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DEFICIT REDUCTION: CAN WE CUT SPENDING TOO MUCH

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JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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JOINT ECONOMIC COMMITTEE

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Thursday, May 26, 1994

SUBMISSIONS FOR THE RECORD

DEFICIT REDUCTION: CAN WE CUT SPENDING TOO MUCH

THURSDAY, MAY 26, 1994

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

The Committee met, pursuant to notice, at 10:20 a.m., in room 2359, Rayburn House Office Building, the Honorable Lee H. Hamilton (Member of the Committee) presiding.

Present: Representatives Hamilton and Saxton; and Senators Bennett and Dorgan.

Also present: Richard McGahey, Executive Director; Lawrence Hunter, Minority Staff Director; William Buechner; Susan Lepper; Christopher Frenze; and Morgan Reynolds, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, MEMBER

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

Last year, the Congress enacted President Clinton's major five-year deficit reduction package. As a result of that package and the strength of the current economic outlook, it now appears that the ratio of debt to GDP has been stabilized for the next five years or so at just slightly above 52 percent.

This is in marked contrast to the increase of a point or more a year that was in prospect before the Congress acted, an outlook that could threaten to unsettle financial markets at any time. From that perspective at least, the deficit problem has stabilized.

Nevertheless, total national savings was only 12 percent of GDP last year, 4 percentage points below the average of the 1960s and 5 percentage points below the 1970s. The large drain on saving caused by the federal deficit is an important part of the problem. Looking further down the road, it appears that under current laws, the costs of Medicare and Medicaid will continue to increase causing budget deficits in the federal debt to accelerate again by the end of the century.

The current long-term projections for social security also point to looming problems before too long into the next century. These concerns suggest two questions: Why not start now to get the deficit down further. And by how much and how fast can we cut the deficit without hurting the economy. These are really the basic questions that we would like to explore today.

We are fortunate to have with us to examine these issues three distinguished economists—Mr. Lawrence Chimerine of the Economic Strategy Institute; Mr. James Galbraith of the LBJ School of Public Affairs, University of Texas at Austin; and Mr. Norman Ture of the Institute for Research on Economics and Taxation, former Under Secretary of Treasury during the Reagan Administration.

Each of these gentlemen has considerable experience in public policy analysis. Each brings a somewhat different perspective to the subject. So we are going to have a good, lively discussion; I hope enlightening as well.

I will ask my colleague, Congressman Saxton, if he has a statement at this point.

OPENING STATEMENT OF REPRESENTATIVE SAXTON, MEMBER

REPRESENTATIVE SAXTON. Mr. Chairman, first, let me thank you for recognizing me for an opening statement and let me say that I am very pleased you are here as chairman today. This is my first opportunity to serve on a committee with the Chairman, although we have been friends for many years. I look forward to a substantive debate on economic policy, one in which I hope we can clarify some issues, although I am confident that all of us will not agree on every issue.

Mr. Chairman, in preparing to come here today, I took some time to examine some of the testimony. It seems to me that today's hearing actually sets the stage for a very substantive debate that is to come.

In some of the testimony that I read, which I think we are going to hear shortly, there is at least some notion that deficit problem can be cured in three ways. I think everybody who is going to testify today —from what I was able to glean—believes that federal spending needs to be brought into check. But there are some apparently who believe that future tax increases are part of the mix here, and some of us are going to take very strong exception to that, whether it is by taxing benefits for older Americans, or taxing further businesses or further redistribution of wealth, to change our tax code, we are going to certainly have substantive differences on it.

In addition, there are those who, I think, are going to advocate further defense cuts; and I would only say that the defense cuts we have today are headed for the already projected lowest level of defense spending since World War II. That is very clearly demonstrated by the chart that I brought with me today.

The red line shows projections in current policy relative to defense cuts; so while we are going to certainly find some areas of agreement in terms of limiting spending of the Federal Government, there certainly will continue, I am sure, to be differences of opinion and differences of policy positions, relative to tax policy and to military spending.

Once again, Mr. Chairman, I look forward to this discussion and to working with you.

REPRESENTATIVE HAMILTON. All right.

We also have a statement from Congressman Ramstad for insertion in the record at this point.

[The written opening statement of Representative Ramstad starts on p. 33 of Submissions for the Record:]

REPRESENTATIVE HAMILTON. Gentlemen, we will begin with your summary statements. I understand that you have been asked to keep those statements down to about 10 minutes. I would appreciate it if you would use that time; and after you have each presented your statements, we will move to questions.

Mr. Chimerine, why don't we begin with you?

We will move across the table.

STATEMENT OF LAWRENCE CHIMERINE, PH.D., MANAGING DIRECTOR AND CHIEF ECONOMIST, ECONOMIC STRATEGY INSTITUTE

MR. CHIMERINE. Thank you very much. Thank you, Mr. Chairman. I am delighted to be back and happy to see you again.

I congratulate you for holding hearings on this subject. It seems to me that after the difficulty of getting last year's package passed, and the fact that deficits are falling right now, and that the economy seems to be doing a little bit better, the deficit issue seems to have faded out of the public debate. I think that that is a big mistake.

As I will describe in a moment, I think we still have a serious problem with the budget deficit and have to take additional steps over the next several years to address it.

I have submitted a statement for the record. I will stay within your 10-minute guideline.

REPRESENTATIVE HAMILTON. All of your statements, of course, will be entered into the record in full.

MR. CHIMERINE. Let me briefly describe or make reference to this sense of complacency that I referred to a moment ago, particularly with respect to the economy. Clearly, the economy has done better over the last six or seven months than at any time since the long period of slow growth and stagnation began in the late eighties.

In fact, I must say that it coincides with the enactment of the tax increase and budget package, although I am not suggesting cause and effect. In any case, the economy is doing better. There are some people in fact making the argument that our economic problems are solved. We are back; we are becoming more competitive again; we are starting to dominate global markets; and they say that our growth rate has surely picked up.

I think that there is a confusion between what is a cyclical bounce and still, in my judgment, relatively unfavorable, long-term secular factors that suggest to me the cyclical bounce we are getting is not likely to be sustained unless we take measures to improve our investment rate, our saving rate, the quality of education and a number of other factors, which, in my judgment, are vital for long-term economic growth.

In fact, the upturn we had in recent months primarily results from huge pent-up demand for consumer durables and business equipment created during that long period of slow growth, and to some extent being funded by debt refinancing—both home mortgages and corporate debt —which is freeing up sizable amounts of purchasing power and cash flow. I don't think we can count on either of these two factors to generate long-term growth at an acceptable rate. Certainly not like the old days in the 1950s and 1960s, when we had strong economic growth, rapid job creation, and rising living standards all at the same time. We have not experienced those conditions in the United States for many, many years and still are not right now.

I think it reflects a deterioration of the long-term factors that determine economic growth in the United States.

The second reason that I am concerned is that with the deficit coming down right now—and I guess it is at the lowest level now in four or five years at least, certainly as a share of GDP—there is the feeling we have solved the deficit problem.

As you indicated in your opening remarks, Mr. Chairman, I think this is unfortunate. It is inaccurate. It appears we are getting a temporary decline in the deficit for a couple of reasons: the large defense cuts; economic recovery, which is likely unsustainable; the thrift bailout costs are fading out, after being very substantial; CBO's numbers, and almost any other projection that I have looked at, clearly shows that by the end of this decade, deficits will start rising again and continue to rise into the next decade, both in absolute terms and as a share of GDP; and the important debt to GDP ratio will start rising again, as well. In fact, the underlying deficit problem is even worse than those numbers suggest because they include the large social security surpluses that we will be continuing to run for several more years. But sometime early in the next decade, they will begin declining as more baby boomers retire.

Thus, the near- and long-term budget outlook are worse than the numbers, made reference to earlier, and the current CBO numbers suggest. This is a serious problem in my judgment. It is contributing to extraordinarily low national savings.

Our investment rate, despite recent improvements, is still far below many of our foreign competitors. We can no longer rely on foreign capital to finance these deficits, given the fact that many foreign countries, particularly the Japanese, are not as interested in recycling their surpluses in U.S. assets as before. They have lost hundreds of billions on real estate and financial investments in the United States.

In other parts of the world, countries are importing capital. We need more investment and in the long term we are going to have to generate more internal savings to finance those investments. The most reliable way to increase national savings is to reduce the budget deficit.

In my opinion, it should be a very, very high priority.

How would I go about it?

I would use the following general guidelines, and preface that by saying that there is no simple rule; there is no precise simulation that we can use. This is going to be a matter of judgment. Nobody knows the optimal path for future deficit reduction, but it seems to me we need to balance several objectives simultaneously.

First, we must bring the deficit down significantly over the long term to increase national savings. Second, not to further undermine the use of fiscal policy as a stabilization tool, which has already been seriously jeopardized by the incredible deficits and debt buildup that we have had over the last 10 or 12 years. Third, simultaneously, to help build this economy for the future. That will require a change in government spending priorities, including some investments that are now being neglected at the federal level.

It seems to me that we ought to begin with the CBO projection as a starting point. In my judgment, it is based on relatively realistic assumptions—no more rosy scenarios, pie in the sky, assuming your way out of the problem like we did in the 1980s. These are realistic assumptions for growth and for interest rates, and that should be the starting point. They suggest that 10 years from now the deficit will be about $400 billion and rising. In my opinion, that has to be cut at least in half.

We have to put a package in place that will prevent the nominal deficit from rising again, and in fact bring it down relative to GDP, and bring the debt to GDP ratio down instead of allowing it to start rising again. And the minimum target should be a reduction in the 10-year deficit by 50 percent, and perhaps more.

In my judgment, the best way to do that is to adopt a multiyear program as soon as possible that will include the policy actions—and I will give you my preferences in a moment—that will take effect in future years to achieve that deficit target.

Doing so has several advantages. Number one, it will avoid the pain and suffering of having to go through this debate every single year. Second, if it convinces financial markets that there is serious, meaningful long-term deficit reduction in place, I think you will see a positive impact on long-term interest rates, which is the best way to offset some of the fiscal drag that will occur from future deficit reduction. Regardless of how you cut the deficits, either on the spending or tax side, it will create fiscal drag in the future.

And in my judgment, that is the best way to do it. In my view, deficit reduction should focus on entitlement reform on the spending side.

There is not a lot left on defense. There is not a lot left on discretionary nondefense programs. They have been cut dramatically over the past 15 years. In fact, some of them, as I indicated earlier, particularly infrastructure and other programs that help build for the future, may have to be increased in funding.

As a result, if we are going to make spending cuts—and we have to make some—serious entitlement reform is an absolute necessity. I would do it by means testing all of the health and pension programs, by significantly raising the age for full benefits for social security and some of the other entitlements, and maybe even by adjusting the cost of living formula for some of the entitlement programs.

When you do the arithmetic, though, it seems clear to me, to achieve a reasonable deficit target, some additional tax increases will also be necessary. The argument that we cannot afford additional tax increases is way overstated, in my judgment, as we learned over the last seven or eight months. This is a large and complicated economy. Anyone who says small tax increase will destroy or clobber it is overstating the case.

In my view, the arithmetic suggests some are necessary. I would do it by broadening the tax base, by eliminating unproductive tax preferences, deductions, so forth; and if necessary, by enacting limited consumption taxes. I would try to avoid broad-based tax increases that might, at the margin, penalize saving and investment. But it seems to me, the key points I am making are, number one, adopt a long-term program as soon as possible; number two, focus on entitlements and broadening the tax base; and number three, because we do not want to jeopardize the use of fiscal policy as a stabilization tool, and do not want too much fiscal drag at a time the economy may be weakening, I would consider including an escape clause so that if economic growth flattens out or is below a threshold over an extended period, some of the deficit reduction that has been built into the package will get delayed until the economy reaches a targeted growth rate, so we do not run the risk of having too much fiscal drag at a time when the economy weakens considerably.

In my view, Mr. Chairman, if we adopt a package like this as soon as possible, we will go a long way toward building for the future and improving the long-term health of the U.S. economy.

Thank you.

[The prepared statement of Mr. Chimerine starts on p. 34 of Submissions for the Record:]

REPRESENTATIVE HAMILTON. Thank you, Mr. Chimerine.

Mr. Galbraith, please proceed.

STATEMENT OF JAMES K. GALBRAITH, PROFESSOR, LYNDON B. JOHNSON SCHOOL OF PUBLIC AFFAIRS AND THE DEPARTMENT OF GOVERNMENT, THE UNIVERSITY OF TEXAS AT AUSTIN

MR. GALBRAITH. Let me say, it is a particular pleasure for me to return today to the Joint Economic Committee. I want to apologize, if I may, for the fact that my testimony was not here by the deadline specified. It was sent on time by a reliable courier, but I understand that when it arrived in the Senate, it did not pass through the x-ray machines. I knew, Mr. Chairman, that my testimony was explosive, but I did not know this could be detected automatically.

REPRESENTATIVE HAMILTON. We have increased our sophistication around here since you left, Mr. Galbraith.

MR. GALBRAITH. Mr. Chairman, it is easy to show that the deficit, the fiscal condition of the federal budget, depends upon the condition of the economy. We know that if the economy moves into a recession, the deficit will go up. We know that if we come into a period of recovery, the deficit comes down. I show this is very plainly in the first chart that I attached to my testimony.

The converse proposition, however, is the one you asked us to examine today. You questioned if we proceed with a policy of cutting the deficit, what will be the effect of that on the economy? That is much harder to show. I believe that there is a general view that many people hold to the effect that as we cut deficits, that will raise national savings; should lower interest rates; should improve our rate of investment; and should increase our rate of productivity growth, a link of three or four steps in a chain from deficit reduction to the ultimate objective of a higher rate of growth and improvement in the national standard of living.

The observation I would like to make to you is that we do not know with certainty—and I would suggest that we only know with a good deal of doubt—about the reliability of virtually each link in that chain. There are disagreements, points of dispute raised by reasonable people about each of those links; and so, when we proceed with a policy on the deficit by setting out a fiscal rule for the Federal Government, we ought to do so with a good deal of humility about the final effect, and we ought to do so by taking a good deal of care that the steps that we undertake do not backfire on us, do not generate a slowdown in the rate of economic growth in the short term, which we know has the effect of undermining our progress toward deficit reduction.

A very good document through which to view this problem is the economic and budget outlook of last September, published by the Congressional Budget Office. It is a good document for this purpose because between March and September, there were very few changes in the economic outlook. The major change was that Congress wrestled with and ultimately enacted a very large deficit reduction program, so we can see what was expected at the time that that deficit reduction program was enacted, what the economic effects were expected to be.

If you look, CBO provided estimates on the effects of the deficit reductions in 1993 on real gross national product over a five-year timeframe. I reproduced those as Table 1 in my testimony, and show the difference over the five-year time horizon between what was expected to happen to real output before and after deficit reduction is very small; and on balance, over the first five years, it is negative.

CBO was telling the Congress that the effect of these sacrifices in the near-term was to reduce GNP by a slight amount with a potential gain virtually at the end of the five-year planning horizon and presumably more gains to be experienced in subsequent years. But they are so far in the future that CBO does not provide us with estimates of them.

In the one area where it did expect deficit reduction to have economic benefits that would tend to support the chain of economic development, which I outlined a minute ago, from savings to lower interest rates, to investment to productivity growth, CBO did provide an estimate that the consequences of deficit reduction would be to modestly lower the path of short-term interest rates over the five-year horizon to what they otherwise expected and to quite substantially lower the path of long-term interest rates.

Indeed, if one looks at the Administration's own program—and particularly as it was expressed to the Congress in its *Economic Report of the President*, delivered on February 4 of this year—one finds that the Administration, completely in line with the September projections of the CBO, and indeed with the January projections of the CBO, was making the argument that the primary benefit of the deficit reduction package that Congress enacted last year would be a lower path of long-term interest rates, and that this path of lower long-term rates would be sufficient to offset the contractionary effects of deficit reduction.

Of course, beginning on February 4, those scenarios and prognostications were completely upset by the change in policy of the Federal Reserve Board, which began, as you know, on February 4, with a series of moves toward higher short-term interest rates; and contrary to some predictions, those higher short-term interest rates almost immediately produced substantially larger increases in long-term interest rates. So, as I show in Table 2, we now have a long-term rate on the 10-year Treasury note substantially higher—about a tenth of a point higher—than the five-year projection presented in September, and more than a point higher than the 1994 projection presented in January by the CBO.

My point, Mr. Chairman, is that the effects of deficit reduction and our ability to get the benefits, which many believe deficit reduction should bring to the economy, depends very critically on whether the assumption that the very strong actions taken by the Congress this year and last year are in fact accompanied by gradual reductions in long-term interest rates.

This has not been the case with the program that Congress enacted last year; and if I may put the question another way, if the case for deficit reduction does not rest on the promise of lower interest rates and, therefore, on higher rates of investment in the private economy, I would like to know on what premise it does rest.

That said, Mr. Chairman, I think that I am considerably more cautious than my friend Larry Chimerine is about prescribing for the Congress a task of renewed endeavor in deficit reduction. I am inclined to agree with the statement in the *Economic Report of the President*, that the primary task now ought to be what they describe as expenditure switching rather than deficit reduction.

That is to say, the very difficult task of coming to an agreement about public policy priorities: health-care reform; the change in expenditure patterns as we gradually reduce military commitments and, I would hope, gradually increase public investment for civilian purposes. But these are issues about which the political process must have its say, and they are distinct from an overriding goal of deficit reduction for which a much stronger case could have been made last year than now.

Certainly, this is not a call for complete neglect of this issue; far from that. In my view, it is, of course, important for the U.S. Government to preserve its good credit. But as you properly noted in your opening remarks, Mr. Chairman, we have reached a point where under reasonable economic assumptions, the ratio of the public debt to the GDP will remain stable over the next five years and only gradually rise after that.

Given that that is the case, one can, I think, argue that Congress should merely be vigilant to assure that this ratio does not get out of hand in the context of an economy that continues to expand at a reasonable pace.

To achieve that goal, to keep the ratio of debt to GDP stable, which is a very modest objective, still does require that monetary policy and fiscal policy be coordinated to that effect.

I show in, I believe, Figure 3 of my testimony that if we have a continuation of the rise in interest rates that has already occurred, this will move the point at which the debt to GDP ratio starts to rise forward by a year or so, relative to the January 1994 forecast of the CBO; whereas, if we did achieve what I believe was hoped to be achieved, namely a gradual reduction in interest rates from the levels of last January, then the ratio of debt to GDP would not rise to its current level until well after the 10-year forecasting horizon expires in 2004.

I would urge the Congress to look carefully at measures that might bring the Federal Reserve into an effective discussion of the importance of coordinating the fiscal actions already taken and their consequences over the next four or five years with monetary policy. I do not believe—this is not the place, perhaps, to lay this out in detail—that the Federal Reserve has given a coherent explanation of the policy moves that it undertook between February and May; but I do believe those policy moves have consequences that the Congress should not neglect.

Mr. Chairman, I believe I have used the 10 minutes that you have allocated. I have brief comments on other issues.

I do not think at the moment that the Congress should return to the question of the stimulus package. I do believe that a capital budget should be an issue that should be considered at this point. I would certainly oppose such measures as a balanced budget amendment. I would be happy to discuss those questions at greater length. But my main point upon which I think I would rest is that from this point forward, whatever you decide to do with the deficit, the Federal Reserve monetary policy has to be part of the team.

Thank you very much.

[The prepared statement of Mr. Galbraith starts on p. 41 of Submissions for the Record:]

REPRESENTATIVE HAMILTON. Thank you, Mr. Galbraith.

Mr. Ture, please proceed.

STATEMENT OF NORMAN B. TURE, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

MR. TURE. I am very pleased to have an opportunity to come back to the Joint Economic Committee.

I want to commend the Chairman and the Committee for holding this hearing about the considerations that should govern deficit reduction efforts. Attention to the magnitude and direction of changes in the federal budget deficit appear to have virtually disappeared in recent months. I think that that is unfortunate, because the occasion for the concern, I believe, is not primarily how large the deficit is or how large it is likely to be in the future. I think there are much more fundamental economic and political concerns that are involved. I have attempted to address them at least summarily in my statement.

I think the Committee's posing of the economic questions in the letter inviting the witnesses to appear is certainly highly appropriate. Those are the right questions; but there are some political or political-economic concerns, as well, which I address in the latter part of my statement.

The basic concern that the Committee raises is, do we need to worry about further deficit reduction? Will further deficit reduction harm the economy? Is there some such potential peril out there?

My brief answer to that is that failure to reduce the deficit is what poses a danger for the economy's future.

I think the issue of deficit reduction should not be allowed to sit on a back shelf someplace in the Congress' deliberations. It ought to remain as up-front as you can make it.

The occasion for that concern about the potential harm in further deficit reduction stems from a Keynesian model of the interactions of public policies and the economy's performance. In that Keynesian framework, deficit reduction is perceived to exert a contractionary influence on the levels of economic activity, certainly in the short run. But for the long run, deficit reduction is deemed to be essential for growth, because it is needed in order to free up the saving that is undertaken by households and businesses for purposes of addition to the stock of capital, which has a substantial effect on generating expansion of economic capacity and productivity in the work force.

Now this conflict, this tension between short-run and long-run considerations does not emerge in the neoclassical framework. That tension simply is absent. The effect of deficit reduction for the neoclassical model does not depend on the "how-much" question, but on how the deficit is reduced.

For the long pull, there is substantial agreement that deficits do impair the effective use of the savings the private-sector undertakes; but, again, the question of how those deficits should be reduced and how that savings should be released for private-sector uses is more important than the how much.

Let me briefly summarize my responses to the specific economic policy questions that the Committee has posed.

One, reducing the deficit by cutting spending is likely to be not contractionary but stimulative in the short run. By releasing saving for private investment and other productivity-enhancing private uses, reducing deficits by cutting spending will contribute as well to achieving a higher, long-run growth path for the economy.

On the other hand, reducing the deficit by tax increases will have an adverse effect on the economy's performance in both the short run and long term.

The Committee raises the question about what ought to guide public policymakers in setting their deficit reduction goals. I don't think any quantitative target is appropriate. Rather, I think deficit reduction goals should be set by reference to the extent to which the Nation is willing to trade higher levels of output in the future for the government activity financed by borrowing in the present.

The less the benefits that we as a body politic can obtain by the government's current levels of activity or composition of activity, the stronger is the case for deficit reduction achieved by curtailing those activities.

The deficit reduction need not and should not be constrained by monetary policy, or for economic policy, or for economic developments. The view that monetary policy does exert and should exert that constraint on fiscal and budgetary policy is a product of the so-called fiscal monetary- mix hypothesis that was first presented, to the best of my knowledge, to this Committee in 1955 at a hearing that the then Fiscal Policy Committee undertook on fiscal policy for economic stability and growth.

Those were very impressive hearings; and I had occasion to review some of them recently. I invite the Committee's attention to them again. They pre-dated a lot of the developments in fiscal theory that have since occurred, but some of them were very, very prescient, indeed.

It—monetary policy—should focus on price level stabilization, not attempting to fine-tune economic outcomes.

Spending cuts to reduce the deficits should not be deterred by other efforts to help nations deal with their economic difficulties. That is a question that apparently confronts the budget committees of the Congress and has been deemed to pose a substantial fiscal policy issue. That is because, as most of us think about aid to other economies, we think about it in terms of government-to-government grants, loans, other assistance that goes from one government to the other.

It seems to me that even a casual review of the history suggests that government-to-government aid has not been successful; and it is about time to rethink our strategies in trying to assist other economies that are in difficulties.

I think assistance in the future should more take the form of reducing barriers to American businesses' investing and creating new businesses in countries who call for our assistance.

There may indeed be practical considerations that present obstacles to reducing government spending and budget deficits; but although these obstacles may slow the pace at which spending and deficit reductions can be attained, they should not put you off from the effort. They should not deter you from believing that deficit reduction is indeed a plus that will contribute to the economy's growth and more efficient performance.

Let me now turn to the so-called political-economic concerns. For the most part, I think you will recognize they have been almost entirely neglected in discussions about deficits and fiscal policy, generally.

Generally overlooked in these discussions is the fact that borrowing to finance government activities, finance budget deficits, hides the costs of government activity from the public. The consequence is just what one might expect: More government activity than would be undertaken if the body politic were more acutely aware of how much they have to pay for that activity. Tolerating budget deficits, accordingly, implicitly underwrites an expanding public sector.

This government expansion thrust, moreover, is substantially uninhibited by the kind of economizing constraint that households and businesses in the private sector confront continuously.

Moreover, this lack of any economizing constraint on government spending exacerbates an even more fundamental problem, in my judgment, a problem that arises from the apparent lack of any bright line to inform policymakers about what government should and should not do.

The growth of the public sector, in large part, reflects the erosion of any clear consensus that there are some types of activities that should be reserved solely for people in their private capacities to undertake.

The scope of government has expanded along with its magnitude. At the same time, for the same reasons, the quality of government activity, in my judgment, appears to have deteriorated through time.

I don't think that these developments represent an expression of the preferences of the body politic as a whole, even of the majority of us. There are few, if any, among us who know the content of even a handful of government programs and spending objects. When we vote, we cannot endorse or reject specific government activities, most of which we do not even know about. We cannot even endorse or reject the full set of those activities. We never have that on the ballot.

As a consequence, public policymakers' constituents exert little pressure on them to develop some effective economizing formula for making hard choices among activities. On the contrary, constituents pressure policymakers for government activities or policies that will afford them the economic rewards that they cannot seem to obtain in the marketplace. To repeat: nothing inhibits the policymaker from responding affirmatively to these pressures other than the policymaker's own distaste, which is often overcome by the desire to continue in office.

Finding that bright line that will more closely confine government activities appears to be an extremely difficult task. There is a very substantial body of economic analysis for which this is the core concern. We keep waiting for that body of economic analysis to give us the ultimate and definitive answers.

What is needed, I think, perhaps, is some set of rules that at least roughly simulate the bright line's effects. Let me suggest a few of them.

A basic operating rule should be to tie government spending very tightly to government revenues. In a word, we should eschew deficits.

The collateral requirement is that revenues be raised from taxes that, one, have the broadest possible reach in the population of real live living human beings, not organizations, and that, two, are highly visible to those who pay them. In combination, this would establish a much closer nexus than now exists between policymakers and their constituents. By the same token, spending decisions would be more effectively limited by people's willingness or unwillingness to pay the bill.

Along with an effective constraint on budget deficits, there is also needed some budget-making process reform that would intensify pressures for more efficient determination of spending priorities. Balanced budget amendments address the requirement for banning deficits, but they do not preclude untoward expansion of government over time, nor do they exert any substantial pressure to increase the efficiency of priority determination. We need as well to reform the tax system to increase tax visibility and to assure that most of the population is part of the action, pays at least some tax and is acutely and, I say preferably, painfully aware of doing so.

In addition, simplification of the budget-making process and adoption of statutory rules that would make spending authorizations binding on actual outlays are called for.

The Cox-Stenholm and Lott-Shelby Budget Process Reform Act—H.R. 2929 in the House and S. 1955 in the Senate, respectively— would be a major step in this regard.

I think that without changes of the sort I suggested above, without some way of simulating the application of a bright-line constraint on decisions about government activity and spending, there is not much prospect of effectively curbing the growth of government over the long run.

By the same token, there is not much likelihood that budget deficits will be averted or even reduced over the long run.

The adverse economic consequences of these fiscal developments on the economy's growth potential, I think, urge the attention by the Congress to the issues that the Committee has sought to illuminate in these hearings.

Thank you.

[The prepared statement of Mr. Ture starts on p. 51 of Submissions for the Record:]

REPRESENTATIVE HAMILTON. Thank you, Mr. Ture. We will begin with questions.

Senator Bennett, glad to have you here this morning. We will go in this order: Senator Bennett, Congressman Saxton and Senator Dorgan.

Senator Bennett, please proceed.

SENATOR BENNETT. Thank you, Mr. Chairman. I apologize for coming in late and I apologize to Mr. Chimerine for not hearing all of his testimony. I have a general comment to make before I get into the questioning, if I might.

I have not had the experience of spending years at a computer screen crunching numbers as an economist. My years have been spent in the marketplace running a business. The most crucial challenge a businessman faces is his ability to predict the future. It comes into every business decision. Is this employee going to be able to perform as well as he or she interviews? Is this inventory going to move as rapidly as it has in the past? Or, are you going to find shortages? Or, are you going to find overages and you will be stuck with price reductions to get the stuff out of the warehouse; and so on and so forth. You can understand that.

I am stunned to come to the Congress and find that we all seem to be prisoners of a process for predicting the future that is manifestly, obviously, repeatedly and overwhelmingly incorrect.

To sit here and listen to people talk about things that are going to happen five years from now, with certainty, down to the last dollar, when the ability of the Congressional Budget Office to project six months in advance has been called into question again and again blows my mind.

We are sitting here talking about a deficit this year, a number that I hear is $187 billion. I hear congratulations heaped on the President. Because it is down from $300 billion, which we were told a year ago that it would be.

Then, I discover that CBO said prior to the budget summit of 1990 that the deficit in this year would be $118 billion. But after we did the budget summit, we would get it down to $29 billion.

Somehow, nobody is horrified at the fact that instead of being $29 billion as projected, it is $187 billion; but we congratulate ourselves because it is down from the $300 billion our forecasters told us it was going to be; and on that basis we keep going back to the forecasters and allowing them to control our policy.

I say "what" facetiously but with a degree of accuracy. When I speak to people, when they say what can we do to help reform the government, I say pick up your sledgehammers and storm the Capitol and destroy the computers in the basement of the Congressional Budget Office and force ourselves to begin to find some other way to make these kinds of forecasts.

We are all prisoners of those computers. We sit here glibly saying that this is going to happen if we do that; that is going to happen if we do the other; and we put a number on it. We score it. CBO scores it. And then CBO controls the debate.

I have made proposals since I have been here and I have been told, oh, no. That cannot possibly pass because CBO scores it as a net revenue loser. If I may, Mr. Chairman, I would like to give the specific example. We have heard it over and over again. But it has happened to me specifically.

Senator Chafee, a member of the Finance Committee, came to me and said, Bob, will you co-sponsor my bill to remove the luxury tax from the boat industry? I said, John, I am stunned that the luxury tax is still on the boat industry three years after it destroyed it. Well, he said, we have been unable to get the bill through Congress; he said, we think it will get through this time because the Majority Leader, Senator Mitchell, is also on it.

I said well, absolutely. I will co-sponsor the bill to remove the luxury tax from the boat industry. Any businessman who looked at the boat industry at the time of the budget summit would have said that here is an industry that is suffering from overcapacity, is on the verge of extinction anyway; the worst thing in the world you could do to this industry is give it an automatic 10 percent tax increase or, in reality, a 10 percent price raise. These people would be cutting their prices to survive, not increasing them.

The Federal Government came in and ordered a 10 percent tax increase across-the-board and killed the industry, threw thousands of people out of work, caused deep recession in Rhode Island and Maine and some of these other places dependent on the industry.

Absolutely, I will support that bill.

Well, he said, Bob, there is a problem. I said what is the problem? He said CBO scores the bill as a revenue loss. I said you cannot possibly be serious. He said, yes, CBO scores the bill as a revenue loss because they are still projecting revenues from a 10 percent tax on a nonexistent industry that we are trying to revive.

So he said, in order to pass the bill, you have to agree to a tax increase someplace else that will score as much revenue gain as this bill would represent revenue loss.

I said, John, that is absolutely insane. He said, it may be insane, Bob, but it is the way we do business around here.

So, very reluctantly, I agreed to co-sponsor the Chafee bill, with a tax increase somewhere; Frankly, I didn't want to know where it was. I didn't even look. I just said okay.

I listen to these bold predictions of what is going to happen with this grave sense of misgiving that we are all in wonderland because we really don't know. Nobody wants to look up from the comfort of the PC screen when hard numbers are being given us, which seem so wonderful, because we can hang onto them and say that we were here last year and all the numbers that came out of the screen were wrong; we are going to be here next year when all the numbers that come out of the screen are wrong.

Why can't we say that the emperor has no clothes, in this case the emperor being the computers that run the government, because they score every bill we have to debate; and use a little human wisdom to say, you know, it does not make sense to raise the price on an industry where price cuts are their only hope of salvation.

Would you like to comment on that, each of you? This is a speech Senator Dorgan has heard me give before. He is condemned to duty in the Senate chair, where he has to preside when there is nobody else on the Floor, by virtue of his being a Democrat. We are free of that on the Republican side. We can walk out when things get boring.

But I feel this very strongly. It is not a partisan kind of thing. I am really trying to do the best thing I can to help the economy. And I am absolutely frustrated, not by the oratory or the eloquence of my opponents on the Senate Floor, but by the inflexibility, the omnipotence, of the demonstrably wrong computers in the basement of the Congressional Budget Office, who seem to make every economic decision.

MR. CHIMERINE. May I comment, Senator?

REPRESENTATIVE HAMILTON. All three of you may comment.

MR. CHIMERINE. I have several points, Senator. First, you were not here during the 1980s, which in my judgment represents the origin of the deficit and debt problem, during which we used extraordinarily optimistic assumptions. Enormous dynamic effects were built into the assumptions from the tax cuts that we had in the 1980s. I understand your frustration with the scoring system and not taking into account the dynamic effects.

But I also know full well that if it is carte blanche to make any kind of calculation you want in the budget process by putting on added revenues from a tax cut, you know what will happen. Every tax cut will be justified by extraordinary assumed dynamic effects on the economy.

There will always be revenue gainers instead of revenue losers, and in the long run, we will make the deficit worse. I don't think the solution to this is not to do any analysis, not to do any kind of quantitative assessment, and to justify any policy change by incorporating any assumption that you would like about dynamic effect.

SENATOR BENNETT. If I may, that is not what I am suggesting. I am not suggesting that we don't do any analysis, that we make no projections.

I am saying let's look at the programs in the computer and see if they cannot be reprogrammed around reality. It is the same kind of frustration that I have with some of the environmental models that we get, that come before the Energy Committee and say that this is going to happen over the next 200 years, and we ask, can you take that same model, feed into it data available 200 years ago, and have it correctly predict what has happened?

They say, oh, no, when we feed into it data that comes out of 200 years prior to now, it predicts wildly different things than what really happened. We say, maybe you ought to change the model so that you can at least run a dry run of actual environmental information that is 200 years old and have it parallel what happened; and then with some confidence, I will believe nature is going to project what will happen in the future.

I don't see anybody in the economics community trying to go back and say that we will try to reprogram the computers in such a way that they could predict what happened in the last 20 years and then on that basis, say, now, yes, we must make this kind of analysis. Well, you heard the speech. I will not repeat it.

MR. CHIMERINE. I don't think that that is accurate, Senator. I think most of us who do this on a serious basis do try to adjust the models; do try to "predict" the past before we use the models to forecast. But I have to tell you, having been doing this for many years, there is no perfect forecasting model. There will never be a perfect forecasting model. This is true whether we are talking about economic models, or econometric models, or specific-sector models, or even models used in the business community.

I am sure that when you planned your business, you didn't always assume every forecast you made and every assumption you made would turn out to be correct. You looked at the risks. You looked at what could go wrong and what the consequences of those errors might be. Then you made your best decision. The point I think——

SENATOR BENNETT. That made me very humble. It is the kind of humility that I am asking for.

MR. CHIMERINE. If I may make one last comment, this has made me humble as well. One thing I am confident of saying: Within a reasonable range of forecasts about the growth of the economy and interest rates, and taking into account even reasonable dynamic and feedback effects, the deficit outlook for the next 10 years and beyond is unacceptable. It is too high; and to avoid that conclusion, you have to make highly unreasonable assumptions, in my judgment.

Therefore, without focusing on the specific numbers—and none of us know whether it will be $150 billion next year or $170 billion—but a reasonable conclusion is that the long-term outlook is poor. Something has to be done about it; that is essentially my view. And do so without the focus on the specific numbers, because I think you are right, we overstate our ability to forecast these numbers on a year-by-year basis.

MR. TURE. Senator, may I briefly respond to your observations?

First, it is not the machines that need to be destroyed. It is the analysis that is modeled and is simulated. There is a lot of revision that needs to be done there.

But much more fundamentally, it is not a question of what kind of numbers get cranked out, or whether or not you look at them and feel comfortable or distressed by them. I think the real core point that you made is that you perceive policymaking on monumental issues having been reduced to a numbers game. I think that that is substantially correct.

We work primarily but not exclusively in the tax policy area. I report to you what virtually everybody I have talked to throughout the business community and elsewhere have said to me: There is no such thing as tax policy. There is revenue raising. I think they make a pretty good point. I think that implicit in your recommendation is a belief that policymaking ought to focus more on the principles that should guide the policy and much less on estimates of numbers today and in the future.

I think Larry is perfectly correct in observing that there is a lot of fallibility. He is also perfectly correct in urging that it isn't mischief on the part of the econometricians that generate it.

I am sure he wishes that he were in a position to generate much more accurate forecasts than he has been able to do. I am not trying to criticize the quality of your work, Larry. But the point is, it is not whether the numbers are right; it is a question of whether the policy is right. Just as strongly as I know how, I would urge that that is the appropriate refocus of policymakers' attention.

SENATOR BENNETT. Thank you.

REPRESENTATIVE HAMILTON. Mr. Galbraith?

MR. GALBRAITH. Humility is indeed my theme this morning. I have a great deal of sympathy for the remarks you made. I believe that CBO does very useful work in laying out for us the consequences of policy changes under certain given assumptions. Once one recognizes everything is conditional, then one can keep these documents in perspective.

I believe that the kind of difficulties you described with your tax proposal on the boat industry stem not so much from the underlying economic forecasts as from the need to follow a rigid rule—in this case, a path of reduction overall aiming at some target five or six years in the future. Larry would have us go to another path of 10-year reduction of the deficit, in half. Norm would have us go to a balanced budget, I imagine in a considerably shorter time frame, if I heard you correctly.

MR. TURE. ASAP.

MR. GALBRAITH. My view is that because the economics profession has not done a terribly good job about lifting the uncertainty about the consequences of these steps for the economy from your shoulders, as a policymaker and as a businessman, the Congress would do well to be extremely cautious about imposing additional costs on the private economy when the case for them is not as clear as it is often asserted to be; and I would take, as I said, a very, I think, cautious view that while we need to be concerned about the credit of the United States, if that is not in danger, then the burden really should be on those who would go faster to prove their case.

REPRESENTATIVE HAMILTON. Okay.

We will go to Congressman Saxton and Senator Dorgan.

REPRESENTATIVE SAXTON. Thank you, Mr. Chairman.

I have two questions. The first one is related directly to Senator Bennett's question. I would start by asking the question, what went wrong? I relate this to policy matters that we have undertaken as an institution during the last four or five years. In the late eighties, deficits dropped depending upon whose numbers you looked at.

On the low side, we see a 1989 figure of $139.1 billion. There is another number of $152 billion. It tailed off during the late eighties. We found, in 1990, those deficit numbers to be unacceptable. We set out to do something about it.

Institutionally, we met. In fact, our leadership met at Andrews Air Force Base on a bipartisan basis with the Republican President, and concluded that the deficit was too high and that if we did not do something about it by 1995, it would still be projected at $118 billion—unacceptable.

So, based on the notion that that was unacceptable—I would have come to the same conclusion, frankly—we policymakers decided collectively that, based on those numbers that we needed to make some policy changes in 1990, this institution imposed on the American taxpayers the biggest tax increase in the name of deficit reduction.

The computers that the Senator talks about in the basement of CBO said, if you do this by 1995, the deficit will be down to $29 billion. As we moved through the first few years of the nineties, it is no surprise to any of you here today that the deficit jumps to $221 billion in 1990; to $277 billion in 1991; to $310 billion in 1992. And in 1993, of course, things began to get a little better. It dropped, I think, to $247 billion. Of course, in 1993 we said that this is unacceptable; we are going to increase taxes again. and we increased taxes again. I think the point can be made that that was the biggest tax increase since 1990.

Here we are today having the same kind of debate, what do we do about deficits. Our recent history says that either we made bad policy based on bad numbers, or something. So I ask the question, what went wrong?

MR. CHIMERINE. I can take a crack at that. If we start in the late 1980s—I don't remember all the numbers—clearly, what went wrong was that CBO was too optimistic in their economic projections for the next four or five years—back to Senator Bennett's earlier comments—and that is why the deficits turned out to be much higher than predicted at that time.

But to blame it all on the tax increase, I think, is mistaken. The economy began to slow down at least 18 months before those tax increases were passed. By late 1988 or early 1989, the growth we had in the 1980s was tapering off, and this long period of slow growth—I have called it the great stagnation of the 1990s—had already begun. This was in place for 18 months before the tax increases were passed.

What I am saying is that those deficit projections would have been wrong or dramatically understated, whether we had the tax increase or not, because we entered into a period of subpar economic growth for a long period of time, which began before the tax increases were passed. There are a lot of things that affect the deficit, and again, Senator Bennett made this point earlier, and our ability to forecast it from year to year is very limited. I would refer you back to the early 1980s, that the errors you are now talking about are rounding errors, compared to the budget deficit projection errors that were made in the early 1980s when the supply-side program was passed in the first place. We were supposed to have a surplus in 1984. Instead, we had a $275 billion deficit. This is going to happen.

But the key point is that under reasonable assumptions, taking into account reasonable impacts from policy changes, can we draw a conclusion about the long-term deficit outlook? Can we or should we put in place a long-term program to deal with the deficit and not get overwhelmed by the week-to-week and quarter-to-quarter numbers, and I think if you take that approach, it is clear that we need to do something. In fact, if you use the other excuses—we can't forecast perfectly; the economy is now so bad that we can't put a deficit reduction program in place; the economy is good and we don't need one any more—we will never do it. We always have an excuse not to act and that is why the focus, in my opinion, has to be over a long period of time, but also putting in place some kind of safeguard so that we don't dramatically worsen economic prospects in the short and intermediate term.

One other point. I think all of us can chew gum and walk at the same time. I couldn't agree more with Jamie's point about priorities.

We are pretty smart, all of us. I think we can develop a budget package or budget program that provides for deficit reduction on a long-term basis at the same time we determine what our future priorities should be.

To me, what is most unconscionable is that we are piling a debt burden on the next generation that is absolutely unethical, immoral and unconscionable, and we are not building the economy for the future for them either. That is just not acceptable, in my opinion.

MR. TURE. I think Larry is correct that the tax increases of 1990 did not reach back through time and generate a recession that really began, for all intent and purpose, in 1988 or 1989. I think certainly those tax increases did not contribute to overcoming those recessionary influences, they probably strengthened the recessionary impulses, and they probably weakened the recovery.

But I have to say, in response to Larry, by the same token, you should not blame the deficits that were generated during the 1980s on the tax reductions that were legislated in 1981 and did not begin substantially to take effect until subsequent years, in which subsequent years—let me refresh the history—the Congress and the Administration, year after year, called for and enacted tax increases. According to calculations from a Member of our group, by the year 1990, the revenues from the enacted tax increases had swamped the loss of revenues from the 1981 tax cut.

I think what is going on now is more numbers——

SENATOR DORGAN. Would you repeat that because I missed that point.

MR. TURE. By, I think, 1990—I can verify that—the additional revenues that had been generated by the tax increases in 1982 and subsequent years exceeded in aggregate amount the revenue-losing effect of the 1981 Economic Recovery Tax Act.

SENATOR DORGAN. Your reference for that?

MR. TURE. That is out of the budget documents. In each budget document every year, you will find a summary of effects of policy changes on revenue magnitudes and spending magnitudes. This is simply accumulated, this record, over a number of years. I will be happy to put in your hands a brief memo that Mr. Entin from our group has prepared on that.

I was about to say that I think that what we are engaging in—I regret that I am engaging in it too—is more of this numbers game stuff. I have said repeatedly, on virtually every occasion that I have had an opportunity to make the statement, that economists of all philosophic stripes tend to take an extraordinarily mechanistic view of the impacts of public policy and how the economy performs. I think Jamie was very well spoken to cite this.

I will use a metaphor that I use every time I can—it is almost as if there is a perception that this enormous economy of the United States, the single largest economy in the history of the human race, the most complex and dynamic economy that is beyond conception, that this is a little marionette that dangles at the end of public economy policy strings. You pull a string here and the economy will do the following things.

I think that is idiocy and unattached to reality. What public policy does is exert influences on our decisionmaking. By our, I mean, all of us in the private sector. It is not that we ignore the changes in costs and opportunities that public policy imposes on us. We react to that, certainly.

But to say that any of us in a policymaking role can say that the economy is going to be in the following place X number of years from now because I am going to do the following things to it, is not only arrogant, it is just fatuous. That leads me to the observation I made before, for heaven's sake, let's stop playing numbers games. Instead of worrying about these magnitudes that we project only with the greatest of fallibility, let's focus on the principles of policy.

What is it we want government to do? What is the occasion for doing it? How do we want to raise revenues that finances those activities? What kinds of operating rules are well founded in solid fiscal theory principles? Let's see if we can get consensus about that sort of thing.

REPRESENTATIVE SAXTON. My time has expired. Senator Bennett and I got off on a different tangent. What we are really here to discuss is whether deficits matter, and Senator Bennett and I have been talking about what makes them, which assumes that they are bad—I guess, I do assume they are bad.

In terms of Senator Dorgan's question, when you talked about tax policies in subsequent years after 1981, I assume that you were specifically inferring, at least in part, to tax policy that we passed in 1986, which was fully implemented in 1988, which was shortly before the economic downturn began, is that correct?

MR. TURE. I think there were some very nice things about the Tax Reform Act of 1986. I think there were some dreadful things about the Tax Reform Act of 1986.

Senator Dorgan, I know that you were a participant in that process, and I know that you saw some of the desperate efforts that the Ways and Means Committee Members had to go to in order to try and find offsetting revenues because a constraint had be imposed—this must be a no-net-revenue-losing bill. I think the result of a lot of that scrabbling for revenue was very bad tax law, but I am on the record for that.

REPRESENTATIVE HAMILTON. Senator Dorgan.

SENATOR DORGAN. There is so much to discuss, one hardly knows where to begin. I would like to ask a series of questions. Let me close the record on a couple of things.

I didn't vote for the 1990 agreement. I thought it was a bad agreement. I did vote for last year's agreement and I am proud of it and thought it was a good agreement to reduce the budget deficit. But I would say that what happened following 1990 had an enormous amount to do with the significant run up of government spending in health care, among others, out-of-control spending in entitlements for health-care—Medicaid and Medicare. And some people keep talking as if the government willfully decided, let's just dump this money out, spending it on nonsensical things. That is not the case.

Health-care costs were out of control and they almost ruined the federal budget. Second, with respect to the 1981 tax cuts, Mr. Ture, I think that you probably included in your analysis the 1983 social security tax increases. They had to do specifically and only with restoring and making whole the social security system. It had nothing to do with the 1981 tax cuts and economic growth and so on.

If one were to include those in the computation of what happened since and measuring it against 1981, one is, I think dancing nimbly around the numbers.

Let me go on to some questions and I would be happy to hear your comments on that. A couple of you raised a point about the Federal Reserve Board. It is a very relevant point today because we are talking about deficit reductions and taxes and advantages or disadvantages of raising or lowering taxes, cutting spending.

On the other hand, the action of the Fed, in effect, is to raise taxes on virtually every American and virtually every American business in the last couple of months. Isn't the Fed, in effect, proposing a tax increase on productive enterprise in this country with what it has done?

MR. CHIMERINE. Senator, can I try that?

SENATOR DORGAN. Yes.

MR. CHIMERINE. Before I do, I would like to make one comment emphasizing a point that you made a moment ago. There is a perception that spending is out of control.

While I am the first to admit that we ought to solve the problem, as much as we can, on the spending side, I think you made a very valid point. The reason spending is out of control, if it is, is number one, the entitlements, particularly health care; and, number two, the fact that because we haven't dealt with the deficit effectively, the problem keeps feeding on itself and interest keeps rising.

If you look at nondiscretionary expenditures, excluding the entitlements and interest, the Congress has made sizable cuts over the last 10 years. It is far lower, as a share of GNP, than it has been since probably the 1960s. So this wasteful spending myths are just plain wrong. It is the entitlements and interests that are the major problems.

That is another reason for dealing with the problem as soon as possible, because it keeps feeding upon itself through the interest buildup. The longer we wait—we learned that in the 1980s—the bigger the problem becomes, and then it becomes almost unmanageable and impossible to put in place any policy action to deal with it.

On your point about the Federal Reserve, it gets back to the deficit. Even though in recent months the Fed's tightening, and the way they conducted their tightening, by creating a lot of unnecessary uncertainty in the markets, in my opinion, did contribute to the increase in long-term interest rates. The truth of the matter, in my opinion, is that the Fed has lost sizable control over long-term interest rates. Increasingly, they are determined by government borrowing requirements, by whether or not the Japanese and the Germans and other foreigners are willing to purchase our government securities, and in fact during most of the last seven or eight years, the Fed has been the follower. They have followed long-term interest rates rather than lead the way.

I think the strongest argument, or one of the strongest arguments, for long-term, meaningful, convincing, real deficit reduction is that there is a better way to bring long-term rates down over a long period of time rather than relying on the Fed to do it. Because if the markets think that the deficits are too high; if federal demand for credit is too high; if they are worried that it is going to create inflation; if the Japanese don't want to invest in the United States, that will do more to push up long-term interest rates than what the Fed does.

MR. TURE. But if the Fed is waging a battle on the beaches somewhere against inflation, even if inflation isn't on the horizon, isn't it true that the rest of the market is going to see the monetary policies——

MR. CHIMERINE. I agree. I think the Fed was premature. I think the way they went about it without telling the markets what they meant by neutral monetary policy, and how far they were going to go, built in an unnecessary additional premium in long-term rates. But long-term interest rates began to rise before the Fed tightened, and likely would have risen anyway.

Clearly, the Fed made it worse. If the markets knew that you were going to cut these budget deficits by $200 or $300 billion, in my judgment, you would see a sizable decline in long-term interest rates, regardless of what the Fed does.

MR. GALBRAITH. I would like very much to agree with Larry, but I think that we have had a very strong test of his proposition in the last budget deficit reduction exercise, which was an exercise coming to some $500 billion over the next five years. It was accompanied with clear projections that long-term interest rates would fall. I think the lesson that we can draw from the last three months is that unless the Fed is actively cooperating with policies of the Congress in bringing about deficit reduction, it is simply not necessarily the case that the deficit actions will determine the path of long-term interest rates.

Quite the contrary; we see that they are now very much higher than they were expected to be only last January, only last February, in fact. I have done a very simple calculation in Figure 3 of my testimony, just putting in the extra interest cost that is implied in the amount of interest rate increases that have already occurred, and you find that it does in fact tend to push up the debt to GDP ratio. So, if you adopt even the moderate goal of just stabilizing that ratio, you find it becoming dramatically harder to do with higher interest rates than with lower interest rates.

On your final point, Senator, your comment about the equivalence of the interest rate increase and a tax is one, which I must say, I hear with a good deal of pain, because like many millions of Americans, I have an adjustable rate mortgage, and the effect of that on me this year is already very substantially much, much greater than the effect of the income tax increases that were enacted last year.

SENATOR DORGAN. That is the reason I asked the question.

MR. GALBRAITH. A very substantial tax.

SENATOR DORGAN. The difference is, one was public policymaking in the light of day, with full debate and the American people participating in the process. The other was made behind closed doors. I almost think we ought to have a bill that renames the Open Market Committee, which is intentionally closed. Why would you call a closed committee an open committee? That goes to the Fed reform bill that I have. I can't express how disgusted I am with the Fed policy at this time. I think is wrongheaded and is going to injure this country.

MR. TURE. Senator Dorgan, before you leave this point, may I address it?

SENATOR DORGAN. Only if I like what I hear. You and I have disagreed from time to time in the past. I would be happy to hear what you have to say.

MR. TURE. they are always very challenging sessions.

SENATOR DORGAN. Absolutely. Thank you very much.

MR. TURE. I want to point out that I disagree with much of the assessment of interest rates and Fed policy that I have heard in the last few minutes. We do not believe, and we have tried to explain at great length for a very long period of time, that interest rates are a function of deficits, either the magnitude of the deficits or the change in the direction of the deficits. It seems to me that the evidence is so overwhelmingly in support of my thesis that I don't know how it gets challenged.

We do not believe that interest rates are a function of the level of gross domestic product or of projected changes in the level of the gross domestic product. I don't believe that interest rates are exogenously determined by the say so or the wave of the hand of the Fed, which is not to say that the actions of the Federal Reserve may not have some influence on expectations of people who participate in financial markets, virtually all of us, about what is coming down, which in turn may have a significant effect on interest rates that we insist on in contracts.

I agree with you, maybe not for the same reasons, that the Fed's actions beginning in February were, to put it kindly, inept. What the Fed did was to announce to the world at large that there is inflation at a higher rate than at present in the future for us, and the way in which we are going to counter this serious inflationary threat is by raising the target for the federal funds rate by a quarter of a point.

If you are a rational person in the financial market, you look at that and say, I guess they are right; they know something that we don't know about the future of the price level, and they aren't going to do a bloody thing to stop it, in which case you are going to adjust your contracts as quickly as you can, and people did just that.

SENATOR DORGAN. Mr. Chairman, if I could just make two other observations very briefly. One, Senator Bennett made the point about borrowing and debt and he is absolutely correct, but every corporation has a substantial amount of debt in this country. It is what it is for that matters. If we spent $500 billion more than we did this year and cured cancer, it was worth it. It didn't both me a bit that we didn't have the money; it was the best investment we ever made. We are incorporating operating budget deficits year after year that are dangerous. These are not investments so much as they are borrowing to operate our budget and our country.

The second point is the debate that we just had about the $26 billion in additional budget cuts over five years.

This goes to Senator Bennett's point that there is some notion that there are a bunch of squirrelly people down in the engine room of the ship changing all the knobs and dials and levers and they get the engine purring just right.

We don't have the foggiest idea how most of this acts on the economy because there is no model that predicts what happens with an economy that has a $4.5 trillion debt. There is no modeling out there. That is all uncharted waters. We are trying to make some educated guesses traveling in an areas that we have never traveled in before.

But my point is this: $26 billion budget cuts in five years with a $6 trillion economy, which is probably $35 trillion or $40 trillion in production in five years, and we have people with advanced degrees who credibly argue that that amount is going to injure the economy.

What kind of nonsense is that? I think we ought to start thinking in a more sober way when we evaluate what this going to do to the economy—$26 billion in additional budget cuts in five years is like spitting in a tornado. It isn't going to show up in any blip in any area of this economy. It is going to be hard for us to figure out where you do it, but nobody can credibly make the case that that has an impact on any sort of macroeconomic analysis.

MR. TURE. I want to point out, Senator Dorgan, that you and I can agree. You are entirely correct.

SENATOR BENNETT. You may want to change your views. It is hard to sell to our constituents, but the fact is, $26 billion over 5 years is budget dust and you can save it or affect it just as much on the kind of paper you choose to print the budget on over that period of time.

SENATOR DORGAN. That is why I made the point about the Federal Reserve Board. We have sat here and have had great angst about $26 billion in five years, and the Fed comes along and imposes what is, in effect, a tax burden on Mr. Galbraith's adjustable rate mortgage, many times in excess of anything anybody would talk about around here, with respect to tax policy.

SENATOR BENNETT. My only comment there is that that is why I got a fixed rate mortgage.

REPRESENTATIVE HAMILTON. I think the reason I wanted to have this hearing was to focus on the question of how much further we should cut the budget deficit, and it is kind of interesting, isn't it, that we had the budget deficit reduction effort in 1990 and you had one in 1993, but nobody is talking about a budget deficit reduction effort up here now. That is, we are not going to a summit to cut the deficit.

So it appears as if the push, or the priority, we put on deficit reduction for many years has suddenly lost its steam, lost its force, and as I have listened to you this morning, I am going to try and summarize your views a little bit, and that is always a dangerous thing to do, but let me take a crack at it.

Mr. Chimerine, you were saying, I think, that you think deficit reduction now is still very, very important. And you make some specific suggestions as to how that is to be done, both cuts and some tax increases, as I remember. But you clearly put a priority on getting the deficit down further.

MR. CHIMERINE. Over the long term.

REPRESENTATIVE HAMILTON. Over the long term.

Mr. Galbraith, if I heard you correctly, I thought you expressed some considerable skepticism about further deficit reduction.

MR. GALBRAITH. That is correct.

REPRESENTATIVE HAMILTON. You used the interesting phrase, which I haven't heard before—expenditure switching, which was your focus on the priority question. But you have lots of doubts about whether or not we should focus on deficit reduction now and made some interesting comments with respect to monetary policy.

Dr. Ture, you too thought deficits should come down. As I understood your testimony, you put a lot of emphasis on cutting spending, and you don't like the idea at all of any kind of tax increase anywhere.

So two out of three of you, anyway, think that we ought to move these deficits down. I still want to get a statement from you—I know Mr. Galbraith's position, I think—of the urgency of that. Should the President ease up on deficit reduction at this point? Where do you put this in the scheme of things? You have a lot of priorities kicking around here.

MR. CHIMERINE. Yes, If you exclude the political aspect of it and focus on the merits of the issue, I would make it a high priority and I would do it in a way that does not necessarily cut the deficit dramatically this year or next year. But, as I said earlier, enact now, or as soon as possible, a phased-in deficit reduction for the long haul. That way you don't jeopardize the economic recovery that is in place, but seems to be fading right now. But you still need to address the problem long term. That is what I would do and I would try do so at the same time that we deal with some other issues—the expenditure switching or priority issue that Jamie raised.

REPRESENTATIVE HAMILTON. In the immediate term, let's think about the budget deficit that we are working on now—we are voting on appropriation bills now. How big a factor should deficit reduction be in our mind at this time for 1995?

MR. CHIMERINE. Probably small. I would like to see $10 or $15 or $20 billion taken out of the current expected deficit for 1995, but what I would like to see is a package of actions put in place that are phased in over time. For example—I am not necessarily advocating this—but suppose one of the elements of a long-term deficit reduction package would be an increase in the gasoline tax. I don't see any reason why we can't enact now, if our objective is to raise it by 25 cents or 50 cents in 10 years, enact now a program that will raise it 5 cents for the next 10 years in order to get to the target.

What I am saying is, I agree with Jamie in one respect. I would not allow too much of the actual deficit reduction to kick in in the short term. It would have to be phased in gradually over the long term. But I would enact as much of that now as possible.

REPRESENTATIVE HAMILTON. Mr. Galbraith, you wouldn't worry much about deficit reduction, if you were voting on the 1995 appropriation bills?

MR. GALBRAITH. I would think the difference between doing $10 or $15 billion and doing less than that, doing nothing relative to the plan is very small.

REPRESENTATIVE HAMILTON. That is really spitting into the tornado.

MR. GALBRAITH. As far as long-term deficit reduction is concerned, I certainly agree that that is an approach that can work when you are faced with an imperative need to deal with the deficit, and it is something that I think should be revisited in future years. I would not place it in the way of, say, health-care reform this year.

And I would also urge that if such a future tax increase is enacted, there has to be some payoff on the long-term interest rate, or it is not worth doing.

REPRESENTATIVE HAMILTON. So you have to have an accommodative monetary——

MR. GALBRAITH. Long-term action in the long end of the debt markets, yes.

REPRESENTATIVE HAMILTON. Mr. Ture, how do you look at this deficit reduction?

MR. TURE. I quite agree with Senator Dorgan. I'm sorry the Senator left before I had a chance to agree with him explicitly again.

I agree with him that it is not the $26 billion, or whatever the dollar amount is of that magnitude, that is the relevant consideration. I think the concern that you expressed, that maybe we will forget about deficit reduction, is an extraordinarily appropriate concern, and I think it would be tragic if in fact we were to forget about it.

Not because, to repeat, of the numbers that are involved. I think that is a secondary consideration, at best. I think we must continue to give an extremely high priority to deficit reduction. I think what validates trying to do something as small as $26 billion, by way of additional deficit reduction now, is not the dollar amount, to repeat, it is that it would reflect a change in stance.

I think the position that policymakers, those who have responsibility for the budget and for fiscal policy generally, that the appropriate stance that they should have is the sort that I tried to suggest in my remarks about the political concerns of the deficit reduction. I certainly will not impose on you to repeat them. It isn't the numbers that are relevant at this junction, because if we properly understand what we are about, it seems to me that we will set ourselves a different path in delineating the goals and the methods for conducting budget policy, and I would fervently hope that we could get cracking on that.

REPRESENTATIVE HAMILTON. Let me ask you how you look at the deficit. You have a lot of theories out here about the deficit, it seems to me. There is one group of people who say that the budget ought to be balanced all the time, except maybe during a war or something of that sort. It is really the theory of the balanced budget amendment, as I understood it.

You have a theory out here that your fiscal policy should be used for countercyclical purposes, and you have the idea that the federal debt should be stabilized as a percent of GDP to prevent any further growth of the burden of the deficit. You have the idea that the Federal Government should finance capital outlays with debt and require future users to pay similar costs. I am citing ideas about the deficit.

How do you look at the deficit and how should we use it in terms of public policy; that is really the question?

MR. GALBRAITH. I think the fact that you are able to cite half a dozen different and wildly conflicting rules that have been advanced for this indicates the depth of our uncertainly about each of those rules, and it is a good reason in itself for being extremely cautious about adopting one of them, any one of them, particularly if it means very, very sharp policy changes.

I guess, my own general view is that if the economy is functioning well below its capacity, budget deficits are going to be unavoidable and are probably a good thing, because in the short run, they help restore economic activity in those circumstances.

When the economy is close to a normal operating level, then, in my view, the Federal Government probably should follow the prudent rule of financing operating expenses out of taxes and reserving debt for capital expenses. To be able to do that in a coherent way, you would need to be able to move to a capital budget——

REPRESENTATIVE HAMILTON. Which you favor?

MR. GALBRAITH. Which I certainly favor, yes.

MR. CHIMERINE. Quickly, you are right, there are no ironclad rules and no guidelines that can clarify the situation. It seems to me, though, that two of the things we should give more weight to are, one, the full employment surplus or deficit, and a reasonable target is to try and keep the full employment surplus or deficit as close to zero as we can. If the economy is underperforming, we will run an actual deficit, but current CBO projections and other projections show a still very large full employment deficit out in the future, and that is disturbing.

Second, in the long term, I think it is important that we start bringing down the federal debt to GDP ratio. This economy performed best in the 1950s and 1960s when that ratio was declining. A shorter intermediate term objective would be to stabilize it, but long term, I would like to see that come down, and that would also require sizable additional deficit reductions.

I want to make just one other quick point. When I talked earlier about taking $10 or $15 or $20 billion out of 1995, I think you are right, it wouldn't be missed in the short term very much. But the reason I feel so strongly about it is, if our long-term objective is to reduce the deficit by $200 billion a year, the way not to go about it is to wait until the year before and then enact a $200 billion program. The way to do it is take $15 or $20 billion incrementally out of each year and it will accumulate. That is why I suggested the program that I did.

MR. TURE. I have to tell you, Mr. Chairman, I have a feeling of deja vu all over again, because so many of the issues and indeed statements that have come up this morning, I recall from my time on the staff of the Joint Economic Committee, far more years ago than I care to talk about. The full employment budget surplus or balance, for example, is really an ancient idea. I was never able to get any mileage out of it. I still don't, and I don't recommend that that is a guide for conduct of fiscal and budget policy.

Let me make one observation about the notion that fiscal budget policy should be sued for short-run stabilization purposes. This will not be my statement. I will paraphrase what the Joint Economic Committee observed in its Annual Report in both 1979 and 1980—it is and has been mistaken for policy to be focused on the short run; that the focus of policy should shift to the long run. Fine-tuning of economic outcomes by the use of budget and/or monetary devices should be eschewed; that instead, what the Congress and the Executive Branch policymakers should focus on is what are appropriate long-term goals for our society; what is the structure of public policy that best will get us there. People who are very prominent in the current Administration were among the principal authors of that. I wasn't with the Committee at that time, but I certainly applauded the production of those reports. I thought they were great.

REPRESENTATIVE HAMILTON. The bells have rung and we had better conclude the hearing. I want to return to Congressman Saxton for the remaining minutes that we have.

REPRESENTATIVE SAXTON. Mr. Ture and Mr. Chimerine, you made a point that I think is very valid, and that is, how do we do this over the long term? That is a real question for me, and I think for a lot of people around here, because we may agree on what ought to be done in the long term, but then the political process carries that out.

I am reminded of this same subject, deficit reduction, during the 1980s, when we came up with a scheme called Gramm-Rudman. In 1986, we had total outlays of $990 billion in a period of time when we increased outlays by $50 or $60 billion a year. Between 1990, when we had a total outlay of $990 billion, and 1987, when we had total outlays of only $1.3 billion more, we saw Gramm-Rudman begin to do what those who advocated it said it should do. And then it pinched us and we repealed it, and the next year outlays grew by $53 billion again.

My question is, if we come up with a scheme that we collectively agree on and that will work over a decade or so in order to put us where we need to be at the end of the decade, then how do we put it in place and have reasonable expectations that it is going to be unchanged and will work?

MR. TURE. Senator Domenici was speaker at our Morning Meeting this morning. His last observation to the group was to the effect that this Congress cannot tie the hands of a future Congress. It is so obvious a truism that it doesn't really bear discussion.

REPRESENTATIVE SAXTON. The Constitution can bind.

MR. TURE. That is true, subject to the fact that constitutional provisions, when it is convenient, can be very flexibly interpreted.

There is something to be said in favor of the balanced budget amendment. My principal concern about it is that people perceive it to be the be-all and end-all solution for our fiscal budgetary problems. I think it is a step, not necessarily even the most important step,to take. But you raise a very basic question: Is there anything that can be put place today that will have a binding effect for generations?

I am skeptical. I would love to see somebody discover that bright line that I alluded to and have that bright line embraced by policymakers in both the Executive and Legislative branches. Would you bet on that?

MR. CHIMERINE. I don't have a simply answer, Congressman, but I will say this, and I think I said this earlier, there has to be some escape clause or some out, so to speak. For example, if the economy goes into a deep recession and $25 billion of additional deficit reduction is scheduled for the next year, I think most people would agree that it should be delayed. The same is true if a war or another emergency develops. The problem is, if you dilute it too much and make it too easy to override, it will have a no credibility in the first place and you won't get the benefits in the financial markets. Where you draw that line is a matter of judgment, leadership and honesty in budgeting, and there is no simple answer or simple way to do it. I think it is a matter of how each of the Members responds to the situation and the seriousness with which they approach this problem.

REPRESENTATIVE SAXTON. One final question, Mr. Chairman. I notice from a table in front of me that last year—and this goes to the heart of why you thoughtfully called us together today—last year, we spent $210 billion to pay interest on the national debt, and this goes to the question of whether budget deficits matter, and it is a very illustrative point that, I think, I am going to point out. If the deficit figures for the end of this year are correct, we will borrow in the neighborhood of $120 to $200 billion, and we are going to pay $210 billion on the national debt, which means our entire deficit, our entire borrowing, will be spent on interest for the first time in the history of our country. That seems to matter a lot to me.

MR. CHIMERINE. I agree.

MR. TURE. To be discussed on another occasion.

REPRESENTATIVE HAMILTON. I got through about one and a half of 10 pages of questions here, so we will have to come back at it some other day. Thank you very much, gentlemen. We are glad to have you. We stand adjourned.

[Whereupon, at 12:10 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

WRITTEN OPENING STATEMENT OF REPRESENTATIVE RAMSTAD

Mr. Chairman, thank you very much for calling this hearing to discuss the impact of deficit reduction on economic growth.

While I share my colleagues' commitment to strong economic growth, I am astounded by the suggestion that reducing the federal deficit by lowering federal spending threatens economic growth!

In fact, by reducing federal spending we end up with more funds for the productive private sector to keep and allocate in the most efficient manner possible.

Lower federal spending means individuals, families and businesses will ultimately pay less in taxes, which leaves them with additional resources to save, invest and spend.

Mr. Chairman, the one situation where deficit reduction does threaten economic growth is when Congress and the President ignore history and raise taxes. While federal spending cuts waste from a bloated system, tax increases rob productive individuals of the ability to spend, save and invest efficiently.

Raising taxes simply shifts money from a productive to an unproductive segment of our economy. This causes a loss in productivity and stifles natural economic growth. As the rate of economic growth slows, the tax revenues that accompany economic growth slow.

Mr. Chairman, thank you again for holding this hearing. I look forward to exploring these issues with our distinguished panel.

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine. I am Managing Director and Chief Economist of the Economic Strategy Institute. I appreciate the opportunity to testify before the Joint Economic Committee on the advisability of additional actions to reduce the budget deficit.

In sum, my views are as follows:

a. While the Clinton administration economic and budget program enacted last year has dramatically improved the deficit outlook, future deficits will still be unacceptably high without further policy actions. In particular, while the deficit is now falling, most projections suggest that it will start rising again in approximately two years, and will continue to rise substantially into the next decade.

b. Deficits do matter. In particular, cutting the deficit is the only reliable way to increase our anemic national saving rate in order to provide for higher investment in the long term—this is necessary to increase productivity, improve our international competitiveness, and to create a rising standard of living for most of our citizens. Cutting the deficit will also bring down real interest rates and reduce our dependence on foreign capital, both of which are also desirable in the long term.

c. There is no simple rule to guide future deficit reduction. My own view is that a multi-year deficit reduction program should be enacted as soon as possible to reduce the projected deficit in ten years by at least one-half, but to allow for delays of part or all of the policy actions if economic growth in any year is below a specified minimum level. This will avoid excessive fiscal drag at a time when the economy may already be weak, but at the same time will generate confidence in financial markets that significant future deficit reduction will occur in order to get the maximum impact on long term interest rates as soon as possible.

d. Future deficit reduction should be based on reasonable economic assumptions, should be guided by basic principles of fairness, and should be consistent with our need to increase both public and private investment. In my judgment, the critical element will be meaningful entitlement reform which slows the growth in the health and pension entitlement programs. It is also likely that additional tax increases will be necessary --I strongly favor broadening the tax base and/or enacting consumption taxes rather than increases in marginal tax rates.

e. I am strongly against enactment of a balanced budget amendment—I think it would result in budget gimmickry, and in the long run could very well make the deficit outlook even worse.

<u>The Evolution of the Deficit Problem</u>

Many still believe that the enormous deficits of the last fourteen years have been the result of overspending by Congress. However, today's massive deficits, as well as those during the 1980s, were directly attributable to the misguided economic policies that were implemented in the early 1980s under the banner of supply-side economics. Multi-hundred billion dollar deficits for as far as the eye can see were predictable at that time because:

1. The mythical spending cuts that would supposedly result from the elimination of waste, fraud, and abuse were enormously exaggerated from day one.
2. The incentive effects of supply-side tax cuts were inconsistent with most empirical evidence, and thus were enormously overstated.

3. Thus, not only did the big military spending increases and large tax cuts put massive pressure on the deficit, but the anticipated spending offsets, and the added revenues from economic growth, could never and did never materialize.
4. Furthermore, the explosion in health care costs and other entitlements have pushed the cost of those programs far beyond earlier expectations.
5. The problem was worsened by the use of extremely optimistic (and usually inconsistent) economic assumptions, understatement of program costs, budgetary gimmicks, etc. which enabled the Reagan administration to consistently present budgets that were projected to be in balance, when in truth there was virtually no possibility of that occurring.
6. Finally, the problem began to feed on itself. The inaccurate projections created an attitude of indifference and neglect which prevented any real solution to the deficit problem, thereby causing the national debt to skyrocket so that interest on the debt began to grow at an enormous rate.

The Current Deficit Outlook

The Clinton Administration and Congress enacted the most significant deficit reduction package in 1993 since the problem developed. The combination of spending cuts and tax increases enacted last year will reduce total deficits in the 1994-1998 period by almost $500 billion and will also reduce the level of the deficit each year beyond that time. Furthermore, unlike previous attempts to reduce the deficit, this is real deficit reduction—it was based on realistic economic assumptions and estimated impacts of the specific policy actions, so that the actual reduction in the future will closely match the estimates provided at the time the budget plan was implemented.

Unfortunately, however, the deficit outlook is still poor. While the deficit in the next two fiscal years will be about half of the near $350 billion annual level experienced in the early 1990s, in great part because of the new deficit package, as well as because of the economic recovery and lower than expected interest rates, virtually all projections indicate that the deficit will begin to rise again by fiscal 1997, and will continue to rise at a substantial rate into the next century. For example, the Congressional Budget Office is now projecting that the deficit will rise to almost $400 billion in the year 2004, from the approximately $180 billion projected for fiscal years 1995 and 1996. These projections imply increases in the deficit to GDP ratio, and in the national debt to GDP ratio. In great part, this reflects the bottoming out of defense spending near the end of this decade, as well as continued increases in the cost of the entitlements. Furthermore, this horrendous deficit outlook is in reality even worse because it includes sizable surpluses from the social Security trust fund—when these trust fund surpluses begin to be paid out in benefits early in the next century, the unified deficit is likely to skyrocket unless steps are taken to reverse current trends.

Cutting the Deficit Is Important

This outcome is unacceptable. It should now be clear that these enormous deficits do matter. They have already begun to slowly suck the vitality out of the U.S. economy by squeezing out productive investment, keeping real interest rates extraordinarily high, increasing our dependence on foreign capital, reducing the effectiveness of fiscal policy as a stabilization tool, and by creating pressures on those Federal programs that are needed to help build our economy for the future. In my view, the urgency to reduce the deficit is even greater now than it was in previous years , for the following reasons:

1. Personal savings have declined since the 1980s, despite the supply-side incentives, thus reducing the supply of domestic savings.

2. The flow of capital from Japan, Germany, and other parts of the world, which helped fund our deficits in the 1980s when we were the world's major capital importer, has slowed down dramatically. This is resulting from the fact that many of those countries are no longer generating surpluses at the same degree as they were previously, and because other parts of the world have become large capital importers as well.

3. A consensus is finally developing that the most critical need in the United States is to improve our productivity and competitiveness—we can no longer grow, as we did in the 1980s, by building empty office buildings and patriot missiles, and by leveraging the system, while long-term growth factors are deteriorating. It is clear that reversing the weak trend of productivity and improving our international competitiveness will require substantial increases in investment, including modernizing our capital stock, investing in education and job training, and rebuilding our infrastructure. High real long-term interest rates, largely caused by massive deficits at a time of lower domestic savings and a reduced inflow of foreign capital, will discourage some of our needed investment.

In effect, it is essential that we create invest-led growth in the United States in order to begin to build for the future. But to do that, the federal deficit must be gradually reduced in order to free up more of our savings to finance private investment, and to reduce real long-term interest rates. Furthermore, it is essential that government priorities be changed at the same time that deficits are reduced—clearly, more federal spending is needed for rebuilding the existing infrastructure and developing the infrastructure of the future, improving the quality of education, funding more non-defense research and development, and for other such programs that will both directly improve U.S. productivity, and help begin to rebuild the U.S. economy. The challenge of course is how to do both—across the board spending cuts, or any other method that does not result in the necessary change in priorities, will not be sufficient if our objective is to get the U.S. economy on the right course for the future.

Some are now taking the position that additional deficit reduction is not needed because the economy already appears to be back on a healthy growth track. However, the recent upturn in the economy has followed nearly five years of slow growth and stagnation, during which relatively few new jobs were created, and during which real incomes for most Americans were at best stagnant. Second, the recent upturn to a great extent reflects the large pent-up demand for consumer durables and business equipment—replacement of many of these goods has in great part been financed by the purchasing power and cash flow that has been freed up by debt refinancing in response to declines in long term interest rates. However, with the recent rise in interest rates, with the dramatic falloff in refinancing, and with some of the pent-up demand already satisfied, it is unlikely that current growth rates will be maintained—in fact, there are already signs that the economy is slowing.

What is most important is that there is little or no evidence that our long term economic prospects have improved. In fact, the following signs are far from favorable:

- The virtual elimination of U.S. advantages in productivity in a growing number of industries (we've actually fallen behind in many).

- The shrinking technological leadership that once characterized the U.S. economy.
- Still massive trade deficits.
- The dismantling of many important companies and industries.
- A distribution of income which is becoming more unequal.
- An increase in resources devoted to essentially non-productive uses.
- Our net investment rate is half of Japan's and below that of many other major foreign competitors.
- Our national saving rate is at a record low level, despite the so-called supply-side savings incentives.
- Non-defense R & D has fallen below the rates in Japan and Germany.
- Declining SAT scores and other measures show that the quality of education at the elementary and secondary school levels continues to deteriorate, falling further below our major competitors.
- Our infrastructure continues to decay, reflecting the neglect of the 1980s and early 90s.
- No systematized effort is underway to improve job training and provide the needed skills for the 1990s.
- Real wages remain stagnant.

How to Cut the deficit

While additional long term deficit reduction is thus essential, this must be balanced with two other objectives. First, it is important that we do not further undermine the use of fiscal policy as a stabilization tool. In particular, it would be counterproductive to cut the deficit so quickly that we would dramatically weaken the economy when it is already operating below full employment. Second, we need to reduce future deficits in a manner that would not make it more difficult for us to deal with our other critical budget problem, mainly reorienting our priorities away from consumption and more toward public investment and other expenditures that are needed to support long term economic growth.

I suggest the following approach:

1. Unfortunately, there is no precise rule of thumb or model simulation which can give us the optimum path for future deficit reduction. In my view, an appropriate objective would be to cut the near $400 billion dollar deficit now projected by CBO for 2004 in half—this would suggest that over the next 10 years the nominal deficit would be roughly flat, implying a gradual decline in the deficit in real terms, in the deficit as a share of GDP, and even more importantly, in the debt to GDP ratio. Such a target would imply putting in place approximately $15-20 billion dollars per year of budget restraint for each year over the ten-year period—in my judgment, with the safeguards I will list below, I think this is doable and will not create too much fiscal drag on the economy.
2. Spending cuts should be the top priority. In view of the large cuts in non- defense discretionary programs in the 1980s, and given the need to increase spending in some of these areas, it is unlikely that huge savings will be realized from this sector of the budget. Thus, spending cuts must come from additional reductions in military spending, from

an effective health care cost control program, and from slowing the enormous growth in the entitlements, especially the pension and health programs. I would suggest that the concept of entitlements is no longer something that this country can afford. All of the so-called entitlement programs must be slowly converted to means testing, either by scaling back benefits for upper income and high wealth individuals and/or by increasing taxes on those benefits. We should reduce (not eliminate) benefits for those who could do with less—households and individuals with modest means should be spared. Furthermore, consideration should be given to further extending the retirement age for full benefits. Scaling back of health and pension benefits should not apply only to entitlement programs—public employees are now receiving extremely generous benefits which are no longer affordable. Finally, I would suggest that any reductions in social security benefits partly be earmarked for investments to build for our future, especially for education and other programs which benefit primarily younger people. In effect, we would be reducing benefits for the elderly to be used to make a better life for their children and grandchildren.

3. Deficit reduction must be fair. In particular, it is now well documented that most of the benefit of the tax cuts of the 1980s went to those in the upper income groups—in the meantime, large social security tax increases and budget cuts have significantly reduced after-tax incomes for many low and middle income families. This has only been partly reversed in the 1993 budget package. Thus, it is important that deficit reduction be structured in a way that the impact is greatest on those who can afford it. Many will make the argument that increases in taxes on upper income individuals will create huge disincentives for savings and investment and thus would be counterproductive—however, as we learned in the 1980s, these arguments are exaggerated. Furthermore, the economy can not function effectively when a large and increasing share of purchasing power and wealth is concentrated in relatively few hands—this holds down demand and thus will prevent long-term growth.

4. The arithmetic is very clear—even with the phasing-in of entitlement reform and some additional cuts in defense and non-defense discretionary programs, some tax increases will be needed in order to reduce deficits to acceptable levels. The assertion that the problem is not on the revenue side because tax revenues have actually increased as a result of the tax cuts of the early 1980s is inaccurate. Both personal and corporate income tax collections as a share of income and profits, respectively, are below where they were a decade ago—total tax revenues are roughly at the same ratio of GDP as they were prior to the enactment of the supply-side program primarily because of the big increase in Social Security taxes enacted in the mid-1980s, and because of other tax increases enacted along the way.

   In my view, increased revenues should come first from eliminating counterproductive tax expenditures (incentives, exemptions, etc.) now in place, and then secondly, if more revenues are needed, from increasing taxes in a progressive manner on activities that we want to consume less of. Thus, broadening the tax base and consumption taxes should be considered before across the board tax increases. In the former category, some candidates are the following:

- eliminating or scaling back the interest deduction on mergers and acquisitions

- scaling back the deduction for corporate advertising expenses and/or for corporate entertainment.

- a lower limit on the mortgage interest deduction than is now in place

- taxation of a portion of corporate health care insurance premiums (this may also be helpful in controlling health care costs)

5. Most importantly, I believe that to the extent possible, a multi-year program designed to bring about the amount of deficit reduction described above should be adopted as soon as possible. This would be desirable for several reasons. First, it would avoid having to go through the torturous process on an annual basis—the medicine can all be taken at once. Second, and more importantly, one way to reduce the effect of fiscal drag on economic growth is to bring interest rates down as quickly as possible, especially long term rates—this can be best accomplished if the markets believe that a credible program to reduce future deficits is in place. While easier Federal Reserve policy can also help, the Federal Reserve has lost most of its control over long term interest rates. Convincing the markets that the federal demand for credit will be dramatically reduced in the future will be a more effective way to bring down long term interest rates than an easier monetary policy.

6. It is possible to design a multi-year deficit reduction program that can allow some flexibility to deal with emergencies and recessions. This will prevent fiscal policy from worsening economic downturns. If these exceptions are truly limited, they are not likely to undermine the credibility of the long term program. I suggest that the deficit reduction program be accompanied with an "escape clause" in the form of a minimum level of GDP or employment growth, or a threshold unemployment rate, beneath which future installments of deficit reduction will be delayed or scaled back in order not to create an even weaker economic environment. This is particularly important since the current level of economic activity is so low that the economy is likely to be underutilized for many years.

<u>A Balanced Budget Amendment is Not the Answer</u>.

Despite the urgency of reducing future budget deficits, I am strongly opposed to the enactment of a balanced budget amendment In my judgment, it is simply another gimmick like those that have been implemented in the last six or seven years, beginning with Gramm-Rudman, which have had very little, if any, impact. It will not only be an ineffective tool in dealing with the problem, but in my view is simply a way to attempt to avoid what will be difficult choices, and place the blame for any unpopular spending cuts or tax increases on a mechanical formula rather than on Presidential or Congressional decisions. In brief, my concerns, are as follows:

1. Which budget is to be balanced? Is it the structural budget deficit, the unified budget deficit, the on-budget deficit, etc.? Should government investment be included or excluded? Answers to these and similar questions are not intuitively obvious.

2. It is likely to encourage even more use of optimistic forecasts, program underestimation, moving programs off-budget, and other similar techniques in order to avoid the tough decisions that will be needed to be made to actually balance the budget. Thus, the balanced budget amendment has the potential of making the budget process even more

flawed than it was in the 1980s. We are also likely to see the adoption of more gimmicks that produce short-term revenue gains at the expense of revenue loss beyond the balanced budget period, which will simply make the long-term problem even worse.

3. There are times when a balanced budget may be undesirable. These may include periods of recession or slow growth, wartime periods, or situations when domestic emergencies might exist. In my view, it will be difficult to plan for all these contingencies in a balanced budget amendment, and any effort to offset these factors will be harmful to the economy. Furthermore, its goal of reaching a balanced budget in a relatively short period of time may create too much fiscal drag too rapidly.
4. In my view, it will probably make it more difficult for us to deal with our other critical budget problem, namely reorienting our priorities, because the tendency will be to look for the easiest ways of cutting the deficit, rather than those that are best for the economy.
5. What if, in fact, a balanced budget isn't achieved because the economic assumptions turned out to be incorrect, even if they were reasonable in the first place? How do we make adjustments for it? Who gets penalized? These are also difficult issues that would have to be covered.

PREPARED STATEMENT OF JAMES K. GALBRAITH

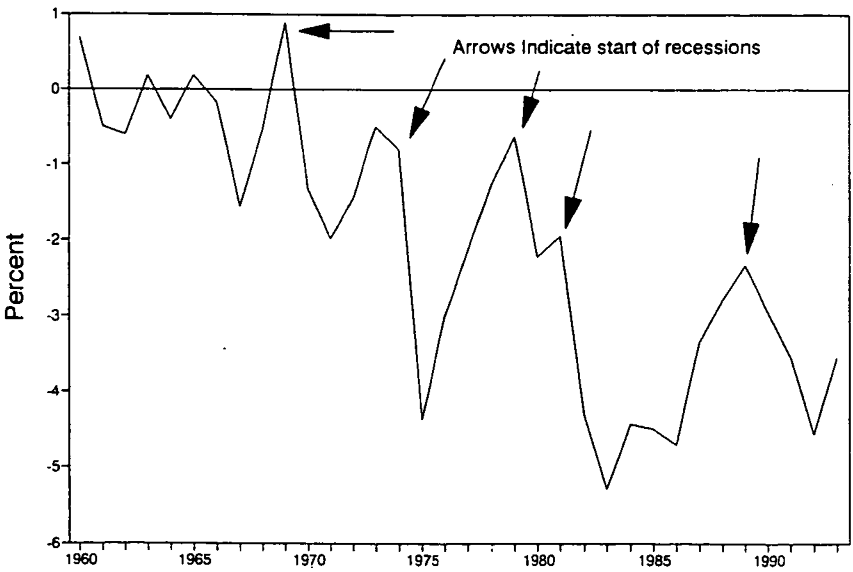
Chairman Hamilton, Members of the Committee, it is my particular pleasure today to return to the Joint Economic Committee.

You have asked this panel to look at the future of fiscal policy, and to consider what policy should govern the deficit. This is an important and also a vexing question. Important—because deficit reduction is for many the single critical indicator of the success or failure of fiscal policy. And vexing—because the policy of deficit reduction, with a view toward eventual budget balance, bears no definite or stable relation to the economic goals of full employment, reasonable price stability, sustainable growth, or higher rates of investment and productivity growth.

Deficit Reduction and the Economy in Theory

It is easily shown that the deficit depends on economic performance. My Figure One illustrates, using the ratio of the deficit to GDP. The arrows indicate the start of each postwar recession. The figure shows that, in every case, a falling economy generates a large increase in the deficit. And a rising economy produces, in every case, a fall in the deficit, even though in the 1980s this improvement never came close to restoring budget balance.

Figure 1
Ratio of Deficit to GDP



But to show that economic performance depends on the deficit, that a policy of cutting deficits *per se* is always or even generally a good thing, is much harder. Indeed there is no simple way to show this. Instead, this is something that we believe, if we believe it, as the result of a training in economics.

The Congressional Budget Office has provided a succinct summary of established belief on this topic:

> ... reducing the budget deficit continues to be an important focus of attention because it will increase national saving. In fact, reducing the deficit is the most reliable way to improve national saving. Over the long run, a permanently higher rate of saving would stimulate new investment, increase productive capacity, lower real interest rates, and raise the nation's standard of living. (CBO, *Reducing the Deficit: Spending and Revenue Options*, March 1994, pp 1-2).

Yes, but is this true?

Mr. Chairman, I will argue this morning that there are very great, and unresolved, weaknesses in the theory and evidence on which a policy of unremitting deficit reduction is based.

Let me take up each part of the CBO's statement.

1. "...reducing the deficit is the most reliable way to increase national saving." This is true, up to a point. The CBO and other economists define "national saving" as the sum of private saving and the government surplus. Any cut in the budget deficit therefore raises national saving, so long as it falls at least in part on private consumption and is not drawn, dollar for dollar, from private saving. But there is a hidden assumption here: that national and personal income are held approximately constant. Cutting deficits must not reduce personal income (through the multiplier), since that would reduce private savings and offset the gains in national saving from deficit reduction. CBO estimates that about 30 percent of deficit reduction is typically offset by reductions in private saving; this low estimate assumes that lower interest rates neutralize the effect of deficit reduction on personal income.

2. "Over the long run, a permanently higher rate of saving would stimulate new investment [and] increase productive capacity..." This statement explains why cutting deficits is supposed to be a good thing. But it is carefully hedged in two ways: it restricts itself to the effects "over the long run" of a "permanently" higher rate of saving. It does not promise that raising saving in the short or medium run, *for example by cutting the deficit as Congress did in 1993*, will produce higher rates of investment. On this point, more in a minute.

3. "...lower real interest rates..." As the Federal Reserve proved in the weeks from February 4 through May 17, there is also no necessary link between cutting deficits and lowering interest rates. Congress cut the deficit sharply last year, on the expectation that stable low interest rates would result. The Federal Reserve has shown that the real power in this matter rests with the central bank, which evidently is not concerned about the interest-rate expectations of budget-cutters in the Congress.

4. "...and raise the nation's standard of living." Of course, a rise in our standard of living depends on productivity growth. But the truth is that despite much effort we economists do not understand productivity growth well enough to offer policies to raise it. We do not know why measured productivity growth rates slowed in the 1970s and 1980s, and we do not know what steps are required to raise them again. A general association across countries between higher rates of investment and high measured rates of productivity growth seems to exist. But this does not tell us that raising rates of national saving ex ante here at home will produce higher rates of investment *ex post*, nor that higher rates of investment, if achieved, will actually raise measured productivity growth. There are cases—the former Soviet Union is the most extreme—where forced-draft investment policies led in the end to economic ruin. It is also possible that with technological changes over the cast several decades, especially in computers and information technology, we may actually need *less*

private investment, and therefore less saving, to achieve a given increase in living standards than was true in the past. Given these imponderables, honesty dictates a frank confession of ignorance. We simply do not know.

The Effects of OBRA-93

The Congressional Budget Office is itself ambivalent about the actual effects of deficit reduction. A good example occurs in the September 1993 publication, *The Economic and Budget Outlook: An Update.*

In September of 1993 Congress had just enacted President Clinton's massive five-year deficit reduction program. But there had been few if any other changes in the economic outlook between September and the preceding March. Thus, the CBO's mid-year update provided an unusual opportunity to evaluate the effects of a large, multi-year deficit reduction program taken almost in isolation from other policy and external changes.

CBO's September report begins on an upbeat note, celebrating the legislative achievement of the previous month:

> In early August, the Congress passed and the President signed the Omnibus Budget Reconciliation Act of 1993—a major package of tax increases and spending reductions. Enactment of this legislation has significantly brightened the budgetary outlook for the next several years.

CBO then notes that in the short term, the effect of deficit deduction is to "dampen" economic activity, although, to some extent, reductions in long-term interest rates may offset the dampening effect. Over the long run, however, CBO's outlook is positive, because "reducing the deficit increases national saving and spurs economic growth in the long run".

With this in mind, let us turn to CBO's numerical estimates of the effect on real Gross Domestic Product (GDP) of the omnibus deficit reduction act. These are reproduced in Table One below.

Table One

CBO Medium Term Economic Projections
September 1993

(Billions of 1987 Dollars)

Real GDP	1994	1995	1996	1997	1998
After OBRA	5190	5330	5476	5620	5755
Before OBRA	5204	5354	5497	5628	5740
Difference	-14	-24	-23	-8	+15

Two facts about these numbers are especially striking. First the difference between them is quite small: CBO sees a net change of only $54 billion 1987 dollars in real GDP, spread out over 5 years, as a result of OBRA93. Second, *the predicted movement is in the wrong direction*. Net declines in real GDP of $69 billion in the first four years outweigh a net gain of only $15 billion in the fifth year. And this fifth-year net gain is so small, and so remote, that it would be well within the forecast error of any econometric model looking one year ahead, let alone five. CBO also sees virtually no effect of OBRA93 on unemployment or inflation, and makes no quantitative claims about the effect of deficit reduction on savings, investment and productivity growth. Indeed, in a special box on rising productivity growth in September's study (p. 20), CBO declines to make any link to budget actions, arguing instead that "the recent increases in productivity growth are likely to be temporary."

Thus, CBO was telling Congress, in September of 1993, that Congress was, by reducing the deficit, buying nothing that could reliably be measured. All economic benefits, to the extent that they existed at all, were over the forecasting horizon, more than five years into the future. And there was a measurable cost, of $54 billion dollars in the first five years.

The above may be qualified in one respect. CBO did project one immediate economic benefit from deficit reduction: lower interest rates. CBO's September 1993 before-and-after OBRA93 projections for interest rates are given in Table Two. CBO foresaw a mild rise in short-term interest rates in any event, but cut that forecast by twenty or thirty basis points after OBRA93 was enacted. And it reduced its projections for the 10 year note by a full half a percentage point, projecting that OBRA93 could yield a stable long bond at 6.1 percent in every year of the forecast horizon.

Table Two
CBO Medium Term Projections for Interest Rates

	1994	1995	1996	1997	1998
3-Month T-Bill					
September 1993:					
Before OBRA	3.7	4.4	4.7	4.8	4.9
After OBRA	3.6	4.1	4.5	4.6	4.6
January. 1994	3.5	4.3	4.6	4.6	4.7
Memo: 5/19/9	4.19				
10-Yr T-Note					
September 1993:					
Before OBRA	6.6	6.6	6.5	6.5	6.4
After OBRA	6.1	6.1	6.1	6.1	6.1
January 1994	5.8	6.0	6.1	6.2	6.2
Memo: 5/19/94	6.94				

We now know how far wrong CBO's interest rate forecasts were. The T-Bill rate has already jumped to levels not anticipated until 1995. And the ten-year rate, far from falling, has already soared nearly a point above the five-year forecast.

Did CBO mis-specify the effects of deficit reduction on the economy and the credit markets? Of course, not. What it did was to ignore the independent effect of a radical change in Federal Reserve policy, which it could not in any event have anticipated, and which took place on February 4 of this year. Put simply, the Federal Reserve wrecked the scenario.

There is a lesson in this. It is that estimates of the effect of deficit reduction on interest rates are strictly meaningless, unless they are accompanied by an explicit and firm commitment by the Federal Reserve to validate them through the conduct of monetary policy. In this case, no such commitment existed. And while the Federal Reserve's leadership undoubtedly encouraged the belief that deficit reduction would produce lower interest rates, they have now made clear that they do not plan to behave as though chat encouragement placed them under any ethical obligation to keep interest rates low.

The Federal Reserve's action raises the most serious questions about the viability of future policies aimed at deficit reduction. What confidence can Congress now have, that such policies will be permitted to have any positive effect on interest rates and hence any beneficial effect on economic performance? Put another way, if the case for deficit reduction does not rest on the promise of lower interest rates, then on what premises does it rest?

The Administration's Program and Federal Reserve Actions

In this connection, it is painful to review the excellent 1994 *Economic Report of the President*, with its careful documentation of the extent to which our economic recovery so far has relied on lower interest rates, and the extent to which the Administration expected it to continue to do so. For example, on page 34 we read:

> ... the medicine of low interest rates now seems to be taking hold. ... If we divide GDP into its interest- sensitive components (business-fixed investment, housing, and consumer durables) and everything else, the data tell a fascinating story. While the three interest-sensitive pieces typically account for about 30 percent of GDP, in 1993 they accounted for virtually all of GDP growth.

On page 35, we find:

> Long-term nominal and real interest rates dropped sharply in 1993. The decline in rates was closely linked to the proposal and enactment of the Administration's budget.

And on page 36:

> ... some people worry that deficit reduction might retard growth in the short run by siphoning off aggregate demand. Such a concern is justified. Deficit reduction *by itself* certainly does tend to contract the economy. After all, raising taxes and cutting government spending reduce the demand for goods and services. But deficit reduction *accompanied by sufficient declines in long-term interest rates* need not be contractionary.

As of February 4, the date of transmittal of the *President's Report*, the Council could still end this analysis on an optimistic note:

> Analysis by the Council of Economic Advisers suggests that the declines in long term interest rates that have occurred since the 1992 election, even after the backup in late 1993, are more than enough to offset the contractionary effects of this decrease in the structural deficit [due to OBRA93 over the period 1993- 1995].

But now, three months later, the long term interest rate is higher in both nominal and real terms (inflation being actually lower) than it was at the time of the election in 1992. And by CBO's own estimate, each full percentage point increase in interest rates will add up to about $30 billion per year, over time, to the deficit itself. Indeed, taking the average rise in interest rates across the yield spectrum so far at about one percent and using the table found at p. 76 in the January 1994 CBO *Economic and Budget Outlook*, we find that the Federal Reserve has already added over $100 billion to the cumulative 1994-1998 budget deficit, wiping out one-fifth of the progress made in OBRA93 last year.

Mr. Chairman, well may one ask: who's in charge here? The President and Congress, who last year enacted over $500 billion in deficit reductions, on the explicit, widespread, and highly articulated assumption that further declines in interest rates would follow? Or the Federal Reserve, meeting in secrecy and unable to give a coherent account of or explanation for its contrary actions? And if the latter, then what point remains in pursuing policies of deficit reduction, whose intended effects are so easily negated in this arbitrary and capricious way?

A Guideline for Deficits and Debt

Let me return to the heart of the questions you posed, Mr. Chairman, in your letter of invitation to this hearing. What should policy on the deficit be?

Having now already expressed my opinion that one cannot expect miracles of saving, investment or productivity growth from deficit reduction, I have an answer in two parts to this question.

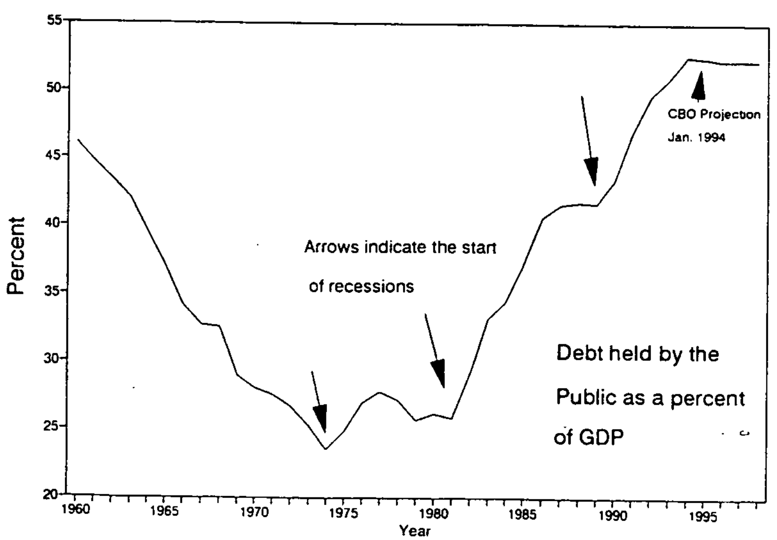
First, Congress and the Administration should manage the budget to meet public purposes, while preserving the good credit of the United States. This can be done at those deficit levels that were projected, as of January 1994, to be the result of last year's deficit reductions, *provided the economy remains stable.*

It is certainly not true that "anything goes." It is possible, and has happened in history many times, that nations spend themselves and borrow themselves into oblivion. From Louis XIV to Ronald Reagan, nations have experienced rulers who did not appreciate the need for fiscal discipline.

Is the United States in such a fiscal crisis now? The evidence shows that we are not. Congress as early as 1982 began to repair the excesses of President Reagan's first year. President Bush, to his credit, pressed for deficit reduction in 1990, and accepted higher taxes to that end. And President Clinton, together with Congress, worked mightily last year to place the epoch of ever-rising deficits behind us.

The result is shown in my Figure Two, which displays the public debt in relation to the carrying capacity of the economy, measured by GDP. The figure shows that the rise in the debt ratio was already arrested once, in 1988-1990, at a level around 43 percent, only to be unhinged at the end of the decade by the effects of recession. But now, the corner has once again truly been turned, and the debt ratio is expected—or was, as of January—to stabilize and even to decline through the end of the present decade, unless of course a new recession destabilizes it once again. Truly, to evoke the name of a great Republican leader, it is time to invoke the George Aiken solution, namely to declare victory and get out.

Figure 2
Ratio of Debt to GDP



Mr. Chairman, the Administration has rightly stated, in the *Economic Report of the President*, that the prime object of policy today is not deficit reduction but *expenditure switching* (p. 36). The right policy is to choose a mix of public and private investments, income redistributions, and human welfare and services programs that best meets the actual needs of our present and future population. This is a complex task—but we live in a complex world. Policy today is rightly focused on the complex tasks of expenditure switching, and in particular on effecting a smooth transition from unneeded military to needed civilian investments, and of course on the unfinished work of health care reform.

Suppose then that we adopt a simple rule of thumb for the budget, consistent with the basic objectives that public purposes be met and the good credit of the United States be preserved. Let this rule be: hold the ratio of public debt (in the hands of the public) at or below the present level of about 52 percent. This may not be the best of all possible rules. But in our ignorance of the world and in the disorder of our economics it has two important virtues: (1) it will certainly preserve the good credit of the United States, and (2) it does not impose draconian tax increases or cuts in social security, national defense and public investment that are not otherwise called for on the merits of those decisions.

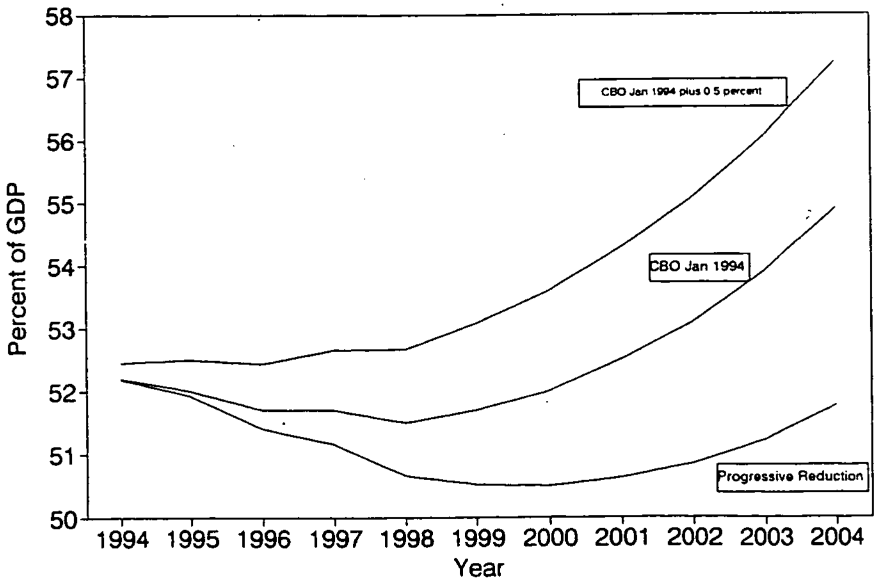
Having accepted this rule, let us inquire whether substantial policy changes are required to achieve it.

The answer is that they are, but in only one area in the short and medium run, and that area is, once again, *monetary policy*.

My Figure Three illustrates the extraordinary sensitivity of the debt-to-GDP ratio to the projected level of interest rates. The middle line presents the CBO estimate of this ratio through 2004, as of January 1994, under the interest rate assumptions that seemed reasonable then. You can see the slight decline achieved by OBRA93, followed by an increasing ratio after 1998, when domestic spending caps expire, under the additional assumption that health care costs are not controlled through the enactment of health care reform.

Figure 3

Debt/GDP with Different Interest Paths



The upper curve provides an approximate calculation of the present situation, following the interest rate moves of the past three months. I base this calculation on the conservative assumptions that they will add 0.5 percent to the average interest cost facing the federal government, and that they will have no other effects on the budget or economy. As you see, the debt/GDP ratio no longer falls even in the short run, and starts to accelerate toward historic heights in 1998. Under this scenario and the criterion outlined above, it is not too much to say that Congress faces a budgetary crisis by the end of the decade.

The lower curve, finally, shows the effect of a progressive bunt very slow reduction in average interest costs, of 0.125 percentage points per year—one full percentage point over 8 years, leading to an overall reduction in average effective net interest costs from the present 5.8 percent to 4.6 percent by 2004. That kind of reduction might have been a reasonable result of the actions Congress took last year. The figure shows that under this assumption the debt/GDP ratio continues to fall until the year 2000, and thereafter does not rise even to present levels before the estimating period expires in 2004.

The conclusion is that while some further fiscal actions to reduce the deficit may be needed some day, no such action is needed now. And none need be needed for almost a decade—provided that monetary policy cooperates with the fiscal steps Congress has already taken.

<u>Congress and the Federal Reserve: The need for action</u>

The *second* part of my answer is therefore that Congress and the Administration should now conduct budget policy with an understanding of the imperative need to link deficit reduction to the conduct of monetary policy and the decline of interest rates.

Congress has the power to change Federal Reserve policy if it chooses. The Federal Reserve is *not*, under the constitution, a fourth branch of government. It is an agency created under the Constitutional provision that *Congress* has the power to "coin money and regulate the value thereof." It is, in the term of art, *a creature of Congress*.

Congress has delegated the administration of monetary policy to the Federal Reserve. But Congress can set policy for the Federal Reserve if it chooses to do so. It has done so, for example, by writing the general objectives of "maximum employment, production and purchasing power" into the 1946 Employment Act and "full employment" alongside "reasonable price stability" into the 1978 Humphrey-Hawkins Full Employment and Balanced Growth Act.

Congress can of course order a change in Federal Reserve policy by passing a law. To do that now, however, might set an unpleasant precedent, because it would involve the President directly in FRB policymaking, and effectively bring an end to the independence of the Federal Reserve from the executive branch. It also seems a draconian step to remedy a short-term problem of policy incoherence.

There is an alternative to passing a law, albeit less constitutionally clear-cut. This is for Congress to place a directive on monetary policy into a concurrent resolution. Concurrent resolutions, such as the annual budget resolution, do not require the President's signature. They therefore lack the force of law. But they are acknowledged—in repeated past (reluctant) testimony to Congress itself by past Chairmen of the Federal Reserve Board—to be binding in principle on the Federal Reserve. A concurrent resolution would be binding in practice partly because the FRB is a creature of Congress, and partly because, should the FRB defy a congressional policy directive, Congress retains the power to invoke the more serious sanction of public law.

Congress has in fact taken this step twice in recent history. In 1975, in House Concurrent Resolution 133, Congress directed the FRB to conduct policy "so as to lower long-term interest rates." And in a continuing resolution at the end of 1982, Congress ordered that monetary policy "achieve and maintain a level of interest rates low enough to generate significant economic growth and thereby reduce the current intolerable level of unemployment."

Forty-four members of Congress have written Chairman Greenspan on April 28, 1994, asking that interest rates be raised no further. With the help of their colleagues, they have the power to make this a mandatory policy if they choose. For example, Congress could send the Federal Reserve a gradual rollback order, covering the next six months or a year, by placing an instruction to that effect in a concurrent resolution.

Such intervention is strong medicine, suitable only for serious illness and short-term use. The previous two cases, 1975 and 1982, differed importantly from the present. The patient (the economy) was sicker, and the treatment was exceptionally cautious. Did the Federal Reserve obey? Policy was consistent with the directive in both cases, but we do not know, in fact, whether the language in either H. Con. Res. 133 or the 1982 continuing resolution wrought any changes relative to what policy would otherwise have been. We do not know what would happen now, if the Congress were to vote a rollback order and the Federal Reserve chose to defy it.

For this reason, Congress should not take the step of giving direction to monetary policy lightly. It should offer the Federal Reserve a full opportunity to prevent that step from being taken. This could be done, were the Federal Reserve to present a convincing and credible basis for the policy actions of the past three months, based on a full release to Congress and the public of all studies and verbatim minutes of all official discussions leading up to the policy change. This Committee could well take on the assignment of providing such a review, and of determining, on behalf of Congress, whether a convincing and credible basis for the policy change existed. Or, if the Federal Reserve prefers to avoid such a public post-mortem, the right result could equally be achieved by the independent, public adoption of a rollback policy by the Federal Open Market Committee.

Conclusion

Mr. Chairman, had I longer to prepare and longer to speak, I could have taken up several additional issues.

- I have not argued for the use of a more expansionary budget to raise the rate of economic growth. I favored such a policy in the spring of 1993 when President Clinton proposed it, but believe it is neither necessary nor achievable today.

- I have not presented the case here for a capital budget. I think such an exercise, by dividing the budget into capital and current outlays, would help educate the public as to the benefits of public investment projects, and would help to deflect unconstructive pressures to cut proposed public investments from the budget. Such investments are, in my view, the most desperately needed new initiatives of the government sector. However, we should not allow these accounting issues and political preferences to divert our attention from the fundamental economic questions of deficits, debt and interest rates.

- I have not discussed the balanced budget amendment. Suffice to say that this dangerous proposition has no serious economic rationale, and Congress was right to reject it again this past year as it has in the past. There is no earthly reason why the Federal Government of the United States should become the only major government on earth to forego the issuance of net new debt. By the same token, those who argue for a "gradual approach" toward a balanced budget should not be seen as "moderates" in this discussion. Rather, the burden should be on them to show why their radical goal should be preferred to present policy, taking into account the large tax increases and expenditure cuts they would impose to achieve it. Truly, we ought to acknowledge that the goal of a balanced budget cannot be achieved at all. The depressing effects of tax increases and spending cuts on output, employment and therefore revenues would overwhelm their direct effects on the budget (witness my Figures One and Two), and as we have seen we cannot rely on the Federal Reserve to reduce interest rates by enough to stabilize the economy in the face of sharp deficit reduction.

I have therefore focused my remarks on what I believe is today the central budget policy issue facing the Congress. This is the relationship between budget policy and credit policy, between deficits and interest rates.

My objective in raising this issue, Mr. Chairman, is not to specify *how* the Congress should enter into some new contract with the Federal Reserve. It is rather to underline that the implicit contract of last year's deficit reduction, which was not honored by the Federal Reserve, can no longer be accepted as an adequate basis for coordination between monetary and fiscal policy. It is to emphasize that under the Constitution, the final authority in these matters rests with Congress. And it is to urge that the Congress, perhaps under the leadership of this Committee, enter actively into a search for new ways to assure that the pain of deficit reductions already undertaken, let alone those that might be considered in the future, is rewarded by the benefits of stable and lower interest rates.

Thank you very much for the opportunity to testify today.

PREPARED STATEMENT OF NORMAN B. TURE

The Joint Economic Committee is to be commended for holding this hearing concerning the considerations that should govern deficit reduction efforts. Attention to the magnitude and direction of change in the federal budget deficit appears to have waned in recent months, in part, I am sure, because of the more immediate interest in health care reform and other important domestic policy initiatives, as well as events and developments abroad. In some part, as well, the seeming decline in concern in the public policy forum and the media about the deficit may be attributable to OMB and CBO projections of decreases in the deficit over the next few years. This waning of attention is unfortunate, because the occasion for concern, I believe, is not primarily by how many hundreds of billions of dollars government budget outlays exceed budget receipts nor whether that amount is estimated to increase or decrease over the next four or five years. Much more fundamental political and economic issues of public policy are involved.

The economic issues are encompassed by the questions the Committee has posed to the witnesses. The political issues concern the effects of acceptance of budget deficits on public policy makers' decisions concerning the volume and composition of government activity; in turn, this involves fundamental issues concerning the responsibilities properly assumed by government in a free society. With the Committee's indulgence, I want to address my observations to the latter issues after responding to the specific questions addressed to the witnesses in the letter of invitation.

Economic Concerns

The stated purpose of this hearing is to examine how much further the budget deficit can be reduced without harming the economy. The implied concern is that deficit reduction *per se* may have adverse economic effects or that there is some amount of deficit reduction, undertaken in some stipulated period of time, that would harm the economy.

The idea of "too much" or "too fast" deficit reduction is an artifact of the Keynesian model of the interaction between the fisc and aggregate levels of economic performance. It relies on a presumption that government budget results and changes therein have so-called first order income effects, that is, directly affect disposable income, hence aggregate demand, which in turn determines levels of employment, output, and income.

In the Keynesian context, government spending is perceived to add to disposable income, hence to increase the economy's aggregate demand for products and services, while taxes are deemed to reduce disposable income, thereby reducing consumption and aggregate demand. These changes in aggregate demand are identified as the principal determinants, in the short run, of the volume of total output, hence the amount of employment and of total income. Deficit reduction necessarily implies either an increase in taxes, a reduction in government spending, or some combination of the two that must have the effect of reducing aggregate demand, hence reducing or curbing the increase in total output, income, and employment.

In this model, the perceived danger is that there is some additional amount of deficit reduction that might overwhelm the economy's current expansionary thrust. I believe that concern is warranted only if the deficit reduction is sought by increasing taxes, in which case virtually any amount of deficit reduction would pose some threat to the economy's effective performance.

In its early formulations and public policy applications, the Keynesian analysis was little concerned with questions concerning the growth of the economy's production capability. The influence of public policies, including tax and spending policies, on the conditions of supply were given little attention. Public policies were deemed to have little influence on the conditions of supply of labor services; saving was generally perceived as a leakage from aggregate demand, hence as exerting a contractionary influence on economic activity. In more recent years, however, the importance of saving and capital formation and of other nonconsumption uses of income and production capacity as determinants of the level and slope of the economy's growth path has been universally recognized. At the same time, it has been recognized that government budget deficits preempt saving, hence impede economic growth. The Keynesian model, therefore, creates a tension between short-term economic stabilization objectives, which appear often to dictate budget deficits, and long-term growth objectives, which call for minimizing budget deficits' preemption of saving.

I infer that this is the context of the Committee's concern about how much more the deficit can be safely reduced.

This tension between growth and stabilization objectives is not generated in the neoclassical framework of analysis. In the neoclassical analysis, the first-order effects of fiscal variables are identified in terms of their impact on the relatives prices and relative costs confronting private sector decision makers. Fiscal aggregates *per se* do not determine levels of real aggregate demand, output, employment, and income in the short run. The effects of taxes and government spending are derived instead from their influences on the relative prices and costs confronting household and business decision makers. These influences affect the conditions of supply of labor services and the allocation of income between consumption and saving and other uses; changes in factor supply conditions result in changes in output, hence in income, hence in aggregate demand for products and services.

In this framework, government spending, instead of adding to disposable income, tends to raise the costs of production inputs to households and businesses, reducing the amount of these inputs in private uses. Thus, increases in government spending tend to displace, not add to, private sector employment, output, and income; indeed, except in those cases in which government uses of production inputs are more productive than the displaced private uses, total output, employment, and income are reduced by government spending. Increases in government spending, whether or not they increase budget deficits (or reduce budget surpluses) exert a contractionary, not an expansionary, influence on the economy.

In the same vein, taxes raise the cost of the taxed activity relative to other costs, tending to reduce the amount of such activity that is undertaken by households or businesses. Income taxes of the present configuration, as well as payroll taxes, raise the cost of market-directed uses of one's time, energy, and resources, relative to so-called "leisure" uses. Income taxes also increase the cost of saving relative to current consumption uses of income. Insofar as market-directed effort or saving decreases in response to tax-induced increases in their relative costs, output and income must also fall.

In this neoclassical model, the near-term effects of deficit reduction depend on the manner, not the amount, of deficit reduction. Reducing government outlays, or curbing their growth, will tend to have a stimulative effect on levels of economic activity. Most tax increases, on the other hand, will exert a depressing influence on production, employment, and income.

It is a matter of national income accounting arithmetic that government borrowing to finance budget deficits takes up saving, reducing its availability for private sector, growth-generating uses. By releasing saving for growth-generating uses, cutting government spending to reduce the budget deficit will contribute to achieving a higher long-run growth path for the economy. Most tax increases enacted to achieve deficit reduction, on the other hand, will exert a depressing incentive effect on growth-generating activities that may well outweigh the favorable effects of whatever cutback in government borrowing is achieved.[1]

It must be acknowledged that government spending reductions may have disruptive effects in the short run. These spending cuts, by their very nature, release production resources from government uses or change the opportunity costs of their alternative private sector uses. Reallocation of production inputs ordinarily is not costless, but merely averting those reallocation costs is not sufficient reason to forgo spending and deficit reduction opportunities. Moreover, the frictions of reallocation will be less the more efficiently the market mechanism operates; market efficiency generally is enhanced by reducing government claims on production capability.

What should determine deficit reduction goals?

The principal economic consideration that should determine deficit reduction goals is the extent to which the nation is prepared to accept lower levels of output than would otherwise be attainable in the future in order to undertake more government activities in the present. Government borrowing to pay for the difference between outlays and receipts necessarily preempts saving by households and businesses that would otherwise be used to add to the stock of tangible and intangible capital. Such saving and capital additions reflect savers' willingness to forgo current consumption in favor of greater production capability, hence higher levels of income in the future than would otherwise be available. If the government spending financed by borrowing is to be justified, it must afford gains that exceed its opportunity cost—the forgone additions to the society's income-generating capacity.[2]

Government finances should not be permitted to exert a preemptive claim on the saving that households and businesses undertake. When government

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[1] For a fuller and more detailed discussion of the neoclassical analysis and its implications for fiscal and budget policies, see Norman B. Ture, "The Economic Effects of Tax Changes: A Neoclassical Analysis," in Joint Economic Committee, *Special Study on Economic Change, Volume 4, Stagflation: The Causes, Effects, and Solutions*, Joint Committee Print, December 17, 1980, pages 316-347. Also see, Norman B. Ture, "Supply Side Analysis and Public Policy," in *Essays in Supply Side Economics*, David G. Raboy, Ed., Washington, D.C., The Institute for Research on the Economics of Taxation, 1982, pages 8-28.

[2] Indeed, all government activity, irrespective of how it is financed, should be required to meet this test. All government spending either preempts some of the society's production capability or directs the private sector's uses of some of that capability. For this reason, all government spending entails distortion of the results of the market's operations. If one believes that in the absence of such distortions the market system tends to perform efficiently, any government spending should be required to meet the test that the benefits it will provide at least equal the cost it will impose in terms of market impairment. This test is difficult to administer, in practice, and it is often difficult to determine the test results.

There are, to be sure, those who believe that markets operate imperfectly and that government intervention is needed to overcome these imperfections. This is not the venue in which to argue the point. Instead, I invite attention to a study by Dr. Roy E. Cordato, *Social Costs, Public Policy, and Freedom of Choice*, Fiscal Issues No. 7, Washington, D.C., 1992, Institute for Research on the Economics of Taxation, for a rigorous discussion of the enormous limitations on government's ability to improve on market outcomes.

borrows, it finances the deficit at the cost of lowering the economy's growth path through time, compared to the level it would otherwise attain. Government deficits, particularly if they are more than transitory, represent public policy makers' willingness, perhaps unwitting, to sacrifice higher living standards in the future for whatever gains are sought by government spending in the near term. One should not categorically assert that there can never be circumstances in which such a trade-off would afford a net gain for society, but history encourages a healthy skepticism on this score.

Should deficit reduction goals depend on the kind of budget changes made to lower the deficit?

Insofar as releasing government's hold on the nation's saving is the principal objective, deficit reduction should be pursued solely by curtailing government spending. Deficit reduction achieved by reducing outlays is almost certain to release saving from government uses. Unless it can be shown that the government's uses of that saving would afford greater additions to the society's well being than would the private sector's uses, there is a clear cut gain to the economy from deficit reduction produced by curtailing government spending.

On the other hand, deficit reduction achieved by tax increases is likely to have seriously adverse effects on the economy, both in the short run and certainly in the long run. Reducing the deficit by increasing taxes will have little if any effect in raising the national saving rate because the tax increase, particularly if it takes the form most often used, will reduce household and/or business saving by at least as much as the deficit is reduced, hence by at least as much as the government's borrowing of the private sector's saving. Tax increases, moreover, are almost certain to intensify the distortions of market-generated price and cost relationships, hence result in less efficient uses of the nation's production resources.

Do further deficit reduction actions need to be tailored by monetary policy, foreign economic conditions, or other circumstances that influence the overall strength of the economy?

In terms of economic policy considerations, appropriate deficit reduction efforts should not constrained by monetary policy or economic conditions abroad. The basic constraint on fiscal and budget policies should be to minimize the impediments that government activity erects to the efficient functioning of the market system. Deficit reduction efforts, if successful, will free up household and business saving for growth-generating uses and will moderate the distortionary influences of government spending. Such efforts, therefore, impose no obligations on monetary policy which should aim at stabilizing the price level, not at determining the level of aggregate economic activity.

The view that monetary policy should be somehow calibrated to changes in budgetary policy or anticipated budgetary outcomes derives from the notion that deficit reduction exerts a contractionary influence on the level of economic activity; the companion notion is that an expansionary monetary policy can offset any unduly contractionary impetus generated by deficit reduction. This is readily recognized as the fiscal-monetary policy mix thesis that was formally presented to the Fiscal Policy Subcommittee of the Joint Economic Committee in 1955.[3]

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[3] See Paul A. Samuelson, "New Look in Tax and Fiscal Policy," in *Federal Tax Policy for Economic Growth and Stability*, Joint Committee on the Economic Report, Joint Committee Print, November 1955, pages 229-234.

The historical record as well as rigorous analysis rejects the thesis. The influence of monetary policy on real output is difficult to discern, and where seemingly evident, appears to be opposite to that suggested by labels such as "expansionary" or "contractionary." Expansionary monetary policy leads to a heightening of inflation expectations, reflected in higher market interest rates and bond yields, which, if anything, exert contractionary pressures on real economic activity. A contractionary monetary policy, on the other hand, casts up deflationary or disinflationary expectations, resulting in lower market interest rates.

More to the point is that attempting to adjust monetary policy to expected changes in budgetary outcomes generates uncertainty in the financial markets about the longer-term course of monetary developments. Efforts to hedge against this uncertainty impose costs and impair efficient functioning of the financial markets in valuing alternative uses of saving and assuring its efficient allocation among these alternatives. These considerations urge that monetary policy should be geared to stabilization of the price level, not to fine tuning the short-term economic outcomes deemed, often mistakenly, to result from deficit reduction.

The fact that economic activity in the United States takes place in a global economy should urge public policy makers to emphasize budgetary policies that will minimize the obstacles to effective competition by American businesses in the world market place. Reducing government's claims on business and household saving by curbing spending will also decrease the upward pressures on business costs that virtually all government spending exerts.

The difficulties afflicting many nations' economies are perceived by some policy makers as calling for U.S. economic aid in the form of government-to-government grants or loans. The track record for this form of assistance is so bad that one wonders why it is not rejected outright as a waste of our resources and as creating additional barriers to those nations' ability to solve their economic problems. What is called for instead is infusion of private business ventures and private investment to provide new and superior production capacity and real employment opportunities. Much of that kind of economic assistance must come from other nations, including the United States. Providing that assistance doesn't call for abatement of appropriate efforts to reduce government budget deficits.

<u>Are there "speed limits" on the amount of deficit reduction that can be undertaken safely in any one year?</u>

The "speed limit," if there is any such, is imposed by the reluctance to incur the costs of resource reallocation that may be imposed by reducing government spending. As urged earlier, these costs are not likely to be substantial or persistent, particularly if the spending reductions permit the market system to work more efficiently. On the other hand, if deficit reduction is sought by tax increases, the damage done in terms of forgone growth and efficiency gains will indeed be greater the more substantial and speedier is the deficit reduction.

There are, of course, practical road blocks that would slow efforts to achieve appropriate deficit reduction. The impediments to spending cuts are particularly severe in the case of certain entitlement or mandatory spending programs that have developed substantial dependent constituencies. Here, too, the gains to be realized from cutting these programs or curbing their growth should not be ignored merely because significant adjustment costs will be incurred.

So far as economic effects are at issue, the Committee should have little concern that additional deficit reduction may have significant adverse effects on the economy. The danger arises if deficit reduction is sought by tax increases. Indeed, looking not too far into the future, the proper prescription for budget policy may be significant spending reductions accompanied by appropriately designed, i.e., growth-generating, tax reductions.

Political Concerns

I respectfully suggest that the Committee also focus its concern on the political aspects of the deficit problem—on the effects of budget deficits on the size, scope, and quality of government activities and spending.

Generally overlooked in discussions of budget deficits is that borrowing to finance them hides the cost of government activity from the public. The consequences is just what one might expect—more government activity than would be undertaken if the body politic were more acutely aware of how much must be paid for that activity. Tolerating budget deficits, accordingly, implicitly underwrites an expanding public sector.

This government expansion thrust, moreover, is substantially uninhibited by the kind of economizing constraint that households and businesses in the private sector confront continuously. Private sector spending is constrained by the value product, hence the incomes, that people can produce. One can expand one's current spending only by increasing one's income, thereby forgoing leisure uses of one's time and energy, or by forgoing some of one's future spending power—by saving and investing less of one's current income. To be sure, one may borrow to finance increases in current outlays, but only if one can satisfy the lender that the debt will be fully serviced, either by curtailing future spending out of a given level of income or by increasing one's future income.

The lack of any comparable economizing constraint on government spending exacerbates the problem arising from the apparent lack of a bright line to inform public policy makers about what government should and should not do. The growth of the public sector in large part reflects the erosion of any clear consensus that there are some types of activities that should be reserved solely for people in their private capacities to undertake. The scope of government has expanded along with its magnitude. At the same time, and for the same reasons, the quality of government activity appears to have deteriorated through time.

These developments don't represent the preferences of the body politic as a whole or even a majority of it. There are few if any among us who know the content of even a handful of government programs and spending objects. When we vote, we can't endorse or reject specific government activities, most of which we do not know, or the full set of those activities.

As a consequence, policy makers' constituents exert little pressure on them to develop some effective economizing formula for making hard choices among activities. On the contrary, constituents pressure policy makers for government activities or policies that will afford them the economic rewards they can't seem to obtain in the market place. To repeat, nothing inhibits the policy maker from responding affirmatively to these pressures, other than the policy maker's own distaste that is often overcome by the desire to continue in office.

Finding that bright line that would, if obeyed, more closely confine government activities appears to be an extremely difficult task. What is needed, perhaps, is some set of rules that would at least roughly simulate the bright line's effects.

To that end, I suggest that a basic operating rule should be to tie government spending very tightly to government revenues. The collateral requirement is that revenues be raised from taxes that (1) have the broadest possible reach in the population of real people, and (2) are highly visible to those who pay them. In combination, this would establish a much closer nexus than now exists between public policy makers and their constituents. By the same token, spending decisions would be more effectively limited by people's willingness to pay the bill.

Along with an effective constraint on budget deficits there is also needed some budget-making process reform that would intensify pressure for more efficient determination of spending priorities. Balanced budget amendments address the requirement for banning deficits, but they do not preclude untoward expansion of government over time. Also needed is reform of the tax system to increase tax visibility and to assure that most of the population pays at least some tax and is acutely aware of doing so. In addition, simplification of the budget-making process and adoption of statutory rules that would make spending authorizations binding on actual outlays are called for. The Cox-Stenholm and Lott-Shelby Budget Process Reform Act (H.R. 2929 and S. 1955, respectively) would be a major step forward in this regard.

Without changes of the sort suggested above, without some way of simulating the application of the bright-line constraint on decisions about government activity and spending, there is not much prospect for effectively curbing the growth of government over the long run. By the same token, there is not much likelihood that budget deficits will be averted or even reduced over the long run. The adverse economic consequences of these fiscal developments for the economy's growth potential urge the attention by the Congress to the issues the Committee has sought to illuminate in these hearings.

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