the Month to whoever in your shop put that sentence together. I just invite you to take a guess about that.

You have the whole horizon out there with that statement—high or low or unchanged and the specifics of the situation changing day by day.

Why don't you let us into your thinking a little bit, sort of narrow the horizon a bit for us.

Mr. GREENSPAN. I subsequently endeavored to do so, Senator. I felt that I would start off with as broad a statement of nonspecifics as I knew how to write and then go from there. If you want to be specific, I'll try to be as specific as I think is desirable.

Senator SARBANES. Well, let me pursue this recession question for a minute.

Where does this second definition of a recession come from?

Mr. GREENSPAN. It really is the original definition.

Senator SARBANES. The deterioration in an interactive, cumulative manner.

Where does that definition come from? Let me put the question more pointed.

Why are you trying so hard this morning, at least as I perceive it, to redefine what constitutes a recession? We've generally operated on this first definition of two consecutive quarters of GNP decline, and that's what these economists means when they are talking about a recession. That must be the definition they're using. That's been our traditional use.

Why do we have you this morning really going through a very serious drill here of trying to redefine the definition of recession?

Mr. GREENSPAN. I think it's important for policy reasons.

The original concept of a recession essentially goes back to the early business cycle analyses and essentially the works of Wesley Clair Mitchell earlier in the century and, in later years, to my mentor, Arthur Burns. They described the cycle in terms of process, and I think quite appropriately so, because it does matter whether or not the economy is sagging—that is, in effect, in a rolling readjustment, which is another term that's evolved over the years—or whether there's something actually fundamentally different going on.

We use the same term for recession with, say, of two quarters minus 1 percent GNP as we would for the type of recession we had, for example, in 1958 or 1975.

They are two different economic processes, and to use the same word in the English language to describe both of them I think is a mistake. As far as policy is concerned, as I indicated to Chairman Hamilton earlier, the issue is using the GNP in the way in which we use it when we know these numbers are rough approximations and subject to rather significant revisions. I would not like to find out afterward that we were not in a recession when we thought earlier that we were.

Senator SARBANES. All right. Now let me ask you this question. I take it, on the basis of that answer, it's your view that significant policy changes are warranted if you have the second definition, but not the first. Is that correct?

Mr. GREENSPAN. I would say that there is a difference in the policy response, yes.

Senator SARBANES. And it's a difference of significance.

Mr. GREENSPAN. Yes, I would say it is.

Senator SARBANES. In other words, the first does not call forth a significant response.

Mr. GREENSPAN. Well, certainly, it may well call forth policy actions that try to fend off the second definition, but it clearly is a different process.

Senator SARBANES. All right. Now when was the last time we had a recession by the first definition?

Mr. GREENSPAN. 1982.

Senator SARBANES. And when was the last time we had a recession by the second definition?

Mr. GREENSPAN. I'm sure we've had several—1957, probably would be in that class.

Senator SARBANES. 1957. Have we had any recessions between 1957 and 1982?

Mr. GREENSPAN. Oh, yes, we have. A sharp one in 1974–75.

Senator SARBANES. All right. Now let me ask you this question. Why wouldn't a change in economic performance, pursuant to the first definition of recession, the two consecutive quarters' definition, which you've tried to downplay or dismiss this morning, but which would represent an experience for the economy which it has not undergone in 8 years, constitute a significant development and call for a significant policy response?

Mr. GREENSPAN. Well, Senator——

Senator SARBANES. In other words, if you came in here and said, well by this first definition, we're finding ourselves in a recession every other year. This definition doesn't work any more. By this definition, we had a recession last year, we had one 15 months before that, we had one a year before that. Clearly, we need some different definition of recession.

So I'm now going to give you this deterioration in an interactive, cumulative manner, for a definition of recession.

But the fact of the matter is, using the first definition, the one you've tried to dismiss, the more limited one, we have not experienced that for 8 years.

Now, if we do experience it, doesn't that represent a significant development in the economy that calls for a significant policy response?

Mr. GREENSPAN. Well, let me suggest to you that there are significant changes and, indeed, one can argue that what we have been seeing in the last 6 to 9 months is significantly different from what we have seen before.

I'm not trying, in effect, to say that the definition is meaningless, that there is no change and that there is no policy response. I have not said that, Senator, and I do not intend to say that because I don't believe that.

There are many policy responses that occur in monetary policy which have nothing to do with whether or not you are in a recession or you're not in a recession.

And I'm not saying that there is a simple rule that says you take action only under certain circumstances or under certain definitions. It may very well be that we are in a period at some point in which we are in a modest negative growth which requires a rather significant policy response. Then, again, it may not. I don't think it's appropriate to say that I am defining recession in a manner which delimits policy. That is not what I intended to do, and I hope I have not done that. I'm merely saying that there are two different, qualitatively different, stages of economic contraction and the response to either one of them has to be different because they are two different phenomena.

I'm merely arguing that we shouldn't use the same word for both.

Senator SARBANES. If we had a recession by the conventional definition of two consecutive quarters of GNP decline, something which has not occurred in the economy since 1982, would you take that to be a very serious situation?

Mr. GREENSPAN. Certainly, I would.

Senator SARBANES. And it would require a serious policy response?

Mr. GREENSPAN. I would say that serious policy responses are implied in all deviations from what I would consider to be an optimum economic growth path.

Senator SARBANES. When the economy is in the second definition, deteriorating in an interactive cumulative manner, how far away from depression are we when that takes place?

Mr. GREENSPAN. It depends on how long that process lasts.

Senator SARBANES. But at that point, we would be into the spectrum, or we would then, in effect, have some apprehension of depression, would we not?

Mr. GREENSPAN. Probably. Sure.

Senator SARBANES. Now, I want to address my second line of questioning, less to whether there is a recession or is not a recession, but to what policy might be able to do if we experience a recession. And particularly, the constraints that may be on the Fed and on monetary policy.

At the beginning of the month, Newsweek had an article which discussed how the oil crisis had affected the Fed's ability to prevent a recession. I quote:

> To investors added dismay, there's almost nothing the Federal Reserve Board can do. The weakening dollar—its usual role as a safe haven for investors overwhelmed by the United States' economic problems, along with surging oil prices—mean that interest rates can't come down. One analyst commented, the stock market thought the Fed would lower interest rates and avoid a recession. Now Saddam has made long-term rates go up. Saddam has locked the Fed up.

How do you respond to this observation?

Mr. GREENSPAN. Well, Senator, in my testimony, I indicated that, indeed, the oil shock has clearly increased both the probability of inflation and recession. And to the extent that that is working in the wrong direction, it obviously makes policy, not only monetary policy, but policy in a very general sense, more difficult.

I would not want to argue, as is implied by that article, that there are no actions that we can take which would ameliorate the situation. I don't believe that.

Senator SARBANES. Are you being increasingly limited in the actions you can take by the situation in which you find yourself?

Mr. GREENSPAN. I would say it's a discontinuous change, in the sense that——

Senator SARBANES. Well, does the weakening dollar and the rise in oil prices limit your ability to lower interest rates in response to the weakening of the economy?

Mr. GREENSPAN. It doesn't limit our ability to move the Federal funds down. But it would almost surely, under certain types of conditions relevant to exchange rates and oil prices, make it difficult to expect that long-term rates would move with Federal Reserve actions to move short-term rates down.

Senator SARBANES. If we go into a recession, what would be the effect on the banking, or the financial system?

Mr. GREENSPAN. Negative.

Senator SARBANES. How serious?

Mr. GREENSPAN. It depends on the extent of the contraction, but clearly, it would not be helpful.

Senator SARBANES. Would it bring about a substantial increase in the number of bank failures?

Mr. GREENSPAN. It probably would create some. But I don't necessarily think that it's something which is an extreme problem, as I indicated to the House Banking Committee last week. While we have problems in the commercial banking area, and we've discussed them at great length, they are really of a different order and magnitude from those which have confronted the thrifts.

And I would say further that, in many respects, commercial banking may be better off now than, say, it was a number of years back. Had we run into a recession earlier on, I think we might have had some considerable difficulties.

Senator SARBANES. Would lower interest rates be of help to the banking system, the financial system, with respect to its problems?

Mr. GREENSPAN. You mean with both long- and short-term rates lower? I would answer yes to that.

Senator SARBANES. And are the other economic developments constraining the Fed from trying to reach that state of affairs?

Mr. GREENSPAN. By "other," you're referring to——

Senator SARBANES. Well, you've expressed a concern about inflation here this morning.

Mr. GREENSPAN. Right.

Senator SARBANES. You have the rise in oil prices, the weakening of the U.S. dollar.

Mr. GREENSPAN. Yes. If we remember that what we must be concerned about is the long-term stability of the economy, it is very clear that there are actions that we can take in the short run which would be perceived to have short-term benefits, but could have major intermediate and long-term negatives.

It's appropriate for monetary policy to be balanced in a manner which tries to minimize the risks to the economy over the longer term, as well as the short term.

There's a very difficult tradeoff, Senator, and it is clearly more difficult now than it was before the oil price shock.

Senator SARBANES. I want to get one factual matter straightened out.

You said in response, as I heard it, to Congressman Upton, that, fortunately, our dependence on foreign capital has been declining.

Mr. GREENSPAN. Well——

Senator SARBANES. Let me carry it on through because I may have misheard you.

Mr. GREENSPAN. OK.

Senator SARBANES. First of all, the oil price hike may raise our import bill by $30 billion, according to your own estimate. And second, in Monday's Wall Street Journal, it suggests that there are signs that private capital inflows into the United States are slowing, causing the dollar to weaken, which I assume will force us to depend on foreign government lending. And there are some rather striking figures about the decline in private foreign capital inflows into the country.

Mr. GREENSPAN. I think that part of that, of course, is really an arithmetic reflection of the fact that the current account deficit of the United States has come down and that the surpluses of the Japanese and Europeans have also come down. So the flows are less.

And remember particularly what we have had was a response in the Japanese markets when, in effect, the decline in stock prices has created a situation in a number of institutions where they felt the need basically to pull in a little bit.

So that what we are observing at this particular stage is also part of the process of this large surplus on current account in Japan and elsewhere and large deficits in the United States narrowing.

One of the consequences of that is the flow of capital from, say, Japan to the United States, slows down. And that's what a goodly part of those numbers are indicating.

Senator SARBANES. Thank you.

Representative HAMILTON. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

I want to welcome you, Mr. Greenspan, to our committee once again.

Getting back to the budget negotiations, as you know, there has been some problem spots and they've reached sort of an impasse, I guess.

What kind of signal would we be sending if the Gramm-Rudman targets were to be modified? I mean, there's been a number of issues that have been speculated upon with regard to what will happen in October, first of all, whether or not we'll have sequestration for the short term; second, whether or not Gramm-Rudman targets will be modified or we'll have a modified sequestration; third, that we would postpone, pass a continuing resolution and postpone any other decisions until perhaps February or in a lame-duck session.

Mr. GREENSPAN. Well, I think, Congresswoman Snowe, implicit in the budget agreement, obviously, would be a revision of the Gramm-Rudman targets because the $50 billion figure would not be in line with the previous legislation, and that presumably would be changed as part of the agreement. And as I indicated earlier I think that that would have a positive effect overall on the markets and on the economy.

If, however, Gramm-Rudman were changed without any real response, the markets would take that, and I think appropriately so, in a rather negative manner.

Representative SNOWE. And if we didn't have the package they're discussing 5 years, $500 billion, that there was a modification of that, and it was less than 5 years or less than $500 billion, or if it was a partial package and then we came back in a lame-duck session or postponed any further decisions until February.

Mr. GREENSPAN. I think the reaction would be negative.

Representative SNOWE. So it would have an impact.

Mr. GREENSPAN. Yes.

Representative SNOWE. What about sequestration? What kind of impact does that have on the economy?

Obviously, it has leverage. I guess it's going to decide who's going to play this scenario out if an agreement is not reached.

But what impact does sequestration have on the economy?

Mr. GREENSPAN. Well, I must say, Congresswoman Snowe, I don't think sequestration is good economic policy. Basically, we should get the budget issue resolved in an appropriate manner, and $50 billion for one year, $500 billion for the total package, is a sensible package for the type of environment in which we find ourselves. And I don't think we should give up on that at this particular stage, and I would just as soon that we solve this problem short of sequestration.

Representative SNOWE. What kind of situation would we have been in if we had reached an agreement on the budget prior to the August recess and prior to the Persian Gulf crisis?

Would the economy have been so dire in that sense, or at least being viewed that way? Would there have been less pressure on the economy?

Would it have made a difference?

Mr. GREENSPAN. You mean if the agreement——

Representative SNOWE. That's right. If the budget negotiators had reached an agreement prior to the August recess and prior to the Persian Gulf crisis.

Mr. GREENSPAN. It would have been better had it been done then. But it's far better that it be done now than not at all.

Representative SNOWE. Right. What about the combination of reduction in spending and tax cuts—and tax increases, I should say? Is there anything there that we should be concerned about in terms of the balance more than anything else? Are the tax increases—as you know, they're talking about, I guess, revenue figures of about $120 or $150 billion, I guess that's being debated.

But does that have an impact on the economy? Does that bother you in any sense of taking more money out of the economy in addition to the oil price increases?

Mr. GREENSPAN. Well, as I've said before this committee and other committees in the past, the mix of that does matter. Clearly, it matters. But at this particular stage, it's far more important that we get the package implemented in its full totals than be overly concerned about the particular mix.

I don't mean that the mix is unimportant. On the contrary, it may be quite important. But if the mix problem is going to prevent a deal from being made, I would much prefer to see that the budget deficit be brought down in a manner which would be less than optimum so far as mix is concerned, at least in my judgment, than not to see the budget deficit brought down at all.

Representative SNOWE. Right. So that's obviously a preference. But the question, what kind of tax increase has an impact on this economy, especially verging on a recession, has yet to be determined.

Mr. GREENSPAN. Yes. Congresswoman Snowe, when the budget negotiations began, I opted out of answering questions of what I thought was positive or negative, because I thought, were I to do that and the Federal Reserve to do that, we probably would just add new elements of uncertainty to the negotiation, and it's tough enough as it is without our intellectual meddling.

Representative SNOWE. They might need that. [Laughter.] Oil price increases. Obviously, I come from a part of the country where that has significant impact.

Last December, we saw prices rise to $1.50 a gallon. Right now, they're about $1.23 a gallon for oil.

Given the fact that this is going to be a long-term situation, at least through the winter, we can expect that we'll feel some impact in terms of supply and obviously, we'll see an increase in price of oil.

What impact will that have on the economy? Has the Federal Reserve Board done any projections on increasing oil a dollar— each dollar increase in the price of oil, what impact that has on the economy?

Mr. GREENSPAN. Well, obviously, we have made all sorts of estimates. We have a rule of thumb in which, for the economy as a whole, as I indicated in my statement, a $10-a-barrel increase would have the effect over a year of bringing down the level of the GNP by about 1 percent.

Now that clearly will vary by region, and it is a very crude rule of thumb.

Representative SNOWE. So it obviously will have an impact. If it's $1.23 now, I could visualize this increasing——

Mr. GREENSPAN. Obviously, to the extent that the price of imported oil increases and you say, just for the sake of argument, import the same amount, there is an additional payment to nonresidents. It's a net claim of foreigners on the United States which ultimately reduces the GNP.

Representative SNOWE. On capital gains, I know you addressed this question earlier. Obviously, this is an issue that has been the subject of contentiousness with the budget negotiators because the President feels so strongly about it.

Do you think that it can be an effective tool for economic growth and job growth?

Mr. GREENSPAN. As I indicated earlier to Congressman Upton, and many times before to this Congress, I think the capital gains tax rate is too high. In my own judgment, its effect on asset values is significant, and there is no question that were the capital gains tax lower than it is, that we'd have a better real estate environment than we currently have.

Whether that should be part of this negotiation or not, is not something which I think I'm in a position to discuss effectively one way or the other.

Representative SNOWE. But it could be an effective tool for that purpose.

Mr. GREENSPAN. Let me put it this way. Leaving it independent of everything else, on occasion, I've said that it is a valuable tool. But, if, in the process of achieving a lower capital gains tax, we had to raise, as a tradeoff politically, the marginal rate on individual income taxes, which is reversing the 1986 act, I would suspect that that probably wouldn't be a good tradeoff.

But if you are asking me, in and of itself, is a cut in the capital gains tax helpful to the economy, my answer would be yes.

Representative SNOWE. And finally, what about the rate of job creation? Obviously, that's slowed down significantly. What can we hope for for the future? What should we be doing?

I look at this next decade, and it doesn't look very positive in the sense of some of the trends that are developing.

Mr. GREENSPAN. Well, I think that we could look at it two ways.

First, we have obviously got the problem, which is a big puzzle, about the slowdown in labor force participation. In a sense, if that is real and not just a statistical aberration which will reverse itself fairly quickly, then it's suggestive of the fact that we will be limited to a certain extent by slower labor force growth than we had earlier anticipated. That means that, to offset that, we need increased productivity growth, and as best I can judge, the only realistic way to assume that that's going to happen is if we have higher capital investment, and the only way that that is likely to happen is if we have higher domestic savings. This is one of the reasons why, as I indicated earlier, I consider the issue of resolving the budget deficit question and reducing the drain on domestic savings coming from the Federal Government so crucially important to long-term growth.

Representative SNOWE. Thank you. Thank you, Mr. Chairman.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

It's a great pleasure to have you back.

Mr. GREENSPAN. Thank you.

Representative SCHEUER. You talk about the limitation that labor force availability imposes on our continued economic growth.

You're aware, of course, of the terrible mix, or nonmix, of corporations needing people with literacy skills, numeracy skills, computing skills, and the large number of low-income kids without those skills.

In New York, approximately 75 percent of all the new jobs that will be created in this decade will require some postsecondary education. And not more than 10 or 15 percent of the young people, especially minorities, have those skills.

So you have 75 percent of the corporations chasing the 10 or 15 percent of young people that have those skills in the minority community, and you have the other 80 or 85 percent of the people that don't have those skills chasing the 25 percent of the jobs that will be created in this decade that don't require literacy, numeracy, and ability to process information.

Would you say, then, that in terms of the long-term future and in terms of the assurance of continued economic growth, it would be necessary to improve the way our society deals with these young people who aren't making it through school and improve the way that we approach the education and training of non-college-bound youth in our country?

Other countries in the developed world have far more sophisticated and thoughtful and effective policies of moving non-college-bound youth through the education system so that they get the skills that they need, and then segueing them, moving them smoothly right into the work force. The transition to the work force from the school, moving from the world of school to the world of work, is infinitely more easily accomplished in almost all of the other developed countries around the world than it is in ours.

Now, if the goal is to produce a larger work force of competent, competitive workers, as is necessary to improve our economic output and our productivity, would you say that we ought to concentrate on the non-college-bound youth in our society and that this budget agreement ought to have as ingredients in there whatever programs are necessary to make these young people into effective, competitive, productive members of the work force?

Mr. GREENSPAN. Well, Congressman, as I've indicated earlier, I have eschewed discussing individual programs with respect to this budget summit, and will continue to do so.

But I would certainly subscribe to your general evaluation of the situation, which is an issue that is crucial to long-term productivity growth in conjunction with the increase in capital investment.

In other words, capital equipment doesn't run itself. It needs minds and people and individuals to interact with the system.

If there's inadequate capabilities to do that, having the savings and the capital investment will turn out to be a necessary but not a sufficient condition for an appropriate growth rate for the American economy.

Representative SCHEUER. Well, let's talk about savings.

It's obviously one of the great problems in our society. That's why we have to look to foreign lenders to provide us the capital for research and development, for new plant and equipment, for all of those things we urgently need to be a competitive economy and competitors on a global scale.

Japan has a personal savings rate, individual savings rate, of 18 or 19 percent of individual income. We have a fourth or a fifth of that, maybe somewhere between 4 and 5 percent.

Can you recommend anything that we ought to be thinking about in terms of a program next year or elements in this budget reduction package that would enhance the attractiveness of savings, and encourage savings?

Mr. GREENSPAN. Congressman Scheuer, part of that gap between Japan and the United States narrows when we revise the statistics in a manner that makes them more consistent.

But there's no question that no matter how you play with the numbers, there is a big gap. And no matter how you look at our data, our savings rates are low, even though I've seen innumerable articles which try to indicate otherwise. I find them less than persuasive.

Over the years, we've had innumerable programs, the purpose of which was to create a marked increase in domestic savings. There have been some marginal successes, but, clearly, looking at the data, not enough to come to grips with the underlying problem.

It's for this reason that I have rather reluctantly turned as strongly as I have to the notion not only of bringing the Federal budget deficit down and hence, reducing the drain on domestic savings, but even, as I've indicated on other occasions, to go to Federal Government surplus to create an addition to domestic savings from the Federal accounts.

That is not a superior method of obtaining savings, nor even equal to increasing savings in the private sector. It is something which is, I would say, a policy thrust that occurs only when one runs out of other realistic alternatives.

Nonetheless, there is no doubt in my mind that no matter how we do it, to improve the saving rate, the total domestic saving rate, which is available to finance domestic investment in this country, may well be the most important long-term policy issue that confronts this country.

Representative SCHEUER. Mr. Greenspan, let's talk about taxes for a moment. And I know you don't want to get into the budget negotiations, but your counsel is needed.

We have now the lowest personal and corporate taxes that our country has known in a half century. For most of the time that I grew up, corporate taxes were 52 percent and individual taxes went up for the ultrarich to 70 percent. And now, of course, we're talking about 70 percent down to 30 percent, 52 percent down to 28 percent.

Would there be room, in this moment of economic anguish where we must increase government revenues, for the kind of job training and education programs that we need for these non-college-bound youth to get into the labor market and fill the need that you describe?

Would it be appropriate at this time to think of a 1- or 2-percent increase of tax rates across the board—take the 30 percent tax and raise it to 31 or 32, take the 28 and raise that to 29 or 30. The increased revenues would be in the hundreds of billions.

Now that President Bush has liberated us all to think about taxes being among the components of a deficit reduction program, would such an across-the-board tax increase of 1 percent or 2 percent max be something that we should consider?

Mr. GREENSPAN. Well, I don't know how I could answer that, Congressman Scheuer, without violating what I've been trying to adhere to; namely, to avoid getting involved in the specifics of the summit.

I must say, I have been a supporter of the significant reduction in taxes that has occurred in the last decade, and I think that has actually, in the broadest sense, assisted this economy. So I am not going to argue that these lower tax rates have not been productive; on the contrary, I think, as best I can judge, they have been.

But I'm not going to, if I can hopefully avoid it, get involved in this because I'm not sure it's useful.

Representative SCHEUER. Can I have time for one last question?

Representative HAMILTON. Go ahead.

Representative SCHEUER. You've testified that an increase in the price of a barrel of oil of $10 is equal to a $30 billion drain from our national economy. We're exporting our capital to the Middle East.

In terms of conserving capital, conserving resources, and lessening our energy dependence on the Middle East, on Middle East oil, would you recommend that the Federal Government and the President take leadership in making our economy and our society more fuel efficient?

For example, we import, I think, something like 8 to 8½ million barrels of oil a day. Just going to a natural gas-driven car, for fleets—for taxis, for buses, for delivery vehicles—in our cities would save a million and a half barrels of oil a day.

Mr. GREENSPAN. Are you referring to natural gas?

Representative SCHEUER. Natural gas, yes. That's an enormous savings. I can't give you the specific figures, but if we increased the miles per gallon of our fleets by only a few miles, we'd realize enormous savings. If we required sophisticated technology to be placed on our utilities on our manufacturing end, enormous savings of fuel.

The Japanese found that when they had a national program to clean their environment and to get a cleaner burn in their utilities, their manufacturing plants, and their automobiles, they had a dividend that may have been unexpected. They became a much more fuel-efficient society.

As a result of investments they made to get a cleaner burn, obstensibly for the purpose of cleaning up the environment, they now can produce a unit of output at half the energy input that it costs us, and a quarter of the energy input that it costs Eastern and Central Europe.

Would you think that our current high level of dependence on Persian Gulf oil would be an additional reason, a powerful reason, for driving us to make whatever capital expenditures are necessary to become a far more fuel efficient society? That is easily within our grasp. The technology is available.

Mr. GREENSPAN. Well, let me just say this.

I have always been supportive of a significant increase in the gasoline tax, for reasons related to what you're suggesting, Congress Scheuer.

Representative SCHEUER. What order of magnitude? A dollar a gallon?

Mr. GREENSPAN. No, I don't think we need to go anywhere near that high. But I do think that certainly, it's in the double digits as far as cents are concerned. How far, I don't want to say specifically.

But we do consume more that 7 million barrels a day in motor gasoline; and there is a very clear effect of a gasoline tax, or specifically, a rise in the price to consumers of gasoline, on consumption. It also has the advantage of not working its way into the cost structure of the economy, which a broad-based tax would do.

I have held that position, I must say, for a very long period of time, and the reason I've been able to hold it is that nothing has happened. [Laughter.]

There are technical problems in going to a tax on natural gas. In all of these alternates there are significant hurdles involved. But I do certainly agree with you that we should continue to be looking at that issue very closely.

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

Representative HAMILTON. Mr. Chairman, one of the assumptions that we have had, I think, is that if there is a credible reduction in the budget deficit, that we would get a reduction in long-term interest rates. And I think you've said that, as well as others.

Now, if long-term interest rates in Germany and Japan and other countries are as high or higher than they are in the United States, why would those interest rates fall here, even if we have a credible Federal deficit reduction?

Mr. GREENSPAN. Well, Mr. Chairman, I think you first have to recognize that we have had periods when our rates have gone down relative to others when certain changes in the domestic and foreign economies have occurred.

What happens is that, say at the moment, long-term interest rates in Germany are roughly the same as they are in the United States. And the Japanese rates, which are still somewhat below ours, about half a percentage point, have been coming up fairly rapidly. This is in the context basically of long-term expectations about inflation and credit demands in the United States.

So if you were to get a credible, enforceable package, which I don't think the market has fully discounted at all—in fact, I think there's a good deal of skepticism out there—you change at the margin the relationships that occur between the various different instruments. And one would expect a decline in U.S. Treasury long-term rates, say, relative to comparable long-term rates in Germany.

I might also add, parenthetically, that our rates coming down as a consequence of that, probably would have some effect on foreign rates as well.

Representative HAMILTON. Even if we get the $50 billion reduction, and we all hope we do in the first year, you're still going to have a Federal deficit for 1991 under the current CBO estimates, of $210 billion.

So you have a $200 billion deficit out there. You have long-term capital flowing out of the United States for the first time in years.

How are you going to finance that large a deficit—in actuality, it's a lot larger—without some increase in interest rates?

Mr. GREENSPAN. Well, first of all, let me say that the fiscal 1991 and 1992 data are affected very significantly by the Resolution

Trust Corporation requirements, especially the working capital requirements.

What is really crucial to long-term interest rates is not the short-term outlook. In fact, that is one of the reasons why all economists have argued that a 1-year deal on the budget isn't worth very much.

If you look beyond the RTC effect and the repayment of the working capital, which actually reduces requirements in outyears, that $50 billion is a very big number, which actually gets larger as you move into the middle 1990's. And so, it's not the $50 billion which is really relevant, as much as the $500 billion. The $50 billion is relevant as sort of the starting point and the wedge which picks it up.

But even though there are significant financing problems implicit in the short term, if we get a budget deal, it, in a very major way, improves the climate. As a result, you will get eager financing of that budget process because the amount of Treasury issues will have fallen in a major way.

Representative HAMILTON. So you hold with the assumption that I stated initially, that a credible reduction package will reduce long-term interest rates.

Mr. GREENSPAN. Yes, I do, Mr. Chairman.

Representative HAMILTON. We've had at least one witness that I can remember, maybe others, that have said in effect that this really is the worst time to increase taxes. It's the worst time to cut Federal spending, because you're right on the edge of a recession and if you do this, you'll knock the economy into a recession.

I take it from your testimony this morning that you reject that point of view.

Mr. GREENSPAN. I do.

Representative HAMILTON. I also take it from your testimony that the priority of the budget summit should be to get the reduction in the deficit rather than a specific component of that package.

Mr. GREENSPAN. I would say the particular components of the package do matter, but not as much as the total package.

Representative HAMILTON. So if you could not get a cut in the capital gains tax, would you scuttle the whole budget summit?

Mr. GREENSPAN. I'm not in the position to do that one way or the other. [Laughter.]

Representative. UPTON. Was that a yes? [Laughter.]

Representative HAMILTON. But the priority, if I understand your testimony, is to get the deficit down. That's the overriding priority.

Mr. GREENSPAN. Yes.

Representative HAMILTON. Senator Sarbanes.

Senator SARBANES. There are lots of proposals, Mr. Chairman, for cutting one or another tax on the basis of the good it would do the economy one way or another—encourage savings, encourage investment—both of which are serious problems.

I take it from this response that you're not in favor of any of that if it costs revenue and adds to the deficit—in other words, if it's not compensated for in some way.

Is that correct, given the importance you've attached to bringing the deficit down?

Mr. GREENSPAN. You can infer that, obviously, from the conclusion I come to. But I've really endeavored to try to avoid getting involved in the process of making the types of important political judgments that are crucial to these negotiations because what we are talking about are important values in our society.

Senator SARBANES. I understand that, and I'm not going to ask you to be specific.

But as a general proposition, I'm trying to determine how much primacy you give to the importance of deficit reduction. And I take it, also based on the answer that you gave to Congressman Scheuer on the education problem, that both with respect to increasing spending or reducing taxes, in both instances, you're not in favor of it if it adds to the deficit—in other words, unless it's somehow compensated for. Is that correct?

Mr. GREENSPAN. That is correct.

Representative HAMILTON. I want to talk to you, ask you some questions about timing and lags.

In your Humphrey-Hawkins testimony, you indicated that you were not concerned about the lag in monetary policy and its impact on the economy, and I quote you here:

> What adjustment might be necessary and how it might be timed cannot be spelled out before the fact. We can decide that a policy adjustment is appropriate and implement it fully, all in the same morning, if need be, and the effect of the change will show through to interest rates and financial asset prices almost immediately.

So the question is, if the Fed changed policy one morning, would it have an immediate effect on the economy, including important yardsticks like growth, output, employment, and other similar measures of performance?

Mr. GREENSPAN. No, not immediately, Mr. Chairman. It would occur with a lag.

The context of those remarks was in reference to the issue of a presumption that if there were a budget agreement of substantial magnitude, that monetary policy would not be able to respond in an appropriate timeframe to offset the so-called fiscal drag.

The nature of the comment I was trying to make at that point is that both have an effect with a lag—there are lags in both fiscal and in monetary policy. I was trying to suggest that I see no reason to presume that monetary policy's lag is of a different order of magnitude from the fiscal policy's lag.

Representative HAMILTON. Well, suppose you did in fact alter your policy one morning. How long would it take the monetary policy adjustment to alter the performance of the economy?

Mr. GREENSPAN. Well, obviously, its effect on the financial markets, to the extent that they were not anticipating action by us, would be immediate.

Representative HAMILTON. We're on the edge of a recession. No growth now. You've put all kinds of negative words in your testimony this morning about the economy.

Why not just begin to ease now, right now?

Mr. GREENSPAN. I know of no way to answer that question without getting into a lot of other issues, Mr. Chairman.

Senator SARBANES. Be our guest. [Laughter.]

Mr. GREENSPAN. I would much prefer, if you wouldn't mind, to be a little more hypothetical.

All I will succeed in doing is creating sentences which Senator Sarbanes will start to pick apart again. [Laughter.]

Representative HAMILTON. Well, the question is not an unreasonable question.

Mr. GREENSPAN. No, no. I grant you. It's the answer that is the problem. [Laughter.]

Representative HAMILTON. Well, I've always said, it's a lot easier to ask these questions than it is to answer them, Mr. Chairman.

Senator Sarbanes.

Senator SARBANES. Chairman Greenspan, the Federal Reserve does a survey of household finances which includes data on family income and the value of financial assets. I'm interested, based on the Federal Reserve's latest survey of household finances, in the current distribution of deposits in thrift institutions and in banking institutions by household income.

In other words, what percent of thrift deposits are held by the top 1 percent of households measured by family income? The top 2 percent. The top 5 percent. And so forth.

Mr. GREENSPAN. Senator, we have a survey for 1989, but it has not been completed yet. So that the latest data that we have in this respect go all the way back to 1983.

We have, for example, for savings and loans and mutual savings banks the percent of total deposits by income class, and that shows that persons with the top 1 percent of income owned, at that time, 8.4 percent of thrift deposits.

My suspicion, however, is that, with the obvious changes that have occurred and the more likelihood than not that the larger holders rather than the smaller holders have moved out of the thrifts, that that number probably is smaller today. But we won't know that until we get somewhat closer on the new survey.

Senator SARBANES. What's the figure for the top 10 percent by income of households?

Mr. GREENSPAN. Well, let me see. The trouble, unfortunately, is that I don't have it exactly.

The top five is 23 percent. The top 12.9 is 57.7. So it looks like roughly half.

Senator SARBANES. So the top 13 percent of income, household income, holds 58 percent of the thrift deposits.

Is that correct?

Mr. GREENSPAN. In 1983.

Senator SARBANES. 1983. Do you have it for the banks?

Mr. GREENSPAN. Yes. The top 1 percent in that respect is 13.6 percent. The top 5 percent is 26.5 percent. And 9.4 percent—that is, households with incomes in excess of $50,000—held 37 percent of commercial bank deposits, which means, one would presume, that 10 percent would be in the area of, say, 40 percent, or thereabouts.

Senator SARBANES. Well, concerning the so-called bailout of the thrifts, there's been a focus on the regional shifting of money. There's been a considerable number of articles about that.

But there's also obviously a significant shift—I assume, depending on how taxes are distributed—of wealth from the poorer to the richer families in the country.

Is that not correct?

Mr. GREENSPAN. You mean, are you talking about regionally?

Senator SARBANES. No. I'm just talking about income classes.

Mr. GREENSPAN. I'm sorry, I don't follow the argument.

Senator SARBANES. Well, if the top 13 percent of the income holds 58 percent of the thrift deposits, and if the whole country's going to pay significant taxes in order to cover those thrift deposits, then, in effect, working people are being taxed in order to cover the deposits. But their own deposits represent only a small percentage.

The bulk of those deposits are held by the people at the top of the income scale.

Mr. GREENSPAN. Well, what we would need is another comparable column which designated not only the share of individual income taxes that those same groups paid, but also some endeavor to allocate corporate and other taxes by income groups, which is a very rough calculation. In other words, to make a determination as to whether or not that there is an income shift, one obviously needs to know what the distribution of taxes is, as well as the distribution of——

Senator SARBANES. That's a very reasonable point. And I make my point in the context of the studies and the figures that are shown, that based on the tax system and the income distribution, there's been a very significant shift of income and wealth to the top 10 percent of the income scale over the last decade.

This only compounds that trend. I mean, I think your response is good, and if, in effect, that had not taken place, then that has to be balanced.

But the consequence is that because of that development, this only compounds what's taking place.

Mr. GREENSPAN. Well, the figure I haven't seen, Senator, because I'm not sure it's been calculated in exactly this particular form, is what is the percent of taxes that that group pays. If you're looking here, for example, at the commercial banks, those over $50,000 of income have close to 40 percent of deposits. We need to know what percent of taxes that that group pays.

In other words, obviously, if it is significantly less, then clearly, there is a shift in the direction you indicate.

Senator SARBANES. Right. Could you submit those figures for the record on the concentration of holdings in thrifts and banking institutions?

Mr. GREENSPAN. I'll be glad to.

[The following information was subsequently supplied for the record:]

Table 1
Characteristics of Households with Accounts at Insured Institutions
By Institution Type and Income Classes
Estimates Based on 1983 Survey of Consumer Finances

Item	% h'holds with accts at inst. type	Holdings at inst. type ($ thou.)		% deposits at inst. type held by group	Ratio of group deposits at inst. type to all h'hold deposits (percent)	Median ratio of deposits at inst. type to financial assets (percent)
		Mean	Median			
Savings and loans and MSBs						
Income classes						
Under $10K	3.9	3.2	0.8	3.5	1.1	87.0
$10K to $20K	8.1	8.1	1.7	18.5	5.8	71.4
$20K to $30K	7.3	9.9	2.0	20.3	6.4	57.4
$30K to $50K	8.0	9.5	2.8	21.4	6.7	35.6
$50K and over	4.9	26.5	6.3	36.3	11.4	21.1
All classes	32.1	11.1	2.0	100.0	31.4	50.0
Top 5%	2.4	34.2	5.5	23.0	7.2	13.3
Top 2%	0.8	52.5	11.0	13.0	4.1	5.9
Top 1%	0.5	70.3	17.0	8.4	2.6	6.9
Commercial banks						
Income classes						
Under $10K	13.1	3.2	0.5	6.1	3.7	100.0
$10K to $20K	19.6	6.9	0.9	19.7	11.9	99.1
$20K to $30K	14.9	6.1	1.0	13.4	8.1	71.6
$30K to $50K	16.7	9.8	1.5	23.9	14.4	50.0
$50K and over	9.4	26.7	5.5	36.9	22.3	17.7
All classes	73.7	9.3	1.1	100.0	60.5	78.8
Top 5%	4.8	37.7	9.0	26.5	16.0	16.0
Top 2%	1.9	68.4	23.0	19.7	11.9	9.5
Top 1%	1.0	91.7	26.1	13.6	8.2	7.1
Credit Unions						
Income classes						
Under $10K	1.0	1.9	0.6	2.1	0.2	50.0
$10K to $20K	3.5	2.1	0.5	8.0	0.6	47.8
$20K to $30K	5.2	6.6	0.9	38.6	3.1	40.0
$30K to $50K	5.7	5.0	1.4	31.4	2.5	29.8
$50K and over	2.4	7.7	2.7	20.0	1.6	23.9
All classes	17.9	5.1	1.0	100.0	8.1	35.1
Top 5%	*	*	*	*	*	*
Top 2%	*	*	*	*	*	*
Top 1%	*	*	*	*	*	*

Table 1, continued
Characteristics of Households with Accounts at Insured Institutions
By Institution Type and Income Classes
1983 Survey of Consumer Finances

Item	% h'holds with accts at inst. type	Holdings at inst. type ($ thou.) Mean	Median	% deposits at inst. type held by group	Ratio of group deposits at inst. type to all h'hold deposits (percent)	Median ratio of deposits at inst. type to financial assets (percent)
All insured institutions						
Income classes						
Under $10K	15.7	3.6	0.6	5.0	4.8	100.0
$10K to $20K	23.9	8.7	1.5	18.4	18.4	100.0
$20K to $30K	18.5	10.7	2.0	17.6	17.5	100.0
$30K to $50K	19.4	13.8	4.1	23.7	23.7	95.3
$50K and over	10.2	39.4	14.6	35.4	35.4	55.0
All classes	87.7	12.9	2.4	100.0	100.0	100.0
Top 5%	5.0	53.8	19.3	23.9	23.9	44.2
Top 2%	2.0	89.8	36.0	16.2	16.2	20.0
Top 1%	1.0	116.6	44.0	11.0	11.0	14.7

Memo item:
Percent of households in each income class

Under $10K	24.0
$10K to $20K	26.8
$20K to $30K	19.3
$30K to $50K	19.7
$50K and over	10.2
Top 5%	5.0
Top 2%	2.0
Top 1%	1.0

Notes:

1. "*" indicates that the cell size is less than 0.5 percent.
2. Percentages may fail to sum to appropriate totals because of rounding error.
3. Income includes household income from all sources in 1982 (the most recent year for which complete data were available at the time of the 1983 SCF), including wages, salaries, commissions, interest (taxable and non-taxable), dividends, pensions, Social Security, unemployment insurance, disability payments, businesses, child support, alimony, inheritance, AFDC, food stamps, other welfare programs, pensions, annuities, and other sources of income.
4. For purposes of this table, savings banks and savings and loans are grouped together.
5. Holdings at the financial institutions in this table include balances in all types of accounts in 1983, including checking, money market deposit, IRA, Keogh, savings, and other types of accounts and certificates of deposit.
6. Financial assets include the account types listed in note 5, money market mutual funds, other mutual funds, stocks and bonds, and trust accounts.

Senator SARBANES. And when will the comparable figures based on the 1989 survey be available?

Mr. GREENSPAN. I've been told it will take another year before those data are readily available.

Senator SARBANES. Thank you.

Representative HAMILTON. Mr. Chairman, we have a vote, so we're going to conclude here very quickly.

You gave a quick reference to the "Beige Book." I think some report comes out today on that. Can you tell us if there are any regions of the country that are clearly in recession?

Mr. GREENSPAN. Clearly, New England and the Eastern Seaboard is weaker than the West. In fact, my impression is that as we move from the East to the West, things improve.

Representative HAMILTON. May I ask you—I'm not sure we have this on the record—what impact do you think the Iraqi crisis will have on the inflation rate?

Mr. GREENSPAN. It's going to depend, obviously, on whether or not those oil prices stay where they are or retreat. That's a very significant issue. If we can contain the spillover effects so that it does not filter into the wage structure, then eventually it will fully unravel.

The major danger of this sort of event, as I imply in my remarks, is that the increase in prices of oil will get into the wage structure, and even after oil prices have either stabilized or come down, you still have the wage inflation in there. And that's the type of thing——

Representative HAMILTON. Can you give us the figure that you would anticipate at the moment of an increase in inflation?

Mr. GREENSPAN. Overall?

Representative HAMILTON. Yes.

Mr. GREENSPAN. Well, the hypothetical one, which I put in my testimony, was that a $10 a barrel increase would add 1½ to 2 percent to the level over the next year.

Now, obviously, if it does not get into the wage level and the oil price flattens out, that 1½ to 2 percent will go back to zero.

Representative HAMILTON. Mr. Chairman, I want to express my appreciation to you for your testimony. We're very pleased to have you this morning.

I would like to submit some questions to you for written response, if I may. I have some questions on M2 and the value of the dollar and all of those sorts of things, and I'll submit those to you in writing.

Mr. GREENSPAN. OK.

Representative HAMILTON. We stand adjourned. Thank you.

[Whereupon, at 12:01 p.m., 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. ALAN GREENSPAN TO WRITTEN QUESTIONS POSED BY REPRESENTATIVE HAMILTON

Congress of the United States

JOINT ECONOMIC COMMITTEE

(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)

Washington, DC 20510-6602

September 27, 1990

The Honorable Alan Greenspan, Chairman
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman,

On behalf of the Members of the Joint Economic Committee, I am writing to thank you for appearing before the Committee on September 19 and for your very helpful testimony on the economic outlook and economic policy.

The inopportune vote that forced an end to the hearing left me with a number of questions unasked, some of which follow. I would appreciate having your response to these questions at your earliest convenience.

1. Prior to the past month or so, there was very little growth in either M1 or M2 this year. I understand this can be due, at least in part, to the slow growth of GNP and that, in such circumstances, interest rates normally would decline or at least not rise. If slow growth is at least in part responsible, why have interest rates risen during this year's slow growth? If the slow growth continues, when would you expect interest rates to begin to decline?

2. Why has M2 growth increased since early August? Does it represent an easing of monetary policy? Does it reflect stronger growth in the form of an increase in spending plans and loan demand, or does it reflect deteriorating consumer confidence, more savings, and a preference to hold savings in liquid form?

3. Have the restrictive bank credit conditions that led the Federal Reserve to reduce the Federal funds rate in August persisted or worsened? What does your latest survey of bank lending practices show in this regard? Is this problem contributing to the slowdown in economic growth and, if so, should the Fed respond to further indications of tightened lending terms by again reducing the Federal funds rate?

4. The apparent lack of official foreign exchange intervention during the past six months suggests that the Fed and the Treasury are not concerned about the decline of the dollar this year. Is the recent decline in the dollar acceptable to the Federal Reserve? Should the value of the dollar be allowed to fall further? If not, what can you do to prevent any further decline? What will be the effects of the decline in the dollar on the economy? How will it affect the ability of the Fed to restrain inflation?

5. The recent statement by the G-7 Ministers implies that current exchange rates are appropriate and that the dollar should not fall any further. Is this consistent with the sizable reduction in the U.S. budget deficit that was advocated in the Ministers' statement? If a budget agreement reduces interest rates in the U.S., won't that cause a further decline in the dollar? If not, what would prevent that?

6. In your prepared statement, you testified that a sustained $10 per barrel increase in the price of oil to $30 per barrel for the next year would raise the inflation rate by up to 2 points and cut 1 percentage point off the rate of growth of GNP. Since then, the price of oil has risen further, to almost $40 per barrel. If this price persists, how would that affect the outlook for inflation and economic growth? Would it cause a recession and, if so, when? Is there some price of oil at which recession becomes inevitable?

7. In the event of a substantial and enforceable budget agreement -- one that would lead to lower interest rates as you indicated -- what are the sectors of the economy that would be stimulated? To what extent would they offset the fiscal restraint from the budget and how quickly?

8. There has been an acceleration in the rate of increase in the employment cost index this year, which is contributing to inflation. Most of the acceleration is due to a rapid increase in benefits costs, primarily health insurance. Is it appropriate for the Federal Reserve to pursue restrictive monetary policy to restrain inflation from this source? How does restrictive monetary policy hold down the cost of health insurance? Is restrictive monetary policy fair to the workers who have no control over the cost of health insurance?

9. In your testimony, you suggested that because businesses have been keeping a tight rein on inventories, excess inventories would probably not be a contributing factor to a cumulative unwinding of the economy or a recession in the near future. How do you interpret the latest inventory and sales data, in particular the upturn of the inventory-sales ratio at durable goods manufacturers? Is it a source of concern?

10. Are real investment outlays by nonfinancial businesses currently constrained by the burden of debt accumulated to finance corporate restructuring and capital outlays? How much of this debt is short-term or variable rate debt that would become less of a payments burden if interest rates declined? How is credit availability and spending affected by the present overhang of non-performing loans at commercial banks and the threat of more loans becoming non-performing if the economy weakens? How might this situation be improved by lower interest rates?

I look forward to hearing from you.

Sincerely,

Lee H. Hamilton
Chairman

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

October 31, 1990

ALAN GREENSPAN
CHAIRMAN

The Honorable Lee H. Hamilton
Chairman
Joint Economic Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am responding to your letter of September 27 in which you enclosed a number of follow-up questions to my testimony before the Joint Economic Committee on September 19.

The answers to these questions are presented in the enclosure. Please let me know if I can be of further assistance.

Sincerely,

Enclosure

.1. Prior to the past month or so, there was very little growth in either M1 or M2 this year. I understand this can be due, at least in part, to the slow growth of GNP and that, in such circumstances, interest rates normally would decline or at least not rise. If slow growth is at least in part responsible, why have interest rates risen during this year's slow growth? If the slow growth continues, when would you expect interest rates to begin to decline?

.1. The slower pace of GNP growth over the past year or so was just one of the factors restraining the monetary aggregates during the first half of 1990. Similarly, the path of economic activity has been only one of the influences on the level of interest rates.

During 1989, interest rates across the maturity spectrum came down significantly as the economy looked weaker than expected and the Federal Reserve eased policy in a series of small steps. Since the end of last year, however, short- and long-term rates have parted company: short-term rates edged down further, while long-term yields rose as much as a percentage point. In part this increase in bond rates was an international phenomenon, with yields in Japan and Germany rising even more than those here. In addition, however, market concerns about inflation--heightened by higher oil prices--and the persistent federal deficit had undercut the U.S. bond market.

The outlook for interest rates is always uncertain, but one can assert with some confidence that if the monetary authority pursues a policy consistent with an approach to price stability and the fiscal authorities act to get their house in order, interest rates will decline substantially over time.

Q.2. Why has M2 growth increased since early August? Does it represent an easing of monetary policy? Does it reflect stronger growth in the form of an increase in spending plans and loan demand, or does it reflect deteriorating consumer confidence, more savings, and a preference to hold savings in liquid form?

A.2. After growing at an annual rate of just under 4 percent from the fourth quarter of 1989 through July, M2 has accelerated somewhat in the past 2 months. While a bit of this pickup may reflect the monetary policy easing step taken in July, more of it appears to owe to the crisis in the Middle East, soaring oil prices, and turbulence in the stock and bond markets. The heavy flows into money market mutual funds in August mirrored large withdrawals from equity and bond funds, and money fund inflows remained substantial in September. As the level of uncertainty about the economic and financial outlook escalated, investors apparently reacted by moving into more liquid instruments. By contrast, there is little evidence in recent indicators of spending or surveys of consumer sentiment to suggest that the somewhat faster pace of money growth is symptomatic of a strengthening in economic activity.

Q.3. Have the restrictive bank credit conditions that led the Federal Reserve to reduce the Federal funds rate in August persisted or worsened? What does your latest survey of bank lending practices show in this regard? Is this problem contributing to the slowdown in economic growth and, if so, should the Fed respond to further indications of tightened lending terms by again reducing the Federal funds rate?

A.3. Credit supply conditions have remained tighter in recent months, especially for certain types of loans. For example, a large majority of bankers responding to the August Survey of Bank Lending Practices reported that they had become more selective in approving applications for commercial real estate loans, but only a handful noted any tightening up on single-family mortgages. The results of the latest Survey of Terms of Bank Lending, which tracks various characteristics of loans made to businesses, indicate that the more stringent lending terms and rates observed earlier in the year generally have remained in place.

The credit provision process plays an essential role in the economy, and the Federal Reserve is continuing to monitor that process carefully. At present, credit demands appear to have softened amid evidence of a weakening of economic activity, while credit availability has been limited to an extent by the more cautious attitude on the part of lenders. The Federal Reserve remains alert to the possibility that a further change in market lending standards may point in the direction of another adjustment to our operating stance. Nevertheless, credit market conditions are only one of many considerations in formulating monetary policy; all the surrounding circumstances, such as the outlook for reduction in the federal deficit and developments in world oil markets, must be taken into account.

Q.4. The apparent lack of official foreign exchange intervention during the past six months suggests that the Fed and the Treasury are not concerned about the decline of the dollar this year. Is the recent decline in the dollar acceptable to the Federal Reserve? Should the value of the dollar be allowed to fall further? If not, what can you do to prevent any further decline? What will be the effects of the decline in the dollar on the economy? How will it affect the ability of the Fed to restrain inflation?

A.4. The G-7 communique of September 22 stated that the Ministers and Governors "concluded that exchange rates were now broadly in line with continued adjustment of external balances." I concur with that statement.

As I indicated in my prepared testimony, a decline in the exchange market value of the dollar, other things equal, tends to provide some stimulus to our exports and to restrain our imports. It also, however, adds to upward pressure on our price level and hence raises further concern about inflation and instability. The latter effects could be of significant concern if the dollar were to depreciate very rapidly, for example, in the context of a loss of confidence in U.S. policies. Such a development would considerably exacerbate the difficulties already facing U.S. monetary policy in seeking economic stability.

Q.5. The recent statement by the G-7 Ministers implies that current exchange rates are appropriate and that the dollar should not fall any further. Is this consistent with the sizable reduction in the U.S. budget deficit that was advocated in the Ministers' statement? If a budget agreement reduces interest rates in the U.S., won't that cause a further decline in the dollar? If not, what would prevent that?

A.5. If a budget agreement leads to a decline in U.S. interest rates, that decline would tend to put some downward pressure on the dollar in foreign exchange markets. However, the ultimate effect of a budget agreement on the dollar would also depend upon how markets viewed its likely implications for the U.S. economy. The dollar could be strengthened, for example, if the budget package resulted in an easing of inflationary pressures, an improvement in our current account deficit, or an increased scope for private capital formation in the United States.

Q.6. In your prepared statement, you testified that a sustained $10 per barrel increase in the price of oil to $30 per barrel for the next year would raise the inflation rate by up to 2 points and cut 1 percentage point off the rate of growth of GNP. Since then, the price of oil has risen further, to almost $40 per barrel. If this price persists, how would that affect the outlook for inflation and economic growth? Would it cause a recession and, if so, when? Is there some price of oil at which recession becomes inevitable?

A.6. If the price of oil were to remain at $40 per barrel, both the rate of growth of GNP and the rate of inflation would be affected adversely, with economic activity weakening further and inflation rising further. The range of uncertainty about the model-based rules of thumb of the type that I cited in my testimony increases the more the hypothetical situation departs from recent historical experience with oil prices. Obviously there is some level of oil prices that, if it were sustained, would itself push the economy into recession. It is difficult to say whether oil prices have yet reached that point. Of course, it is also difficult to say what the near-term course of oil prices is likely to be, since the underlying balance of world oil production and consumption would not seem to warrant the high prices we have seen.

.7. In the event of a substantial and enforceable budget agreement -- one that would lead to lower interest rates as you indicated -- what are the sectors of the economy that would be stimulated? To what extent would they offset the fiscal restraint from the budget and how quickly?

.7. Lower real interest rates are likely to stimulate most directly the demand for durable goods, broadly speaking--items purchased with the expectation that they will provide services over a period of time. Housing and business plant and equipment fit this description, and so do many types of consumer goods, most obviously motor vehicles. It is quite conceivable that state and local infrastructure investment also will be boosted, as municipal bond yields fall.

In the long run, one can reasonably expect a full "offset"--and likely more than that because the higher level of investment should raise the productive potential of the economy. In the short turn, the degree of offset is more difficult to predict; it will depend greatly on the extent to which interest rates respond to the longer-range prospect of lower federal borrowing requirements. This is one reason why I indicated in my statement that the magnitude and timing of any monetary policy adjustment cannot be specified in advance.

.8. There has been an acceleration in the rate of increase in the employment cost index this year, which is contributing to inflation. Most of the acceleration is due to a rapid increase in benefits costs, primarily health insurance. Is it appropriate for the Federal Reserve to pursue restrictive monetary policy to restrain inflation from this source? How does restrictive monetary policy hold down the cost of health insurance? Is restrictive monetary policy fair to the workers who have no control over the cost of health insurance?

.8. In an accounting sense, a good deal of the labor cost pressure has indeed come in the form of rising health insurance rates. In economic terms, however, it probably is more appropriate to look at the total package of wages and benefits as being the variable influenced over time by expectations about future inflation and current and anticipated business and labor market conditions; from this viewpoint, monetary policy undoubtedly does exert some influence on the rate of increase in health insurance costs, as part of the overall compensation agreement between workers and management. But, in addition, monetary policy may damp the inflation in health insurance costs by reducing the rate at which the prices of the inputs to medical care--goods and labor--rise.

In the end, one must recognize that monetary policy is a blunt instrument, whose effects can be uneven. But th fact remains that prudent monetary policy is a necessary condition for achieving overall economic stability. All this argues for ensuring that inflation never again gets out of control and unbalances the economy.

Q.9. In your testimony, you suggested that because businesses have been keeping a tight rein on inventories, excess inventories would probably not be a contributing factor to a cumulative unwinding of the economy or a recession in the near future. How do you interpret the latest inventory and sales data, in particular the upturn of th inventory-sales ratio at durable goods manufacturers? I it a source of concern?

A.9. Inventory data lag considerably, so available statistics are not as current as one would like. The data in hand suggest no significant problems exist that would heighten chances of recession. Indeed, the aggregate stocks-to-shipments ratio in durables good manufacturing looks quite low; despite the fact that rising production of commercial aircraft in the past few years has been reflected in a corresponding build-up of materials and work-in-process in the pipeline.

Q.10. Are real investment outlays by nonfinancial businesses currently constrained by the burden of debt accumulated to finance corporate restructuring and capital outlays? How much of this debt is short-term or variable rate debt that would become less of a payments burden if interest rates declined? How is credit availability and spending affected by the present overhang of non-performing loans at commercial banks and the threat of more loans becoming non-performing if the economy weakens? How might this situation be improved by lower interest rates?

A.10. Some firms undoubtedly are finding strained balance sheets an impediment to new investment. Heavy loads of short-term or variable rate debt are part of this problem, but it is impossible to quantify this with any precision; data on debt structures have many limitations, and, moreover, the existence of interest rate swaps and various hedging devices further complicate analysis. I think it safe to say, though, that cash flow pressures on nonfinancial corporations would be eased by lower rates.

As regards conditions in the commercial banking sector, the problems with asset portfolios clearly have contributed to some reduction in lending capacity and to more cautious lending practices. All things equal, this tends to damp spending, which is why we made a policy adjustment in July to offset an unintended tightening of overall credit conditions that was not consistent with our policy intentions. The lower short-term interest rates we fostered presumably made it less expensive for banks to lend and buoyed credit expansion.

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