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THE 1994 ECONOMIC REPORT OF THE PRESIDENT: THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JANUARY 31, 1994

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THE 1994 ECONOMIC REPORT OF THE PRESIDENT: THE ECONOMIC OUTLOOK

MONDAY, JANUARY 31, 1994

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

The Committee met, pursuant to notice, at 10:30 a.m., in room 2172, Rayburn House Office Building, Honorable David R. Obey (Chairman of the Committee) presiding.

Present: Representatives Obey, Saxton and Cox; and Senators Sarbanes, Robb and Bennett.

Also present: Richard McGahey, Executive Director; William Buechner, Glen Rosselli, Caleb Marshall, Chris Frenze, Larry Hunter and Ed Hudgins, professional staff members.

REPRESENTATIVE OBEY. Good morning. On behalf of the Joint Economic Committee, I would like to welcome our witness this morning, the Chairman of the Board of Governors of the Federal Reserve, Alan Greenspan.

Before we begin, I want to thank Chairman Greenspan for agreeing to testify today. He has to leave to catch an airplane at 1:00 in order to attend a meeting of the Bank for International Settlements in Switzerland. We will do our best to get you out of here by that time. I will dispense with an opening statement and make whatever comments I have in the question period so that we can get right to your testimony.

Mr. Armey, do you or your designee have a brief statement?

REPRESENTATIVE ARMEY. Let me also welcome you, Mr. Greenspan. We are anxious to hear from you.

REPRESENTATIVE OBEY. Please proceed, Mr. Chairman.

STATEMENT OF THE HONORABLE ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

MR. GREENSPAN. Mr. Chairman, just let me make a minor correction in my destination. I am off to London, not to the Bank for International Settlements. I am fearful that your announcement may create an expectation on their part, and they will wonder what happened to me when I don't show up.

REPRESENTATIVE OBEY. Sorry.

MR. GREENSPAN. In any event, Mr. Chairman, I want to thank you and the Members of the Committee for the invitation to appear before you.

As you know, the Federal Reserve will be meeting later this week and will submit its Semiannual Report on Monetary Policy to the Congress in late February. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation and for monetary policy in 1994.

Under the circumstances, my opening remarks this morning will focus on identifying the major tendencies currently visible in the economy and the broad considerations that will likely be shaping our policy decisions in the weeks and in the months ahead.

As you may recall, in my appearances before this Committee in recent years, I discussed in detail the structural imbalances that I believed were impeding U.S. economic growth. I referred in particular to the enormous strains on the balance sheets of many households and businesses. Those strains, which grew out of the excessive debt expansion of the 1980s, were exacerbated by the subsequent weakness in real estate prices in the early 1990s. Moreover, these difficulties spilled over to the financial intermediaries, which—faced with mounting loan losses and with pressure from the markets and regulators to improve their capital ratios—restricted credit supplies to many small firms and other borrowers.

Considerable progress has been made in correcting these imbalances. Many households and businesses have materially improved their financial positions—as evidenced by the drop in debt-servicing burdens for all sectors and the decline in debt-to-equity ratios for businesses. In addition, banks and other financial institutions, having replenished depleted capital bases, have begun to demonstrate a greater willingness to make loans.

The Federal Reserve, through its deliberately accommodative stance, has played a key role in the restructuring process. But it is important to emphasize that monetary policy must not overstay accommodation: Maintaining the confidence of financial market participants has been crucial for sustaining the declines in inflation expectations and, hence, in long-term interest rates that have facilitated the balance sheet adjustments to date.

The actions taken last year to reduce the federal budget deficit have been instrumental in creating the basis for declining inflation expectations and easing pressures on long-term interest rates. Although we may not all agree on the specifics of the deficit reduction measures, the financial markets are apparently inferring that, on balance, the Federal Government will be competing less vigorously for private saving in the years ahead.

Partly because of these structural adjustments, the foundations of the economic expansion are looking increasingly well-entrenched. Real gross domestic product rose at an annual rate of nearly 3 percent in the

third quarter of 1993, and the advance estimate for the fourth quarter indicated growth of nearly 6 percent at an annual rate. The labor market has also shown signs of notable improvement. Payroll employment rose about 2 million last year, and unemployment dropped appreciably. The unemployment rate for December 1993, at 6.4 percent, was almost a full percentage point below the level of late 1992.

The greater buoyancy in economic activity of late has been evident across the household and business sectors. Housing construction, stimulated by mortgage rates that are the lowest in more than 25 years, has increased markedly; and consumer spending, after hitting a lull in the first quarter of 1993, has posted sizable gains over the past three quarters. Outlays on consumer durable goods have been especially robust, in part to make up for the spending on motor vehicles that was deferred during the 1990-1991 recession and the early expansion period. In addition, the pickup in home sales is bolstering purchases of furniture and appliances.

Business fixed investment was very strong throughout 1993. It rose nearly 15 percent in real terms over the four quarters of the year, and order books for early 1994 are apparently filling rapidly. Stimulated by dramatic innovations in products and extensive price-cutting by the computer manufacturers, real outlays for office and computing equipment have continued to soar as cost-conscious businesses have rushed to exploit the new technologies. And with a favorable outlook for overall business sales, ample profits and cash flows, and relatively low cost of capital, firms have also increased their outlays on more traditional types of equipment. In addition, activity in the nonresidential construction sector finally is recovering from the depressed levels of the past few years.

Business inventories have been expanding only moderately in the aggregate in recent quarters, and stocks generally are lean, especially at manufacturing firms. Should businesses decide that higher levels of stocks are appropriate, we could see production boosted substantially over the next few quarters. Order lead times on the delivery of materials, however, remain low and do not, at least for now, suggest an acceleration in inventory investment.

Although recent economic developments, on the whole, have been favorable, the expansion has remained uneven. In the labor market, firms' efforts to restructure and improve productivity are continuing to restrain hiring, and concerns about job security persist. In addition, employers seem to be relying to an unusual degree on the use of overtime and temporary employees, in part perhaps because of the cost of providing fringe benefits to permanent full-time workers.

Moreover, not all business sectors are faring well. In particular, industries and regions that depend heavily on military spending will continue to experience sizable dislocations and disruptions. Also, many state and local governments are still struggling to reconcile a rising demand for services—especially in education, health and crime prevention and correction—with limited growth in revenues.

Another concern is the weakness in the economies of some of our major trading partners, which has continued to constrain our export performance. Among the industrial countries, Canada and the United Kingdom appear to be emerging from deep slumps. However, signs of near-term improvements in Japan and continental Europe are scant. In Japan, asset deflation and associated financial problems continue to hold back growth; and, in Germany, the far-reaching and costly adjustments associated with unification are still a restraining factor. In reaction to their economies' weak performances, monetary officials in the two countries fostered continued, cautious reductions in interest rates in 1993, as did officials in most other industrial countries. Government budget deficits generally worsened last year because of cyclical factors and, in some cases, endeavors to stimulate demand. This deterioration of budget positions has limited the scope for further fiscal action in most countries.

As for the developing nations, economic conditions in Asia, fueled in part by exceptionally rapid growth in China, remained strong in 1993. In Latin America, however, real growth in Mexico fell to near zero, reflecting the depressing effects of a policy attempting to contain inflationary pressures and, for a time, growing uncertainty about whether the North American Free Trade Agreement would be implemented.

The passage of the NAFTA in November represented a significant achievement for the North American continent. Besides reducing tariff and nontariff barriers on trade, the NAFTA extends liberalization to nontraditional areas, such as financial services and intellectual property. The trade agreement reached in December in the Uruguay Round of the GATT also covers some of these nontraditional areas. Approval by the Congress of the GATT agreement would likely stimulate U.S. exports of high-technology products. More broadly, these agreements are significant because they represent a rejection by the United States and our major trading partners of calls to turn inward in our economic and financial policies.

Interpreting the economic data for the United States over the next few months will be especially complicated. As you know, the Bureau of Labor Statistics is redesigning the household survey of employment. Also, many key indicators of production and spending will be affected by the earthquake in southern California and by the extraordinary weather conditions elsewhere. Nevertheless, although real GDP growth will almost surely slow appreciably from the rapid pace of late 1993, the economic fundamentals appear to be in place for further solid gains in the level of activity in the quarters ahead.

Recent data on prices and wages generally suggest that inflation remained in check through 1993, with the fourth-quarter to fourth-quarter change in the so-called core CPI edging down to 3.1 percent, the lowest reading since the early 1970s. To be sure, the acceleration in domestic economic activity has put some upward pressure on prices of a number of industrial materials, and measures of resource utilization are considerably higher than they were six months ago. Nonetheless,

productivity growth has kept unit labor costs subdued, and the broad measures of inflation have remained well contained.

No doubt, many of the forces that helped restrain inflation in 1993 will continue to do so in 1994. Businesses will almost certainly remain intent on boosting productivity and controlling costs, and competition from abroad will continue to deter price increases—even in markets with limited spare domestic capacity.

History suggests, however, that higher price inflation tends to surface rather late in the business cycle and, hence, is not a good leading indicator of emerging troubles. By the time inflation pressures are evident, many imbalances that are costly to rectify have already developed, and only harsh monetary therapy can restore the financial stability necessary to sustain growth. This situation regrettably has arisen too often in the past.

The challenge of monetary policy is to detect such latent instabilities in time to contain them. Unfortunately, they are rarely visible until relatively far advanced. Moreover, once they are identified, policy actions to counter them take time to have their effects. Thus, the need of monetary policymakers for early indicators of developing problems is evident.

Historically, many such indicators have come from the financial sector: Money supply growth, the slope of the yield curve, quality spreads, and credit flows are among the variables that have helped monetary authorities over the years to act in advance of developing problems.

In recent years, however, as a result of financial innovations and the unusual nature of the most recent business cycle, such indicators have, at times, produced misleading signals. The broad money and credit aggregates, for example, have suggested declining inflation in the United States, but by far more than has actually occurred.

Turning to nonfinancial variables, the degree of slack in the economy is important because it plays a major role in influencing whether inflation is increasing or decreasing. Over the longer haul, however, the level of inflation—that is, the rate of price change—depends crucially on price expectations and not on the degree of slack in the economy.

In the 20 years after World War II, most economists gave short shrift to expectations as a key determinant of inflation. Unemployment and inflation were considered simple tradeoffs. A lower rate of unemployment was thought to be associated with a higher, though constant, rate of inflation. Conversely, a higher rate of unemployment was associated with a lower rate of inflation.

But the experience of the past three decades has demonstrated that what appears as a tradeoff between unemployment and inflation is quite ephemeral and misleading. Over the longer run, no such tradeoff is evident. Attempts to force-feed the economy beyond its potential have led in the past to higher inflation and, ultimately, not to lower unemployment but to higher unemployment as destabilizing forces and uncertainties associated with inflation induced economic contraction.

In that regard, experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living.

Currently, we have the difficult task of assessing the appropriate time to move away from an extended period of monetary accommodation. The policy was established purposefully, largely to address the balance sheet strains I mentioned earlier. This monetary policy has been effective in that households and businesses are now in a stronger financial position. But the job is not yet complete.

Unfortunately, although we can assess how far the process of repairing balance sheets has proceeded, we do not know how much further it will go, mainly because of the difficulty of gauging desired levels of debt. What is clear, however, as I indicated here a year ago, is that we did not need to complete the job before evidence of faster economic growth would emerge. We have been growing in fits and starts, but smoothing through the data of the past two years we have seen real gross domestic product rise at a respectable 3.4 percent annual rate—sufficient to reignite job creation and significantly reduce unemployment.

A number of questions will have to be addressed by the Federal Open Market Committee. Foremost will be when is the appropriate time to move to a somewhat less accommodative level of short-term interest rates. We will have to make the judgment as to how long we can continue monetary accommodation without sowing the seeds of another bout of inflationary instability accompanied by steeply rising long-term rates. Such an outcome would bode ill for economic growth in 1995 and beyond.

On the other hand, we will also have to judge whether higher rates will slow the necessary completion of balance sheet repair to a point where economic growth is inhibited.

Short-term interest rates are currently abnormally low in real terms. At some point, absent an unexpected and prolonged weakening of economic activity, we will need to move them to a more neutral stance. Such an action would not be taken in order to cut off or limit the economic expansion but rather to sustain and enhance it. The foremost contribution monetary policy can make to achieving higher standards of living in the United States is to provide the stable financial foundation for continued economic growth.

Thank you, Mr. Chairman.

[The prepared statement of The Honorable Mr. Greenspan starts on p.35 of Submissions for the Record:]

REPRESENTATIVE OBEY. Thank you very much, Mr. Chairman. Let me say that last year when you testified before us at a similar time, a number of us— Mr. Sarbanes and I, especially—expressed some concern about what the future activities would be of the Fed. If I can paraphrase Shakespeare, "I come today not to criticize Greenspan but to praise him." I think that you have done a first-rate job in helping to

nurture noninflationary growth over the past year, and I think it has been especially constructive to see that you and the Administration have worked well together, with no appreciable conflicts that might upset the economy or its major players in any way. I want to congratulate you for that. I think you have every right to feel very good about the contribution that you have made towards the standing and the nurturing of that recovery.

MR. GREENSPAN. Thank you very much, Mr. Chairman.

REPRESENTATIVE OBEY. Let me say that there are a number of questions to ask you in a very brief period of time. So, in order to get you out of here in time, I will keep my questions short, and if you will keep your responses short, we shouldn't have any problem.

First of all, I would like to turn to the gas tax. As you know, we provided last year in the budget agreement a 4.3 cent increase in the gasoline tax, which went into effect in October. In September, the price at the pump was $1.15. Because of falling oil prices, the price at the pump is now $1.13½. At this point, given those numbers, I think it is safe to say that at this point the consumer is not experiencing any negative impact on the gas or energy price out of the ledgers, is that correct?

MR. GREENSPAN. That is correct, Mr. Chairman.

REPRESENTATIVE OBEY. Let me ask you about growth. The Blue Chip forecast for the coming year is coming in at around 3 percent. From what you see in the economy, do you believe that is a reasonable assessment?

MR. GREENSPAN. Well, Mr. Chairman, we will be coming forth to the Congress toward the end of next month with our projections for the future, and we have not yet completed the numbers, but, obviously, we are not going to be radically different from that number when we come before this body and produce in some detail our forecasts for the future.

REPRESENTATIVE OBEY. Last year, as you know, growth in the last quarter was very comfortable, but then it was much lower, especially in the first two quarters of 1993, recovering significantly in the last two quarters and providing strong growth. Do you believe we can be absolutely certain that there will not be a recurrence of that pattern with a major dropoff of less than 1 percent growth in the next quarter?

MR. GREENSPAN. Mr. Chairman, any forecaster who says he is absolutely certain about anything is tempting fate beyond any measure that I would like to get involved with. I do think it is true, however, that there is sufficient evidence to suggest that, unlike the period in early 1993, there seem to be underpinnings currently that—while not capable of sustaining growth at near the fourth quarter level, which was a partial aberration—are nonetheless of sufficient credibility to suggest that there is a degree of support in this economy that was absent at this particular time a year ago.

REPRESENTATIVE OBEY. So you think there is a strong underpinning in the economy, but there is certainly not 100 percent——

MR. GREENSPAN. There can never be 100 percent certainty. One should never assume, even if the broad spectrum of economists conclude that there is no problem, therefore, they are correct. Economists tend to cluster their forecasts together, and very often that is not an indication of the degree of certainty that they hold.

REPRESENTATIVE OBEY. Inflation over 1992 was 2.9 percent, correct?

MR. GREENSPAN. Yes, sir.

REPRESENTATIVE OBEY. And for 1993, 2.7 percent?

MR. GREENSPAN. Correct.

REPRESENTATIVE OBEY. With the exception of 1986 when we had a huge drop in oil prices, when is the last time we have had inflation as low as 2.7 percent?

MR. GREENSPAN. I would say the more relevant number is what we call the core inflation rate, which abstracts from volatile food and energy prices. And in order to get a comparable number at the level that we had last year, which was roughly 3 percent, slightly higher, you have to go back to the early 1970s.

REPRESENTATIVE OBEY. In addition, productivity last year was up what amount?

MR. GREENSPAN. It was well in excess of 1 percent. We still don't have the data for the fourth quarter, but it looks to be a shade under 2 percent, fourth quarter to fourth quarter.

REPRESENTATIVE OBEY. And unit labor costs, they rose 1.8 percent?

MR. GREENSPAN. Unit labor costs.

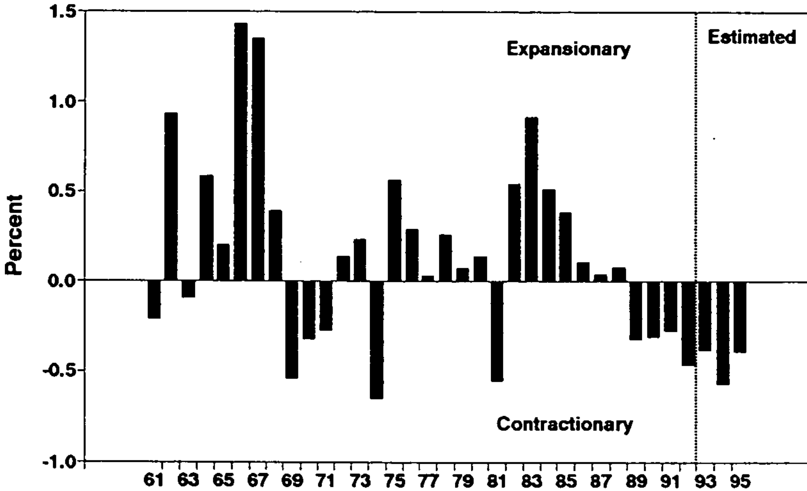
REPRESENTATIVE OBEY. From third quarter to third quarter.

MR. GREENSPAN. Unit labor costs are clearly in the area of roughly 2 percent.

REPRESENTATIVE OBEY. At this point, there is no appreciable pressure on the wage front that would indicate a significant expansion of inflation, especially given the fact that we are in a world economy and we have significant sluggishness, as you cited, in Europe and Japan?

MR. GREENSPAN. There are very marginal elements of evidence of some tightening in certain areas, but they are really at the margin, Mr. Chairman, and overall, I would not disagree with the characterization of the labor market that you just put forward.

REPRESENTATIVE OBEY. Let me also point out that there is another downward pressure. This chart is meant to demonstrate what the fiscal thrust result is from the federal budget policy, and what it demonstrates is that in past years, you have had some pretty heavy stimulus applied to the economy in the early 1980s (see chart below).



Source: JEC Staff calculations using data from CBO and Federal Reserve.

Obviously, you had some contractionary impact on the economy over the last two or three years, as well. But if you take into account what we did last year on the Budget Act, with the increase in revenues and the reduction in spending on a number of items, a significant portion of that is going to kick in this year. So our Committee staff estimates that the negative fiscal thrust, because of the Budget Act last year, is between 6 and eight-tenths of 1 percent of GDP. That certainly is not an inflationary action, is it?

MR. GREENSPAN. Mr. Chairman, throughout most of last year in discussing the issue of bringing the budget deficit down, I emphasized, to the extent that the budget deficit reduction was credible—meaning that it had long legs —that interest rates in the longer maturities would come down and that you would get a significant offset to the so-called fiscal drag coming from a significant decline in long-term interest rates.

Indeed, what I argued at the time is that the purpose of getting a lower budget deficit was essentially to improve the long-term outlook, and that if the deficit reduction is credible, then the long-term outlook gets discounted upfront. Indeed, that is precisely what is happening. The result is that as the prospective long-term outlook improves, what we get is a financial anticipation that is actually expansionary. And that, in my judgment, is the major reason why we have not had the effects of fiscal drag occurring as a consequence of the reduction in the deficit. But I would emphasize that it matters that those reductions remain credible. It is very easy to lose the gains that have been made in this area.

REPRESENTATIVE OBEY. I agree with that. If you look at the action that we took just on the budget side alone, you could argue that it, in fact, might create a negative impression on the economy. But when you factor in, as you said, the resulting expansion that comes from lower interest rates and confidence in the markets, we are better off in the long term.

I would like to close my ten minutes by making two points. First of all, I would like to congratulate the President for having the courage to tackle the budget issue in a credible way last year. I think we have seen some of the positive results of that. I want to congratulate you for, likewise, playing a very constructive role in seeing to it that the overall mesh and mix of public policy is one that did build a firm, noninflationary growth foundation for the economy.

I would like to say that I know that there has been a considerable number of stories written in the press discussing the fact that you might be entertaining sometime soon at least a small increase in short-term interest rates, and I would like to express a hope that that doesn't occur yet. Because as your statement indicated, absent an unexpected and prolonged weakening of economic activity, we will need to move to a more neutral stance.

I would agree with that, but simply express the view, given the limited number of indicators that inflation is around the corner and given the uneven nature of the recovery of corporate balance sheets and some other problems in the economy, that time, I hope, can be delayed for a few months. Thank you for your appearance here today.

Mr. Armey, please proceed.

REPRESENTATIVE ARMEY. Thank you.

It seems to me, Mr. Chairman, we have a very confusing set of circumstances. I am always torn between trying to determine whether inflation is too many dollars chasing too few goods or cost-push inflation. I think in the 1970s we had cost-push inflation.

It seems to me right now that we have a lucky set of circumstances. We have the M-1 growing at around 10 percent. It is hard to imagine that we can grow the money supply at that rate and come out with such nominal inflationary impact. Yet that, it seems to me, is compensated by the unusual circumstance in energy costs going down and the fact that businesses are gaining productivity by restructuring their use of labor in order to avoid mandatory fringe benefit costs.

Now, it seems to me that that puts us in the somewhat precarious position, if for some reason energy costs should return to an upswing and business exhausts its ability to minimize per-unit labor costs and gain productivity through those structural adjustments in employment, if Congress were to pass some major new mandate onto business, which also might involve a $250 billion increase in the deficit, it strikes me that the Fed could be forced into a substantial reduction in the rate of increase in the money supply. It seems to me, you make it very clear that there is going to be some tightening.

The question that puzzles you, that you struggle with, is when this will happen. So I guess my point is that, obviously, you have to watch five or six balls in the air at the same time, only a couple of which you can control. Don't you think this would be a particularly important time for Congress to go cautiously into the business of, one, creating new business mandates that would affect labor costs and, two, effecting the major public policy change that could have substantial impact on deficit increase? It strikes me that that would make your job almost impossible if we moved in that direction.

MR. GREENSPAN. First, let me just say that there were technical problems with interpreting M-1 increasing at the 10 percent rate. We have to recognize that some of that is the result of a very substantial acceleration of U.S. currency being shipped abroad, and one must presume that that is not impacting on the liquidity of the domestic system.

But I certainly agree with your concerns with respect to introducing long-term commitments in this economy that will be difficult to finance, because I think we have succeeded—and the Chairman has since alluded to it—that the underlying long-term economic outlook in this country is improving quite measurably. And, indeed, I don't recall as good an underlying base for the long-term outlook that we have today in the last two or three decades.

So I should certainly hope that we are very careful to nurture that extraordinary achievement and try to keep it going so that we can look forward to a continuation of solid economic growth in the years ahead and not run into a degree of financial instability which, historically, has always thrown us into a severe contraction or at least into a major slowdown in economic growth.

REPRESENTATIVE ARMEY. Thank you.

Let me say, Mr. Chairman, again, I admire the work that you do at the Fed. I want to just take a moment to reaffirm my belief that the Fed must be an independent agency in this country, that a separation between monetary and fiscal policy must be held firm, and that the biggest mistake we could make would be to do anything that would in any way abrogate your independence as an agency.

I know that the Fed is a favorite whipping boy in this town, but I have to tell you that I think the Fed does a magnificent job compensating for the failures of fiscal policy, and I want to express my appreciation to you and the other people at the Fed.

MR. GREENSPAN. Thank you very much, Congressman. I appreciate that, and I am sure my colleagues do as well.

REPRESENTATIVE OBEY. Before I call on Mr. Saxton, I want to say that Senator Robb had to leave earlier, and he wanted me to ask you a question, which I doubt very much that you will answer. Following up on the comment that I made to you about the Fed intentions, he wanted to ask whether you would be willing to indicate a trigger point that would result in the Fed's—assuming that it was substantial—raising short-term interest rates?

MR. GREENSPAN. I agree with the Senator's expectation of my willingness to respond to that.

REPRESENTATIVE OBEY. Well, I expected that, but I thought I would, out of courtesy to the Senator, ask the question anyway.

Mr. Saxton, please proceed.

REPRESENTATIVE SAXTON. Thank you, Mr. Chairman.

Mr. Chairman, in your testimony, which was really quite thorough, I thought, you seemed to get to two issues that we have all talked about for years and have tried to deal with for years. One is the deficit and the other is the fine job that you have most recently done, in terms of control of monetary supply, and the job that you have done in monetary policy.

Let me pursue something that Congressman Armey brought up just a moment ago. Early in your testimony, when you were discussing the bringing back into line of business and household debts and you mentioned that banks are again willing to make loans, which are certainly two ills that have come into more balance in recent times, you then went directly to several paragraphs about the deficit. Are those issues related?

MR. GREENSPAN. They are related in the sense that the major problems that we saw emerging when we started to ease in the spring of 1989 had to do with very strained balance sheets. And it was fairly clear, as the months and years wore on, that significant declines not only in short-term interest rates but in long-term interest rates were an essential ingredient for removing that strain and improving the structure of the financial system.

Crucial to that was a necessary reduction in inflation expectations over the longer run. And important to that—in fact, if not largely determinative—is the expectation that the budget deficit on a current services basis, which appeared to be accelerating out of control as we moved into the early years of the next century, be contained. It is only if that process is shown to be under control that inflation expectations will fall adequately. And long-term interest rates, as a consequence, will fall and bring about the remaining elements of improvement that we still foresee are necessary in the balance sheet structure of both households and business and, of course, of the financial institutions as well.

REPRESENTATIVE SAXTON. Thank you, Mr. Chairman.

The concern that I have is that we don't do something in terms of policy to upset what you described as a delicate balance. And I think it is.

Some months ago I asked the Republican staff of this Committee to look at pending policy to try and determine whether we may be headed on the wrong track in regards to, particularly, the President's health-care initiative.

Now, we can talk about the President's health-care initiative in terms of benefits that the public will derive from it, how it will affect medical

health-care delivery, and we can also talk about the finances of it. This study would seem to indicate that the projected monies that are available to pay for this program leave a substantial gap beginning in 1995, if it were to be enacted as it is in 1995, or 1994, and on through the year 2000.

As a matter of fact, depending on certain assumptions, the budget gap in those years could be as high as $1.7 billion, or it could be lower, depending on, again, the assumptions that one makes. Is this something that would have a negative impact on the economic growth, in your view?

MR. GREENSPAN. Mr. Chairman, obviously, anything that is significant change in any major program within this economy has impacts, and Congress and the Administration are, obviously, acutely aware of what economic impacts various different proposals will have on the economy.

These are very complex analytical questions. And even though we at the Federal Reserve try to understand the potential impacts of a lot of the different alternative programs, it is not easy to make realistic judgments as to how they impact on the economy. But I do think that there is a fairly important awareness, certainly, in the Office of Management and Budget, Congressional Budget Office, and a number of other areas of the Administration that are involved in this, that whatever is done has economic consequences, and that has to be a critical consideration of how we move forward in this particular area.

REPRESENTATIVE SAXTON. I certainly don't want to put words in your mouth, but, generally speaking, your testimony indicates that things are somewhat better today because the deficit appears to be shrinking. And, therefore, if Congress did some kind of a policy change relative to health care or any other subject that increases the deficit a substantial amount, it would not be considered to be good for the economy?

MR. GREENSPAN. That is correct. If there is any program out there or any combination of programs that reverse the view held in the financial markets that we are apparently coming to grips with this eroding budget problem, should that occur, the results could be adverse. And I suggest that one of the things that we have learned in the last year is how important it is to remove the expectation from the markets that the budget deficit is a potentially dangerous element in our system. I think a substantial part of the improvement in economic activity and the low rates of inflation can be directly related to a changing financial expectation that we might finally be coming to grips with this very severe problem.

REPRESENTATIVE SAXTON. I thank you, Mr. Chairman.

I would just conclude by saying that I certainly would not expect you to comment on this study, because it would be unfair to do so, but this study does indicate that there could be as much as a $250 billion a year shortfall in the President's plan. We have called this study, "$1 Billion a Day: The Financing Shortfall in President Clinton's Health Care Pro-

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posal." Whether we are right or whether we are wrong about the numbers in this, it is certainly an area of great concern, not only from a health care point of view but from an economic point of view. Thank you very much.

REPRESENTATIVE OBEY. Senator Bennett?

SENATOR BENNETT. Thank you very much, Mr. Chairman.

We have two Messrs. Chairmen here. If I could address Chairman Obey for a minute, I want to thank you for your praise of Chairman Greenspan. I sat here a year ago as a brand-new senator and listened to the things you referred to, where Chairman Greenspan was being told, look, if we don't get a recovery, it is going to be your fault. And now to hear you praise him, I, for one, appreciate your candor and your willingness to do that. I wish Senator Sarbanes had been here to hear it.

REPRESENTATIVE OBEY. I think he would agree.

SENATOR BENNETT. I was present on the Banking Committee when Senator Sarbanes told Chairman Greenspan that the President's proposals were contractionary, and if the Fed didn't get busy and bring about a contrary role and do something to inflate the economy, we were going to be in terrible trouble, and we shouldn't worry about inflation, said Senator Sarbanes. So I am delighted that we are having this kind of love-fest today. I appreciate the attitude Chairman Obey has taken with respect to that.

Now, Chairman Greenspan, there are some who have referred to the bond-market rallies as being demonstrative of expectations that the economy would get worse. Some journalists and commentators have said, "Well, the only reason people are buying bonds is that they expect the economy will get worse and that bonds will be their haven. If they really thought the economy was going to do well, they would get out of the bond market and get into stocks."

Is it your feeling that that is a wise analysis on their part? Or is economic growth generally good for the bond market as well as the stock market?

MR. GREENSPAN. Senator, I don't deny that there are those who have concluded that, and probably a number of investors in long-term Treasury issues as well, because they think the economy is weak. But I think the problem they fail to recognize is that if you have an unduly weak economy in the type of society that we have, the pressures to create inflationary recoveries probably mount in direct proportion to the perception that there is economic weakness. If we are talking about long-term government issues, 10 years, 20 years, 30 years, clearly the expectation of a very significant reflationary endeavor has to be negative to bond prices. And, in that sense, one should argue for the longer term that stable, solid long-term growth is probably more consistent with lower long-term interest rates than a chronic weakening that always has the overhang of a potential significant reflationary set of policies, which

must, of necessity, be adverse to long-term bonds and invariably push long-term interest rates higher rather than lower.

SENATOR BENNETT. I recall in the early 1980s a Treasury auction in which one of my clients was looking at buying a 30-year bond at over 15 percent. Looking back on it, that might be a pretty good instrument to hold today, but that, of course, added to the enormous deficits that we ran in the 1980s when the Federal Government was having to pay 15 percent on a 30-year instrument in order to finance the debt. And, today, what is the rate on a 30-year bond?

MR. GREENSPAN. Yield?

SENATOR BENNETT. Yes, yield.

MR. GREENSPAN. About 6.20 percent.

SENATOR BENNETT. Okay. Does not this reflect the very thing you are talking about, that the inflation expectations have gone out of the equation? So, if someone says, if I buy $100,000 worth of bonds today, I will get $100,000 worth of purchasing power some years from now, and, therefore, I can do with a much lower interest rate. Is that a fair analysis?

MR. GREENSPAN. There is a fairly significant inflation expectation still embodied in long-term nominal interest rates and if inflation over the longer term is expected to be less than is currently embodied in those rates, long-term rates will probably fall.

SENATOR BENNETT. And that, of course, produces a tremendous benefit to the deficit. I think the dropping of interest rates in the cost of financing the deficit has had as much to do with bringing the deficit down as some of the things Congress has done.

MR. GREENSPAN. I would think that it is also relevant to what it does to the economy and, therefore, the receipts side of the budget. One can presume that low inflation and low long-term interest rates are consistent, at least from the data that we have seen, with maximum economic growth over the longer term. And since real receipts are related to the level of real economic activity, one must presume that you have an improvement in the deficit outlook from that direction as well.

SENATOR BENNETT. So, by bringing the inflation expectations down, we bring interest rates down, so the government has to pay less to finance the debt. At the same time, we increase economic growth, and there is more revenue out of constant tax rates by virtue of larger economic activity, and we get the best of all possible worlds. Is that a fair summary?

MR. GREENSPAN. That is a fair summary.

SENATOR BENNETT. Therefore, harking back to my earlier comment, your resisting congressional pressure to do something about reinflating the economy was indeed the wise thing to do a year ago, and we are now seeing some of the benefit of that. Have I gone too far in praising you, or will you agree with that as well?

MR. GREENSPAN. I would suggest you put it in escrow, Senator, and pull it out in a year or so and see how it looks.

SENATOR BENNETT. All right. Fine. Thank you very much. I join my colleagues in congratulating you.

I notice in your testimony a rejection of what I understand to be the Phillips curve about inflation and unemployment being offsetting, and I think what you are saying is that we have demonstrated over the last little while that the Phillips curve indeed is not operative, and that those who believe in it should back away from it. Is that also a fair summary?

MR. GREENSPAN. I think that the economics profession, as such, has clearly altered its view from where it was a generation ago on that question.

SENATOR BENNETT. All right. Thank you, Mr. Chairman. I have nothing further.

REPRESENTATIVE OBEY. Mr. Cox.

REPRESENTATIVE COX. Thank you, Mr. Chairman. I am delighted to be present at a hearing wherein the Members of the JEC and the Chairman of the Fed can agree that the Phillips curve is interred, and we are in effect placing flowers upon the grave today.

It is an accomplished fact already, as the Chairman points out. I appreciate very much your plain English description of how this has transpired, first in the 20 years following World War II and then in our experience, subsequently.

You go on to make what I consider to be one of the most important statements in your entire testimony; that attempts to force-feed the economy beyond its potential have led in the past to higher inflation, presumably on the mistaken assumption that the Phillips curve was an iron law, and ultimately not to lower unemployment but to higher unemployment.

Your statement implies that if we could, we would know something about what constitutes force-feeding, what kinds of measures to stimulate demand, for example, and that we also would have in mind some sense of what is the real growth potential of the economy.

I wonder if I could ask you about both, since specifically you state attempts to force-feed the economy beyond its potential have led in the past to higher inflation. I wonder if you could illustrate that with a few historical examples that you would consider to be that type of force-feeding, which lead to higher unemployment in the first place. I would put that question to you.

MR. GREENSPAN. I would just as soon not get into very specific examples, because lots of people were involved in making those decisions as to what was done. It is pretty clear, however, that as we came out of the 1960s and into the 1970s, we began to get a phenomenon that was inconsistent with the Phillips curve that we labeled "stagflation." It did not seem essentially to be consistent with any of our previous notions as to the way the system functioned.

It is an understanding basically of what that process was: How one could have a situation of chronically high unemployment consistent

with chronically high inflation. It is an understanding of that process that has led us to a more general awareness that inflation expectations are a critical variable with respect to the actual performance of the economy, and, more than that, the data are increasingly beginning to suggest, although there is some technical dispute as to how to interpret this, that the rate of inflation is associated inversely with the rate of growth of productivity; meaning that low inflation seems to be consistent with a higher growth rate in productivity than periods of high inflation. What that suggests is that a period of low inflation is conducive to persistent long-term economic growth.

REPRESENTATIVE COX. Well, I certainly have every reason to agree with you, and I appreciate your circumspection in declining to illustrate, with an historical example or two, the kinds of force-feeding in the past that you have described in your testimony.

I wonder, on the second point, whether you might help us grapple with the question of knowing what is the real growth potential of the economy beyond which demands stimulus measures or even supply side measures might be considered to be force-feeding.

Last year, we saw 3.9 percent growth rate. Our historical average of the post-World War II period is about 3.1 percent. Some people are figuring that because of the slow rate of growth in the first half of 1993, even with a strong fourth quarter, it is going to come in lower than the 3.9 percent of 1992.

What is the economy's current growth potential? Should we perhaps adjust ourselves to something less than we have been accustomed to in the post-World War II period as we look ahead to the future?

MR. GREENSPAN. First of all, Congressman, we have had some slowdown in labor force expansion as the demographics of our society have slowed down the rate of growth of the number of people entering the labor force each year, and, of course, that has a significant lowering impact on the long-term rate of growth.

Granted that, the major element that determines the growth over the long term is productivity, or productivity growth, I should say. What we are seeming to observe in the last several years is some acceleration in the long-term growth in productivity, which is, to a substantial extent, the result of the restructuring that we have seen, which has had obviously some significant adverse effects in that it has created a good deal of job insecurity for a number of people in the work force. And that is clearly a darkened cloud in the process, which in general is quite favorable to long-term standards of living.

The Congressional Budget Office estimates that the long-term growth rate is, roughly, 2.5 percent at an annual rate. I want to emphasize, however, that we should be a little careful about taking these numbers of potential growth as though they are rigid, and we should not endeavor to improve on them because there is a considerable amount of gain in productivity that could occur, which we will not be aware of except in retrospect. And so we have to be careful not to look

at economic policy aiming at a fixed growth rate beyond which we are afraid to move.

The important question is that we should endeavor to gain long-term sustainable growth at its maximum level, and that we should be continuously observing the internal structure of the economy, the financial aspects of it, the inflationary aspects of it, to make judgments as to whether we are straining the system.

The issue is not a certain amount of growth, a ceiling that we should not endeavor to go beyond. More importantly, we should try to evaluate as we look at the economy whether it is moving forward in a reasonably solid, nondestabilizing sense—in which case what we are saying is that it is good growth—or whether we are looking at imbalances that are creating the seeds of some major structural change, which would contract the economy and raise the unemployment rate.

So, while it is useful for forecasters and policymakers to have a judgment as to where the growth potential is, as best they can judge, we have to be very careful not to assume that economic policy, whether it is budgetary or monetary policy, takes those numbers as a given and fails to continuously monitor the system to see whether what we are looking at is balance or distortion.

REPRESENTATIVE COX. I appreciate it. As always, you have given not only an answer but a lot more. Thank you.

MR. GREENSPAN. Thank you.

REPRESENTATIVE COX. I yield back. Thank you, Mr. Chairman.

REPRESENTATIVE OBEY. Thank you.

Mr. Greenspan, just a couple of points. Reference was made to Senator Sarbanes by my good friend Senator Bennett. I would simply say that I think Senator Sarbanes was correct in assessing the decisions that were made last year in the federal budget as being contractionary. They were meant to be, because it was felt that that was the only way that we could get a handle on the rising size of the deficit as a percentage of GDP.

I think that all Senator Sarbanes was indicating last year was that if we did not have the properly meshing monetary policy, the result could be an economic nose-dive if we got contractionary policies coming out of both the Federal Reserve and the U.S. Government's fiscal policy. I think that problem has been managed quite well, as I indicated.

Again, I don't want to debate the health-care proposition with my friends here to my left, although they are on my right. I don't want to debate health care today, except I would not want you to draw from comments made here today that staff analysis of the health proposal made by the President has any relationship to reality.

I noticed Senator Mitchell saying a week ago Sunday on Meet the Press, in response to a question from Bob Scheiffer, I think his words were, "The assumptions in the question are at variance with reality." I think the assumptions in the study were at variance with reality.

I don't want to get into that at this point. We will have plenty of time to do that. I think it is useful simply to recite again what has happened on the deficit as a result of that contractionary policy, when viewed narrowly, on the part of the budget. For 1993, President Bush estimated that the deficit would be $331 billion and CBO estimated it would be $310. It wound up being $255. For 1994, CBO estimated on January 1993 that the deficit for fiscal year 1994 would be $291; they now estimate it to be closer to $223, which is a $68 billion improvement. And for 1995, the CBO estimated on January 1, 1993 that the deficit would be $283 billion. They now project it to be $171, which is an improvement of $103 billion. So I think that indicates that things are headed in the right direction.

I would like to return to the Phillips curve comment that your comments have elicited from the Committee here. You indicate that the experience of the past three decades has demonstrated what appears to be a tradeoff between unemployment and inflation is quite ephemeral and misleading. You then cite examples that primarily relate to efforts to move the economy to the upside.

Let me ask, do you not also agree that the Phillips curve linkage on the downside is not also ephemeral, given the integration of the U.S. economy into the world economy to date; given the fact that that means workers, even if conditions in our own economy might dictate some pressures on their part for upward adjustments in wages, which might theoretically be inflationary, are inhibited in their ability to do so because of the integration of the world economy, and because of the fact that they are in competition today with goods around the world produced, in many cases, by low-wage workers? Does that not also mean that we should not assume that just because unemployment gets to a magic level of 6 percent or 5.5 percent that that is an automatic indicator of immediate inflation around the corner?

MR. GREENSPAN. I agree with that, Mr. Chairman. It is a symmetrical conclusion. The evidence clearly suggests that the slack abroad, which has led to low domestic prices abroad, translated into low import price inflation in the United States, especially since the dollar has been stable over the most recent years. So what we do get reflects actions coming from abroad. What we do not pick up, however, is any significant secondary effect from slack abroad having a significant impact on the degree of wage inflation in the United States.

What is clearly the case is that we have been through in the early part of the post-World War II period is a period of low inflation and low unemployment. I mean, there is nothing that suggests that low unemployment means high inflation for precisely the same reason that the reverse is also not true over the long term.

REPRESENTATIVE OBEY. Let me ask, because Mr. Armey and I were both talking about the fact that the BLS will be releasing its unemployment data for this month on the basis of a new survey that reflects a new method of collection of unemployment information, has there been adequate discussions between your people and BLS people that

the Fed clearly understands what the meaning of those numbers will be when they are released this coming week?

MR. GREENSPAN. There has been very extensive discussions between our two agencies. The Commissioner came over and visited with us a while back and went over in some considerable detail what the data were showing. We have had very considerable staff contacts on an on-going basis, and when the new data come out, I am sure we will be in close contact with the Bureau of Labor Statistics to see whether or not we can infer precisely what the changes are as they affect the economy.

REPRESENTATIVE OBEY. Thank you. My five minutes are up in this round.

Mr. Armey?

REPRESENTATIVE ARMEY. Thank you. I don't want to belabor these points, but the fact is that the Clinton budget plan was enacted in August 1993 and the fiscal year ended about a month and a half later. So I don't think we ought to detract from the Federal Reserve's role in this matter by claiming, in any way, that the fiscal policy of the current Administration had any impact on fiscal 1993. It just simply did not; no more than any other Presidency's impact.

I have to tell you, Mr. Chairman, I am distressed. We went through a trauma in the 1960s with President Johnson insisting on an integration of the Fed being more closely under the jurisdiction of the Executive Branch of government. This specter seems to be rising again, and I have no doubts that those of you in the Fed will understand the importance of this. But it strikes me that one of the most dangerous things that we could do to the future stability of the American economy would be to pursue any number of the plans that are out there, which essentially compromises your jurisdiction and independence over monetary policy.

So I would, again, aside from all we might talk about who did what and how it got done, I do want to affirm that there is at least one stalwart champion of the Federal Reserve's independence, who has enough of an institutional memory on this subject to still thank God that William McChesney Martin got away from the Texas barbecue with his hide, and the fact is that the Nation has survived ever since that time without suffering the foibles of the compounding of Executive Branch jurisdiction on both fiscal and monetary policy.

I know I do have a chance to have another round, but I do know that Mr. Wayne Angell is leaving. I hope for your sake, the sake of the Fed, the sake of the Nation, that we can find somebody of his strength, understanding and character to join the Fed in his absence.

But let me again thank you. Milton Friedman is my hero, and there are few things that I have ever disagreed with the professor on, but one is his comment that if you cannot find something bad to say about the Fed, don't say anything at all. I find the Fed, to a degree, less than most institutions in this town, is worthy of that kind of compliment.

So my hat is still off to you. I appreciate the good work you do and the diligence by which you maintain the surveillance over our money supply, and I want to thank the Fed for its contribution to the current sustained recovery from the modest recession that we experienced a few years back. Thank you.

MR. GREENSPAN. Thank you very much, Congressman.

I want to say for my colleagues, we are going to miss Wayne Angell. Unless you work on a day-by-day basis with him, you are not very clear what contribution he has made, but he is a man of extraordinary integrity and conceptual insight. And I must say that I personally will miss him and trust that his endeavors in the future are as productive as his tenure at the Federal Reserve has been.

REPRESENTATIVE OBEY. Mr. Saxton.

REPRESENTATIVE SAXTON. Mr. Chairman, late in your testimony you talked about indicators that occur in the economy, that the business cycle may be turning perhaps in a negative way, and you also indicated that oftentimes by the time we recognize those indicators—I have forgotten the term you used—drastic measures have to be taken to make corrections.

I guess my question is, what are those indicators today, what do they look like, and how does monetary policy currently reflect what is happening with those indicators?

MR. GREENSPAN. I am sorry, would you repeat that for me? I didn't quite get it, Congressman. Which indicators are you referring to?

REPRESENTATIVE SAXTON. The indicators that are inherent in the economy, which you referred to——

MR. GREENSPAN. You mean the various financial indicators?

REPRESENTATIVE SAXTON. Yes, sir.

MR. GREENSPAN. Well, clearly money supply growth—meaning M2, which is the conventional measure that we have been using for a number of years —has still not moved back on track. You may recall a year or so ago that I argued something very abnormal was occurring, that we were getting a divergence in nominal gross domestic product, which was rising more rapidly than the projected gross domestic product from the money supply. Well, that gap has not closed. It is still fairly wide. And the evidence is that even though the growth in M2 is within the ranges we postulated a year ago, it clearly was adjusted to those ranges because we saw the relationships had gone off track.

I might say that the fact money supply is growing in the lower part of our ranges is a measure of the fact that it is still off track.

So far as the slope of the yield curve is concerned, we moved to an extraordinary, probably historic, spread between short- and long-term interest rates a number of months back in 1993. In other words, we had a very severe tilt with the long end of the market high and the short-end low. It has tilted back a little bit, but it is still at a very historically high slope.

So the change is not large, but there has been some change in those indicators with respect to economic activity, but they are still not working all that well.

CONGRESSMAN SAXTON. Do you contemplate changes in monetary policy that would tend to act as a correction mechanism?

MR. GREENSPAN. I don't think we would introduce particular monetary policy actions to address ourselves to those particular indicators, because, remember, they are symptoms of what is going on in the system, and we want to see what they are doing. In other words, as Congressman Armey mentioned earlier, we were getting divergent readings with respect to our various different measures of money supply, which was creating somewhat differing views as to what the degree of liquidity was in the system.

These are all measures of the temperature of the economy, if I may put it that way. And the last thing we want to do is to try and find policies that somehow play with the thermometer rather than the patient, which we are trying to deal with.

So we are displeased with the fact that a number of those very useful early indicators of emergent troubles have gone astray, but we suspect that they may come back at some point and be as useful as they have been in the past. But I am disinclined to say at the moment that one can infer as much now as in the past from the data.

REPRESENTATIVE SAXTON. Thank you.

Thank you, Mr. Chairman.

REPRESENTATIVE OBEY. Mr. Bennett?

SENATOR BENNETT. I see Senator Sarbanes has come in. I probably should defer to him. Having raised his name without his presence, I better let him defend himself before I go on further.

REPRESENTATIVE OBEY. Why don't you go ahead and let him organize his notes.

SENATOR BENNETT. All right. I need to be appropriately differential to him, since it looks as though he is going to be Chairman of the Banking Committee later on, which I serve on.

If I might, Chairman Greenspan, take advantage of your presence to return to one of my hobby horses and get you to comment, in the atmosphere of the soundness of the economy, on the issue of the capital gains tax. What would happen to the economy if Congress were to make some changes in the capital gains tax, which is now at historic highs? I understand revenue from capital gains is at relatively low levels, considering the amount of economic activity that is going on.

President Bush proposed to increase the revenue from capital gains tax by lowering the rate, thereby freeing up a number of investments that otherwise are staying as they are in order to avoid the historic high rate for capital gains. Others have suggested indexing capital gains; that is saying that there would be a zero rate on inflationary growth in capital gains, but not the existing rate on the real growth.

Of course, you have expressed your preference for a zero rate across the board, which if you and I were running the world is what we would have. I don't think that is politically possible. I think history has demonstrated that.

Could you comment on the other two possibilities: Either lowering the rate to something in the neighborhood that President Bush proposed; or indexing capital gains so that that which is taxed is only real gain rather than inflationary gain?

MR. GREENSPAN. Senator, on the indexing, I think that it is appropriate to view a realized capital gain as composed of two elements: One, the underlying general inflation rate in the economy, which has nothing to do with the particular investment that was taken by the investor; and the actual realized gain over and above that.

I don't think it is proper to have a tax that essentially reflects the degree of laxness in governmental economic policy that leads to inflation. If one is going to tax capital gains—and as I have indicated previously I have a long-held belief that that is not a useful means of achieving revenue in an economy—but if one is going to tax them, it strikes me that an individual investor should not be taxed on the fact that inflation has occurred as a consequence of actions over which he had no control.

So I would argue strongly, if one does have such a tax, that at least the rate be imposed on the actions over which the person being taxed has control, and not taxed because there was, say, a less than responsible policy that engendered a degree of inflation that affected the value of the property that he has.

SENATOR BENNETT. Do you have any numbers that would indicate what effect that would have on the economy, if we were to move to an indexed capital gains? Would we be better off now?

MR. GREENSPAN. No, Senator, I do not, but my general view is that it could be nothing but positive.

SENATOR BENNETT. That is my general view as well. I have heard people say, "Well, if you change the tax on capital gains, everybody would simply shift income from ordinary income to capital gains income and thereby avoiding the tax." I have been in business a lot of years and I have never figured out how to do that.

Do you have any strategies for shifting income, or any understanding of how people could shift their income, from regular income to capital gains income?

MR. GREENSPAN. There are innumerable strategies that used to exist. My judgment is that many of them have been eliminated in recent legislation, but, in any event, when I was in the private sector and I looked at all of these vehicles, it always struck me that it was the lawyers and the accountants who really got the value added and not the taxpayer who figured ways around that. So I have never been able to really find a means by which you can very significantly avoid the tax structure, and

that is especially the case, incidentally, with the statutes as they currently exist.

SENATOR BENNETT. I see.

Thank you, Mr. Chairman.

REPRESENTATIVE OBEY. Mr. Cox?

REPRESENTATIVE COX. Thank you, Mr. Chairman.

There is another theory, I understand, about why some people are shifting into capital assets, particular financial assets, and I would like to have you comment upon it, if you would. Those of us who are trying to track what it is the Fed is doing have noticed that while M2 has been expanding relatively slowly over the last year, indeed over the last 13 weeks, both averages around 2.5 percent, that the monetary base has been growing much more rapidly during the last 52 weeks, in the area of 10 percent growth. Recently, some slower growth, around 5 percent; but over the 52-week period, ending right about now, 10 percent.

Some analysts have expressed concern that the rapid growth in this so-called high-powered money is not going into M2 but rather into the securities market, and as a result, they fear, in financial asset inflation, inflation that does not show up in the CPI because it is not going into M2. If this scenario is accurate, the analysis goes, the bubble could pop; we would see a break in the market, sudden rapid increase in M2, and a knife-edge inflation burst. Could this theory be real? How would you respond to those analysts who put it forward?

MR. GREENSPAN. First of all, we have examined the issue of the lead elements involved in the monetary base, and we have not been able to find significant use for the monetary base. Certainly M2, except for its most recent period, has been a rather useful indicator, and I feel somewhat chagrined that we have lost some of the potency of it.

But as I said earlier, remember that the monetary base includes currency—which is, to a large extent, reflecting a substantial flow abroad—and reserve balances—which, to a very large extent, reflect transaction deposits, which legally require reserve balances. The very large mortgage refinancings that we have seen in the last year or so have boosted the transaction deposits because there were escrow accounts that were associated with those mortgage refinancings. That has meant that we have had a much larger increase in M1 than would otherwise have been the case. That M1 is largely immobilized. Nonetheless, it still requires reserve balances, and therefore the monetary base has shown some fairly significant momentum.

We have looked very closely at whether we can use the monetary base as an indicator in the same way that we have used M2 over the years. That is, it is certainly the case that you can find sub-periods in which the use of the monetary base seems to coincide with the growth of nominal gross domestic product with a significant lag. And this is largely what a number of these analysts are showing. The trouble is, when you carry it back in time, the relationship falls apart.

It is important not necessarily that monetary relationships are generic through a whole particular period, but if you are choosing a specific sub-period, you have to be able to argue that the particular choice for that period is relevant and the broader period is not. We have not been able to draw that distinction with respect to the monetary base as a useful tool, and especially since we have altered the base over which reserves are calculated relative to deposits.

We do get a narrow effect coming from the fact that transaction balances are involved here, and we are no longer reserving a much broader element of the deposit base in the system.

I don't know whether this appropriately responds to your questions, Mr. Cox, but that is essentially where we have been coming out.

REPRESENTATIVE COX. It certainly is satisfactory on the point, at least for the time being, whether the monetary base might confidently be used as a predictor. It leaves some question, I suppose, definitionally unanswered as to whether we can measure in any way the spread between M2 and the monetary base that might have disproportionately found its way into financial assets.

MR. GREENSPAN. We have looked at that in some considerable detail—about how the household and the business sectors are restructuring their balance sheets with respect to how various different elements in the monetary system behave. Indeed, one of the things on which we have done an extraordinary amount of work, subsequent to the difficulties we have had with M2 as an indicator, is looking at all such relationships that you indicate, and we have found some.

We have found, for example, that if you take M2 and add mutual funds, you get a more stable relationship recently. Unfortunately, the trouble with that is mutual funds' values are affected by the prices of the assets that they have, and that can very significantly distort what the measure of liquidity would have. As a consequence, we are still working to find better relationships than we currently have.

I am finding it, I must say, rather frustrating that we are not able to do as much as I would like to do. But that has not deterred us from trying to understand in far more detail the various processes of what the economy is doing for which these various financial indicators were used as a proxy. If we cannot have the proxy, it means that we have to look in far more considerable detail at how the system is working.

It makes it more difficult for us to understand the processes of economic growth and contraction in inflation and instability, but it does not mean that we have lost control of how we do our job. It just makes it more difficult. It takes more effort and more focus, and it means we cannot use a number of the simpler indicators, which we found so useful in the past. It does not mean that we cannot know what is going on and how our policies affect the economy. It just means that we have to work in a far more detailed manner looking at far more elements within the system in a far broader context than we had been able to do 5, 6, or 10 years ago.

REPRESENTATIVE COX. Well, I certainly appreciate that, and I hope for my part that some of these analysts are wrong.

I also thank the Chairman and want to recognize the time limitation, so I will not put any more questions. I would like to add at the conclusion of my time that there has been some question raised about the validity of the assumptions that went into the JEC staff report on the President's health care plan. I think it would do us all well to take a look at that report because the assumptions, all with respect to revenues, are favorable to the Administration. They are all based on static analyses, and they assume, for example, that the CBO predictions about growth in GDP actually come true; that is, health care on balance will have no unfavorable impacts on business activities, despite the mandates and the taxes and so on.

They assume that wages and salaries remain at their historic 49 percent share of GDP, so the act would have no unfavorable impacts on wages and employment. In a footnote to this report, it is pointed out that if these favorable assumptions do not materialize—as people like Martin Feldstein suggest they will not—rather than looking at $3.5 billion shortfall in financing for this health-care proposal, we will be looking at significantly worse numbers, because, for example, as Feldstein points out, the health-care tax increases will reduce 1997 wages by $115 billion, and therefore depress federal tax revenue that year by a total of $49 billion.

So my colleague, Mr. Saxton, was citing numbers that are at least taking the report at face value. The most favorable numbers that we can come up with, using all of the Administration's own assumptions, if we use other people's assumptions, the picture looks worse still.

I thank the Chairman.

REPRESENTATIVE OBEY. Let me simply say before I turn it over to Senator Sarbanes, I am sure the study will receive all the attention it deserves.

Mr. Greenspan, before I turn you over to Senator Sarbanes——

MR. GREENSPAN. You make that sound as though I am being fed to the lions.

REPRESENTATIVE OBEY. No, I just want to make sure he gets his shot at you before you leave for your plane.

I do want to observe that I hope you keep in mind the fact that while the growth number that was announced in the last quarter last week was very impressive, I think even more impressive was the fact that the inflation numbers, which were also part of the report were very encouraging. In fact, apparently because of those inflation numbers, the 30-year Treasury prices actually rallied, and they are doing that somewhat again today as well, which is good news. I can't help but put in context what that GDP deflator looks like historically. As you can see, we have not had a year with the GDP deflator as low as it is today, going all the way back to 1964. It almost made it once in the 1980s, but

not quite. So I think, in historical terms, the performance looks awfully good.

MR. GREENSPAN. In fact, Mr. Chairman, that 1980 number is the 1986 figure that had the significant oil price drop, which had an extraordinary impact on it.

I do think what is interesting about the data that are coming out is the importance of looking beyond the Consumer Price Index to get an essential judgment as to the total inflation level. In that sense, it is not so much the GDP deflator *per se,* but some of the other components like domestic purchases with fixed weights, which essentially is the Consumer Price Index plus elements purchased by the business community and others. This shows a lower rate of inflation than the CPI, because there are very considerable downward pressures coming from computer prices that feed into the business sector. And it is not only in personal computers that that is occurring.

In that regard I think what the markets are responding to is this broader measure of inflation, essentially the one that is reflecting the degree of stability, or lack thereof, in the economy, and as a consequence of that, there has been, I think, increasing awareness that these broad measures are important to understanding the degree of inflation in the total system.

They all measure different things, incidentally, and we have to be careful not to assume that they are all looking at the same thing. For example, the Domestic Purchases Index is closely related to the Consumer Price Index, whereas, the GDP deflator—the one you show there, which is, I assume, the implicit deflator—has only the cost structure in the domestic economy and strips out the effects that occur as a consequence of import prices changing; whereas the fixed weight Domestic Purchases Index does reflect this broader impact. That is largely what is depicted in the chart that you showed us today.

REPRESENTATIVE OBEY. I understand.

Senator Sarbanes?

SENATOR SARBANES. Thank you very much, Chairman Obey.

Mr. Chairman, I have been listening to these answers with some concern, not so much by the substance ... I gather you are about to leave and get on an airplane. Could I inquire what kind of timeframe——

MR. GREENSPAN. I actually have until 1:00.

REPRESENTATIVE OBEY. However, Senator, you do not get all that time.

SENATOR SARBANES. But I assume I will get time that equalizes me with my colleagues?

REPRESENTATIVE OBEY. I will recognize you for 15 minutes, because the others had a 10-minute opening round and a 5-minute follow up.

SENATOR SARBANES. All right. First of all, let me say at the outset, just to set the stage, Chairman Obey, that I want to welcome, as I know others have done, Chairman Greenspan before the Committee. It is

always a pleasure to have him here and to have an opportunity to exchange views with him.

I cannot understand the kind of wailing and gnashing of teeth I am hearing over the fact that the economic ship is off course. All the reports that are coming in now—we had the CBO report the other day—indicate that this economic ship is on course.

My own view is that the policy on everybody's part ought to be "Steady as she goes." I think that means that the Congress, of course, needs to stay with the discipline of the fiscal policy that was enacted in the measure passed last August, and I would hope it would also mean that the Fed would stay with its monetary policy and not move it around at this point.

Now, last February in the Humphrey-Hawkins report, the Board of Governors came to the Congress and said, and I quote:

> With regard to fiscal policy, credible action to reduce the perspective size of future federal budget deficits could yield a very direct and meaningful payoff in the form of lower long-term interest rates.

Apparently Senator Bennett made some comments, but it is quite true about what I pointed out, along with Chairman Obey last year, was that if we were confronted with this problem of trying to address a federal budget deficit that was on an upward trend line, so much so in fact that as a percentage of GNP, it was growing, and that was seen as a very important thing to accomplish.

Even though we were confronting significant unemployment, it was asserted to us, as I have just read from the Humphrey-Hawkins report, and more generally, if we could put in a credible deficit reduction program, it would bring a response on the financial and monetary side, which would give us better interest rates to work with and that the sectors of the economy sensitive to the interest rates would then respond.

So, while you were restraining the economy through your fiscal discipline, you would get some impetus for growth in the economy through the response to an accommodating monetary policy. My own view is that that is what has happened, actually. And I think this package that was put together has been working pretty well. In fact, it has been working so well that there has now been a revision of the deficit reduction goals, or projections, I should say, so that they are even more forthcoming than they were when we put the package in place.

So I am very concerned with keeping this economic ship on course. I know that does not come as a surprise to you, but I wanted to say that by way of preface to some questions I want to put.

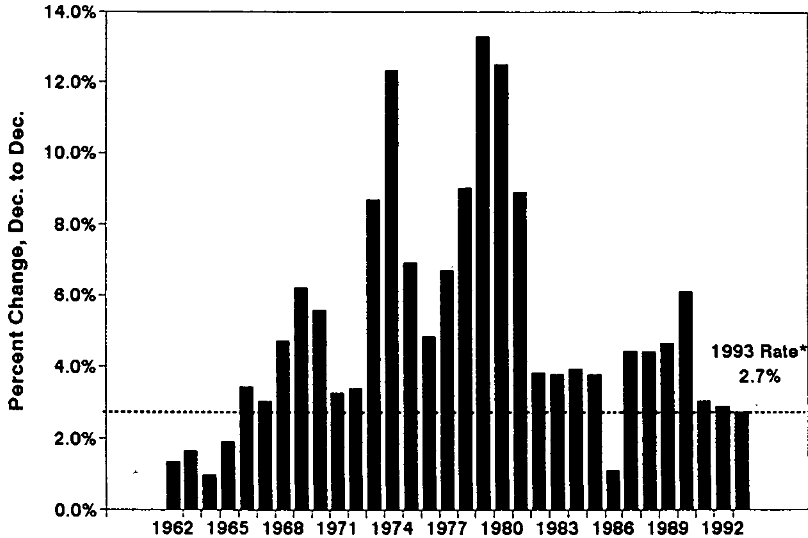
First of all, my understanding is that the inflation performance rate last year was 2.7 percent; is that correct?

MR. GREENSPAN. Yes, sir.

SENATOR SARBANES. That is the lowest inflation rate—this is the CPI inflation rate—the lowest inflation rate since 1965, with one exception. The one exception being——

MR. GREENSPAN. 1986.

SENATOR SARBANES. Yes, 1986. That is reflected in this chart (see chart below). This is the inflation rate for last year, and as we can see, it is lower than any year going back to 1965, with the exception of this year in the mid-1980s when we had a sharp break in oil prices. Am I correct in that analysis?



MR. GREENSPAN. That is correct, Senator.

SENATOR SARBANES. So on the inflation front, that is really a very, very good performance. I mean, it is the best performance in almost 30 years, with one exception.

Now, I also understand that the Bureau of Labor Statistics has done some studies published in the *Monthly Labor Review*, which suggests that the inflation figure of 2.7 percent could actually overstate the actual inflation rate by as much as half a percentage point. Are you familiar with those studies?

MR. GREENSPAN. I am, Senator. In fact, our view is that we suspect the adjustment may be even more than that.

SENATOR SARBANES. And is that based on some studies that the Fed staff has done?

MR. GREENSPAN. Yes, the Fed staff and a number of economists in the private sector who have been looking at these data in some detail.

SENATOR SARBANES. Now, if those studies are accurate—because time is limited, I will not probe into the factors of those studies, although, Mr. Chairman, at some point, it might be helpful for us to do a hearing that would do that—but if those studies are on track, then it is quite possible that we are really dealing with an inflation rate more around 2 percent than 2.7 percent. Would that be correct?

MR. GREENSPAN. Yes, sir. That is a CPI inflation rate. The point I was making earlier with Chairman Obey is that if one looks at the broader inflation rate, it is probably less than that.

SENATOR SARBANES. Even less than that?

MR. GREENSPAN. Yes. I have said on many occasions in testimony before the Congress that I thought we were not all that far from price stability. Indeed, I think history does suggest that while we are not there yet, clearly, we have made considerable progress in that direction, as those data show.

SENATOR SARBANES. There are some who think that if you get growth of any significant degree and duration, you are going to get an increase in labor cost. I would like to ask about that because it is not quite clear to me that the old connection that was posited between those two factors exists. First of all, you have a fairly good productivity performance. Would you agree with that?

MR. GREENSPAN. I do.

SENATOR SARBANES. Second, we are now more integrated into an international economy, so as you get slow growth in Europe, high unemployment and low wages in developing Third World countries, all of which, of course, put their products into the international trading regime. Does that not also act as a pressure or a restraint on an increase in labor costs here?

MR. GREENSPAN. It works in that sense, if you are asking: Does an increased degree of imports that has occurred in this country where inflation rates are being suppressed by excess capacity abroad, does that impact on the price levels in the United States? The answer to that is yes. Import prices have been rising at a fairly subdued pace and have contributed to a not insignificant part of the decline in overall inflation as reflected in the Consumer Price Index. But I think we do have to be a little careful about presuming that one is dealing wholly with an international market where the effects of high unemployment in one area are fully transmitted into the United States. The evidence we have suggests that that is a relatively minor effect. And we have not been able to find, other than through the direct effect on import prices, a major impact on domestic wages or domestic prices as a consequence over that phenomenon.

SENATOR SARBANES. I was struck by a column written recently by Hobart Rowan in which he pointed out that there are many pressures on wages in the United States, including plentiful imports from abroad,

where labor is in excess supply, double-digit unemployment in Europe and low wages in Third World countries.

Just to address this notion, if you begin to restore employment and bring down the unemployment rate and therefore begin to tighten up the labor market somewhat, it is inevitably going to lead to rising inflation. I think that lays the basis for the inflation dimension that I want to address.

MR. GREENSPAN. Let me add one thing, Senator. Remember that most of this process seems to be working through the goods components of imports. And the evidence, as far as I can judge, that we are getting spillover effects in the services area from abroad is inconclusive on that question.

SENATOR SARBANES. The other point, on the commodity indices, I gather that the raw materials used in industry and manufacturing actually are declining that index.

MR. GREENSPAN. I am sorry, is what?

SENATOR SARBANES. Raw materials for industry and manufacturing are declining?

MR. GREENSPAN. No. As I indicate in my prepared remarks, there is some evidence that they have been firming of late. That is a consequence of the fact that there has been some pickup in orders and demand and the degree of domestic industrial production slack has gone down, and there is some relationship that exists with respect to those particular prices and the levels of industrial activity, which seem to be working now as they have in the past.

SENATOR SARBANES. I will stand corrected. I understood that the index based largely on farm prices rose steadily during 1993. Of course, we had the flood in the Midwest and drought in the Southeast that impacted food prices, and which are hopefully one-time occurrences and will not repeat themselves in 1994.

I understood the other index, based primarily on prices of industrial raw materials, fell during most of 1993.

MR. GREENSPAN. I think you can find, if you want to dissect the producers' price index, that there are elements that are going up and going down.

In general, prices have been remarkably stable. We have seen, for example, some pickup in some of the domestic raw materials prices. For example, steel scrap prices have risen quite significantly. Lumber prices have risen. My recollection is that cement has risen. There are a number of them. They are not sufficiently broad-based to stipulate that there is a major expansion coming from the commodities' side by any means.

SENATOR SARBANES. I will close on this by quoting from this morning's *Wall Street Journal,* which says:

> Treasuries were pushed higher across the board Friday on word that inflation pressures were minimal in the fourth quarter.

Soon after, in the morning, the Commerce Department reported fourth-quarter gross domestic product figures prices began soaring. Profit taking by midafternoon took some of the glow off the gains, but, nonetheless, the market put in an impressive performance. The Commerce Department reported the fixed-price deflator rose at a rate of 2.2 percent, and the implicit-price deflator, a measure of consumer consumption patterns, rose at a rate of only 1.3 percent.

Now, let me turn to the growth figures. What I am concerned about is this talk about, quote, a preemptive strike. Now, a preemptive strike, the way it is being defined, is something that would be done without any rational base, without any figures with which to work off, at least as some asserted. I am not attributing this to you, Mr. Chairman, but I am talking about some others who talk about it.

In effect, they say, "Well, these figures are all very good." In fact, they are the best figures, as I have outlined, in 30 years. Everywhere you look, you can find a little tightening here and a little tightening there. But, as you have said this morning, it is basically stable. Yet, you get people coming along saying, well, now, we have to have a preemptive strike. Yes, we know all of those figures, and I can't cite you something that warrants it, but we want to move in in anticipation. Of course, you can do anything on that basis. I mean, all you have to do is to conjure up a scenario, then you anticipate it, and then you do your preemptive strike.

Now, let me ask you this question. Last year at this time, do you recall what the Blue Chip forecasters were predicting for the growth of the economy?

MR. GREENSPAN. You mean for basically——

SENATOR SARBANES. For 1993.

MR. GREENSPAN. You mean the end of January, or thereabouts?

SENATOR SARBANES. Yes.

MR. GREENSPAN. By then, they were revising growth down significantly. I have forgotten what the numbers were, but since you obviously have them there—at least, I hope you do—I would not want to guess what you can tell me.

SENATOR SARBANES. My understanding is 3 percent.

MR. GREENSPAN. Well, that is not too far from what actually happened.

SENATOR SARBANES. No. We got eight-tenths of a percent in the first quarter.

MR. GREENSPAN. Oh, you were talking about the first quarter. I thought you were talking about the year as a whole.

SENATOR SARBANES. They were projecting that the growth experienced in the fourth quarter of 1992 would slow, but would slow to about 3 percent in the first quarter of 1993.

MR. GREENSPAN. Yes.

SENATOR SARBANES. Of course that did not happen. It slowed to eight-tenths of a percent. Then, in the next quarter, it went to 1.7 percent, I believe.

MR. GREENSPAN. Well, it depends. It is an interesting question about the second quarter. If you come at it from gross domestic income, which is a conceptually equivalent view of the second quarter, you get a somewhat higher figure, and there were more indications of strength in the second quarter than the gross domestic product showed. But, clearly, it was subdued, and acceleration did not occur in any meaningful sense until we got into the second half of 1993.

SENATOR SARBANES. The information I have is that last year in the January 1993 issue of *Blue Chip Economic Indicators,* they predicted that economic growth in the first half of 1993 would be roughly 3 percent. Instead, we had average growth in the first half of barely 1 percent.

Now, the only reason I bring this history lesson forward is because I want to stay on the steady-as-she-goes course in order to get a good reading—or a much better reading than I have at this point—about where the economy is going to be going in 1994. A lot of the kick that is coming to the economy now, at least as I perceive it, is coming from interest-sensitive sectors of the economy. Would you agree with that, Mr. Chairman?

MR. GREENSPAN. I think that is correct. Yes.

SENATOR SARBANES. As a worthy accommodation on the monetary side, in response, I think, to doing a fiscal policy, which you have urged on us over the years. I think that is fair to say, is it not?

MR. GREENSPAN. It is, indeed.

SENATOR SARBANES. I do not necessarily want to tie you down to the exact quantity or the components of it, but in the macro sense, we moved in that direction last August. This a creditable way in which you have been advising us to do for quite some time. Is that a fair statement?

MR. GREENSPAN. That is correct, sir.

SENATOR SARBANES. All right. Now, I am concerned that this growth continue on a fairly steady basis, and my own view is that we are not anywhere near far enough into 1994 to be sanguine on that point. I will just leave that as an observation.

My time is almost up, but I want to close with one point. The Open Market Committee meets on Thursday and Friday of this week?

MR. GREENSPAN. That is correct, Senator.

SENATOR SARBANES. On Friday, the Commissioner will be before us to report the unemployment rate determined on a new basis, as you know. That figure may jump around. We are not really sure what is going to happen. There are new survey techniques, greater use of the computer. An alteration in the sampling pattern is being done. Has all of that been explained to the members of the Open Market Committee?

MR. GREENSPAN. We have had extensive discussions with the Bureau of Labor Statistics on the details, and we have communicated clearly to the Board and to the Presidents and, I would presume, to the staffs of the various Federal Reserve Banks who are involved in this. So we are about as knowledgeable at this moment as one can be with the very large uncertainties, with respect to shifting from one sample procedure to another, which will inevitably create some difficulties in interpretation.

I would certainly presume that since we are meeting after those data are released, our staff will go over in some detail with the members of the FOMC as to what they can infer from those data and what the contacts we had with BLS, with respect to them, suggest.

SENATOR SARBANES. Well, I only make this point to urge a certain amount of caution or prudence in reacting or interpreting these figures, just as I assume you would want us in the Congress to exercise some caution and prudence in responding to these figures until we fully understand exactly what they mean. They may be different in a significant way from the figures we have been dealing with, and, until one can digest all of that, it ought not to be the basis for change in policy.

So, Mr. Chairman, I conclude as I began. I think the economic ship is on course. I think steady as she goes is the lesson all of us should draw from the current situation. Thank you very much.

REPRESENTATIVE OBEY. Mr. Chairman, I want to thank you for coming. You are out of here in time to catch your plane, and I would simply echo the last comment of Senator Sarbanes and hope you have a good trip. Thank you very much.

MR. GREENSPAN. Thank you very much, Mr. Chairman.

[Whereupon, at 12:40 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF THE HONORABLE MR. GREENSPAN

Mr. Chairman and members of the Committee, as you know, the Federal Reserve will be meeting later this week and will submit its semiannual report on monetary policy to the Congress in late February. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation and for monetary policy in 1994. Under the circumstances, my opening remarks this morning will focus on identifying the major tendencies currently visible in the economy and the broad considerations that will likely be shaping our policy decisions in the weeks and months ahead.

As you may recall, in my appearances before this Committee in recent years, I discussed in detail the structural imbalances that I believed were impeding U.S. economic growth. I referred in particular to the enormous strains on the balance sheets of many households and businesses. Those strains, which grew out of the excessive debt expansion of the 1980s, were exacerbated by the subsequent weakness in real estate prices in the early 1990s. Moreover, these difficulties spilled over to the financial intermediaries, which—faced with mounting loan losses and with pressure from the markets and regulators to improve their capital ratios—restricted credit supplies to many small firms and other borrowers.

Considerable progress has been made in correcting these imbalances. Many households and businesses have materially improved their financial positions—as evidenced by the drop in debt-servicing burdens for all sectors and the decline in debt-to-equity ratios for businesses. In addition, banks and other financial institutions, having replenished depleted capital bases, have begun to demonstrate a greater willingness to make loans.

The Federal Reserve, through its deliberately accommodative stance, has played a key role in the restructuring process. But it is important to emphasize that monetary policy must not overstay accommodation: Maintaining the confidence of financial market participants has been crucial for sustaining the declines in inflation expectations and, hence, in long-term interest rates that have facilitated the balance sheet adjustments to date. The actions taken last year to reduce the federal budget deficit have been instrumental in creating the basis for declining inflation expectations and easing pressures on long-term interest rates. Although we may not all agree on the specifics of the deficit reduction measures, the financial markets are apparently inferring that, on balance, the federal government will be competing less vigorously for private saving in the years ahead.

Partly because of these structural adjustments, the foundations of the economic expansion are looking increasingly well-entrenched. Real gross domestic product rose at an annual rate of nearly 3 percent in the third quarter of 1993, and the advance estimate for the fourth quarter indicated growth of nearly 6 percent. The labor market has also shown signs of notable improvement. Payroll employment rose about 2 million last year, and unemployment dropped appreciably; the unemployment rate for December 1993, at 6.4 percent, was almost a full percentage point below the level of late 1992.

The greater buoyancy in economic activity of late has been evident across the household and business sectors. Housing construction, stimulated by mortgage rates that are the lowest in more than 25 years, has increased markedly; and consumer spending, after hitting a lull in the first quarter of 1993,

has posted sizable gains over the past three quarters. Outlays on consumer durable goods have been especially robust, in part to make up for the spending on motor vehicles that was deferred during the 1990-91 recession and the early expansion period. In addition, the pickup in home sales is bolstering purchases of furniture and appliances.

Business fixed investment was very strong throughout 1993. It rose nearly 15 percent in real terms over the four quarters of the year, and order books in real terms over the four quarters of the year, and order books for early 1994 are apparently filling rapidly. Stimulated by dramatic innovations in products and extensive price-cutting by the computer manufacturers, real outlays for office and computing equipment have continued to soar as cost-conscious businesses have rushed to exploit the new technologies. And with a favorable outlook for overall business sales, ample profits and cash flows, and relatively low cost of capital, firms have also increased their outlays on more traditional types of equipment. In addition, activity in the nonresidential construction sector finally is recovering from the depressed levels of the past few years.

Although recent economic developments, on the whole, have been favorable, the expansion has remained uneven. In the labor market, firms' efforts to restructure and improve productivity are continuing to restrain hiring, and concerns about job security persist. In addition, employers seem to be relying to an unusual degree on the use of overtime and temporary employees, in part perhaps because of the cost of providing fringe benefits to permanent full-time workers.

Moreover, not all business sectors are faring well. In particular, industries and regions that depend heavily on military spending will continue to experience sizable dislocations and disruptions. also, many state and local governments are still struggling to reconcile a rising demand for services—especially in education, health, and crime prevention and corrections—with limited growth in revenues.

Another concern is the weakness in the economies of some of our major trading partners, which has continued to constrain our export performance. Among the industrial countries, Canada and the United Kingdom appear to be emerging from deep slumps. However, signs of near-term improvements in Japan and continental Europe are scant. In Japan, asset deflation and associated financial problems continue to hold back growth, and in Germany, the far-reaching and costly adjustments associated with unification are still a restraining factor. In reaction to their economies' weak performances, monetary officials in the two countries fostered continued, cautious reductions in interest rates in 1993—as did officials in most other industrial countries. Government budget deficits generally worsened last year because of cyclical factors—and, in some cases, endeavors to stimulate demand. this deterioration of budget positions has limited the scope for further fiscal action in most countries.

As for the developing nations, economic conditions in Asia, fueled in part by exceptionally rapid growth in China, remained strong in 1993. In Latin America, however, real growth in Mexico fell to near zero, reflecting the depressing effects of a policy attempting to contain inflationary pressures and, for a time, growing uncertainty about whether the North American Free Trade Agreement (NAFTA) would be implemented.

The passage of the NAFTA in November represented a significant achievement for the North American continent. Besides reducing tariff and nontariff barriers on trade, the NAFTA extends liberalization to nontraditional areas, such as financial services and intellectual property. The trade agreement

reached in December in the Uruguay Round of the GATT also covers a some of these nontraditional areas. Approval by the Congress of the GATT agreement would likely stimulate U.S. exports of high-technology products. More broadly, these agreements are significant because they represent a rejection by the United States and our major trading partners of calls to turn inward in our economic and financial policies.

Interpreting the economic data for the United States over the next few months will be especially complicated. As you know, the Bureau of Labor Statistics is redesigning the household survey of employment. Also, many key indicators of production and spending will be affected by the earthquake in Southern California and by the extraordinary weather conditions elsewhere. Nevertheless, although real GDP growth will almost surely slow appreciably from the rapid pace of late 1993, the economic fundamentals appear to be in place for further solid gains in the level of activity in the quarters ahead.

Recent data on prices and wages generally suggest that inflation remained in check through 1993. With the fourth-quarter to fourth-quarter change in the so-called core GPI edging down to 3.1 percent, the lowest reading since the early 1970s. To be sure, the acceleration in domestic economic activity has put some upward pressure on prices of a number of industrial materials, and measures of resource utilization are considerably higher than they were six months ago. Nonetheless, productivity growth has kept unit labor costs subdued, and the broad measures of inflation have remained will contained.

No doubt, many of the forces that helped restrain inflation in 1993 will continue to do in 1994. Businesses will almost certainly remain intent on boosting productivity and controlling costs, and competition from abroad will continue to deter price increaes—even in markets with limited spare domestic capacity.

History suggests, however, that higher price inflation tends to surface rather late in the business cycle and, hence, is not a good leading indicator of emerging troubles. By the time inflation pressures are evident, many imbalances that are costly to rectify have already developed, and only harsh monetary therapy can restore the financial stability necessary to sustain growth. This situation regrettably has arisen too often in the past.

The challenge of monetary policy is to detect such latent instabilities in time to contain them. Unfortunately, they are rarely visible until relatively far advanced. Moreover, once they are identified, policy actions to counter them take time to have their effects. Thus, the need of monetary policymakers for early indicators of developing problems is evident.

Historically, many such indicators have come from the financial sector: Money supply growth, the slope of the yield curve, quality spreads, and credit flows are among the variables that have helped the monetary authorities over the years act in advance of developing problems. In recent years, however, as a result of financial innovations and the unusual nature of the most recent business cycle, such indicators have, at times, produced misleading signals. The broad money and credit aggregates, for example, have suggested declining inflation in the United States—but by far more than has actually occurred.

Turning to nonfinancial variables, the degree of slack in the economy is important because it plays a major role in influencing whether inflation is increasing or decreasing. Over the longer haul, however, the level of inflation—that is, the rate of price change depends crucially on price expectations, and not on the degree of slack. In the twenty years after World War II, most economists gave short shrift to expectations as a key determinant of inflation. Unemployment and inflation were considered simple tradeoffs. A lower rate of unem-

ployment was thought to be associated with a higher, though constant, rate of inflation; conversely, a higher rate of unemployment was associated with a lower rate of inflation.

But the experience of the past three decades has demonstrated that what appears as a tradeoff between unemployment and inflation is quite ephemeral and misleading. Over the longer run, no such tradeoff is evident. Attempts to force-feed the economy beyond its potential have led in the past to higher inflation and, ultimately, not to lower unemployment, but to higher unemployment, as destabilizing forces and uncertainties associated with inflation induced economic contraction. In that regard, experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living.

Currently we have the difficult task of assessing the appropriate time to move away from an extended period of monetary accommodation. The policy was established purposefully, largely to address the balance sheet strains I mentioned earlier. This monetary policy has been effective in that households and businesses are now in stronger financial condition. But the job is not yet complete. Unfortunately, although we can assess how far the process of repairing balance sheets has proceeded, we do not know how much further it will go, mainly because of the difficulty of gauging desired levels of debt. What is clear, however, as I indicated here a year ago, is that we did not need to complete the job before evidence of faster economic growth would emerge. We have been growing in fits and starts; but smoothing through the data of the past two years, we have seen real GDP rise at a respectable 3.4 percent annual rate—sufficient to reignite job creation and significantly reduce unemployment.

A number of questions will have to be addressed by the Federal Open Market Committee. Foremost will be when is the appropriate time to move to a somewhat less accommodative level of short-term interest rates. We will have to make the judgment as to how long we can continue monetary accommodation, without sowing the seeds of another bout of inflationary instability accompanied by steeply rising long-term rates. Such an outcome would bode ill for economic growth in 1995 and beyond. On the other hand, we will also have to judge whether higher rates could slow the necessary completion of balance sheet repair to a point where economic growth is inhibited.

Short-term interest rates are currently abnormally low in real terms. At some point, absent an unexpected and prolonged weakening of economic activity, we will need to move them to a more neutral stance. Such an action would not be taken in order to cut off or limit the economic expansion, but rather to sustain and enhance it. The foremost contribution monetary policy can make to achieving higher standards of living in the United States is to provide the stable financial foundation for continued economic growth.

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ROUNDTABLE DISCUSSION ON THE ECONOMICS OF HEALTH CARE

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

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ROUNDTABLE DISCUSSION ON THE ECONOMICS OF HEALTH CARE

THURSDAY, APRIL 21, 1994

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

The Committee met, pursuant to notice, at 10:15 a.m., in room 2359, Rayburn House Office Building, Honorable Lee H. Hamilton (Member of the Committee) presiding.

Present: Representatives Hamilton and Saxton, and Senators Dorgan and Craig.

Also present: Patricia Ruggles, George Foy and Morgan Reynolds, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, MEMBER

REPRESENTATIVE HAMILTON. The meeting of the Joint Economic Committee will come to order. We are having another in a series of round table conversations that the Joint Economic Committee is holding with prominent economists to discuss the state of the economy and economic policy.

Today's topic, the Economics of Health Care, is certainly one of the more important economic policy issues of the 1990s. We are pleased to have as our guest, Mr. Henry Aaron, Director of Economic Studies at the Brookings Institution.

Over the years, Mr. Aaron has made important research into the areas of property taxation and social security, tax reform, and most recently health care. He is the editor of the Brookings Institution 1990 book, *Setting National Priorities, Policies For The 1990s*, and he has written of course extensively on health care.

We are pleased to welcome you, Mr. Aaron, and look forward to a good discussion with you. We will let you proceed with whatever opening statement you would like to make and then we will turn to questions.

STATEMENT OF HENRY J. AARON, DIRECTOR, ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

MR. AARON. I will try to be brief. Thank you very much for inviting me. It is a privilege to have this opportunity.

Conversation entails a two-way exchange, so I am going to be brief in my opening statement.

The health-care debate has passed through the initial phases during which the various parties put forward their ideal plans. None of the plans can command a majority in either House of Congress in my view. Regardless of what our personal preferences for the best of the candidate plans, compromise is going to be essential.

In my view, compromise is possible, specifically a compromise that would enable most of the supporters of the major health-care reform proposals to join together in a signing ceremony in the Rose Garden and declare victory, declare that they have achieved the major purposes of their health-care reform bills.

I turned in a brief outline, which is headed, "Draft Specifications of a Compromise Plan." It was put together with that express purpose in mind.

There are many centers of ideas on health-care reform. I focused on four of what I regard as the more important and larger groups in Congress. Of course, President Clinton's plan has its supporters, and Senator Chafee's proposal enjoys considerable support, particularly in the Senate.

Congressman Cooper's proposal has bipartisan support in the House of Representatives, and although I think many members of the fourth group would acknowledge that they have little chance of triumphing in the end, a very sizable fraction of the House of Representatives favors what is sometimes called the single-payer or Canadian-style approach to health-care reform.

In the end, in my view, most members of those four groups are going to have to join together and be prepared to vote for a bill that the President can sign.

The draft proposal that I put forward was assembled with that express goal in mind. Let me run very briefly through the main provisions of it, and I will try and point out where specific elements of the proposal link up with what seem to me to be preeminent objectives in each of the four groups, starting with an employer mandate.

The President's plan embodies it. It is the instrument by which he assures that all employees and their families will be covered by insurance, and not unimportantly, that those funds now being spent by businesses remain in support of health insurance.

Nonetheless, there is powerful and very effective opposition to the employer mandate from the small business community and from some larger companies that operate through small outlets—fast food chains, for example.

Provision one would impose an employer mandate, but only on firms exceeding a certain employment size. Furthermore, the mandated share of health insurance costs that employers would be required to pay I suggest at a lower level than that contained in the President's plan. I use 50 percent as an illustration, but obviously that is not anything but a person's suggestion.

Furthermore, I suggest reintroducing what is clearly a loophole that used to exist in the tax law with respect to the corporation income tax. There was a provision enacted some years ago called the Thom McAnn rule, which was designed to prevent large corporations that consist of many separate outlets from organizing to take advantage of the lower corporate tax rate on the first few dollars of corporate earnings. The Thom McAnn rule required corporations to consolidate.

My suggestion is that with respect to health insurance, that rule not be applied so that large collections of small outlets—fast food operations— would be regarded as collections of small businesses, and the mandate would not apply to them.

As you will see, however, when I come back to certain later provisions, I believe that the financial incentives will confront even such businesses with offers for incentives to sponsor and pay for insurance that they will not be able to resist.

Purchasing cooperatives perform many important functions in three of the four major groups' plans that I described: Senator Chafee's, Congressman Cooper's, and President Clinton's. Nonetheless, the particular formation of alliances or cooperatives that President Clinton proposed has run into intense and, I think, overwhelming opposition.

Accordingly, the second element of what I suggest proposes an alliance structure that is looser and less prescriptive in many ways than President Clinton's.

A public alliance in a geographical area, much like that proposed by President Clinton, would be created, but it would not have monopoly authority. Other groups containing, again, an illustrative number, at least 5,000 members, could form alliances of their own. There would be no prescription as to which organizations could band together to do so.

I suggest that one not leave to State legislatures the task of trying to draw alliance boundaries, the reason being captured, I think, in a quip that somebody made about alliances. The joke was that alliances are redistricting to meet school finance needs.

The political difficulties of drawing alliance boundaries, I think, could be sufficient to derail implementation of a proposal by itself. For that reason, the second element of this cooperative or alliance structure would be the use of some already existing federal boundary system, Federal Reserve districts, Health and Human Services region, census districts, I am not sure what, but adopt some such boundary structure presented to Congress much as base closing legislation was presented, up and down.

If the alliances want to negotiate with one another, all right, they can write treaties. It is voluntary among themselves, but you have something to go with at the outset, and it doesn't entail a monopoly.

The most innovative part of this compromise proposal concerns the subsidy structure. The Clinton bill has been, in my view, rightly criticized for the subsidy structure applied to businesses. Low, average-wage small businesses are eligible for subsidies, not others.

That creates incentives for outsourcing, for reorganizing businesses to qualify for subsidies. It also doesn't deal with the disemployment effects that might arise if one mandates expensive health insurance in large companies.

Accordingly, subsidy structure at the business level should be keyed to workers, not to businesses. My suggestion is that whatever share of health insurance cost business is required to bear, it be capped at a certain percentage of the worker's earnings, say 10 percent. That would put the added cost of health insurance for those businesses not currently sponsoring and paying for health insurance at about the magnitude of actual increases in the minimum wage that have been enacted.

Studies indicate that the disemployment effects from those increases in the minimum wage have been trivial. For that reason, I think we delay a side concern about the disemployment effects.

But the key part of this is that the amount of subsidy paid on behalf of any family to help them buy insurance shouldn't be based on the average earnings of their employer. It shouldn't be based on the wages of any one household member. It should be based on family income.

That truth, I believe, lies at the heart of the Chafee proposal.

Accordingly, each year at year end, the employer, on the W-2 form that every employee receives, would have another box that would report how much the employer had paid for health insurance. The employee's family would, on the annual tax return, have a one-page added with a table, based on family income and family size, one would read off the dollar amount of premium that household is required to pay for health insurance, subtract what the employer has paid already. The household owes the difference or, in special cases, if more has been withheld than the family owes, the household receives the refund. This minimizes subsidy cost because you use the right index for targeting aid, family income, not an inaccurate measure, earnings or average wages in a business.

It is a simple system that would be easy to incorporate into withholding so that people on an ongoing basis pay for their health insurance. One could use the withholding framework much as we now use it to enforce the personal income tax.

The final element of the subsidy structure that comes back to provide, I would say, a very powerful incentive for small businesses to sponsor and pay for health insurance is that employer payments for health insurance, as under current law, would be tax exempt, not excluded from personal income tax. The payments made at the house-

hold level would not be deductible. That means that every worker knows, first of all, he or she is going to be covered by health insurance, is going to have to pay a certain dollar amount based on family income—no getting away from it. If the employer pays for it, you don't have to pay taxes on it. If the worker pays for it, they do have to pay taxes on that income.

That means that every worker is therefore transformed into a lobbyist with his or her employer to urge that employer to sponsor health insurance and pay for the employer's share of the cost.

That situation does not exist today, because if the employer doesn't sponsor, the worker doesn't have to buy health insurance. For that reason, I believe this arrangement would encourage strongly mom and pop grocery stores, McDonald's, and everybody else, to enter the market voluntarily for health insurance.

The fourth element is the benefit package. The President's plan is relatively generous. Congressman Cooper's is unspecified. I don't think you can get away with an unspecified benefit package leaving that to subsequent administrative action.

Congress is going to want to know what it is buying, but I believe it is possible to meet the President's commitment to universal coverage, without which he says he will not sign a bill, and I believe him, with a smaller benefit package.

One could raise cost sharing. One could trim back certain benefits, many of which are desirable, and actually I would like to see in health insurance. I would buy it if it was available to me. But they raise the cost of health insurance and make it more difficult for Congress to put together a fiscally coherent package.

If you could trim the package back from about the 50th or the 60th percentile of major corporate plans, which is where the President's plan is now, to say the 15th or 20th percentile, you could knock about 15 percent off the overall cost of the plan, and while that may not seem a lot, it has a big bearing on subsidy costs and on the initial premiums that companies not now sponsoring insurance would face.

Fifth, slow down implementation. I suggest that both for administrative and budgetary reasons. Implementing national health insurance through whatever mechanism is a monumental job. We don't have a lot of the data. We don't have a lot of the administrative apparatus.

I think we need somewhat more time than contained in the President's proposal.

Finally, not a gesture, but a genuine movement to Congressman Cooper and supporters of managed competition, a big debate out there was whether changed incentives will actually suffice to slow the growth of health-care spending.

I think the overwhelming majority of Americans would be just delighted if, by changing incentives, we could slow the growth of health-care spending sufficiently and do away with the need for prescriptive administrative rules there.

There may be some junkies who love administrative rules, but I don't know any.

On the other hand, there is broad skepticism that simply modifying incentives will cut spending adequately or fast enough. The last element of what I suggest is, I call, the put-up or shut-up approach to managed competition. That is to say, one sets up the rules for purchase of insurance, then changes the tax rules in some ways I haven't gone into here that are in the brief statement to encourage cost conscious buying on the part of households.

One establishes targets for spending and a period of time over which one is going to give managed competition a fair run. If at the end of that period spending is within target levels and you can't set the targets unreasonably slow, they have to be modified back in view of my expenditures, then you declare victory and you stick with the incentive structure. No need to call into effect the regulatory devices.

If they fail, however, you enact a regulatory device the same time you pass the bill initially, and you have an administrative apparatus ready to go.

In a nutshell, that is what I think could be the basis of a compromise plan all parties favoring major legislative modification could endorse. It has the employer mandate and universality for President Clinton. It has, in the end, subsidies based on households for Senator Chafee. It has a fair run for managed competition for Congressman Cooper, and for those who advocate the single-payer approach, as with many of the proposals, it should have a state cutout. If any state wishes to adopt a straight Canadian style approach, as long as they meet certain federally established performance standards, they should be free to do so.

[The prepared statement of Mr. Aaron, together with an attachment, starts on p.38 of Submissions for the Record:]

REPRESENTATIVE HAMILTON. Mr. Aaron, thank you very much.

We will begin with questions. I will begin with you, Senator Craig. We will move along under a loose five-minute rule.

Senator Craig, please proceed.

QUESTIONS BY SENATOR CRAIG, MEMBER

SENATOR CRAIG. My time is going to require that I clearly stay under five minutes, Mr. Chairman. I do have to leave. Thank you.

REPRESENTATIVE HAMILTON. You go right ahead.

SENATOR CRAIG. Mr. Aaron, in your concept where you develop the purchasing cooperatives or the alliances, do I understand you to say that you permit voluntary alliances, but I say establish public alliances. Are you looking at two different types?

MR. AARON. The principle here is that there exists a public alliance, which is, if you will, an alliance or a cooperative of last resort. Business that has more than 5,000 employees, as in the President's plan, is automatically permitted to form its own alliance.

A voluntary private organization that wishes to form an alliance, as long as it has a minimum—I selected 5,000—a minimum number of members, is permitted to organize.

Now, if one does this, there is an additional layer of administration that has to be brought into existence. In particular, in order to avoid groups of low-cost patients from banding together in order to get special deals and——

SENATOR CRAIG. Game the system.

MR. AARON. Game the system. One needs to have risk rating over alliances, and that would have to be done presumably at either the state or at the national level, but it would permit people to join different alliances.

SENATOR CRAIG. My next question, you did not speak to insurance reform as a part of your mechanisms, and you mentioned the gaming of the system or types of groups coming together that have unique healthcare needs, or lack thereof.

MR. AARON. That is an important point, and I am glad you raised it. I tried to keep it short and readable. One of the functions of the cooperative or alliance, in my view, should be enforcing the rule that any insurer who offers coverage through one alliance must offer insurance on the same terms through all. That means at the same premium. That means community rating.

Now, whether community rating is defined over just the classes that President Clinton has proposed—really three or four, depending on how you treat couples versus single people with children—is a separate issue. Many people who generally favor community ratings say that there should be some age variation, nonetheless, so that one could have a single community rate for people under the age of X and a different one for people over the age of X. I have not gotten into that. That is a highly technical issue.

One really needs actuaries and model builders who deal with the gradations of community rating.

SENATOR CRAIG. The reason I react to that, I come from one of the lowest cost states in the Nation, and we don't want to have to pay for New York's problems.

MR. AARON. I know that. The lowest?

SENATOR CRAIG. To be very straightforward about it, Idahoans are very fearful that a more uniform system, as proposed by the President, is going to level the field and we will go up, while others may not come down, but we will be forced up to other standards. And if you go to community ratings, you can capture the culture and the environment of a given area, and it ought to be allowed that——

MR. AARON. I agree. In fact, Idaho is the lowest cost state. Massachusetts is the highest, and Idaho spends half per capita——

SENATOR CRAIG. That is right.

MR. AARON. ——of what is spent in Massachusetts. So I can understand your sensitivities fully.

SENATOR CRAIG. Thank you, Mr. Chairman. Thank you, Mr. Aaron.

REPRESENTATIVE HAMILTON. Mr. Cox, please proceed.

QUESTIONS BY REPRESENTATIVE COX, MEMBER

REPRESENTATIVE COX. Thank you, Mr. Chairman. It has been pointed out often in the course of this health-care debate that the United States is nearly unique among nations of the world in not having a system of national health.

The good news implicit in this observation is that Congress has many models to look to in designing our own system and choosing which model to emulate.

Which country's system would you say your compromise plan most closely resembles?

MR. AARON. One can learn a great deal from other countries, mistakes they make, things that work. I think it is important, especially in the area of health care, not to see the reform process as one of adopting one or another country's plans.

Health insurance arrangements emerge from enormously complex historical patterns, differences in the delivery systems, wars, value structures, cultural and ethnic divisions.

No country's system is exactly like any other's and ours is not and never will be, in my view. What I have described would allow the Canadian system—if Vermont's legislature changes its mind and wants to adopt it, or some other state followed that model. It would allow the managed competition structure in California or Minnesota, if those states wanted to rely on that mechanism for cost control.

In the end, requiring employers to pay for a part of health insurance, not all, usually around 80 percent, that is a system that is widely used in many countries.

I don't think the system that I have described neatly lines up with that of any other country. It is an evolutionary variation on the system that exists in the United States.

REPRESENTATIVE COX. If that is the case, is it true that the elements of the proposal then are untested, that they have not proven to work in some other country, or can we point to another country where they do work?

MR. AARON. All health-care reforms are untested in the United States. None has been tried. We have tried the current system, and we know it is falling apart in a variety of ways.

Costs are rising at grossly excessive rates, in my view, and in the view I think of many others. The market for private insurance is imploding, so the issue of trying something untested, in a way, that is almost a recommendation. Ones that have been tested here are not working.

The various elements of this kind of a proposal, I think, have been tested and tried in different places. Employers are required to pay for a portion of health costs in Germany and some other European countries. Subsidies are implicitly or explicitly provided to households in the systems of all countries for families who have low incomes.

Setting rules for the marketing of insurance and the use of community rating—certainly in the latter community rating—certainly exists in most countries that rely on some kind of an insurance system.

We are unique, I think, in allowing the exquisitely attuned underwriting practices that have come into existence in the United States. So I think it is safe to say that no element of what I have described is untested or untried. The package is different.

It is a package that pulls together components of major reform proposals now on the table. The only thing in this proposal that I think is new is the subsidy structure, which is a way of linking an employer mandate to keep those employers now paying for insurance in the game, mostly at levels below what the vast majority of employers are now doing. So the bite of the mandatory part of this is really quite slight, linking that to a system of family-based subsidies, such as Senator Chafee has proposed. That is the really the only new part in this proposal.

REPRESENTATIVE COX. Taking the one country that you have listed, Germany, as an example, it has used a requirement to employers pay a portion of health care, has that worked satisfactorily as far as you are concerned?

MR. AARON. I think that health-care systems all over the world are under enormous stress today. To characterize any system as working well today requires a loose use of terminology.

REPRESENTATIVE COX. Let me be very specific. You cite Germany's example of a country that uses an employer mandate. Has the employer mandate worked in Germany?

MR. AARON. Generally, yes.

REPRESENTATIVE COX. The effects on unemployment, job creation?

MR. AARON. You have probably heard about this from other folks. In general, labor markets in Europe have a degree of rigidity far greater than that in the United States.

I don't think this particular provision significantly contributes to that rigidity, and we have in the United States and in other countries lived with a variety of mandates on employers. Employers don't like them many times, but they have not stopped the U.S. labor market from being remarkably flexible.

That holds true for the vast majority of companies that now do sponsor health insurance. There is no reason in my view to think that if a modest additional number phased incentives that encouraged them to pay for a portion of health insurance, the flexibility of U.S. labor markets would be significantly modified in any way.

Let me just add one thing. In fact, I think the availability of insurance, in general—and this is a point not new with me obviously, and President Clinton stressed it, correctly—we are concerned about job lock today. That is a major element of rigidity in current U.S. labor markets that I think none of us really likes very well. Health-care reform would loosen that and thereby facilitate mobility of the workers among jobs.

REPRESENTATIVE HAMILTON. Mr. Saxton, please proceed.

QUESTIONS BY REPRESENTATIVE SAXTON, MEMBER

REPRESENTATIVE SAXTON. Thank you, Mr. Chairman.

Mr. Aaron, I read with some interest, actually very early this morning, some of the things that you had written, and I came across an editorial that you wrote, which appeared in the *Plain Dealer*.

I think a similar one also appeared in the *New York Times,* where you were analyzing the economics of the Cooper health plan and its effect on the behavior of lower income people. And I think, in a general sense, you came to the conclusion that the Cooper plan would be counterproductive, in terms of encouraging positive economic growth, because of the way the plan was structured, and that people would be discouraged and it would be a disincentive for people to work to get above the poverty level. Is that a fair analysis?

MR. AARON. I was concerned about the work disincentive effects of the subsidy structure of the Cooper bill, yes.

REPRESENTATIVE SAXTON. So this is certainly a recognition—and you have mentioned this morning, as well—that there is a place for incentives. In reading, I didn't see anything that addressed what incentives or disincentives would result from the employer mandates that you and Mr. Cox were just talking about, relative to what type of behavioral effects employer mandates might have on employers, and I think you just said you didn't think they would be significant.

I find that a little bit strange in light of the fact that you recognized in other places that these types of economic changes do have effects on people's behavior.

MR. AARON. As in many issues, we can agree on the sign of an effect. The question is the magnitude. In this case, Congressman Cooper's bill, if enacted in its proposed form, would confront workers over a substantial range of the earnings' distribution with tax rates in the vicinity of 75, 80 percent.

That would mean that if you earned an additional dollar, you got to keep 20 or 25 cents of it. That is a big test. We could all agree about that and for that reason I was concerned about the effect on work incentives.

That tax rate came from the intersection of personal income tax rates—well, actually not personal—phase out of the earned income tax credit, the substantial rate at which subsidies for health insurance were phased out over this income range and various other taxes. You can't

get away from the phase-out of the earned income tax credit, and Congress isn't going to be legislating about payroll taxes for Social Security when it is dealing with health insurance. What it can do is limit the rate at which subsidies are phased out as income rises.

The approach that I described would have a much lower rate of phase out for the subsidies for health care than the Cooper bill called for, although any tax, let's be honest about it, has some effect on work incentives. Can't get away from it, the magnitude of the tax implicit in the proposal I described is much lower than that in Senator Cooper's—I was anticipating the election—Congressman Cooper's——

REPRESENTATIVE COX. President Cooper.

MR. AARON. He hasn't announced for that in his proposal, and so I could not go into it. I did not analyze lots of aspects of it. Let's stipulate that if one phases out subsidies—that is an implicit tax—that it is going to have some work incentive effects. They are just smaller.

REPRESENTATIVE SAXTON. So you and I agree that there are behavioral changes that might occur, that would occur vis-à-vis an employer mandate. We just would have to talk about what the effect of those changes in work incentive might be.

MR. AARON. I think one has to talk about the behavioral effects of the entire package, the payment structure, the availability of health care.

Let me mention one other effect that I think many economists would argue was more important than the one we are focusing on right now.

Under current law, to get health insurance, you have to go to work pretty much, unless you are poor enough to be eligible for Medicaid, or old enough to be eligible for Medicare, or rich enough to pay for it on your own, and that is really quite a challenge these days. You get health insurance by going to work.

If health insurance is available uniformly for everybody as a matter of more or less entitlement, then you don't have to go to work in order to get health insurance. So there is going to be work incentive effects from that. There are going to be work incentive effects that arise from the termination of job lock, which will be a plus.

There are going to be changes in relative competitive balance among companies and their ability to compete for different kinds of workers if you get health insurance everywhere. So there are a whole lot of effects, and I would urge careful attention to the work incentive effects pervasively through the proposal.

REPRESENTATIVE SAXTON. Thank you. Let me change to another issue that concerns me a great deal. In any plan we have identified—and I say we collectively—there are a finite number of sources of funding for any plan.

In the Clinton plan, for example, we identified, and I suspect this is true of most any plan, new mandated premiums in the area that we are already extending. There are other private health insurance expendi-

tures that are currently being made, which is another source in the total universe of monies available to pay for a plan.

There are currently some federal health expenditures, you just mentioned them basically—Medicare and Medicaid—and there are some monies currently being spent by state and local health expenditures, and finally out-of-pocket expenses that people pay themselves, basically five sources.

One of the major sources that the President calls on to help with the funding of his plan is the Medicare fund where he would reduce Medicare expenditures in the current universe by a very significant amount. I have forgotten the exact number, $118 billion over the five or six-year period of time.

There are some hospitals in the United States that, under the current plan, rely very, very heavily on Medicare, to the extent that 65 to 70 percent of their patient load are Medicare reimbursable expenditures. The people who are responsible for maintaining services through those hospitals are suggesting very strongly to some of us that there is no way they can meet their obligation to the older Americans they serve with those kinds of cuts in the Medicare plan.

REPRESENTATIVE HAMILTON. And keep the quality up.

REPRESENTATIVE SAXTON. And keep the quality up, exactly. In fact, they say unless something different is done, we have to close. I didn't want to be that extreme in my question, but that is the thrust of it. What is your reaction? I am sure you have looked at this.

MR. AARON. I have. You mentioned the article in the *Cleveland Plain Dealer*. Last September, I also had a piece in the *New York Times* on the Clinton proposal, in the course of which I raised my concerns, and they resonated, I think, with some other people, regarding the magnitude of the cost containment built into the calculations of the financing of the President's plan. Part of that are the economies projected for Medicare.

Economies of that magnitude become imaginable, desirable if one believes that in a relatively brief period of time, a few years, one can squeeze out a great many inefficiencies from the U.S. health-care system. That such inefficiencies exist, that we provide a considerable amount of wasteful care, that much of care has very low benefits, I think is beyond dispute. But I raise questions as to whether it is possible to do this as fast as President Clinton's calculations suggest. I remain concerned about that, and I think Congress should be concerned.

There is capacity for achieving economies and of course it is always in the interest of those who would be subjected to the rigors of controls to emphasize the pernicious effects that would arise from such controls.

Nonetheless, the financial course of health-care reform, which I hope passes, will be safer from a variety of standpoints, safer from the standpoint of the availability of services, safer from the standpoint of the fiscal risks confronted by government, Federal Government and

State governments, if we do not rely so heavily on severe presumed cutbacks in spending for currently available services as is embodied in some of the proposals.

REPRESENTATIVE HAMILTON. Let's pursue that a minute. Is the $118 million phony?

MR. AARON. I don't think it is phony at all. I think it is real. It is certainly possible for Congress to curtail legislatively, and actually to reduce Medicare spending by the magnitudes contained in the President's numbers and in the CBO affirmation of them.

The question isn't whether it can be done. The question is what happens if it is done. If costs, in general——

REPRESENTATIVE HAMILTON. The question is whether we do it.

MR. AARON. That is a different issue. That is something you can speak to. I can't. I mean, whether you do it, I believe, will depend on what you think the consequences of doing it would be.

If you were convinced that you would get rid of a lot of waste, fraud and abuse and not harm the delivery of services, you would embrace it enthusiastically. The concern is that either of two things will happen. Quality will deteriorate, or very large cost shifts could occur to the private sector. Those are the two concerns.

REPRESENTATIVE SAXTON. Let me tell you something that concerns me, and I am just trying to find the answers like we all are to these questions. You wrote in the *New York Times* on September the 22, 1993, the following words, I believe—correct me if these are not correct.

> So it is clear that most savings would have to come from changes in medical practice. Physicians would have to administer fewer tests, hospitalize less often, do less surgery and prescribe fewer medications.

That sounds an awful lot like rationing to me.

MR. AARON. It is rationing to the extent that the services curtailed provide significant benefits. If they are not useful services, as some observers believe, then it isn't rationing.

My own view is that it is going to be a slow process of education and research for us to identify where savings can be achieved.

It takes a very peculiar view, I think, of American exceptionalism to believe that we must spend 4 to 6 percent more of our gross domestic product than do other developed, civilized, humane countries with health indicators as good as our own.

Many factors contributed to those health indicators. It is not just the health-care system. So it might be that we need to spend a lot to offset risks that people in our society face.

I don't think you can account for the differences in outlays between the United States and France on that basis, but that's the question, in my mind, and I think it is one that is not a partisan issue. This is one, I think, members of both parties can grapple with and try and reach an unpartisan judgment. Can the culture of health-care delivery in the

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United States be modified? That it can be, I think, is quite likely, but it is going to take time, sir.

REPRESENTATIVE HAMILTON. Jim, may I interrupt one moment?

REPRESENTATIVE SAXTON. Sure.

REPRESENTATIVE HAMILTON. I want to go back to this $118 billion that the President has. That is over what?

MR. AARON. Five years.

REPRESENTATIVE HAMILTON. Five years in his program, $118 billion. What if we took $60 billion out of Medicare. We had Medicare cuts a few years ago. Now, you have $118 billion, as Jim says here. With all of the people in the hospitals, this just can't be done. We can't get the savings.

You have looked at it carefully. Do you think that under the Clinton plan, you can get $118 billion of savings over a several year period?

MR. AARON. You can certainly get $118 billion in reduction in federal spending. Whether hospitals will reduce spending on the Medicare population by that dollar amount, I think is more problematic.

REPRESENTATIVE HAMILTON. And you can do it without loss of quality?

MR. AARON. You may sustain quality and shift costs to the private sector. That is the way we have been doing it.

Just a week ago, for a completely different purpose, I did something that is really rather perverse. I went back and looked at old trustees' reports of the Medicare system. I have a collection of them dating back to 1982.

I looked at the projected outlays under Medicare for the year 2005. The projected outlays in the year 2005 in the 1982 trustee's report were approximately—I will give you rough numbers—6.5 percent of payroll. That is the standard test.

In 1987, the projected outlays were about 3.7 percent of payroll for the year 2005. The projected outlays in 1994 are about 4.8 percent of payroll for the year 2005. My point is that projections of what we are going to be able to do seven years in the future differ sensitively according to policy.

Congress has drastically curtailed federal outlays on Medicare. It pushed back, without raising Medicare payroll taxes at all, the date at which the fund was supposed to run out of money that was the 1982 projection to 2001. That is today's projection.

Now, while that has happened, CBO and others have been doing studies in which they calculate that the proportion of total cost for patients in hospitals covered by reimbursements has diverged between private and public payers. Private payers are about 130 percent of cost. Medicaid is about 80 percent. Medicare is about 90 percent. So you have saved the money on budget.

Outlays have also been reduced. Lengths of stay in hospitals have gone down by about 30 percent, total number of hospital days, pardon

me. Combination of hospitalization rates and lengths of stay since the early 1980s. Those are not confined to Medicare. They are general medical events. But there has been cost shifting to the private sector.

Now, one practical question is whether it is desirable to say that for more federal savings by cost shifting——

REPRESENTATIVE HAMILTON. Excuse me, Jim.

REPRESENTATIVE SAXTON. I guess, I would ask this question. I understand the cost shift that we have done in the past. That has taken place because there have been third-party payers to shift to. If we adopt some kind of a plan that is somehow regulated in terms of how much money there is to be spent, either in terms of an universal budget or in terms of reimbursements for services, who do we cost shift to, then, if we reduce Medicare costs?

MR. AARON. That is a fair question. The cost shifting won't occur if there is a general retardation in the projected growth of spending. Can there be a general slowdown in the growth of spending? That depends upon how fast one can modify the culture of the medical delivery system in the United States.

I don't know the answer to that. That is one reason why I prefer a more modest presumption regarding the degree of cost control to be built into the financing of the system.

If you want to spend more on additional services—I hate to use the word—but you find the tax increases or the expenditure cuts elsewhere to pay for it. I would personally, as an economist, favor something close to pay-as-you-go on financing health-care reform, and using cost savings to fund deficit reduction down the road.

Could I say one other point that I wanted to mention when you were describing the hospital situation? Keep in mind that we do have way more hospital beds than we need. It is easily possible to exaggerate the savings from closing an unoccupied hospital bed because most of the costs associated with when a person is in the hospital and using services.

Nonetheless, they cost something and if financial reform led to the closure of some hospitals, it would not be a bad thing.

Now, having said that, I am not referring to the single hospital within a 100 mile radius in a modest-sized town. I am referring to the low occupancy rates that exist in many large American cities where we simply are badly over bedded.

REPRESENTATIVE SAXTON. If I can just conclude——

REPRESENTATIVE HAMILTON. Jim, you go ahead with your questions. I will run off here and vote and get back as quickly as I can. We will keep the hearing going as much as we can.

REPRESENTATIVE SAXTON. Thank you. I just wanted to conclude my question in the hearing. Then, I will pass the ball to Chris if he has some questions, but I will just conclude by making this observation.

Based on what you have said here, there are basically two ways to deal with the Medicare reduction. One would be to find efficiencies

and the other would be to continue the practice of cost shift, and with regard to the efficiencies, you have indicated in the *New York Times* that the best way to define efficiencies to the magnitude we have, talking about these numbers at least, most savings would have to come from changes in medical practice, and the next sentence is reduce the amount of services that we provide.

MR. AARON. Also rates of reimbursement to providers. Physicians in the United States are exceedingly well paid compared to average earnings, better paid than are physicians in any other country for which I have seen data.

I think we could continue to attract top quality talent even if the rate of remuneration weren't quite so high.

REPRESENTATIVE SAXTON. Now, three things, reduce costs, I guess, in salary accounts, and finally by the cost shift, keeping in mind that if we are going to have a system that works, we would have to have a system that you could cost shift within.

Some of these programs that we are talking about here would have that opportunity, while others might not. Is that fair?

MR. AARON. I think it is basically fair. Let me be clear, I am not advocating cost shifting as a means of financing health care. It strikes me that one of the goals, one of the stated purposes of major health-care reform plans, certainly the President's plan, is to prevent further cost shifting.

Whether that is the consequence of the specific proposals, you folks are going to have to decide, but nobody wants anything to increase public obligations on the backs of private payers through surreptitious means.

REPRESENTATIVE SAXTON. Are you familiar with the report that the Republican staff did here on this Committee, with regard to the Clinton proposal?

MR. AARON. I am not.

REPRESENTATIVE SAXTON. Let me ask a general question. It concluded that there was a significant gap between what the program would actually cost and the total funds that would be available to pay for it.

CBO did a similar study with different results. They too said there would be a gap between the amount of money available to pay for it and the services outlined.

Do you have an estimate as to whether or not you think that is right and if so, what that finance gap is?

MR. AARON. I will be completely honest with you, my answer is, no, I don't, because this is not a solo operator's game. In order to make cost estimates of these health plans, one needs a large staff, the ability to manipulate many diverse data sources and a considerable variety of expertise.

I will say that I think Congress, in its wisdom, created the Congressional Budget Office, perhaps because it appreciated that the President— whichever party is in the White House—always has an interest

in bending assumptions favorable to itself and groups speaking for one party or another in Congress have similar incentives.

The goal was to try and create a detached nonpartisan group to mediate these disagreements.

I have read the CBO report. They have done their best to be careful. They certainly didn't buy everything the Administration said. They indicated that the proposal would marginally add to the deficit, not reduce it as the President had claimed, but it would reduce national health-care spending significantly by the end of the period for which they did their projection.

I know the people involved and I think it was a careful, very professional, and down the middle effort.

REPRESENTATIVE SAXTON. Thank you. Currently, we are watching this process, I guess called a political process, and I don't mean R&D political process. The process through our political system of trying to arrive at a conclusion as to what we are going to do, and it seems to me that we started this debate some time ago, and since that time, we have developed a whole series of options, starting with options with a great deal of governmental influence and a whole spectrum of ideas that end up perhaps on the other end of the spectrum, with proposals that would have a minimum of government or maybe no government influence much at all. I guess that is probably an overstatement.

A minimum of government influence. And we started talking about, I think it is fair to say, a single-payer system, which most people refer to as the Canadian system or one like it, and then we move from that to maybe something like what President Clinton proposed, where there was a good deal of government influence in terms of regulation and budgeting and global budgeting, and regional groups that would do a great deal of control. Then, we move one step further to Cooper, which we have had a lot of discussions about, where there is some government influence in terms of setting it up, but much less than Clinton. So it seems to me that the debate has moved from a lot of government control to maybe not so much government influence and control. Now, the debate is almost on the other side of the spectrum, or moving in that direction, at least, and I think that I heard you say that one of your six areas to talk about in one of your proposals was to slow growth in costs by modifying incentives.

It seems to me that that is one of the areas that we are headed toward, and I am interested to know how we can do that .

MR. AARON. Let me quibble a bit with the history of the debate. I don't think this has been an unidirectional process moving from prescriptive government involvement to the use of incentives, but the efforts going on at various times by people with different points of view on these issues.

Congressman Cooper's bill, in fact, predated President Clinton's and then the Clinton proposal emerged. The single-payer approach has been around for 40 years, and I think if nothing is done, it will be

around for another 40 years, because there is a core group of supporters of that who believe strongly in it.

How does one use incentives to control the growth of spending? Well, the standard approaches that have been advocated by supporters of managed competition, which is what I tried to incorporate, in effect, by reference in what I put as my put-up or shut-up approach, consist of certain rules regarding marketing of insurance.

All insurers have to market a standard plan so that people can compare prices readily. If you tell me two plans differ, one has differing mental health benefits and differing cost sharing, there is no way I can compare prices between those two bills, so I don't know which is really more extensive per unit of service.

They want to cut through that. You get a standard plan, you know the price, end of story.

They also propose a provision under which the cost difference between different plans has to be met with before-tax income, so the excludability or deductibility of health insurance premiums doesn't in effect transfer part of the cost to the public budget and off the shoulders of private payers.

The expectation on the part of advocates of managed competition is that if these changes, and perhaps some others as well are made, individuals through their purchase of insurance will bring to bear on health-care providers a degree of financial pressure that will drastically slow the growth of spending.

This view has widespread support. It has never been tried. It also confronts widespread skepticism. I am a skeptic. I don't personally believe that. I could go into a lengthy explanation of why, which I will spare you. I think the chances that it will succeed are not great, but I don't know. We have not run the trial. None of us has God-like wisdom on this subject, and as I said, if they are right, if through insurance market reform and changed tax rules one could slow the growth of spending sufficiently, we should all celebrate the need and the ability to avoid——

REPRESENTATIVE SAXTON. I hate to do this because the Chairman wanted us to continue on through, but these votes are a fact of life, and so I guess maybe we can take a five-minute recess until the Chairman comes back, or until I get back.

Thank you.

[Recess.]

REPRESENTATIVE COX. [Presiding.] In the sixth element of the outline of your proposal, you describe the taxes that will be necessary to cover subsidy costs and recommend that they be enacted at the front end.

What kinds of taxes are we talking about?

MR. AARON. I did not want to express a specific preference about which taxes would be increased, and I think I would prefer to pass on that now.

REPRESENTATIVE COX. So would everyone in Congress.

MR. AARON. The principle that was embodied here, and this is one that I wouldn't pass and I regret that members have and I think the President has, there is a deep financial dilemma in any health-care reform plan.

The savings from costs containment comes slow. They build and become large. The costs of universal coverage hit quick and don't grow, but that means that health-care reform is a deficit increaser in the short run, even if it is a deficit reducer in the long run.

Now, that creates, as you know, a very difficult problem. You can't, I think, credibly come forward with a plan that raises the deficit significantly in the short run. One can pay for coverage by projecting much faster achievement of cost savings. The President did that.

One can cut other spending programs. The President, Congressman Cooper, Senator Chafee all do that, or one can raise taxes. The force of the Chairman's question or comments, and indeed of Mr. Saxton's, were that there may be leaner pickings in Medicare than is projected in the President's plan. I am prepared to believe that.

I also believe that the savings from cost containment may well come slower than projected in the President's plan. I am a deficit hawk and I am also a health-care reform hawk, and that means in order to make the books balance, you have to be prepared to vote higher taxes.

It could be, and indeed in a Brookings book, Charles Schultz and I advocated using a value-added tax to pay for health insurance. It could be a payroll tax. It could be an income tax surcharge, but the key principle—which I believe is important to admit to the debate at least—is that health-care reform should not add to the deficit in the short run and, if necessary, taxes should be enacted to pay for it. It is too important not to do. It may even be worth raising taxes to do.

REPRESENTATIVE COX. Accepting that premise, the Congress will have to move beyond the general to specific in rather short order. As you know, Ways and Means is presently considering this very legislation. They will finish it and indeed so too will Education and Labor, and so too will Energy and Commerce, so even before the August recess, the House of Representatives will vote on a package that either combines or rewrites all of the foregoing bills.

In addition to all of the things that you mentioned you are, you are also an economist, and presumably can provide us some insight into which of the VAT, a payroll tax or an income tax surcharge, will fall on the respective elements of the economy in least disruptive fashion.

MR. AARON. The purpose of some taxes is meant to disrupt. The purpose of a cigarette tax is meant to disrupt consumption.

REPRESENTATIVE COX. I will state the question anew. I accept the criticism of the question. Which of the VAT, payroll tax or income tax surcharge, which of the three that you mentioned as possibilities will be least harmful to the economy in the purposes we are seeking to achieve?

MR. AARON. Done badly, any of them can be harmful. Done well, none of them is going to be seriously disturbing. If Congress in its wisdom were to decide that another trend of deficit reduction was in the cards, as well as health-care reform, I would suggest serious consideration of the value-added tax.

But I wouldn't suggest it unless Congress was prepared to acknowledge that it was going to raise a lot of money, because introducing a new tax is disruptive, it is divisive and it raises transition problems.

Eventually it is a perfectly administratable tax as every other country has demonstrated, but it is not something you do lightly and it is not something you do for $30 or $40 billion. It is something you do if your targets are very much higher than that.

If your targets are lower, then use some combination of extended excise taxes. There has been discussion of cigarette taxes. Alcohol and tobacco and firearms taxes are additional candidates, particularly with respect to health-care reform, and I don't know whose toes I may be treading on at any given time, but I still think some recourse to one variety or another of energy taxation is a serious consideration.

REPRESENTATIVE COX. We are probably not talking about a gas tax since we just did that again. What do you have in mind?

MR. AARON. I was not dismissing it. The last gas tax was certainly at the low end of the spectrum of rate increases. It still leaves the United States' tax rates on gasoline relatively modest by international standards.

We don't have to have the taxes as high as other countries. We are a larger country. We depend more on the automobile, but I think one certainly could go back to that well.

REPRESENTATIVE COX. If we selected an income tax surcharge, what would be the best way to design it?

MR. AARON. The simplest approach is as a surcharge directly as a certain percentage of liability. That is simplest, but in my view, not best. The income tax base remains flawed in a variety of ways.

Additional revenues could be raised through any number of particular reforms, some of which incidentally would be quite progressive in their distribution, some of which would be rather more regressive in their distribution.

As examples, perhaps of the most progressive, the transfer of capital gains at death, the restatement of basis strikes me as a provision that is difficult to defend, and eliminating it would be highly progressive in its revenue impact.

REPRESENTATIVE COX. I am sorry. Just to understand, the proposal is to eliminate the step-up of basis to death?

MR. AARON. No, I would constructively realize a death subject to averaging rules and cutouts for certain small family-owned businesses.

MR. AARON. The limitations on the use of itemized deductions, for example, by setting floors or ceilings on applicable specific deductions

could be extended. That would have more of an effect on middle class taxpayers. Some additional——

REPRESENTATIVE COX. I just want to understand that. We would have a specific dollar amount as a cap on the total amount of itemized deductions that one could claim?

MR. AARON. As an example, the deduction for state and local taxes, one possibility would be to set a floor, to say that deductibility for state and local taxes is allowed to the extent that state and local taxes exceed a certain dollar amount.

That would have two effects. It would raise revenue. It would also simplify tax filing for some filers who would be moved into the ranks of standard deducters by such a provision. The taxation of Social Security continues to be much more liberal than the tax treatment of private pensions.

Congressman Rostenkowski has made some proposals along these lines. I would go even further. The case for the threshold, it seems to me, to be difficult to sustain from the standpoint of tax policy, although I certainly do understand the political basis for the $25,000 and $32,000 thresholds.

I use these just as illustrations. My point is that one could go to one's usual handbook—the CBO shin-kicker list that they put out annually—as ways to reduce the deficit and find any number of structural modifications in the income tax law that would be good and any one could contribute to this.

As a practical matter, I suspect that if it came to financing something like health-care reform, one wouldn't want to complicate the politics of the debate by having to address each of these specific issues, and one would have recourse to some broader-brush device, such as a surtax if one was going to go to the tax route at all.

REPRESENTATIVE COX. Is your recommendation that we do this at the front end?

MR. AARON. I believe it is important to make sure that we don't get an unpleasant budgetary surprise from health-care reform, and the way to do that is to pay for it upfront, and when the good news comes in the form of cost containment, that is deficit reduction.

REPRESENTATIVE COX. You also mention, in addition to an income tax surcharge and a value-added tax, a payroll tax. If that is an option to cover additional future subsidy costs, I take it that that payroll tax would then go beyond the 50/50 cost sharing that we have already imposed on the employer, or perhaps it would not. Perhaps it would be also a further tax on individuals. How would that work?

MR. AARON. It could be a direct payroll tax, or one could set the financing up so that with respect to some employees, the maximum contribution was based on a calculation of a premium that exceeded the actual premium, so in effect there is an extra contribution made on behalf of those workers.

But I think it is simplest to think of it, if one is going to go the tax route, and use a payroll tax simply as an explicit tax so that people see it and understand it.

REPRESENTATIVE COX. My colleague has shown up, and I yield to you for further questions.

REPRESENTATIVE SAXTON. I have an observation and a question. You are an economist, but you are also very knowledgeable obviously about these health-care proposals and health reform, generally.

I saw an article in the *Post* yesterday said that Chairman Rostenkowski had made a proposal to increase the Social Security wage tax. Is that the kind of a thing that we are talking about? If we are talking about a wage tax, I assume that we are talking about something in addition to what we currently have, and possibly in addition to what Chairman Rostenkowski has suggested might be a good idea.

MR. AARON. Congressman Rostenkowski's increase in payroll tax for Social Security would occur about 20 to 25 years in the future for the first bite, and approximately 50 years in the future for the second bite. It is part of a larger set of proposals, including benefit reductions, designed to deal with the long-run deficit in the Social Security system.

The short run looks just dandy for Social Security, but the long run doesn't, and what Congressman Rostenkowski proposed, I think, is a relatively balanced collection of benefit reductions and tax increases, the effect of which would be to put the 75-year projections back in the balance.

I think that is important to do. The United States is unique in making 75-year projections and paying a lot of attention to them, which is really a breathtaking exercise of faith. Where else do we believe projections even a year or two in advance, much less 75 years, but I think it is sound. It has caused Congress over the life of Social Security to run the program in a very conservative fashion, from a financial standpoint.

One may disagree about the benefit structure, a lot of other things, but up until very recently, Congress has followed the rule that it kept the system within close, long-run actuarial balance plus or minus 5 percent relative to revenues. Costs never were more than 5 percent of revenues.

Currently, it is more in the vicinity of 15 percent or thereabouts, the long-run deficit, and I think it is desirable and admirable that Congress take those long-run projections seriously and enact changes now that will act to restore public confidence—well justified, in my view, that the system is being carefully managed.

That is a different issue. The taxes are in the future. We are talking now about financing of a reform that, if you folks agree to do it, will happen this year, so I don't think they are going to stumble all over each other, at least in the short run.

REPRESENTATIVE COX. Will you yield for just a moment, on this wholly different topic that is not the subject of our hearing?

MR. AARON. I love Social Security. I wrote my Ph.D. dissertation on it, so——

REPRESENTATIVE COX. I serve as a member of the President's Entitlement Commission. We are going to report in December.

Does Brookings have numbers that you have generated on your own on these subjects, projections and forecasts? Because if you do, I would love to get my mitts on them and read them.

MR. AARON. We did work on the deficit problem as part of the studies we have done on setting national priorities, and then later we got more modest and called it setting domestic priorities. I and two colleagues did a study some years ago on the long-run financial condition of the Social Security system and what it would take to put it back into balance, what economic effects of either allowing the deficit to continue or closing it would be on future productivity.

I would be glad to make those available to you. I should acknowledge that the study that Gary Burtless, Gary Bosworth, and I did on Social Security was done at a time when the long-run projected deficit was smaller than it is today, and so you will have to multiply various numbers mentally to come out with the right story, but I think qualitatively the structure we have got holds, and the model we used, if your staff wanted to adapt it, could, I think, relatively readily be updated and used for analytical purposes.

REPRESENTATIVE COX. Thank you very much. I will give you a fancy business card.

MR. AARON. Okay.

REPRESENTATIVE HAMILTON. Let me just ask some broader questions on health care generally. What is driving up health-care costs?

MR. AARON. The major factor, in my view, is the breathtaking pace of scientific advance in medicine. I did some calculations and Joe Newhouse, who is an economist at the Harvard Medical School, subsequently did some calculations attempting to decompose growth of health-care spending into various factors over a relatively long period of time.

We know health insurance has expanded and that reduces the price of medical care at the time people demand services. That increases use. We know there have been some increase in compensation of medical workers relative to other workers in the economy and identify that.

We know the population has gotten older; we can calculate that. When you are all done, you don't explain much of the story.

What we do know is that the list of services provided within hospitals is almost completely different today from what it was a generation ago. Somebody—I don't know on what empirical basis—quipped that the half life of medical knowledge was five years.

A co-author of mine, a physician, now at the University of Southern California, has spent about a year carefully examining and interviewing medical scientists in 10 or 12 different medical subspecialties. He has

identified a series of innovations about to debauch from the medical laboratories into clinical practice.

The cost projected for just these technologies comes, according to his calculations, to on the order of $50 billion a year once they are fully implemented. The story is the medical technology.

REPRESENTATIVE HAMILTON. So you think because the march of technology goes on, these costs are going to continue to rise? If you tried to slow down——

MR. AARON. No, we haven't. What we have had is a slowdown of the growth of premiums reported by a certain subgroup of companies. There has been a very modest slowdown in the Consumer Price Index for health care, an index that is a very good candidate for being the most meaningless statistic issued by the Federal Government.

I can get into that in more detail if you want, but the real gross domestic product spent on health care grew in 1993 at almost the same rate as it did in 1992, and that was faster than it had grown in earlier years.

REPRESENTATIVE HAMILTON. So the argument that is sometimes made that market forces are beginning to correct the problem of rising health-care costs is not accurate?

MR. AARON. Not yet. Whether it will be tomorrow, there are people who have very strong beliefs that it will be and they can cite a lot of anecdotes and specific cases that seem to support their case. But the aggregate numbers are unsettling.

REPRESENTATIVE HAMILTON. The impact of this rise in health-care costs is what, with respect to wages?

MR. AARON. Standard economic theory, which is a phrase that is sufficient to cause many defense walls go up instantly, but I believe that standard economic theory holds that after an adjustment period, perhaps, workers pay for their health insurance, even if the ostensible payer is the employer.

That means very rapid growth in health-care spending is depressing the growth of money wages and as you know from others who have testified, I am sure, actual wages are now lower than they were a couple of decades ago, in real terms.

REPRESENTATIVE HAMILTON. We hear all the time about the health-care costs being, what is it, 14 percent of GDP?

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. It used to be 6 percent or so back in 1965. Is that something we ought to worry about?

MR. AARON. I think so, yes, I do.

REPRESENTATIVE HAMILTON. Why?

MR. AARON. Not, I would suggest, because it makes the United States a poor competitor in international markets, but because——

REPRESENTATIVE HAMILTON. It doesn't have that effect?

MR. AARON. I do not believe so. If workers pay for added health-care costs in the form of lower wages, then it isn't reflected in product prices.

What it is reflected in is a reduced capacity to consume other goods and services. In other words, it in effect hit on our standard of living.

Let me just add, if we thought health-care spending, every dollar of it, was being well spent, we would celebrate it. The reason we are worried about it—all of us from personal experience—is that we believe a lot of money is not being well spent.

REPRESENTATIVE HAMILTON. Let me ask a few questions about this employer mandate. How do you get to universal coverage? What are the options in front of us?

You have the single-payer system, obviously, that would get us there. You have the employer mandate. Would that get us to universal coverage?

MR. AARON. The President's plan is an employer mandate plus an individual mandate. It is an employer mandate for workers and their families and individual mandate for everybody else.

REPRESENTATIVE HAMILTON. Why is an employer mandate better than an individual mandate?

MR. AARON. It is not. It just happens to be where we are—not employer mandate, but employer coverage happens to be where we are. And there is a lot of concern, and I think legitimate concern, that if one has only an individual mandate without an employer mandate, well, lots of people can't afford it, so you have to give subsidies to many low-income households.

Many of those low-income households now receive coverage through work, but employers would then have an actual positive incentive to get out of paying for insurance, because if they get out of it, then the government will pick up part of the costs of the health insurance.

So you would have the effect of shifting onto public budgets a large part, or some part, of currently privately financed health insurance that, as an economist, I can tell you that if it happens relatively gradually, people have time to adjust, not to worry, you shouldn't be concerned. I don't know of anybody who has to face voters and worry about the size of the public sector who agrees with that position.

REPRESENTATIVE HAMILTON. Now, if you have an employer mandate, are you going to have a lot of job losses? Are you going to have a lot of wage reductions?

MR. AARON. You could. Just to give you, I think, a crude number, which tells you what is at stake, family benefits cost $5,000 a year, more or less. Full-time, year-round employment, 50 weeks a year, 40 hours a week is 2,000 hours. That is $2.50 an hour.

If you mandate employers to pay $2.50 an hour for a family who previously hasn't been paid for, that is enough to cause disemployment effects. So nobody requires it, even those who go for an employer mandate.

President Clinton insulates low-wage, small-wage firms. There is a 7.9 percent of payroll cap on liability, and that removes a significant part of the disemployment effects at the price, I might add, of creating incentives to reorganize companies who get all your low-wage workers into small low wage companies where they qualify for subsidies.

REPRESENTATIVE HAMILTON. Now, Senator Chafee's plan, Congressman Cooper's plan, Senator Gramm's plan, they don't have the employer mandate.

MR. AARON. That is correct.

REPRESENTATIVE HAMILTON. Do they get universal coverage?

MR. AARON. Senator Chafee's plan gets it on a contingent basis. That is, he is committed to the principle. The achievement of it hinges on the payment of subsidies to low-income households and the payment of those subsidies is contingent upon achieving adequate savings elsewhere in the budget, particularly in Medicare and Medicaid.

Congressman Cooper has no mandate and, in my view, would not reach universal coverage, nor would Senator Gramm's proposal.

REPRESENTATIVE HAMILTON. Where would you get money for health-care reform? The President gets it out of savings on Medicare largely and the tobacco tax. Is that the best place to get it?

MR. AARON. I think the tobacco tax is a good way to go and savings can be achieved without significantly affecting the quality of care.

I suspect you can't get enough to cover the costs of universal coverage, and that means that other taxes need to be considered.

REPRESENTATIVE HAMILTON. You think that under the Clinton plan, other taxes are going to have to be considered if you enacted the Clinton plan today? Would you have to have other taxes other than what he has recommended; that is, other financing than he has recommended?

MR. AARON. No, if you enacted the Clinton plan. The question is, what would be the consequences of the Clinton plan when it was implemented.

Judgment is that some of the consequences would lead to reconsideration of the implementation schedule and of certain provisions in it, but if you enacted the Clinton plan, I believe the Congressional Budget Office calculations are about as close to being an accurate prediction as we are likely to get in this bail of tiers and inadequate information. They indicate that we could live without financing beyond what the President has proposed, if you enacted, carry it through and implement it as proposed.

REPRESENTATIVE HAMILTON. I want to get into that a little more. In your plan, you cut back on the benefits from the President.

MR. AARON. I do, yes.

REPRESENTATIVE HAMILTON. How much?

MR. AARON. I think one can achieve, in terms of the premium cost, reduction on the order of 15 percent, perhaps 2o percent, but probably not.

REPRESENTATIVE HAMILTON. What kind of benefits are you cutting now?

MR. AARON. I am raising cost sharing, deductibles, and copayments.

REPRESENTATIVE HAMILTON. From what to what?

MR. AARON. I think I mentioned earlier, in order to really do refined specification of provisions, one needs a small army, maybe not 500, but one needs a small army of cost estimators. I do not have those resources. The cost of about a 20th percentile corporate plan is on the order of 15 percent less than that of the President's plan, and one could achieve that in a variety of different ways.

REPRESENTATIVE HAMILTON. You do not think you can get universal coverage without a mandate of some kind?

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. Is that correct? You have to have either an employer mandate or an individual mandate.

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. Or the single-payer plan, in order to get to universal coverage?

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. It can't be done otherwise.

MR. AARON. I do not believe so.

REPRESENTATIVE HAMILTON. You cannot do it with incentives and subsidies?

MR. AARON. This is not an opinion question. The Robert Wood Johnson Foundation has run a variety of demonstrations and experiments in which they offered exceedingly deep subsidies to encourage employers to offer insurance. When I say deep, I mean 50 percent in the aggregate. They got a very slight take-up in large segments of the currently uninsured commercial world.

REPRESENTATIVE HAMILTON. You are saying to me that it is broadly accepted among the experts here that you cannot get universal coverage without employer mandate, individual mandate or single payer? Is that what you are talking about?

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. You can't get there another way?

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. Okay.

Chris.

REPRESENTATIVE COX. Just one quick clarification. I think I heard you say that you believe that the CBO estimate on the Clinton plan is as good as any out there, and that you are willing to rely upon it.

MR. AARON. No, I didn't say that. I said that I think they have done as good a job as it is possible to do with available information and called it down the middle.

If you asked me how much reliance I would place on any particular estimate right now, I would say slight, I guess, in a word.

The reason I say that is that the health-care reform of the magnitude the President or Senator Chafee has proposed entail enormously far-reaching changes in our institutional arrangements. We are going into an environment that we haven't lived in before. As the statisticians say, we are predicting out of sample. We are reaching into an area where we hope our models are right, but we haven't seen the world work this way.

We don't know how people are going to behave in this new environment. That is one reason I think that it is important to make sure that the financial risks are protected against at the outset.

REPRESENTATIVE COX. That is to say that we should front-end the tax increases?

MR. AARON. We should pay for whatever we do and not do it on the come, so to speak.

REPRESENTATIVE COX. All right, let me shift a moment to premium caps, which you recommended on the deferred basis, implementing them five years henceforth, implementing them, if I understand your outline correctly, in advance of five years if targets are not met. Is that what you intend?

MR. AARON. Again, it is an approach I am describing. I don't have any hard numbers to include in this. Specified period of time over which the incentives of managed competition will be given free rein.

At the start, set certain cost control targets, which, if achieved, one will conclude that managed competition was successful and if they are not met, that it was not.

At the front end, enact the regulatory framework that will be called into play if managed competition does not succeed, but under no circumstances implement it for a period of time—three years, five years.

I don't have a firm judgment as to what that would be. But I think it is important and it is a fair challenge to the advocates of managed competition to say, look, you have a new idea.

It has many attractive theoretical features, lots of people are skeptical that it will work, but we are going to give it a run. If it works, we all celebrate because nobody wants the regulations to go into effect if we don't need them. If it doesn't work, this is too expensive a mistake to allow it to go on.

REPRESENTATIVE COX. You have just used managed care as a shorthand, as you say, for the kind of environment in which health care will be conducted post-reform, and there certainly are incentives in your outline and in other proposals for that result.

Likewise, premium caps will serve as an incentive for insurance plans to prefer the kind of environment in which we have gatekeepers and other forms of cost control. Given that you are recommending a reduced benefit package, what will be the circumstance for someone whose illness isn't covered by the reduced benefit package when the gatekeeper doesn't let them in and they need to go somewhere for their medical care?

What will be available for them in this new environment to purchase it somehow, because it wasn't covered in their plan?

MR. AARON. What are the elements of a reduced benefit package? Any adequate insurance plan is going to cover physician, hospital, and essential pharmaceutical products associated with acute somatic illness. The degree of cost sharing will vary and that affects the generosity of the plan.

Any managed competition plan, any health maintenance organization that achieves a degree of cost control uses gatekeepers, and they do so today. How do people react today if they confront those limits? Well, in different ways. Some plans—so-called point of service plans—allow people to go outside the plan at a higher cost. More cost sharing, for example. Those kinds of arrangements could be and, I would expect, would be continued.

One could, and I expect would, allow people to buy supplemental coverage on their own. Some people would, some people would not. One would certainly allow, in my view, people to spend their own resources to buy health care directly. That is an option for which I can see no moral basis for any kind of limitation.

If one was talking about draconian cost limits, then one could, I think, conceive of serious dilemmas and problems of the kind you describe arising.

REPRESENTATIVE COX. I didn't describe a problem. I just asked what would be the circumstance if someone who finds that their malady isn't covered by the reduced benefit package——

MR. AARON. Well, I think a malady that isn't covered is a problem if it is a serious malady. If it is limited to relatively unusual or minor circumstances, which is all that would arise if the degree of cost control is modest as you move into it, then I wouldn't characterize it as a problem.

REPRESENTATIVE COX. Let's take an example from your outline. You said that we should narrow the benefit package for mental health.

MR. AARON. Yes.

REPRESENTATIVE COX. Let us say that we are on the other boundary of the narrowed benefit with a mental health problem.

How does a person or the family in that circumstance deal with the fact that their plan doesn't cover them? And in particular what I am concerned about is what will they find in the environment that has been created by a system of universal coverage in which everyone is

driven to an HMO-like mechanism, to use gatekeepers and other strict cost controls to live within the premium caps?

MR. AARON. I am not sure that everybody would be driven to that, but if my wife were here, she would be delighted that you asked this question. She is a psychotherapist, and we have gotten into a number of arguments about this particular element of my proposal. She doesn't like it at all.

The short answer to your question is a little better than they can deal with it today. Many people are bereft of mental health benefits altogether in their health insurance plans.

What I am describing here is a floor, not a ceiling, and therefore employers that wish to sponsor more generous coverage would be free do so, or individuals who wished to buy it would be free do so.

REPRESENTATIVE COX. But will the private practitioners be there from whom to buy the services?

MR. AARON. They are not going away and in any plan that is a floor, not a ceiling, is going to tend to rise, not fall.

Now, currently, mental health coverage tends to be very, very partial in many plans, and that means whole segments of society are completely cut off, even from crisis intervention. At a minimum, that needs to be part of any health insurance plan. Most HMOs do cover at least a minimum number of visits. Sometimes it will only be six or ten in the course of a year. Others have more generous coverage.

The President's plan, because I think members of his staff are well informed on the character of mental health problems in the United States, were relatively more generous in their design of this benefit provision than are many private-sector plans today.

All I am saying is, if the price of getting through a plan covering acute somatic illness is trimming back mental health benefits, it is a bargain on which you pay a price, but it is worth doing. I don't argue for these curtailments because I think they are desirable or because they are going to be free of the kinds of difficult choices you have described, but because there are economic constraints governing planners and if one can shrink the overall cost of the package, the possibility of finding a viable compromise, I think, increases.

REPRESENTATIVE HAMILTON. On this business of controlling costs, your plan sticks with the managed competition. You make a presumption that managed competition might work. What does the phrase "managed competition" mean?

MR. AARON. To me, it means a set of marketing rules for the sale of insurance that promote cost conscious buying on the part of purchasers.

REPRESENTATIVE HAMILTON. Does that mean you have to have those alliances?

MR. AARON. I think you need alliances, cooperatives, some entity that enforces rules for the sale of insurance.

REPRESENTATIVE HAMILTON. And without it, you don't get managed competition?

MR. AARON. Without it, it is much more difficult to get it. It is a loose term, and for different people, it means different things.

I read an article once that listed about 30 different components of something that one person or another called managed competition, so you paid your money and you take your choice, depending on who you talk to.

REPRESENTATIVE HAMILTON. If you talk with our constituents, the whole idea of choice is really central. They have to have the right to choose their doctor and their hospital.

How do you come out on that now? I would just like your reaction to the plans in general, which you identified first thing in your testimony, your own plan, analyze those plans for me in terms of impact on choice.

MR. AARON. The baseline is that many Americans have essentially complete choice, but many others do not.

REPRESENTATIVE HAMILTON. Let me stop you there. Is choice declining now in the present system?

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. So more and more Americans are finding themselves with less choice under the present system?

MR. AARON. Correct.

REPRESENTATIVE HAMILTON. Okay, excuse me. I didn't mean to interrupt you.

MR. AARON. Well, that is important, because increasingly employers are limiting the number of plans and plans are having close panels of physicians or are imposing penalties if you go outside those panels, so the degree of choice is becoming circumscribed.

The Clinton proposal is, in fact, a very large expansion of choice, at a price. But if one is willing to pay for the cost of the fee for service, any willing provider plan that each alliance would have to offer, then one has total choice, and that would be available as a matter of entitlement to everybody in each alliance area.

REPRESENTATIVE HAMILTON. Costs you how much more?

MR. AARON. There is a limit in the Clinton proposal that would permit the alliance to disallow plans costing more than 20 percent above the regional average, but not requiring them to do so. Whether they would exercise that choice or not, I do not know.

The framework that I have described here is one that would have competing alliances in a given area and which of these alliances one elected to buy insurance through would be a matter of how they got organized.

The public alliance would be available to everybody and the rule that I suggested, which every insurer must offer through any alliance on the same terms, would thereby mean that the public alliance had available

to it all the plans operating in a given area. That is a high degree of choice. It is more choice than most people have today.

I believe that in the end, Senator Chafee's plan and Congressman Cooper's would provide a similar range of opportunity.

REPRESENTATIVE HAMILTON. Now, if your managed competition doesn't work and the costs, technology and other factors continues to explode and you run out the period—whether it is three to five or whatever years—what do you do?

MR. AARON. First of all, I wish you wouldn't say my managed competition. I am not a gung ho managed-competition person, frankly. I once referred to Alan Enthoven as a managed competition monotheist.

REPRESENTATIVE HAMILTON. Wait a minute. I thought you said you had a put-up or shut-up approach.

MR. AARON. That is correct.

REPRESENTATIVE HAMILTON. And you tried this, I thought, managed competition for five years.

MR. AARON. Three to five years. That is correct, and the reason I say that is not because I personally think it is going to work or believe this is the way to go, but I believe that Congressman Cooper has the allegiance for his approach of a significant minority of the House of Representatives and many Members of the Senate. They are going to need to be on board, and this is a way of getting, I hope, the support of many.

REPRESENTATIVE HAMILTON. So your view is that managed competition, as they perceive it, isn't going to work?

MR. AARON. I think it is a long odds proposition, but I don't pretend to be smart enough to know the answer.

REPRESENTATIVE HAMILTON. But at least give it a shot.

MR. AARON. Give it a shot?

REPRESENTATIVE HAMILTON. All right, if give it a shot, doesn't work, what happens?

MR. AARON. At that point, I think the regulatory apparatus suggested by President Clinton is probably the best practical apparatus now on the table.

REPRESENTATIVE HAMILTON. Premium cap?

MR. AARON. Premium caps, that is correct. I think having a little more time to collect the data, develop the administrative capability and learn how to implement it would not hurt, and so I think there is a plus actually for the regulatory approach, the likelihood that it could actually succeed in giving people a little more time to plan.

REPRESENTATIVE HAMILTON. What is the disadvantage of a premium cap? Spell that out for me. What is the downside of it?

The comment you would get from people, I think, in general, who are not the experts, would say it would lead to rationing. I don't know what else they would say about it, but that is one thing they would say about it.

MR. AARON. The downside of any cost control is rationing, and the question that the Nation is going to have to confront at some point is whether it is possible to squeeze out enough waste, fraud and abuse to reduce the growth of spending without rationing.

My own view is that in the end, after a while, we are going to discover, like the person who has been writing prose all his life and didn't know it, that if we do succeed in curbing the growth of spending, we are going to be rationing. Why do I say that?

You cannot think of any medical intervention of any significance today that is not in some cases beneficial, lifesaving, the information provided is extremely valuable. You would never want to forego it. But that same procedure is used in other cases where the benefits are negligible or zero. The name of cost control is trying to get rid of the latter without getting rid of the former.

Nobody will argue with pure waste, but suppose the benefits are positive, but very small. I can personalize this. I have had three magnetic resonance imagining examinations. One of them was the prelude to very accurate back surgery, from which I recovered really quickly. I was home in less than three days and back at work in a week.

Another case was to look at a brain abnormalities where the doctor said, and I quote, "You know, I think the chances that we will find anything are minuscule, and if we found anything, the chances we could do anything about it are smaller still, but you are insured, aren't you?" And I said yes. And he said, "Well, you will feel better and I will feel better if we just rule this out." So, at 7:00 p.m. the same night, I was in there and I had an MRI on my head with contrast media for $1,200 bucks, and I did feel better because it was negative.

But then you ask yourself, consider 10,000 people presenting with the same symptoms I had. I will pull a number out of the air, but it is not far off. Maybe you will find one treatable case. Ten thousand times $1,200 bucks is $12 million bucks for a treatable case.

Now, if you had a system that denied me that MRI, or more to the point, made me pay out of pocket for it, I call that rationing. That is beneficial care and it is rationing.

REPRESENTATIVE COX. Sir, if I might interject, it is price rationing, yes? In your example, it would be price rationing, right?

MR. AARON. No. Let me come back to it in a minute. Let me make one other point, and then I will come to that. I think I ought to have the right to buy the $1,200 MRI myself, but I don't think I should make you folks pay for it. The rationing that would occur if I was not given an MRI through my insurance plan is a kind of budget rationing.

REPRESENTATIVE COX. I am sorry. I was talking about the rationing that would occur if we required you to pay for it.

MR. AARON. If you required me to pay for it, then it is in the same category as fine cars and good dinners. That is correct, that is right. If one wants to use the word rationing for the purchase of automobiles and clothes, yes, but I think that is stretching the term beyond its nor-

mal use. Rationing usually means denying people access to things for which they have the capacity to buy.

REPRESENTATIVE COX. That is government rationing, but if you have many valuable things in a society with more people than there are such things, we have to find a means of allocating scarce goods, and we use price rationing?

MR. AARON. That is right. In that sense, everything is price rationed except medical care.

REPRESENTATIVE HAMILTON. These costs that you are going to put a premium cap on at the end of this period of time if managed competition doesn't work, what impact is that going to have on technology improvement?

MR. AARON. That is the hardest question of all. The reason it is the hardest question is that I believe we are in the midst ... I am saying this as an economist who talks sometimes to biological researchers. I think we are in the midst of a scientific revolution of truly civilization transforming character in biomedical research, and that slowing or aborting avenues of advance in this area would be a tragic loss. I am also an economist who understands that entrepreneurial capital invested in speculative research is going to be reduced if the significant cost control is put into effect.

The implications of that, I believe, are that as part of controls in the growth of spending, it is important for public support of research and development not to decrease, but to increase.

REPRESENTATIVE HAMILTON. Pretty hard to make any estimates about that, I suppose.

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. I wanted to ask you about the unlimited exclusion of the employer-sponsored health insurance from your employee's taxable income.

MR. AARON. Yes.

REPRESENTATIVE HAMILTON. How important is that in the scheme of things here? That is not in the Clinton plan. I guess he phases it in.

MR. AARON. He phases in limits, 10 years hence.

REPRESENTATIVE HAMILTON. Okay. All right.

MR. AARON. There are two aspects to the tax incentives that are on these two pages.

First of all, the excludability from personal income tax from employer-financed premiums is the mechanism that creates an incentive for small businesses and current nonpayers to get into the game. I think that is very important.

The second tax element is a way of turning on its head certain financial incentives that are part of managed competition proposals. The Cooper bill would deny deductibility at the business level to health plans more costly than a certain basic level.

I believe there are serious administrative problems with that idea, but that is a separate issue.

This approach is analogous, I think, to the old practice of gasoline companies charging people a surcharge if they wanted to pay with credit cards. People got very upset about that. It aroused a lot of opposition. So gas companies discovered that they could do the same thing if they gave people a discount for cash. Same effect.

I suggest that you try to apply that example to the financial incentives for being price-conscious shoppers. If you buy a less expensive premium plan that your employer makes available, then the worker is entitled to receive the difference in cost tax free.

Price incentive is exactly the same as in the penalty variance, but it looks different and it is a reward rather than a penalty. It is a reward for being price-wise rather than a penalty for being prodigal.

REPRESENTATIVE HAMILTON. Chris, go ahead.

REPRESENTATIVE COX. I will just ask one question along those lines. In order to get individuals to be more cost conscious, both in terms of the health care that they consume and in terms of the insurance policies that they are interested in obtaining, we are often directed to the problem created by the employer exclusion for health-care premiums.

From my standpoint, working for an employer that provides health insurance, I have a disincentive—a pretty strong one—to go out and shop for something else, because I get it with before tax dollars here at work.

If, on the other hand, we went back to the status quo of not that many years ago, when you did your income tax, medical expenses were deductible. Indeed, if I could deduct as an individual my medical expenses and my medical premiums, wouldn't I suddenly become indifferent to whether or not I did this with before tax dollars at work or outside of work?

MR. AARON. In my view, one shouldn't be protected from the financial consequences of choosing a premium plan, relative to a less costly plan.

That is an individual choice, much as if you decide to buy a $400 suit instead of a $200 suit, that is up to you. The government doesn't subsidize that decision for you. I don't think they should in the case of health care.

So it seems to me that the desirable direction to go is the other way. Politically it has been very controversial. President Reagan proposed it in the early 1980s and had a hard time finding a sponsor in either House of Congress to introduce it. It is now much more widely discussed.

REPRESENTATIVE COX. Yet, you keep the employer exclusion from gross income as part of your system?

MR. AARON. I do so in order to encourage employers to stay in the game, but if the individual buys a less costly plan than some premium

standard that would be defined within an alliance area, they receive the difference.

They don't have to pay tax on the difference in the cost, and that introduces the same price incentive as would arise if you fed it all through and made households pay tax on what their employers did.

REPRESENTATIVE COX. Well, I am not certain that is the case because the individual isn't buying the insurance. The individual is collecting from the limited menu offered by his or her employer, a less expensive employer-provided plan than he might otherwise be entitled to obtain.

But what we are not empowering this individual to do is to go off on his or her own and buy whatever is cheapest.

MR. AARON. The——

REPRESENTATIVE HAMILTON. Excuse me. May I interrupt? I apologize for interrupting. Chris, I am going to have to go on. I am scheduled to testify before the Rules Committee.

REPRESENTATIVE COX. I didn't have lunch myself, and I think Mr. Aaron has been more than generous with his time.

MR. AARON. I will answer your question by mail, because I think I can show in writing—and probably can't do so over the table—that the financial consequences of what I have described get you the same result as you are describing.

Under the arrangements that I am describing and in the President's plan, you would be shopping for insurance yourself. You would be buying it from a cooperative or an alliance, and they would have a menu of options available to you.

What I will show in the example is that if, under the incentives I have described, you pay for the difference, or you reap the reward, out of after-tax income, the incentive is the same as if you got rid of the exclusion.

REPRESENTATIVE COX. If you would respond in writing, take into account that the number of choices that I will be given from the alliance will be far less than the number of choices——

MR. AARON. No, I don't think so.

REPRESENTATIVE COX. Let's say that I get a dozen choices from my alliance, a very, very healthy number of choices.

I just checked with a couple of my local hospitals and they presently accept over 150 different kinds of private insurance, so the spread in the number of things that would be available to me is going to be much smaller if I am getting it through my employer rather than through an alliance.

MR. AARON. I have the choice of three plans where I work, and that is pretty generous coverage. Some places only have one. Very few people have choices of 150 plans, federal employees being an exception.

REPRESENTATIVE COX. Nobody does. President Clinton is precisely right when he says you are not losing that much from an alliance compared to what you get from an employer.

But my point is, if you liberated the employee from a slavish appearance to a limited choice offered by an employer in an alliance and let him or her go out and shop from hundreds, if not thousands, of plans available nationwide, that would be a different competitive environment.

MR. AARON. That is different issue, but I will respond to the tax issue.

REPRESENTATIVE HAMILTON. Thank you very much.

[Whereupon, at 12:30 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF MR. AARON

Some Reasons Why Reforming Health Care Financing is So Difficult

The goals of health care reform are widely acknowledged to center on the achievement of universal financial access to health care, control of the excessively rapid growth of health care spending, and the maintenance of high quality care. Other goals are unimportant as well, but less central, including the extension of the supply of health care providers, and the achievement of specific standards of care for target groups, especially children and pregnant women.

If the goals are widely accepted, why are programs to achieve them so controversial and why is agreement so elusive? Several factors, apart from pure political cussedness, partly explain why.

First, the traditional divisions between those who believe markets almost always produce better results than government management and those who have a keen eye for market failures and a greater respect for the capacity of government policy to solve problems play a very large part in explaining divisions on health care reform. Since both parties agree that the current system is seriously flawed and major change is necessary (although they disagree on the specific diagnoses), most participants favor reforms that entail actions that go well outside past experience. Thus, solutions advanced by all of those who favor major reform rest on a large measure of faith. Advocates of market solutions believe that changing tax rules will induce large changes in behavior—greatly heightened cost consciousness, for example—while advocates of direct regulatory controls on health care spending doubt that behavior will change much or quickly.

Representative Cooper's proposed reforms, for example, embody a profound faith that changes in the tax code will suffice to control growth of health care spending. President Clinton expresses a belief that market reforms will help slow growth of spending, but his proposal includes tight regulatory limits on premium growth should changed tax incentives do less than their advocates think likely.

Similar disagreements arise with respect to other issues. In each case, some evidence is available, but not enough to overcome deeply held prior beliefs.

A second factor concerns the relative weight attached to the various goals of health care reform. President Clinton has declared that unless a health care reform bill assures universal coverage he will not sign it. This seemingly hard-edged commitment is not so rigid as it may seem, since he has not clearly specified what coverage people must be assured to win his approval, and he has not indicated how fast universality must be achieved. Nevertheless, universal coverage is the central goal. His proposal assures universal financial access to care without qualification, regardless of fiscal surprises.

In contrast, Senator Chafee, who also embraces the principal of universal coverage (although by means different from those President Clinton proposes) declares that universal coverage must wait until sufficient savings have been achieved in other government programs to pay for it. Universal coverage is not so preeminent an objective for Senator Chafee. Representative Jim Cooper declares that he favors universal coverage and expresses the belief that his plan, which contains subsidies to help low income households buy insurance,

will achieve it. But the subsidies, like those of Senator Chafee's plan, are contingent on the realization of sufficient savings in government programs to pay for them. Furthermore, his plan does not actually guarantee universal financial access, and few other observers actually believe that universal coverage will result from it.

These three approaches embody a different ranking of the importance of universal coverage and insurance against fiscal surprises.

Apart from fiscal surprises, designers of health care reform must grapple with one vexatious fiscal certainty. The costs of universal coverage come fast; the savings from control in the growth of health care spending come slow. But neither step is possible without the other.

Universal coverage raises *the level* of federal spending because many of those now without coverage cannot afford to buy it and because all of the methods of achieving universality shift some additional costs to the federal budget. These costs must be incurred just as soon as universal coverage is achieved but do not rise thereafter as a share of federal spending.

Cost control entails reducing *the rate* of growth of health care spending—private and public below the rate that would otherwise occur. If growth is slowed from 5 percent annually—the actual rate, adjusted for inflation, that has prevailed for many years—to, say, 3 percent annually, the savings in spending are approximately 2 percent the first year, 4 percent in the second year, 6 percent in the third year, and so on.

Eventually, the savings from a successful program to reduce the rate of growth of spending will exceed the one-time increases in the level of spending from universal coverage. But that takes time. This simple arithmetic fact, leads to the central and inescapable fiscal and political fact about health care reform: in the short run, It must raise federal spending and tends to raise the deficit, while in the long run, it tends to reduce the deficit.

Because Congressional procedures put large obstacles in the way of deficit-increasing legislation and public resistance to such legislation is widely believed to be strong, proponents of health care reform must find some way to offset this central fact. Unfortunately, all the ways are unpleasant. They include cutting other federal programs, raising taxes, or claiming very *large and very rapid* reductions in health care spending.

Fashioning a Viable Compromise

Although all the major health care plans contain many provisions, each embodies certain core principles on which its supporters cannot or will not compromise. Such core principles are not, of course, clearly demarcated or fixed in stone. There are, no doubt, important areas of potential compromise even on core principles. Despite these qualifications, which make identification of core principles difficult and judgmental, the fate of health care reform hinges on identifying them.

Although many bills have been submitted on health care reform, I believe that one can identify four broad approaches: the employer mandate for workers combined with an individual mandate for nonworking families, the individual mandate for all households, full national health insurance (the "single-payer" option), and managed competition without any mandate.

Each of these approaches embodies very far reaching change. Some members of Congress, particularly in the conservative wing of the Republican party, reject such far reaching modifications. In my view, few from this group are likely to support any legislation that would have any chance of winning presidential signature, and I shall not consider these approaches further.

The President has declared clearly that any bill he will sign must assure universal financial access to comprehensive benefits, but that he could compromise on almost anything else. Presumably this willingness to compromise includes the requirement in his proposal that all companies must pay 80 percent of the cost (subject to various caps) of health insurance for their employees and their families.

Senator Chafee and supporters of his bill declare opposition to employer mandates and would rely on a requirement that all individuals and families show that they have health insurance coverage. Although opposed to an employer mandate, there is reason to think that they would not regard a mandate limited to large companies, virtually all of which already pay for health insurance for their employees, as unacceptable. In short, they seem to be opposed to any mandate that would force large numbers of businesses to do something other than what market incentives seem to dictate.

Representative Cooper's primary objective is to change the nature of the market for private Insurance by altering the conditions under which people buy insurance. He would establish marketing cooperatives to reduce the capacity of insurers to compete by selecting low-cost patients and to increase cost consciousness of insurance buyers. The goal is to obviate the need for government regulations to control growth of health care spending. Cooper and many of his supporters are likely to insist that managed competition be given a chance to show that it can control costs.

Representative McDermott and other single-payer supporters favor an integrated reform that would assure universal coverage and cost control. The approach cannot be programmatically divided. but it stands no chance of enactment nationally. Some states might be willing to adopt the single-payer approach, if given the chance under national legislation that established performance standards. Accordingly, the irreducible requirement for support by single-payer advocates must be that states have the option to follow this approach if they meet national performance standards.

The compromise plan, an outline of which is attached, is designed to meet the minimum requirements of these four groups. While fully satisfactory to none of the groups, all could participate in a signing ceremony for such a bill and honestly proclaim that, while they were forced to make compromises they would have preferred to avoid, the bill contains the elements they deem most important and meets their irreducible demands.

Draft Specifications of a Compromise Plan

1. ***Employer Mandate***

   Mandate employers larger than (say) 50 to 100 employees to contribute 50 percent of the cost of health insurance. An individual mandate would apply to everyone else. Employers would be required to withhold employee premiums from earnings (as with personal income and worker payroll tax payments)

2. ***Purchasing Cooperatives [Alliances]***

   Establish a public affiance; permit voluntary alliances so long as membership exceeds a stipulated minimum—say 5,000. Require employees of small companies (with fewer than, say, 500 employees) and individuals to buy insurance through an alliance.

   Define alliance boundaries on the basis of geographical subdivision used for some other public purpose—Census regions, FRB districts. But *do not* leave the drawing of boundaries to states. Require an up-or-down vote (like base-closings).

3. ***Subsidy Structure***

   Company subsidies. Companies are subsidized for low-earning workers, so that total premiums do not exceed a stipulated fraction of that worker's earnings.

   Individual subsidies. Each household is required to pay a stipulated fraction of income for health insurance, starting from a modest fraction from the first dollar of income (as in administration proposal) and jumping to a higher fraction above the poverty threshold. This calculation is done on a separate 1040 form and includes information, to be provided on the W-2, regarding the subsidies provided that household by the employer.

   Tax exclusion. Exclusion of employer-financed premiums would be retained in full; but no deduction would be permitted for individual premium payments. Employees who choose less costly plans than the most costly plan for which employers make contributions would be entitled to receive the difference tax free.

   The low-wage worker subsidy avoids tile incentive to reorganize companies to maximize subsidy payments that arises under a "low-wage company" structure. The individual subsidy saves budget costs because it embeds the employer mandate and subsidies paid to employers within an accounting framework that converts all subsidies into household subsidies based on family income. The tax exclusion preserves Incentive for employers to continue paying for insurance, since their withdrawal is equivalent to a wage cut The tax-free payment to workers of the difference between the most costly plan and the one actually selected is mathematically the same as denial of exclusion above the least cost plan (the Cooper approach), but it is a reward, rather than a punishment [Gas stations met howls when then charged people premiums for using credit cards; but no one complained when gas stations gave discounts for cash.]

4. ***Benefit Package***

   Reduce benefit package from 50th percentile of corporate plans to (say) 15th to 20th percentile, by increasing deductibles and (perhaps) cost

sharing and by narrowing benefits (child dentistry, mental health, substance abuse, or other elements).

5. ***Calendar***

   Full implementation of mandate by 2000 to 2003.

6. ***Cost Control***

   Adopt "put-up-or-shut-up" approach to managed competition. Set national health care spending targets. Enact regulatory controls (premium caps or other devices), *but defer implementation* for, say, five years. If spending targets are met, the regulations remain in reserve, but are not implemented. If spending targets are not met, regulations are put into effect. If regulations are triggered by a failure of managed competition to deliver promised cost control, higher taxes will also be necessary to cover subsidy costs; these too must be enacted at the front end.

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