

**THE 1997 ECONOMIC REPORT
OF THE PRESIDENT: ECONOMIC AND
BUDGET OUTLOOK**

HEARING

before the

**JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES**

ONE HUNDRED FIFTH CONGRESS

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THE 1997 ECONOMIC REPORT OF THE PRESIDENT: ECONOMIC AND BUDGET OUTLOOK

Wednesday, February 26, 1997

CONGRESS OF THE UNITED STATES
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 10:10 a.m., in Room 2318, Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Ewing, Stark, Hamilton and Hinchey, and Senators Sessions and Robb.

Staff Present: Christopher Frenze, Colleen Healy, Robert Keleher, Brenda Janowiak, Mary Hewitt, Roni Singleton, Juanita Morgan, Amy Pardo, and William Spriggs.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. I am pleased to welcome Office of Management and Budget (OMB) Director Raines before the Joint Economic Committee (JEC) this morning.

I would like to start by observing that there seems to be some consensus on both sides of the aisle that the size of the Federal Government relative to the economy is currently too large. Here, at the Joint Economic Committee, we have done some research suggesting that when Federal Government spending as a share of the economy rises too high, it tends to undermine economic growth and income growth. Therefore, I was extremely pleased to see that the Administration proposes to reduce the size of Federal spending below 19 percent by the

year 2002. This is a good general objective and one that many in Congress agree with.

It is also positive to see the Administration proposing an expansion of the Individual Retirement Account (IRA) incentives to encourage individuals to save. I agree that American families need less punitive tax treatment of their savings and investments. In fact, I would propose that we go even further and raise the IRA deduction ceilings for middle class taxpayers. In fact, yesterday I announced a plan to introduce legislation, which I will do tomorrow, to phase in a significant increase in IRA deductibility and to make IRAs more broadly available to American taxpayers.

Unfortunately, there is also disagreement. As expressed in the *Washington Post* and elsewhere, there is widespread skepticism about the validity of the Administration's budget numbers. The back-loading of most of the spending restraint until after the Administration leaves town has not inspired confidence but only has raised questions about the seriousness of the Administration's proposals. It also appears likely that the Administration really is proposing spending increases veiled in a dubious five-year plan purporting to balance the budget but in reality leaving significant and growing deficits.

The Administration's tax proposals have also raised serious questions. Among economists of different stripes, there is agreement that narrowly targeted tax items should be avoided so that tax rates could be as low as possible. Not only is this principal being violated by the Administration's proposals, but the tax credits proposed by the Administration are widely viewed as inefficient and counterproductive in some respects. We will address these issues, of course, in more detail later.

Another issue discussed in the Administration's budget is the possibility of reduction of the Consumer Price Index (CPI), used to index income tax features and benefit programs. I think we should be very cautious about taking steps—and I have said this many times—that would affect many millions of people by triggering \$1 trillion in increased taxes and benefit restraint over the next 12 years. I have requested the Bureau of Labor Statistics (BLS) to study the issues raised by the Boskin Commission report and would suggest that we wait until the study is available in several months before we act. We need to

consider more than one point of view before making important decisions in this area.

In closing, I would like to note that the business cycle expansion that began in 1991 continues today in 1997. The expansion has resulted in employment increases, unemployment declines, and improvement in the budget situation. This expansion is not rooted in the policies of either party but reflects the hard work of the American people and the natural budget cycle. This is a good time to address structural problems in the budget and tax policy, and I look forward to this morning's discussion.

I would like to yield at this point to Senator Robb for any statement he may have.

[The prepared statement of Mr. Saxton, along with charts for exhibition, appear in the Submissions for the Record.]

OPENING STATEMENT OF SENATOR CHARLES ROBB

Senator Robb. Thank you, Mr. Chairman.

I have no formal statement.

The Ranking Member, Senator Jeff Bingaman, would be here; but he has a markup in the Labor Committee which is very important. He extends to you and other Members of the Committee and to your distinguished witness, his apology that he can't be with us this morning.

I, like the other 534 Members of Congress, if left to our own devices, would incorporate our own idiosyncracies into any budget submission, so we are particularly pleased that Mr. Raines is here this morning to present the President's budget and discuss some of the economic assumptions and conclusions that can be drawn from it. I look forward to his testimony; and I will have some questions when that time comes; but I thank you, Mr. Chairman, for holding the hearing.

Representative Saxton. Mr. Stark.

OPENING STATEMENT OF REPRESENTATIVE PETE STARK

Representative Stark. Thank you, Mr. Chairman.

I do have a brief welcome for Mr. Raines in welcoming him to our Joint Economic Committee and discuss this 1998 budget, which I applaud as a credible budget that meets our goal of a balanced budget by 2002. And I am speaking at this point directly to Senator Toricelli saying

that we probably don't need the balanced budget constitutional amendment, and I am sure Senator Robb will take that message back with him later today.

I am pleased that your budget—the President's budget—is not so filled with high-cost tax cuts that it runs the risk of raiding Medicare to meet our targets by 2002. There will be pressure to add a lot of cuts as we go along. If you add up all the press reports, there are probably over \$200 billion more in tax cuts that people would like to add.

I hope the Administration can commit to two areas. One, let's keep the tax cuts in the ranges they are now. They may change. That is okay. But if we are going to avoid a rerun of the 104th Congress with a debate on how tax cuts are going to be funded, we ought to start with a reasonable package. And I think in the size the President has proposed a reasonable package.

I also hope to meet my concerns and all my colleagues' concerns—and we have differing concerns—that the Administration will bear with us as we think about reshuffling the tax cuts that are in the package. Inevitably, on both sides of the aisle there will be differing approaches and concerns. Again, it seems to me as long as we come out with approximately the gross amount that the President has suggested, we are still winning the war.

The battles may change. For example, if I were changing it, I would be concerned that there is a sizable population of working families who get no benefit in the tax credit for dependent children due to its non-refundable design.

And many of us in the House are concerned, and in the Senate as well, over the 10 million uninsured children. The President proposes covering half of them; but, to me, a half solution in this case is heartless. And we might very well be able to use some of that tax credit and apply it to helping all children have health insurance coverage.

For example, in Florida, they are now working on a school-based program to outreach to children and find a way for them to buy private insurance if they can afford it and subsidize it for those who can't. I think there are a lot of ways that we can address accomplishing complete coverage for children.

So I ask your cooperation and expertise in helping us develop these options, perhaps reducing health insurance for children. And I can't resist—of course, the committee I used to chair no longer exists; but, if

it did, we would be talking to you about having Fannie Mae pay State income tax in the District of Columbia to help us bail the District of Columbia out.

Now I think I can reason with you on that issue in a somewhat more objective—you may still have your same position, but it would be something that we would raise a little revenue and help the District of Columbia with. But, in all seriousness, I am proud to have you here; and I am proud of the budget that you are about to present to us. Thanks very much.

Thank you, Mr. Chairman.

Representative Saxton. Are there other opening statements?

OPENING STATEMENT OF REPRESENTATIVE LEE HAMILTON

Representative Hamilton. Let me just welcome Mr. Raines here. We are delighted to have him. He has taken on I think probably about the toughest job in Washington in many areas except perhaps the President, and we are delighted to have him here.

I just want to observe, too, that Joe Minarik is here. Joe, I think is the Chief Economist of the OMB, if I am not mistaken. But he was a staff member of the Joint Economic Committee some years ago, directed the staff, did outstanding work; and it is a pleasure to have both of these gentlemen with us. Thank you.

Representative Saxton. Thank you. Senator Sessions.

OPENING STATEMENT OF SENATOR JEFF SESSIONS

Senator Sessions. Mr. Raines, I would like to welcome you; I am looking forward to hearing your comments.

I must say that I feel good about the employment situation in Alabama, which continues to be strong. Businesses, are looking for employees, and that is good news. I think I would continue to add employees.

My thought is, therefore, that this is a relatively good time in our economy. It is not a great time, but it is a solid time for us, and we need to be putting hay in the barn. It is time for us to make some of the tougher decisions that need to be made—not really brutal decisions, but smart

decisions — that will get our deficit under control now; and, as a result, we will be in a position to move forward long term for the benefit of our country.

Thank you for coming, and I look forward to participating in the questions.

Representative Saxton. Mr. Hinchey.

OPENING STATEMENT OF REPRESENTATIVE MAURICE HINCHEY

Representative Hinchey. Thank you, Mr. Chairman.

I, too, would like to welcome you, Mr. Raines; and I want to thank you very much for the hard work that you have done. I think the President has made a very wise choice in naming you as director of the budget, and we very much look forward to hearing from you today.

My principal concern with regard to the budget is the level of growth that it projects. You may not be able to deal with this in a thorough fashion today, but it is my belief that we need to find ways to get this economy growing at a rate that is faster than 2.0 or 2.3 percent, because the result of that level of economic growth simply means that most Americans, too many Americans, are not sharing equitably in that growth. While the economy has good news for many, it has not very much good news for a lot of other Americans.

So I would hope that both you and the President and others in the Administration will try to work with the Congress to find ways in which we can get this economy growing at a rate that is faster and more productive than a rate of 2.3 percent. I know that is something that concerns you, as it does the President; and I would hope that we could find ways in which we could do that. I very much welcome you here today and thank you very much for your work.

Representative Saxton. Mr. Director, we are ready for your statement, so if you would please proceed and take as much time as you would like.

**STATEMENT OF FRANKLIN D. RAINES, DIRECTOR,
OFFICE OF MANAGEMENT AND BUDGET**

Mr. Raines. Thank you, Mr. Chairman, and thank you, Members of the Committee.

I am pleased to be here this morning to discuss the President's 1998 budget and the Administration's views on the health and direction of the economy.

I will begin by making five basic points about our budget. I will then discuss the budget and economy, focusing on the competing visions of fiscal policy that have dominated the last two decades—the budget policies of the 1980s and the budget policies that President Clinton has pursued.

I will then be very happy to take any and all of your questions.

My first point is that, over the last four years, we have already done much of the hard work of achieving balance.

Before the President took office, the deficit reached a record \$290 billion in 1992 and was headed up. In 1993, he worked with Congress to enact his economic program of lower deficits and more investment. Since then, the deficit has fallen by 63 percent—from \$290 billion in 1992 to \$107 billion in 1996. We have the smallest deficit since 1981 and, as a share of gross domestic product, the smallest since 1974.

The President's plan has exceeded all expectations. It was designed to reduce the accumulated deficits over five years by \$505 billion. In just its first three years, it has already reduced the deficits by almost \$500 billion. We now project that over the same five-year period, the plan will reduce deficits by \$925 billion.

More than that, we now estimate that the plan will reduce deficits through 2002 by \$2.5 trillion—the difference between where our original baseline said the deficits would be from 1994-2000, and where we now project them to be over that nine-year period. This includes actions that we have already enacted into law, as is demonstrated by this modest chart, which shows a significant change in fiscal policy that occurred in 1993.

Throughout the 1980s, deficits show a generally rising pattern, and many of you were involved in very difficult votes that were taken to keep those deficits from getting out of control. But what those votes didn't achieve was to actually bring down the level of deficits. What happened

in 1993 was very different. Instead of simply keeping the deficits from continuing to rise and move out of control, deficits actually began to decline. They have come down from \$290 billion to just over \$100 billion last year.

Now, our projections indicate that if we achieve another \$250 billion of deficit reduction, we can bring the budget into balance in 2002. But the important point here is this big green area on the chart. This is the deficit reduction that has already taken place—it is already in the books, based on decisions you have made. The savings will occur as years go by, but the hard political decisions have already been made.

My second point is that, we are clearly reaping the benefits of our success to date in cutting the deficit.

We inherited an economy that, in the previous four years, had barely grown and created few jobs. Savings and investment were down, interest rates were up, and incomes remained stagnant, making it harder for families to pay their bills.

Since then, the economy has performed well across the board. Business investment has grown at double-digit rates. The private sector has grown faster than under either of the previous two Administrations, while the Federal Government component of gross domestic product (GDP) has shrunk at an annual rate of almost 3 percent.

We have over 11 million new jobs, 93 percent of them in the private sector. Wages are beginning to rise. Inflation has remained remarkably low—below 3 percent by most measures. Interest rates are under control. And unemployment, which measured 5.4 percent in January, is nearly two percentage points lower than when the President took office.

Also, partly due to a strong economy and partly to the Administration's policies, poverty, welfare, and crime are down substantially all across America. For instance, poverty has fallen from 15.1 percent in 1993 to 13.8 percent in 1995, and violent, and serious crime has fallen five years in a row, marking the longest period of decline in 25 years.

With strong growth, low interest rates, low inflation, millions more jobs, record exports, more savings and investment and higher incomes, it is no wonder that such experts as Alan Greenspan, the Chairman of the Federal Reserve, have described this economy as the healthiest in a generation.

Later in my remarks, I will provide more details on how our budget policy has strengthened the economy.

My third point is that the President is proposing a credible budget with real savings, based on conservative assumptions.

It wasn't too many years ago that Presidents would routinely send to Congress budgets that had little relation to reality. They were based on what became known as "rosy scenarios" about how the economy was likely to perform, with unreasonable assumptions about growth and interest rates. They pretended that the deficit would come down. Not surprisingly, it never fell in a sustainable way. Of the 12 budgets submitted by the last two Administrations, the economy performed worse than forecast 10 times.

President Clinton has broken that pattern. For four years, he has submitted budgets that were based on reasonable assumptions about the economy and the deficit. Look at the record. The economy has consistently performed better than the Administration had projected, bringing in more revenues and enabling the Government to spend less on unemployment compensation and other social benefits. As a result, the deficit has fallen more than we estimated, and by an average of \$50 billion a year.

Like its predecessors, in this Administration, this budget is grounded in conservative economic and technical assumptions. With pleasant surprises such as the recent fourth-quarter GDP figures, we expect that, if anything, the economy will continue to outperform our projections.

In addition, the President is proposing significant savings—including \$137 billion by cutting discretionary spending, \$121 billion by cutting mandatory spending, \$34 billion by eliminating unwarranted corporate tax subsidies, \$16 billion in net interest costs, and \$42 billion by extending tax provisions that have expired.

The budget savings total \$350 billion over five years, shrinking Federal spending from 22.5 percent of GDP in 1992 to an estimated 19 percent in 2002. At the same time, the President proposes to cut taxes by \$98 billion, providing tax relief to tens of millions of middle-income Americans and small businesses. Thus, the budget calls for net savings of \$252 billion.

This budget does more than reach balance in 2002. It would keep the budget basically in balance until 2020.

We have a chart that demonstrates this. In this chart, the red line shows what the baseline estimates were in 1993 and what would have happened if nothing were done related to the deficit. And, as you see, the deficits would have risen to catastrophic percentages of GDP. Based on decisions already made by Congress, we have brought down this long-range budget deficit progression substantially.

The President's budget proposal, the green line at the bottom, indicates that the structural deficit is essentially eliminated over the next 20 years or so. But with the demographic changes that will occur, when all of us will be applying for Medicare and Social Security, we again see the emergence of a structural budget deficit, but at a much lower level than was expected four years ago.

Under our plan, 80 percent of the problem will have been dealt with as a result of actions that Congress can take by the end of this year. But that will leave other issues for us to deal with, and the President has called for a bipartisan process to address those challenges.

My fourth point is that, the budget invests in the Nation's priorities.

Balancing the budget is not an end in itself. Rather, it helps fulfill the Administration's central economic goal—to raise the standard of living for average Americans. So, too, do the spending priorities of this budget.

Let me take a moment to walk through some of the highlights.

The budget preserves and improves Medicare, extending the solvency of the Part A Hospital Insurance Trust Fund into 2007. It gives older Americans and people with disabilities, more choices among private health plans, and it proposes new preventive health care benefits to improve the health of senior citizens and reduce the incidence of disease.

For Medicaid, the budget preserves the guarantee of high-quality health care for millions of children, pregnant women, people with disabilities, and the elderly. It reforms Medicaid to give States much more flexibility to manage their programs. It helps an estimated 3.2 million families, including 700,000 children, keep their health care coverage for up to six months until their breadwinners find new jobs. And it provides coverage for up to five million of the 10 million children who do not now have it.

To help welfare recipients move from welfare to work, the budget proposes a Welfare-to-Work Jobs Challenge to help States and cities create job opportunities for the hardest-to-employ recipients; and a

greatly enhanced and targeted Work Opportunity Tax Credit to provide powerful new, private-sector financial incentives to create jobs for long-term welfare recipients. The budget also proposes several steps to address the overly deep cuts affecting single people, legal immigrants, and children that Congress attached to last year's welfare reform law.

The budget expands the President's investments in Head Start, in Goals 2000, in the Technology Literacy Challenge Fund, in Pell Grants, and in other key education programs. It also proposes a \$1,500-a-year HOPE scholarship tax credit to make two years of college universal, a tax deduction of up to \$10,000 to help middle-income families pay for post-secondary education and training, the America Reads Challenge to help ensure that all children can read well and independently by the end of the third grade, and a new school construction fund to leverage new construction or renovation projects.

The budget increases funding for the Environmental Protection Agency's operating fund and funds the Kalamazoo Initiative, a new national commitment to protect communities from toxic pollution by the year 2000. It funds start-up activities at the Grand Staircase-Escalante National Monument, increases funds for the National Park System to help improve park facilities and further protect our natural and cultural treasures, and re-proposes the President's "Everglades Restoration Fund" to provide a steady source of funds mainly for land acquisition to maintain the South Florida Ecosystem.

The budget maintains the President's commitment to biomedical and behavioral research, which promotes the health and well-being of all Americans. For the National Institutes of Health, in particular, the budget includes increases for HIV/AIDS-related research, research into breast cancer and other health concerns of women, minority health initiatives, high performance computing, prevention research, spinal cord injury, and developmental and reproductive biology.

The budget puts 17,000 more police on the street, continuing the progress toward the President's goal of 100,000 by the year 2000. To fight drug abuse, it increases funds for the Drug Courts initiative, for drug testing, for the Safe and Drug-Free Schools and Communities Program, for interdiction efforts along the southern border, and for disrupting the drug industry and its leadership overseas. To strengthen efforts to control illegal immigration, it increases the number of Border

Patrol agents and expands efforts to verify employment eligibility of newly hired non-citizens.

The budget provides a \$500 tax credit for dependent children under 13, expanded individual retirement accounts, and the HOPE scholarship tax credit and tax deduction for post-secondary education and training that I just mentioned. It also exempts 99 percent of all home sales from capital gains taxation by excluding up to \$500,000 in gains for married taxpayers. At the same time, the budget cuts unwarranted corporate tax subsidies, closes tax loopholes, improves tax compliance, and extends various excise and other taxes that were allowed to expire.

The budget continues support for democratic reform and free markets in Russia and the New Independent States of the former Soviet Union, ensures the United States continues to play a vital role in crafting a lasting peace in the Middle East, and proposes a mechanism to liquidate our arrears to the United Nations and its affiliated organizations—presuming these organizations undertake the management, budget and assessment changes that we and others have urged. The budget continues the President's policy of sustaining and modernizing the world's strongest and most ready, military force, capable of prevailing with our regional allies in two nearly simultaneous regional conflicts. It continues our commitment to maintaining high levels of training and readiness for that force and to equipping it with technology second to none.

My fifth and final point is that, we need bipartisan cooperation to achieve a five-year balanced budget plan.

We obviously think that the President's budget is the best plan for reaching balance by 2002, and we think his budget is the right starting point for our discussions. But we understand that the executive and legislative branches share responsibility for enacting a budget.

The time to balance the budget is now. Our economy is strong, so it can absorb the spending cuts that we would have to put in place. And the political stars seem to be lining up in the right orbit. Everyone learned the lesson of the last two years—that conflicts over the budget is not a path to success. Both the President and Congress have voiced their commitment to reach an agreement this year.

So I am cautiously optimistic. But I am realistic as well. Mr. Chairman, as you know, we have been down this road before. You know that agreements that seemed inevitable have eluded our grasp. If we are to avoid that fate, we have to work together, in good faith. I want to

assure you that, from the President on down, this Administration is prepared to do that.

If I might, Mr. Chairman, I would like to shift gears for just a moment and discuss the President's fiscal policy in a broader light by comparing it to the fiscal policy that dominated the 1980s and highlighting the achievements of each.

The 1980s-era fiscal policy held that tax cuts would generate greater saving, investment, and work effort, strengthening the economy and leading to more growth. The deficit, then, would take care of itself.

President Clinton's policy held that reducing the deficit would strengthen the economy, leading to more saving, investment and work effort. His program was designed to reverse the unsustainable rise in our deficit and debt that began in the 1980s, end uncertainty in the financial and investment markets, and show the world that this nation had the will to address its problems.

Now that we have tried the two policies, we can compare the results. And, as the record shows, President Clinton's policy worked. In fact, his program accomplished more of the explicit goals of the 1980s-era fiscal policy—more savings and investment, higher growth, and lower deficits—than that policy itself.

First, let me mention savings. Economists agree that capital formation, a major goal of the 1980s-era budget policy, requires more saving—putting aside some of what we produce to invest in the capital needed to raise future production. Advocates of the tax cuts of the early 1980s argued that when people paid less in taxes, they would save more.

This reasoning had a logical flaw, however; government, as well as households, can add to, or subtract from, the savings pool. If tax cuts raised the Federal budget deficit dollar for dollar, thus reducing the Nation's saving, then taxpayers would have to save every penny of their tax cuts just to hold national saving constant.

In contrast, the President proposed to increase national saving by decreasing Federal dissavings—that is, by reducing the budget deficit that was subtracting funds from the savings pool. His 1993 program relied on both spending cuts as well as tax increases, the latter geared largely to the most well-off Americans.

The result is clear, as seen in this chart on national saving. Net national saving averaged 9.3 percent of GDP from 1960 through 1980. It fell to 5.4 percent from 1981 to 1984, mainly because Federal saving

fell from a negative .8 percent of GDP in the 1960 to 1980 period to a negative 3.7 percent in the 1981-to-1984 period.

Rather than rising, private saving actually fell after the 1981 tax cuts—from 8.1 percent of GDP from 1960 to 1980, to 7.3 percent from 1981 to 1984. Americans chose to consume, rather than save. From 1984 to 1992, national saving continued to fall. By 1992, net national saving was only 2.4 percent of GDP; private saving was only 5.5 percent; and Federal dissaving was negative 4.5 percent.

National saving has risen in the last four years—although it has not yet regained its pre-1980s form. From 1992 to the third quarter of 1996, net national saving rose from 2.4 percent of GDP to 5.4 percent. Federal dissaving fell from negative 4.5 percent to negative 1.8 percent, accounting for most of the improvement. And, although high-income taxpayers faced an increase in their marginal tax rate, private saving also rose a bit—from 5.5 percent of GDP in 1992 to 5.9 percent in the first three quarters of 1996—surely aided by the big increase in corporate profits under this Administration.

With greater saving, we have greater potential capital formation, greater future productive capacity and productivity, and faster potential economic growth. In this important respect, the President was clearly successful.

The second essential for capital formation is strong business investment. Economists generally agree that a larger and newer capital stock will raise our productivity and our productive capacity in the coming years, boosting prosperity and growth. The tax policies of the 1980s were designed to increase business investment; tax incentives for business, such as more generous depreciation allowances and an investment tax credit, were expected to induce greater investment spending.

The Clinton philosophy was different. While the President proposed more investment expensing allowances for small businesses, he relied mostly on a lower deficit and, thus, lower Federal—

Representative Saxton. Mr. Director. Excuse me. If I might ask you—if you would try to summarize as quickly as you can. Your testimony is excellent. Senator Sessions and Senator Robb are going to have a vote at about 11:00 A.M., and I would like to give them an opportunity to ask their questions before that time.

Mr. Raines. Sure, I would be happy to summarize.

Again, the record is clear. As this chart shows, as a percent of real GDP, real equipment spending rose from 5.7 percent in 1977 to 1980 to 5.9 percent in 1981 to 1984, then to 6.3 percent in 1985 to 1988. Since the President's program has come into effect, it has now risen to 8.4 percent, and here you see a comparison of what that rate of growth in equipment has been under the last three Presidents.

With regard to work, we have a similar pattern. I will just point you to this chart that shows that the employment-to-population ratio, the human capital that is being invested in growth, has also now started to rise again as the opportunities for employment and the return from employment have increased.

With respect to growth, the most important point is this: the growth in GDP has not been coming from government, it is now coming from the private sector. And, again, comparing the last three Presidents, you can see that in this Administration, rather than government adding to growth, indeed we have reduced government as a percentage of GDP and what that has done is spurred even greater growth on the private side of the economy and, as I mentioned before, causing 93 percent of the new jobs that have been created to occur in the private economy.

Now, quickly, on interest rates, I will show you another very interesting pattern. We have seen lower unemployment than we have today; and we have seen lower interest rates than we have today. What we have not seen is interest rates this low at the unemployment level that we now have. Interest rates are 1.5 percent lower than the last time that we had the same unemployment rate. So we have been able to drive down interest rates further than would have been expected as a result of where we are now.

On inflation, just quickly, we can see that the core rate of inflation, as measured by the CPI, has come down over this period as well, therefore yielding the deficit result that I mentioned, and turning around that increase in debt—where the debt ratio doubled. Now it has stopped growing as a percentage of GDP, and we are now bringing the debt ratio to GDP down, which is going to permit us to bring interest down as a percentage of our budget.

Mr. Chairman, those are the points that I wanted to make; and I will be happy to answer any questions that the Members might have.

[The prepared statement of Director Raines, along with charts for exhibition, appear in the Submissions for the Record.]

Representative Saxton. Thank you, Director Raines. It is certainly a very articulate, well-thought-out statement.

As I indicated a minute ago, the Senators are going to have to leave us around 11:00 A.M.; so I would like to just pass on my time for now and turn to Senator Sessions.

Senator Sessions. Thank you, Mr. Chairman.

I was delighted to hear you state flatly that reducing government growth has spurred job growth in the private industry. That chart was dramatic. I think it is very obvious to those that have traveled around the State of Alabama, as I have, and visited private businesses that they are incredibly efficient. They are working every day to think up better and smarter ways to remain competitive in a very tough world market. They have not kept as much growth as we would like to see, but they continue to grow, and I think that is a good message for us all to remember.

I know the Chairman is a strong believer in, and has fought for many years, the belief that, if we can maintain the growth of government and allow more of our investment to be available to our private sector, we will have more growth and a healthier economy in the long run.

I was also pleased to hear you say that the time to balance the budget is now. It seems to me, and I think you would agree, that the year we are in, we have the best numbers. Could you tell us now what the deficit will be for fiscal year 1997 in your best judgement?

Mr. Raines. I think our best guess now—we don't have a new official number—but I believe our best guess is around \$125 billion for 1997. As you know, all of the budget plans last year had a blip up in 1997 over the extraordinary achievement we had in 1996. 1996 was something of an anomaly based on both some extraordinary revenue as well as some unusual patterns; for example, some of the benefit programs paid out only 11 checks in 1996, and in 1997 they will be paying out 12 checks. So there were some anomalies like that that caused 1996 to be as extraordinarily low as it is.

Senator Sessions. But it will go up maybe 20 percent of this year over last year's deficit?

Mr. Raines. Yes. But if you look at the pattern from 1993 on, it is almost a straight line down, with 1996 being an anomaly below; but there is almost a steady path that is interrupted by that anomaly.

Senator Sessions. Well, your projections even for the next year, fiscal year 1999, will still have a deficit higher than this year's deficit also.

Mr. Raines. Not this year's deficit, no, from last year's deficit.

Senator Sessions. From last year's deficit. So we are in a good time, economically. I think that is your position and the Administration's position. I sense it myself that things are moving healthfully out there; and it just seems to me that now is the time for us not to rest.

It also seems to me that each year out in the predicting cycle our ability to predict the financial conditions we are going to be facing is less accurate. Wouldn't you agree with that, Mr. Raines?

Mr. Raines. Well, as a general rule, that is true. Over the last several years, we had some difficulty even predicting how well we do in the shorter term in the sense that the economy has performed so much better than any of us expected. We were better than most had predicted, but we underestimated the improvement in the deficit by an average of \$50 billion a year. So we have a good record compared to other people who were estimating, but we all underestimated the performance of the economy and the deficit.

Senator Sessions. Would it not be unusual—well, let me ask you this: Your projections don't project any downturn in the economy in the immediate—in the next half-dozen years, do they?

Mr. Raines. We don't predict a recession. We have modified some of our estimates in terms of the out years that cost us some money in revenue. We don't predict a recession. But I would point out, though, that a recession has a cyclical effect on the deficit. What we are trying to do is eliminate the structural budget deficit.

So, from time to time, we might go into cyclical deficit. But the key is, when the recession ends, you go back into budget balance. We have not been able to do that over the last 15 years, and that is what we are trying to achieve—structural balance.

Senator Sessions. We know that we are in a relatively good time now; and now, in terms of dealing with the economy as a nation, we ought to be paying our bills, for heaven's sakes; we are going to have trouble when the times are not so good.

Along that line, Secretary Rubin testified very ably against the Balanced Budget Amendment in the Judiciary Committee. He talked

about what he called economic stabilizers, those things that when we do have a downturn—and he predicted there would be downturns in our future—those would pump money into the economy naturally, such as unemployment compensation benefits and things of that nature.

Let me ask you about some of the triggers that are in the Presidents budget to remove his proposed tax reductions, such as the home capital gains and the child credits. They would be reduced if the economy is not performing well. I think some of the educational tax reduction would also be lost if the economy is not doing well.

Would you not say that those are negative contributors? In other words, if the economy goes into a recession, we lose those tax deductions. In effect, we have a tax increase. Couldn't that have the tendency to exacerbate the downturn?

Mr. Raines. Well, in our view, we believe that we should continue working on reducing the structural deficit even in a cyclical downturn. What we don't believe is that we should turn off the automatic stabilizers.

The automatic stabilizers would offset our continuing effort to reduce the deficit; and, hopefully, monetary policy would adjust as well to offset the recession. So, in our plan, we try to maintain our approach to structural change in the deficit path to ensure that when we come out of the recession we don't see a widening deficit.

Senator Sessions. I just was concerned that we are going to have automatic tax increases during the time of an economic downturn; and I don't think that is going to be a way to help us out of the problem.

My time is up, Mr. Chairman.

Representative Saxton. Thank you.

Senator Robb.

Senator Robb. Thank you, Mr. Chairman.

Again, Mr. Raines, thank you for appearing. You have a very positive story to present to this Committee, as you have presented to other committees. Budget and some of the money committees in both the House and Senate.

As a terminal insomniac, I sometimes have access to some of those appearances on very late night C-Span; and I had the opportunity to not only see your presentation but hear you respond to, in many cases, difficult questions to answer; so I won't cover all that ground again.

I think there is general agreement by almost everyone, at this point at least, that we are in very good shape. I agree with Senator Sessions that this is a good time to make some changes and to attack some of the long-term structural challenges that face the country.

One question I have—and I know there is bipartisan support for this and I am in a minority being concerned about any form of tax cuts before we bring the budget into balance, but the one that tends to create uncertainty among many economists has to do with the \$500 tax credit for children. Could you just give us some suggestion as to what impact that credit will have in economic terms and what the failure to enact that particular proposal would do to the budget if it were eliminated—not all the rest of the tax cuts for the moment but just that one tax cut, economic benefit and the consequences of not enacting that one?

Mr. Raines. Are you referring to the \$500 per child tax credit?

Senator Robb. Yes.

Mr. Raines. The President's tax credits are intended to perform double duty. They are aimed at dealing with the American people's desire for tax relief as well as focusing that relief on their particular needs. So we are dealing with particular concerns, as expressed by the American people. The child tax credit is aimed at helping people raise their kids.

Senator Robb. But I am refining the question a bit, if I may, and addressing specifically the economic impact. And I understand the broader impact and the well-articulated desire from many people to have some sort of a tax credit. I am not quarreling with the public demand.

Mr. Raines. Sure. Senator, I think the honest answer on the economic impact is that tax cuts of that size have a very modest impact on the overall economy. Therefore, they will not have a significant impact, one way or another, on the path of the economy. That is why we don't bill the tax cuts as a part of a package for expanding growth. We view them far more as being targeted to the needs of individual families. But regardless of whether the child credit is on or off, it would not have a dramatic impact on the path of the economy in the out years.

Senator Robb. So the justification would be largely based on other factors to which you eluded at the beginning of your response?

Mr. Raines. Yes.

Senator Robb. I will accept that.

Let me ask you one other very broadly based question. Many of us who are very much concerned about the deficit and have expressed those concerns over a long period of time have cited the fact that if we do nothing—and again your budget does not propose doing nothing—to correct the current trends that by the year about 2012 all of the then projected revenues for the Federal government could be consumed simply by entitlement spending and interest on the national debt.

I raise that in this context: First of all, we focus more often today on the fact that the deficit as a percentage of gross national product (GNP) or GDP is low. It is low compared to other industrialized nations, etc. But we sometimes mask the fact that, with the size of the debt and the interest on that debt, which comes right out of any given year's budget, that the percentage of the money available for spending by the President and the Congress on programs that the American people deem beneficial to the country, the percentage of the debt continues to go up rather than down and the fact that the entitlement programs, again without some constraint, will take up all of the rest of the available inflow of dollars during that period of time.

First of all, do you agree with that basic premise if appropriate changes are not made that that is a reasonably accurate assumption of where we would be in that year? And if that is the case, one of the charts—and I know you don't have it with you today, but what I would very much like to see would be a chart that reflects what happens with respect to those two entities not only through 2012 but 2020, 2025 or so, based on the projections and assumptions and recommendations that you are making in the President's budget or any other budget that is presented.

Mr. Raines. Well, I have a couple numbers that reflect your point. But I think on your first question, you are accurate. If we did nothing, we would see the inexorable increase in mandatory spending and interest costs that would begin to consume all that the American people seem to be willing to pay for their national government.

A couple of numbers: If you look in 1993, the projections were that entitlements would rise from 11 percent of GDP to 14 percent of GDP by 2002, that interest would rise from 3 percent of GDP to 4 percent by 2002.

Under the President's program, entitlement spending will stay at 11 percent of GDP, and interest costs will decline to 2 percent of GDP. That is part of how we are able to balance the budget, by taking money that

would have been spent on interest and instead using it for either deficit reduction or programmatic spending.

The opposite of the vicious cycle is the virtuous circle. Once we start to turn around that debt and stop it from rising, it will become a smaller and smaller burden as a percentage of our economy.

Senator Robb. Let me say that I agree and, in fact, applaud the Administration for what was done, particularly in 1993, to make some fundamental changes that were not universally popular at the moment but I think certainly can take a fair share of the credit for a much-improved position in terms of where we are and likely to be in the near term.

Indeed I have pointed out over the years that in the last couple of budgets, but for the debt that had to be serviced from prior decisions to go into debt, that the budget would be essentially in balance for this particular time. But I think again to the extent we compare it to a percentage of GDP or GNP, rather than to what is available to spend for the programs which we are required to fund under all the laws of the Congress, etc., that we tend to lose sight of the fact that the problem is still getting tougher even though our relative position vis-a-vis GDP and GNP will improve and continue to improve.

Mr. Chairman, my time has expired. I thank you, and I thank Director Raines for his very patient explanation of many of the difficult and arcane theories that are inevitably a part of any discussion of budget or economics; and I thank you for the opportunity to ask our questions so that we can go vote in time.

Representative Saxton. Thank you, Senator Robb.

Let me say, Mr. Director, that I appreciate very much your being here and sharing the Administration's view with us on the economy. I view—as I have had discussions with other Members of the Committee, I view our job as an analytical one, to try to discover what it is that Federal policy does or does not do to the economy and, obviously, to make some suggestions on what we might be able to do constitutionally to tailor Federal policy to effect the best economic growth possible. And I think both Senator Sessions and Mr. Hinchey made very good points this morning.

Senator Sessions said the economy is doing okay, and Mr. Hinchey said we ought to do things to get the economy doing even better. So there is discussion on both sides. All of that I think is very important.

I think one of the things that we have to do between the Administration and Congress and together with the two parties is try to find areas where we can agree on policy so we can work in a bipartisan or nonpartisan way to effect positive change. But I think—before we get to that point, I think we have to understand each other and agree on basic facts. You mentioned some things in your testimony that I would just like to ask you to explain so that I could understand those items better.

First, in your testimony—and I think this is your quote—that this Administration inherited an economy that had hardly grown. In the President's *Economic Report*, it points out some facts here that I interpret differently than I think perhaps you do.

As we all know, we had a recession in 1990; and in 1991 we finally came out of the recession; and in the last year of the last Administration we experienced significant growth—I believe it was around 2.7 percent. Now in the last two years we have had, according to the President's *Report* on the economy, growth in 1995 of 2 percent and growth in 1996 of 2.5 percent.

Now, I have trouble understanding how you inherited a weak economy and can claim today that this economy is so good when the growth rate was higher in the last year of the last Administration than it has been for either of the last two years. Would you explain that to me?

Mr. Raines. The difficulty is to look at when are you coming out of a recession, when are you going through a steady period of growth, and when you are going into a recession to try to even them out. Also, there is a qualitative point I was making as to where the engines of growth are coming from.

If you look over a period of years, and the Bush and Clinton periods are of comparable length—actually, Clinton's is slightly shorter because these data don't cover the whole period—but you can see the difference in real growth by sector. Despite the reduction in growth in the Government sector, you can see real growth within the time of this Administration compared to the last Administration and also the Reagan Administration, that the extent to which the overall growth was driven not just by private but also by growth in government spending. So that we had a relatively weak economy, virtually no job growth in the prior few years. We had basically a jobless recovery before, and we have seen actually higher levels of sustainable growth over the period of this Administration. And it is in the private economy, which is worth more

because you don't get real improvements in wealth as a result of growth in the governmental sector.

Representative Saxton. Mr. Director, you don't deny that when you took over, when this Administration took over in 1993, that the growth rate the previous year was higher than the growth rate in the last two years? You don't deny that, do you?

Mr. Raines. No. As you mentioned, I think in your opening statement, the recovery from the recession had begun. And when you are coming out of a recession, you obviously have an abnormally high short-term rate, but if you looked at it over the period of four years—

Representative Saxton. But you didn't inherit four years, you inherited an economy that existed in 1992 that was growing at 2.7 percent.

Mr. Raines. We inherited an economy coming out of a recession, and when you're coming out of a recession, 2.7 percent is a pretty ordinary growth rate. If we had continued the same policies, I think we would have seen what we saw earlier in the 1980s, that is, the growth rate would have topped off and we would not have had sustained growth.

Representative Saxton. Let me pursue this idea that you just initiated that we need to look at periods of time.

My facts indicate that since World War II, which is a fairly long period of time, our average rate of growth in GDP and GNP, which were used at various times as the measure, that the average rate of growth since World War II was 3.1 percent. Today we have got average growth over the past two years of 2.0 and 2.5 percent, respectively. How does that measure up, do you think, in terms of where we ought to be policywise?

Mr. Raines. We think our current growth rate and the potential of the economy is too low, and we believe that we need to have a set of policies that increases that potential so that we can see expanding wealth and expanding opportunity. That is why we are trying both to focus on private sector investment, but also to invest in the budget in human capital so that we can increase the economic potential and get higher rates of growth.

I should mention, though, just for the record, that our current concerns about inflation measures may have an impact on how we think about our rate of growth as compared to other periods. Because if our inflation measures are too high and we are using that to discount the

nominal growth rate, we may be masking some level of growth that we have got. But I think there is general agreement that we need to invest in order to increase our rate of growth above what we have been able to achieve in the last four years.

Representative Saxton. Let me turn to something else which you mentioned in your statement which I am having a hard time understanding. You talked about rates of personal savings. Again, in the President's *Report* from this year, the statistics pointed out here don't seem to bear out the thrust of your statement when you said that personal savings are up over the 1980s.

Beginning in 1981, the President's *Report* indicates that we had a personal savings rate of 9.1 percent and in 1982 of 8.8 percent, and savings rates that stayed above 5 or 6 percent all the way until 1989. The savings rate in 1993 in this *Report* is 4.5 percent, and the savings rate in 1994 is 3.8 percent, and in 1995 it is 4.7 percent.

I don't understand how you can make the claim that personal savings rates are up over the 1980s, given these facts.

Mr. Raines. Well, I think this chart makes my point. If you draw a trend line from 1980 to 1992, what you will see is a line that shows the savings rate is coming down at a pretty steady rate, interrupted by what happened in recessions and a few other things; but the trend is very clearly heading down to the lower right-hand corner.

Representative Saxton. Excuse me. Excuse me. I don't understand this. This is the President's *Report*, and the facts are laid out here as I read them—8 percent, 9 percent, 9 percent, 6 percent—and when you get to the 1993, 1994, 1995 period, it is all under 5 percent. How you can draw a trend line based on these facts mystifies me. I don't understand. Please explain it.

Mr. Raines. If you look at the entire economy—I am not sure. Are you looking at private savings?

Representative Saxton. It says personal savings.

Mr. Raines. The chart shows the whole economy. This is what we have really to invest. This is not just what people are able to save.

Remember the dissaving point I made about the Government. The Government is on the other side of this equation, dissaving. This is the net that is available, and I think that may be the difference in the two sets of numbers.

I believe I stole this chart from Joe Stiglitz, so these do reflect the numbers that are consistent with the CEA. But what I am saying is that the trend line is moving in the right direction.

Representative Saxton. So you are saying that the trend line is moving in a positive direction not because people are saving more today but because the deficit is lower?

Mr. Raines. Yes. As I mentioned, people are saving slightly more if you are looking at chunks of a period, but very slightly more. The big difference is the Government is dissaving less. That is why we are focusing on the deficit.

Representative Saxton. I am sorry, Mr. Director, and I am trying to be fair; but I am looking at these numbers; and I see that in 1995 the personal savings rate was 4.7 percent where it averaged well over 7 percent during the 1980s. I don't see how you can say that the personal savings are up or people are saving more.

Mr. Raines. Total savings is not just personal savings. Corporations save—

Representative Saxton. You say people are saving more, and that is not true.

Mr. Raines. Actually, if you look at when the Administration came in until now, the rate is up very slightly.

Representative Saxton. We agree on that. When the Administration came into power, the personal—as a matter of fact, in 1992 the personal savings rate was 5.9 percent. Then when the Administration came into power, it diminished down to 4.5 percent, then to 3.8 percent. This year it is back up slightly, to 4.7 percent. That is correct.

Mr. Raines. So our point here and really the whole point of our fiscal policy—and that was the point I was trying to make in my testimony—is that you can't look just at what has happened in the private sector. Because if the Federal government is consuming those savings, then you don't have net savings available to invest, and that is why we argue you can't ignore deficits.

The fiscal policy of the 1980s said that you can do things and deficits didn't matter. Some economists maintained that, because of all the incentives we were getting on what was then called the supply side, deficits didn't matter. Our argument is just the opposite. If we can

increase national savings, then we don't need to make the kinds of supply side adjustments, particularly very deep tax cuts and other things, that would deprive the Government of the resources necessary to balance the budget. It is a difference in philosophy, and my only point is that two very different philosophies have been tried out, and we believe that the President's philosophy has worked very well.

Representative Saxton. Well, you and I agree that we ought to try to increase savings in the private sector. As a matter of fact, in the budget submission that came over from the White House, you folks are talking about increasing individual retirement account programs so that people who are in middle income brackets have access to the program.

I agree. I would even probably step it up a little bit higher, because I think a couple of people making \$40,000 each in a family today could save more than the threshold that even the Administration has proposed. But we will have more to say about that later.

Let me ask about some other facts, and then I will relinquish my time.

You talked about interest rates being lower. Once again, when you inherited the economy in 1993, in 1992, the last year of the Bush Administration, short-term rates in particular were quite low. As a matter of fact, it looks like the discount rate was about 3 percent when the Clinton Administration took over, and they are now a little above 5 percent. The Federal funds rate was about 4 percent, and it is now about 6 percent. Long-term rates were steadily declining until 1993, and then they went up quite steeply and then leveled off and came back down some.

But the fact of the matter is that, in all cases, interest rates are higher now than they were in early 1993. How does that translate into lower interest rates? I don't understand.

Mr. Raines. Well, as I mentioned before, you have to look at where you are in the business cycle to see if rates are relatively higher or relatively lower than you expected.

This chart, if I could walk over to it, makes a good point. In 1992, we had unemployment just under 7 percent; and we had relatively low rate on the 10-year Treasury Note—but it was relatively low because unemployment was high. So what you really want to see is, at any given level of unemployment, are rates higher or lower than previously? And this chart is showing that, if you pick 1993, we had an unemployment

rate roughly comparable to 1992. Interest rates were lower in 1993 at the same level of unemployment.

Again, if you take 1995 and compare it with 1990, you will see the unemployment rate was the same, but interest rates are lower than they were in 1990.

When I saw this chart, I found it quite remarkable that this relationship we usually think of as locked in place—interest rates and unemployment directly related—but it is possible to get low unemployment and low interest rates and, more importantly, we can have lower interest rates than we are used to at any given level of unemployment, and that is the important engine for the economy.

Representative Saxton. Mr. Director, I just have a very difficult time with your explanations of these facts. Let me just refer again to this subject—the President's budget, which you all sent over this year. In talking about economic benefits on page 25, it says, quote, falling deficits enabled the Federal Reserve to hold short-term interest rates low in 1993. Quote, in addition, the markets also reacted favorably, cutting long-term rates in 1993.

Now, I don't see any cut in long-term rates in 1993. They actually went up. Beginning in the middle of 1993, the trend of long-term rates was going up; and then they were, of course, followed by the discount rate and the Federal funds rate, which also showed a very steep upward incline following the tax increase in 1993.

Mr. Raines. Well, actually, I think your chart shows that average rates in 1992 were higher than average rates in 1993. Indeed, many of you probably remember refinancing your mortgage just at that time because rates across-the-board, including consumer rates, had come down very significantly; and, as a result of that, in my former business, we had the largest boom in our company. I think we doubled our business that year as a result of the reduction.

Representative Saxton. That is fine.

Let me just make one final point. Interest rates were trending down. The trend down in interest rates began in 1990; and they trended down through 1991, 1992 and bottomed out in 1993. That red vertical line indicates the time that the Omnibus Budget Reconciliation Act, or the tax increase, was signed into law; and almost immediately interest rates trended up. So the trend was down until that event took place. Then the trend went up.

And your claim, I don't understand, that fallen deficits enabled the Federal Reserve to hold short rates down doesn't match. I don't understand that at all.

Mr. Raines. Well, again, I think we are comparing apples and oranges. What you see during that period, a relatively high unemployment and recession, the Federal Reserve dramatically reduced short-term rates to try to counteract that recession, and that is where you see those rates coming down.

As the economy began to improve, the Fed then began to take counteraction to keep the recovery from getting out of hand; and they raised the Federal funds rate, which has been their policy over the last 10 years, to try to counteract the real economy by changes in monetary policy. I think that matches up pretty exactly with my testimony.

Representative Saxton. The Fed doesn't control long-term rates, do they?

Mr. Raines. No, they don't directly control long-term rates.

Representative Saxton. Why do you suppose long-term rates went up ahead of short-term rates after the tax increase?

Mr. Raines. Long-term rates you would expect to go up as a result of an expectation of increased economic activity that they think might have caused increased inflation.

Representative Saxton. The concern that I have here is that the budget states that long-term rates fell in 1993, when, in fact, at the end of 1993 they were higher than they were at the beginning of 1993. And yet your budget says that they fell, and I don't understand that.

Mr. Raines. I think this is a factual question. Even looking at your chart, I think your chart indicates declining rates during most of 1993. At the end of 1993, there was an uptick. But during most of that year, rates were low; and, again, I think that was the common experience of most of the people in the country.

But point to point, you will always get discussions among economists: Are you comparing average rates across the year? Are you comparing fourth-quarter to fourth-quarter? If it is a factual point, I think we can get back to you to resolve what rate calculation we used in the budget. [Inserted for the Record by Mr. Raines: Interest rates on 10-year Treasury bonds fell in 1993. This is the case whether you compare annual averages of 1992 and 1993, quarterly averages for 1992 and 1993, monthly and weekly averages, or market rates on the first and last days of 1993.]

But I think the general point that interest rates were falling in that period was the common experience of average people, as well as, what your chart is saying.

Representative Saxton. Well, thank you very much. I have taken enough time, and I am going to yield to others for their questions.

Mr. Hamilton was here first. Mr. Stark? Okay. Thank you.

Representative Stark. Thank you, Mr. Chairman.

Again, thank you, Mr. Raines.

I have a couple questions on the tax side of the budget. There is some concern—I suspect there is some bipartisan concern, I mean, on both sides of the aisle. Some would like to see bigger tax cuts. I suppose some would like to see no tax cuts until the budget is balanced, and I think there are some on both parties who feel that way. There are some of us who are concerned that these tax benefits are principally for middle class taxpayers and undo some of the progressivity that OBRA '93 began.

So you outlined the benefits of lower interest rates and lower deficits and yet the tax cuts in the President's budget make lowering the deficit more difficult. Are you prepared, then, to argue that we need dynamic scoring to make the proposed tax cuts a better policy? Are we going to be better off because of the tax cuts in the President's budget than we would be with a balanced budget without the added cuts? In other words, if we are going to get all these benefits from lowering the deficit, why not wait on the tax cuts or is there some secret in there like dynamic scoring?

Let me go on. It is really three questions, and they all relate, and it probably might be easier.

To follow on, we had a decade really of making the Tax Code actually more regressive until 1993; and then the Tax Code became somewhat more progressive. Now the non-refundable credits, the cuts in the President's budget, appeared to be weighted toward higher income families. This budget makes the tax system on net or does it make it more or less progressive?

If it doesn't make the tax system more progressive, would you contend that the spending changes redirect enough spending to lower income people so that the net result—in other words, I am going to challenge you to show me that the tax cuts are not somewhat regressive. Therefore, can you tell me that you are redirecting enough of the

spending to make the overall package more progressive? I don't think so, but maybe you can weave through that one.

Then for those who would like to have more tax cuts, which the Chairman on the Ways and Means Committee would like to do, what is the spinach we have to eat? Where would you find, for example, \$50 billion more cuts in spending? Do you have that list in your back pocket, that you are going to say, okay, guys, if you want \$50 billion more in tax cuts, here is what we have to cut in spending? Can you deal with that?

It is a long question, but I would just as soon lay it out for you in those three parts.

Mr. Raines. I will just mention this to give you the context of what I am about to say. If you are going to balance the budget, you have got to bring revenue and outlays together. In this budget, we propose to do so in 2002, at about 19 percent of GDP.

As you can see on the receipts line in the chart, we are expecting essentially flat receipts as a percentage of GDP over that period. Most of the changes are coming on the outlay side.

In specific answer to your question, we have paid for our tax cuts the old-fashioned way. We had \$350 billion of total cuts in the budget. We spent \$98 billion of that.

So there is no dynamic scoring. It is simply that we have made tough choices to allocate cuts and spending, and we have moved lots of money around in this budget, and we have moved part of it towards these tax cuts. That is why I described what we are trying to achieve by them, rather than some dynamic or other impact of their own.

On your second question—more or less progressive—we clearly acknowledge that these tax cuts are aimed at middle income families. They are not aimed at higher income families. They will benefit some lower income families, but the major impact will be on middle income families.

Particularly, let me point to the HOPE scholarship. Last year, we proposed the HOPE scholarship with a refundability provision to it. A number of people said to us that they thought that that would not work as well as we had hoped in progressivity and access. So we took those dollars, and we moved those directly on the education side and put those into scholarship programs on the education side, both expanding the availability of the scholarships as well as expanding access to them. So

we did exactly what you suggested to ensure that we don't have an overall negative impact.

On the third point, I too would be interested in seeing how a very large tax cut would be paid for; and I have suggested that we will wait, with interest, to see how such a tax cut would be paid for.

We believe that any changes to the President's budget that would increase tax cuts would need to be paid for within the context of a balanced budget. To date, I have not heard of a plan that had, as part of the plan, both tax cuts and the pay-fors.

Representative Stark. If I can respond, I think what you are suggesting to me was that—I gave you a way out. I guess I shouldn't have. But you are suggesting some of the spending, when you couple the spending with the cuts, the net benefits would make your overall package somewhat more progressive. I will take that on faith, but I hope that if I can show it in a more empirical sense that that is not quite right, maybe you will support any changes we could make to make those figures add up exactly.

On the question of tax cuts, where we pay for them, maybe if you are not willing to propose to us what you would have to do to find \$50 billion more, can you give us some areas which are exhausted where you can say to us there is no more room?

I am not sure you can say that about defense. I always felt we could take another \$20 or \$30 billion out of defense in a minute, but that is a philosophy that is not shared broadly.

We certainly, I don't think, can take it out of foreign aid. Mr. Hamilton is an expert in that area, and I don't think you would suggest that.

What areas are proposed to us? Give us a little process of elimination here to say, if we want to expand the capital gains or if we want to make bigger tax cuts by a process, what is left to us? Can you expand on that just a little more?

Mr. Raines. Sure, Mr. Stark.

I think, as a budget director, you never in your own mind close off anything as impossible. It is just a question of your priorities; and if we reorder our priorities, you can move money from a spending side to tax cut sides.

Our position simply is we are unwilling to reorder our priorities in a way sufficient to pay for an enormous tax cut. We believe the President made a lot of tough choices here making cuts while making investments. He did not simply come in with an austerity budget that cut everything.

So, for example, in education and training, we are going up by 20 percent. That is not an austerity approach. That is making tough choices. That meant some other things had to be held constant or cut to pay for that at the same time that we are reducing the deficit.

Representative Stark. Mr. Chairman, will you indulge me for another second? I guess what I am getting at is—and I am not sure this are—but I am going to give you some hypotheticals. Then I will get off this—I have a hunch that you might have looked at public works and said, wait a minute, our infrastructure is already suffering from deferred maintenance. Forget about building new highways. We have got to repair the old bridges. And if Congress is responsible, that isn't really an area for big, additional cuts. I think you might say that.

We obviously can't save money by cutting the interest we pay. That is not available to us. There isn't very much in foreign aid. That is a piddly part of our budget. Yeah, I mean it is—what—15, 18 billion. That is not going to handle the 50 billion.

I think if you follow that, you get us pretty quickly to defense; and I am not sure that the same people that want a bigger tax cut would be very comfortable with a big cut in defense. Maybe there are some other areas that I don't know of, but where are there big chunks, bigger than 10 billion, left to us where we have any discretion? Medicare? I mean, there is a political kind of roadblock there; but that is one defense. Where else would we find—even if our priorities would let us, where else do we find that kind of money?

Mr. Raines. Well, Mr. Stark, I think the answer to your question is sort of the reverse of Senator Robb's observation on what has happened with entitlements and other programs. I believe the era of easy cuts is over, and the reductions in this budget will require very difficult decisions.

The President made his decisions and included them in the budget. It is not going to be easy for people who believe that we need to make dramatically larger cuts to make those cuts without making a statement about their priorities. I think that is going to be true across the board.

We looked at the whole budget. We looked at the Tax Code. We are proposing \$34 billions of Tax Code changes that focus on lower priority provisions. We think they are unwarranted subsidies, primarily with regard to corporations.

So we went into the Tax Code. We looked at the Defense Department. We looked at entitlement programs. We looked at everything across the board.

You are probably hearing people say that this budget may not make cuts as large as they might like. You are probably hearing that steady drumbeat from people who say, "I am in favor of a balanced budget, but not this one and not that one." I think that is going to keep growing and growing as Congress moves closer to addressing the budget.

So I don't believe it is going to be easy for anyone to find very large spending reductions without having to tackle very big, and uncomfortable, policy issues.

Representative Stark. I agree.

Thank you, Mr. Chairman.

Representative Saxton. Thank you, Mr. Stark.

From the first day I walked in the Joint Economic Committee, Lee Hamilton was Chairman. I was saddened to read of your decision to retire, Lee; and we look forward to working with you for the next two years. But we are pleased you are here today, and you may ask any questions.

Representative Hamilton. Thank you very much, Mr. Chairman, for your kind remarks. It is a pleasure to be here, and thank you for holding the hearing.

Mr. Raines, I just want to start with a kind of technical question if I may. I was struck by your phrase that you are cautiously optimistic here about balancing this budget. And I guess most people feel that way. We have certainly conveyed that to the American people, that we are going to get a balanced budget agreement this year. We are going to look pretty bad if we don't get it, it seems to me.

Just in terms of timing here, tell me how this plays out, from your standpoint, in the Administration. We have a budget resolution that will be coming up, I don't know when, April, May sometime. When are you going to get down to the nitty-gritty here on a balanced budget agreement? Just in a point of timing, how do you see it playing out this year?

Mr. Raines. Well, Mr. Hamilton, we have been trying to get those discussions going since the day after the election; and we are prepared to sit down and begin those discussions at any time.

Representative Hamilton. Those discussions are not going on now?

Mr. Raines. I am not aware of any formal discussions taking place now that would lead to a balanced budget plan.

We have had several good meetings. There was a meeting with the Leadership that resulted in a number of task forces being put together to try to see if there is any low-lying fruit on which we can get some early agreements. The Budget Committees are doing their work. They are holding hearings on the budget and beginning to outline their own ideas. I am not sure when they will be ready.

Representative Hamilton. But it is likely that this balanced budget agreement, if it is struck, and we all hope it will be struck, will be late summer or fall? Is that kind of the context that we are looking at?

Mr. Raines. It would be my hope that we would make good progress on it by the time the Congressional Budget Resolution is adopted.

Representative Hamilton. That is only a few weeks away.

Mr. Raines. That is right. Then the implementation of that resolution certainly would require a couple of months, because it would require the authorizing, appropriations, and tax committees to write implementing legislation. So we might not have all the decisions done until later in the summer, but I believe the outlines of an agreement ought to occur as soon as possible so that the other committees can begin their work. Because our position—

Representative Hamilton. As you look at it now, as you survey the budget balancing agreement, what is the sticking point? Is it on the tax side or is it on the spending side?

Mr. Raines. I think there are a number of points that must be dealt with.

First of all, there is the question of the baselines. There is roughly \$50 billion difference—and we will see the estimates in the next few days—but roughly \$50 billion difference in the estimates of our budget baselines. That is a very big number. There are proposals to have substantially larger tax increases, and that is a very large number.

There are differences as to the sizes of discretionary spending and the composition of that between defense and nondefense, and that will be a very big discussion. And within the entitlements, there may still be, although I don't know yet—

Representative Hamilton. You see a lot of sticking points?

Mr. Raines. Oh, yes. This is by no means going to be an easy task or a formula.

Representative Hamilton. Let me direct your attention to this question of growth a little bit. You emphasized pretty heavily the President's proposals with regard to education, work training and all the rest. Everybody, I think, would agree with the proposition that we would like to see the American economy grow faster than it is.

I know that you get to the question with economists, what causes growth, you get a lot of things in the mix. Everybody agrees education is important, but there are two things you can say about education. Number one is it works; and, number two, it works very slowly.

Now, if you want to get growth—early on in the Clinton Administration, you were quite interested in infrastructure investment. If I read the budget correctly—I may not read it correctly—but if I read it correctly, you are not putting much of an emphasis on increased infrastructure investment. I am no economist, but if I look at my own State and what causes economic growth in a particular area, I am impressed that there are very few things that you can do that bring about more immediate increase in economic growth other than infrastructure development. You improve a highway, you improve an airport, you improve a water system and it has an impact and it has an impact quickly.

So one question here—you usually get questions from us like why don't you cut spending more? But I am kind of asking the question, why don't you spend more? If you want to get growth, why don't you spend more in the President's budget on infrastructure or research?

That is the other thing that economists say will drive growth—technology, research. Why don't you have more spending in these areas? Why are you increasing only in the education area? Or are you?

Mr. Raines. I think your characterization of the infrastructure part of our budget is fair. We do not have major spending increases in that area. We do have increases in research, but we do not have major increases in infrastructure.

Indeed, on the day we introduced the budget, the press asked me what area would the President identify as that in which he was the most disappointed, in terms of what he was unable to do with the budget. I said infrastructure. We wish we could have done more.

When you think of what government can do to help expand the economy, one of the biggest things it can do, in addition to having a sound fiscal policy, is to invest in human capital. That is where we believe the education and training investments will pay off. Government can also help invest in physical capital, and that is where the infrastructure comes in. We have a substantial infrastructure program, but if I had my druthers, it would be larger.

We simply, in putting together the budget and meeting our goals, were unable to do all that we would have liked to have done within the infrastructure area.

Mr. Hamilton. If I understood the little dialogue you had with the Chairman a moment ago—he was citing figures with regard to the personal savings rate. You were showing a chart up here with regard to the net savings rate. They are two different things. But the economics of this—if I understand it, savings are important in the economy because savings lead to investment, right?

Mr. Raines. Yes, sir.

Representative Hamilton. And what is really important with regard to the pool of money available for investment is net national savings; is that not correct?

Mr. Raines. That is correct.

Representative Hamilton. One of the criticisms made against the budget—and I will conclude here quickly, Mr. Chairman—one of the criticisms is this question of back loading the spending cuts, and I would like to give you an opportunity to respond to that just by way of a figure. I don't know whether it is correct or not.

I have heard that the President's budget plan calls for 75 percent of the spending cuts in the last two years, when he may not even be in office. Is that a fact, that you have given us a budget here with back loaded spending cuts?

Mr. Raines. Well, Mr. Hamilton, I think that every sound budget I have ever seen has "back loaded spending cuts." If you make cuts that are not just one-time cuts, but are those that will yield benefits over time,

you create what is known as a wedge. That is, small change now saves you more and more money every year.

The other thing that has happened to us is that, when these discussions began, people were talking about a seven-year budget plan out to 2002. Then it became a six-year budget plan to 2002. Now we're down to a five-year plan. Indeed, we suffer a little bit from the contraction of time, and a greater percentage of the cuts are in the end of the time frame.

The important point here is one that I think you can see in the 1993 decision, which created this green area. You could have said all of those cuts are back-loaded, even though they start small and keep getting bigger and bigger. But the important point is that we are asking that all the decisions be made now. The decisions to cut discretionary spending and set a discretionary cap should be made this year. The decisions to cut mandatory programs and to change the policies in those programs should be made this year. The decision to reduce tax subsidies should be made this year. And more benefits would be happening every year.

Representative Hamilton. I understand. But the pain would come later.

Mr. Raines. I think part of what this chart is meant to show is, if you are judging budget balancing by pain, decisions you have already made are going to swamp any pain from anybody's plan. You are talking about \$2.5 trillion in this period. You have already voted for most of the impact in 2002. That is already going to happen. Whether you use our plan or double our plan, you have already voted for most of that pain.

In part, I think we don't give credit to decisions that have been made. And I think the American people have said they like this trade-off. They like what is going on in the economy, and they are willing to take that pain if they can reap the benefits.

Representative Hamilton. Robert Reischauer, as you know, was the Director of the Congressional Budget Office; and he had that article in the *Post* recently in which he said that if the President's budget shows much more than 68 percent of the pain concentrated in the last two years, its credibility has to be called into question.

Now, your budget does that. Do you quarrel with him on that?

Mr. Raines. I do quarrel with him on it. Because, again, if you looked at it over six years, it would be less than his number. What he

doesn't say is that he is adjusting his number for the number of years that we have got.

If we took his exact same test last year, our number would be lower than 68 if you do it in five years; and indeed if you do it over a four-year budget, most budgets would flunk it even more. But we took his whole test; and I think if you compare all of his criteria, we do quite well against the criteria that he sets forth in that article.

Representative Hamilton. Well, I have got a lot of other questions; but I think that is time for me. I appreciate it, Mr. Chairman.

Thank you, Mr. Raines, for coming. We are very pleased to have you here today.

Mr. Raines. Thank you.

Representative Saxton. Thank you.

Mr. Hinchey.

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

Mr. Raines, among other things in your presentation I was happy to see at one point that you stipulated that balancing the budget is not the ultimate end in and of itself, that the ultimate end is to raise the standard of living of the American people. That is the ultimate end of this budget, as it ought to be the ultimate end of any budget presented by any president and passed by any Congress; and I think that is something that we have to keep in mind.

Again, as I think you have pointed out in your remarks, the critical decision that was made here with regard to the progress that has been made on the budget deficit and also the improvement in the economy and, therefore, the standard of living of the American people was the decision that was made in the Budget Resolution of 1993, which benefits we see reflected in that chart that you have brought with you and is behind you. Deficit is down very, very substantially, about a third of what it was—a little over a third of what it was just a few years ago.

In that Budget Resolution, in addition to raising taxes on those people that had tax reductions previously, raising them a little bit, there was almost some demand side provisions. The earned income tax credit, for example, the improvement there, provided some demand incentive for the budget; and I think that was very instrumental in improving the strength of the economy at the same time that it improved the standard of living of the American people.

What kind of demand provisions do you have in this budget? And following up on questions that were raised by Mr. Hamilton a few moments ago, what is there in the budget that is going to make this economy grow better and grow faster in addition to the education provisions that you have?

Mr. Raines. Well, I have to at least mention the education initiatives, because we invested so much in them. We are investing \$51 billion in education and training programs in this budget, and that is by far our largest item.

We have proposed increases in the university-based research and other research that we believe will have a very significant impact on our future ability to grow the economy. We have a number of regulatory changes in the budget that are reflected in some of the budget reductions we have made, but we think that they will also unleash productivity increases, particularly in our health programs, Medicaid and Medicare, where we try to encourage more competition and newer forms of delivery of care.

In fact, one of the criticisms of our tax provisions is that they have a demand-side flavor to them, that people think that we are encouraging people to consume more education, and argue that we should not have a particular point of view as to how people spend the money they receive as a result of the tax cuts.

That is a legitimate criticism. We plead guilty. We are trying to encourage people to consume more education than they otherwise would, because we think the Nation would benefit. So we plead guilty.

Representative Hinchey. But the problem of deferred maintenance, which was mentioned a few moments ago, is one that I think will haunt us in the future to a much greater degree than any budget imbalances that we might project will occur in the out years. This is a matter that is only going to get appreciably worse as time goes on. The longer we defer this maintenance, the more costly it is going to be and the more difficult it is going to be to get it into a budget that will address those needs in a responsible fashion. Don't you think that this is something that we ought to be paying more attention to?

Mr. Raines. I agree totally, and we do make a number of investments in that regard. Let me give you a couple of examples.

We have a program to help schools either build new facilities or remodel existing ones. We have new programs and fees in the National

Park Service, and we propose to keep those fees in the Park Service so they can invest in infrastructure.

We soon will be sending up an authorization bill for surface transportation that has serious funding commitments to sustain our national highways. So we have a very large commitment there. My only regret is that this couldn't be an even larger commitment, because I think we can find very useful and profitable investments of infrastructure funds within the Nation. We simply ran out of money.

Representative Hinchey. Well, I think this is something that the Congress is going to have to address itself to. I know the President talked about this in his first campaign, but we really haven't addressed the need in the way we ought to.

Let me, in the time I have left, mention something about the interest rate provision which was a discussion between you and the Chairman just a few moments ago. In the budget document it mentions that the last time that unemployment was at this relatively low level, the interest rate on the 10-year Treasury bond was about two points higher than it is. So that point I think is an important one to be made.

Also, the tick-up that you see in the short-term interest rates there on your chart was due to the fact that the Federal Reserve wrongly saw inflation in the economy. As the economy began to grow as a result of the 1993 budget initiative, as the economy began to pick up, they thought that inflation was going to jump up; and they began to take action against it, anticipating an inflation that never really arrived; and they raised inflation rates eight times in that very short period of time.

So that is why those short-term interest rates went up. It was an act by the Federal Reserve, which I think is something that I think prevented the economy from growing at a faster rate than it would have if they had just refrained from those interest raises at that time.

Mr. Raines. I think you are right, they were anticipating a repeat of the past pattern where, if you had increasing growth, it would automatically turn into inflation.

But this expansion has shown that you can have growth that does not translate into accelerating inflation. Indeed, most economists have now changed their formulas for the level of unemployment at which you would expect to see accelerating inflation. We are learning a lot about this new economy. It has been performing far better than anyone,

including the Administration, predicted it would perform; and we are benefitting from that.

And I am one person, having just come into the Government from the private sector, who believes that there are very fundamental changes going on in our economy. And I think these changes are going to continue to surprise us as to what our economic capacity is, how fast we can grow, how low-interest rates can be, and what expectations we can have for improving economic well-being. None of that is in our budget, I think we again may be on this virtuous circle side of the equation, where we can see the economy performing better than has been our historical experience.

Representative Hinchey. Thank you very much.

Representative Saxton. Let me just conclude with a couple of questions which I think explore a couple areas that we agree on.

As you know, the Boskin Commission reported some months ago that the Consumer Price Index is less than accurate and suggested that we ought to somehow change the formulas so that it would come closer to being what the Boskin folks thought was accurate.

Subsequent to that, the Joint Economic Committee staff looked at it; and we, subsequent to that, suggested to the Bureau of Labor Statistics that they take a look at the Boskin recommendation and give us their feeling as a result of their study in a report which we anticipate receiving from BLS sometime in the summer or early fall.

Would you agree with our position that it would be perhaps less than prudent to move quickly on this issue rather than to wait and make sure we know the full effect of what we are doing subsequent to a report from BLS?

Mr. Raines. Well, we certainly agree that we need to have an accurate measure and that any changes we make have to be grounded in good science. And we need to put in the time and effort necessary to ensure that we have the best science available to all policymakers before any changes are made in the CPI.

We have been examining the Boskin report, we have ongoing discussions with BLS about their work, and, in this budget, we funded additional work for the BLS to make improvements in the CPI. So we are very carefully monitoring the vast amount of work going on around this town, and around the country, on this issue.

Representative Saxton. What concerns me about this is that a group of—a bipartisan group called the Blue Dogs in Congress apparently are introducing legislation today that would reduce the Consumer Price Index by eight-tenths of a percentage point. That causes me concern because I believe that an across the board, if you will, or a reduction of some arbitrary point causes a variety of actions to take place throughout the government and the private sector, which include tax increases and benefit cuts and effects on private contracts that are set to increase or decrease according to the CPI. It seems to me that we ought to have a pretty good idea of what those effects would be before we proceed to make any such changes. Would you agree with that?

Mr. Raines. Well, I agree we have to know what the impact of any changes might be, not just on Federal programs but on the private economy.

I have to give a great deal of credit, though, to the BLS. They have done an enormous amount of work over the years. Indeed, much of the work used by those whom critique the CPI uses what was developed by the BLS. So the BLS has been a source of great information on this subject, and I think we can continue to look to them for insight, not only about the Consumer Price Index but about its use in the economy.

Representative Saxton. Thank you. Let me explore one other area with you.

The President has proposed some tax cuts in the budget, and I think that is certainly an area where we used to diverge fairly remarkably and seem to be finding some common ground. However, the President's tax cuts are very focused on education, welfare, and former welfare recipients; and I wonder if one of the things that we could look at is something that you suggest again for the second year in your budget, and that is expansion of the IRA provisions.

Let me just say this and see if you agree. You indicated earlier in your testimony, I believe, that increased savings generally provides the stimulus for economic growth. Yes?

Mr. Raines. Yes, an increase in net savings does that.

Representative Saxton. And one way to increase net savings is to have personal savings increase.

Mr. Raines. Yes.

Representative Saxton. And an IRA expansion would have the effect of increasing personal savings.

Mr. Raines. Well, I think the history is that it can. There is leakage, and you have to be very careful in designing an IRA change to make sure that you are not simply enabling people to move their personal savings from a non-tax-favored form to a tax-favored form. But if you are careful in designing an IRA, we believe it can have a positive impact on savings.

Representative Saxton. And it would also be one of the factors that would have an influence on interest rates if we were able to expand personal savings. Is that correct?

Mr. Raines. Yes, that is true.

Representative Saxton. So a tax cut in the form of an expansion of IRAs could be a stimulus to the economy if it were done correctly. Is that correct?

Mr. Raines. It can be a part of a policy that will help to expand the economy. I want to be careful about stimulus because that implies that in the short term you are increasing aggregate demand and, therefore, increasing the GDP in the short run. It can increase investment, which should improve growth, which should increase the economy. So if we put all those steps together, I would agree with you.

Representative Saxton. Well, I would really enjoy the opportunity to chat with you more about this last subject. Unfortunately, as you can see, we have got some votes in process; and I am going to have to close the hearing and leave.

Mr. Hamilton requested that we ask that we submit some questions in writing. So if you have no objection to that, we will proceed to do that.

Thank you again very much for being with us this morning. We appreciate the fact that you took your time to come here and made the effort to chat with us about what we think are very important issues. So thank you very much, and we look forward to seeing you again.

Mr. Raines. Well, thank you very much, Mr. Chairman.

Representative Saxton. Thank you very much, too, Mr. Raines.

[Whereupon, at 12:00 p.m., the Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I am pleased to welcome Office of Management and Budget (OMB) Director Raines before the Joint Economic Committee this morning.

I would like to start on a positive note by observing that there seems to be some consensus on both sides of the aisle that the size of the federal government relative to the economy is currently too large. Here at the Joint Economic Committee (JEC) we have done some research suggesting that when the federal government as a share of the economy rises too high, it tends to undermine economic and income growth. Therefore, I was pleased to see that the Administration proposes to reduce the size of the federal spending below 19 percent by 2002. This is a good general objective, and one that many in Congress agree with.

It's also positive to see the Administration proposing an expansion of Individual Retirement Account (IRA) incentives to save. I agree that American families need less punitive tax treatment of their saving and investment. In fact, I would propose that we go further and raise the IRA deduction ceilings for middle class taxpayers. Yesterday I announced a plan to introduce legislation to phase in a significant increase in IRA deductibility and to make IRAs more broadly available.

Unfortunately, there is no room for some disagreement as well. As expressed in the *Washington Post* and elsewhere, there is widespread skepticism about the validity of the Administration's budget numbers. The back loading of most of the spending restraint until after the Administration's proposal. It also appears likely that the Administration really is proposing spending increases veiled in a dubious five-year plan purporting to balance the budget, but in reality leaving significant and growing deficits.

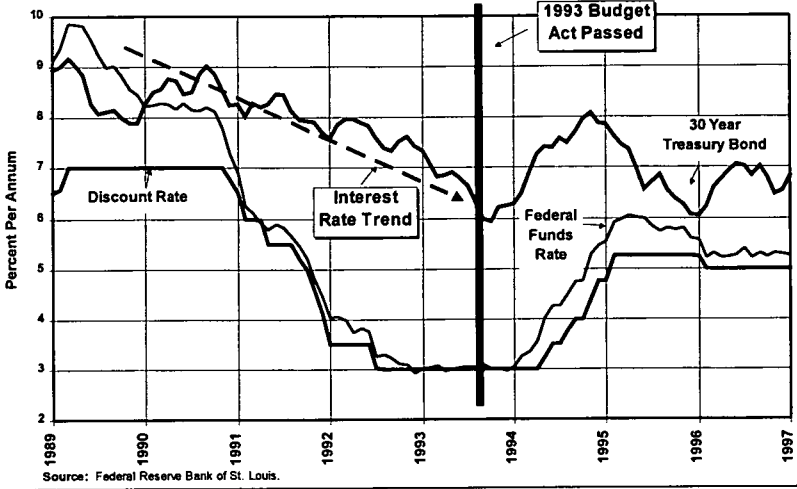
The Administration's tax proposals also have raised serious questions. Among economists of different stripes there is agreement that narrowly targeted tax items should be avoided so that tax rates can be as low as possible. Not only is this principle being violated, but the tax credits proposed by the Administration are widely viewed as inefficient

and in some respects counterproductive. We will address these issues in more detail during the question period.

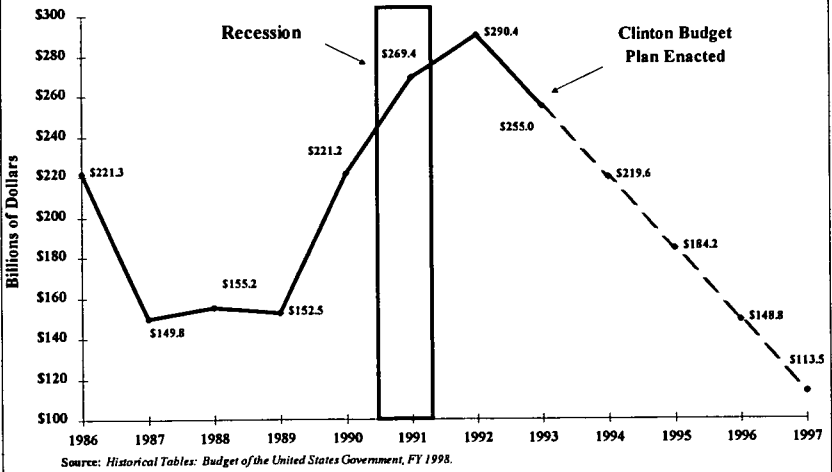
Another issue discussed in the Administration's budget is the possible reduction of the Consumer Price Index (CPI) adjustment used to index the income tax and benefit programs. I think we should be very cautious about taking steps that would affect many millions of people by triggering \$1 trillion in increased taxes and benefit restraint over the next 12 years. I have requested a Bureau of Labor Statistics (BLS) study on the issues raised by the Boskin Commission report, and suggest that we should wait until this BLS study is available in several months before acting. We need to consider more than one point of view before making important decisions in this area.

In closing, I would like to note that the business cycle expansion that began in 1991 continues into 1997. This expansion has resulted in employment increases, unemployment declines, and improvement in the budget situation. This expansion is not rooted in the policies of either party, but reflects that hard work of the American people. This is a good time to address structural problems in budget and tax policy.

Interest Rates



Illustrative Deficit Reduction Path



**TESTIMONY OF
FRANKLIN D. RAINES
DIRECTOR
OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
JOINT ECONOMIC COMMITTEE
UNITED STATES CONGRESS**

February 26, 1997

Mr. Chairman, Members of the Committee, I am pleased to be here this morning to discuss the President's 1998 budget and the Administration's views on the health and direction of the economy.

I will begin by making five basic points about our budget. I will then discuss the budget and the economy, focusing on the competing visions of fiscal policy that have dominated the last two decades -- the budget policies of the 1980s and the budget policies that President Clinton has pursued.

I will then be happy to take your questions.

We have already done much of the hard work

My first point is that, over the last four years, we have already done much of the hard work of achieving balance.

Before the President took office, the deficit reached a record \$290 billion in 1992 and was headed up. In 1993, he worked with Congress to enact his economic program of lower deficits and more investment. Since then, the deficit has fallen by 63 percent -- from that \$290 billion to \$107 billion in 1996. We have the smallest deficit since 1981 and, as a share of Gross Domestic Product (GDP), the smallest since 1974.

The President's plan has exceeded all expectations. It was designed to reduce the accumulated deficits over five years, 1994 to 1998, by \$505 billion. In just its first three years, 1994 to 1996, it has already reduced the deficits by \$485 billion. We now project that over the same five years, the plan will reduce the deficits by \$925 billion.

More than that, we now estimate that the plan will reduce the deficits through 2002 by \$2.5 trillion -- the difference between where our original baseline said the deficits would be from 1994 to 2002, and where we now project them over those nine years. Our new projections are based on the steps we have already enacted into law. The 1998 budget calls for a net \$252 billion in additional savings to reach balance in 2002 -- just 10 percent of the savings that we put in place in the 1993 plan. Having done much of the work, we surely can finish the job.

We are enjoying the fruits of our labor

My second point is that, we are clearly reaping the benefits of our success to date in cutting the deficit.

We inherited an economy that, in the previous four years, had barely grown and had created few jobs. As I previously said, the deficit had hit record levels. Savings and investment were down, interest rates were up, and incomes remained stagnant, making it harder for families to pay their bills.

Since then, the economy has performed well across the board. Business investment has grown at double-digit rates. The private sector has grown faster than under either of the previous two Administrations, while the Federal Government component of GDP has shrunk at an annual rate of almost three percent.

We have over 11 million new jobs, 93 percent of them in the private sector. Wages are beginning to rise. Inflation has remained remarkably low -- below three percent by most measures. Interest rates are under control. And unemployment, which measured 5.4 percent in January, is nearly two percentage points lower than when President Clinton took office.

Also, partly due to a strong economy (and partly to the Administration's policies), poverty, welfare, and crime are down substantially all across America. For instance, poverty has fallen from 15.1 percent in 1993 to 13.8 percent in 1995, the last year for which we have data. And violent and serious crime has fallen five years in a row, marking the longest period of decline in 25 years.

With strong growth, low interest rates, low inflation, millions more jobs, record exports, more savings and investment, and higher incomes, it's no wonder that such experts as Alan Greenspan, the chairman of the Federal Reserve, have described this economy as the healthiest in a generation.

Later in my oral remarks, I will provide more details on how our budget policy has strengthened the economy.

We are proposing a credible budget to finish the job

My third point is that, the President is proposing a credible budget with real savings, based on conservative assumptions.

It wasn't too many years ago that Presidents would routinely send to Congress budgets that had little relation to reality. They were based on what became known as "rosy scenarios" about how the economy was likely to perform, with unreasonable assumptions about growth and

interest rates. They pretended that the deficit would come down. Not surprisingly, it never fell in a sustainable way. Of the 12 budgets submitted by the last two Administrations, the economy performed worse than the forecast 10 times.

President Clinton has broken the pattern. For four years, he has submitted budgets that were based on reasonable assumptions about the economy and the deficit. How do we know? Look at the record. The economy has consistently performed better than the Administration had projected, bringing in more revenues and enabling the Government to spend less on unemployment compensation and other social benefits. As a result, the deficit has fallen more than we estimated, and by an average of \$50 billion a year.

Like its predecessors in this Administration, this budget is grounded in conservative economic and technical assumptions. With pleasant surprises such as the recent fourth quarter GDP figures, we expect that, if anything, the economy will continue to outperform our projections.

In addition, the President is proposing significant savings -- including \$137 billion by cutting discretionary spending, \$121 billion by cutting mandatory spending, \$34 billion by eliminating unwarranted corporate tax subsidies, \$16 billion in net interest costs, and \$42 billion by extending tax provisions that have expired.

The budget savings total \$350 billion over five years, shrinking Federal spending from 22.5 percent of GDP in 1992 to an estimated 19 percent in 2002. At the same time, the President proposes to cut taxes by \$98 billion, providing tax relief to tens of millions of middle-income Americans and small businesses. Thus, the budget calls for net savings of \$252 billion.

This budget does more than reach balance in 2002. It would keep the budget basically in balance until 2020. After that, demographic changes -- specifically, the retirement of the baby boom generation -- will present significant challenges in ensuring the continued viability of Social Security and Medicare. The President has called for bipartisan processes to address those challenges.

This budget invests in the Nation's priorities

My fourth point is that, the budget invests in the Nation's priorities.

Balancing the budget is not an end in itself. Rather, it helps fulfill the Administration's central economic goal -- to raise the standard of living for average Americans. So, too, do the spending priorities of this budget.

Let me take a moment to walk you through the highlights:

Strengthening Health Care. The budget preserves and improves Medicare, extending the solvency of the Part A Hospital Insurance Trust Fund into 2007. It gives older Americans and people with disabilities more choices among private health plans, and it proposes new preventive health care benefits to improve the health of senior citizens and reduce the incidence of disease. For Medicaid, the budget preserves the guarantee of high-quality health care for millions of children, pregnant women, people with disabilities, and the elderly. It reforms Medicaid to give States much more flexibility to manage their programs. It helps an estimated 3.2 million families, including 700,000 children, keep their health care coverage for up to six months until their breadwinners find new jobs. And it provides coverage for up to five million of the 10 million children who do not now have it.

Making Welfare Reform Work. To help welfare recipients move from welfare to work, the budget proposes a Welfare-to-Work Jobs Challenge to help States and cities create job opportunities for the hardest-to-employ recipients; and a greatly-enhanced and targeted Work Opportunity Tax Credit (WOTC) to provide powerful new, private-sector financial incentives to create jobs for long-term welfare recipients. The budget also proposes several steps to address the overly deep cuts affecting single people, legal immigrants, and children that Congress attached to last year's welfare reform law.

Investing in Education and Training. The budget expands the President's investments in Head Start, in Goals 2000, in the Technology Literacy Challenge Fund, in Pell Grants, and in other key education programs. It also proposes a \$1,500-a-year HOPE scholarship tax credit to make two years of college universal; a tax deduction of up to \$10,000 to help middle-income families pay for postsecondary education and training; the America Reads Challenge to help ensure that all children can read well and independently by the end of third grade; and a new school construction fund to leverage new construction or renovation projects.

Protecting the Environment. The budget increases funding for the Environmental Protection Agency's (EPA) operating fund and funds the Kalamazoo Initiative, a new national commitment to protect communities from toxic pollution by the year 2000. It funds start-up activities at the Grand Staircase-Escalante National Monument; increases funds for the National Park System to help improve park facilities and further protect our natural and cultural treasures; and re-proposes the President's "Everglades Restoration Fund" to provide a steady source of funds mainly for land acquisition to maintain the South Florida Ecosystem.

Promoting Science and Technology (S&T). The budget maintains the President's commitment to biomedical and behavioral research, which promotes the health and well-being of all Americans. For the National Institutes of Health, in particular, the budget includes increases for HIV/AIDS-related research; research into breast cancer and other health concerns of women; minority health initiatives; high performance computing; prevention research; spinal cord injury; and developmental and reproductive biology.

Enforcing the Law. The budget puts 17,000 more police on the street, continuing the progress toward the President's goal of 100,000 by the year 2000. To fight drug abuse, it increases funds for the Drug Courts initiative, for drug testing, for the Safe and Drug-Free Schools and Communities program, for interdiction efforts along the Southern border, and for disrupting the drug industry and its leadership overseas. To strengthen efforts to control illegal immigration, it increases the number of Border Patrol agents, continues Port Courts to expedite removals, and expands efforts to verify employment eligibility of newly hired non-citizens.

Providing Tax Relief. The budget provides a \$500 tax credit for dependent children under 13; expanded individual retirement accounts, and the HOPE scholarship tax credit and tax deduction for postsecondary education and training that I just mentioned. It also exempts 99 percent of all home sales from capital gains taxes by excluding up to \$500,000 in gains for married taxpayers. At the same time, the budget cuts unwarranted corporate tax subsidies, closes tax loopholes, improves tax compliance, and extends various excise and other taxes that were allowed to expire.

Projecting American Leadership. The budget continues support for democratic reform and free markets in Russia and the New Independent States (NIS) of the former Soviet Union, ensures that the United States continues to play a vital role in crafting a lasting Middle East peace, and proposes a mechanism to liquidate our arrears to the United Nations and its affiliated organizations -- presuming these organizations undertake the management, budget, and assessment changes that we and others have urged. The budget continues the President's policy of sustaining and modernizing the world's strongest and most ready military force, capable of prevailing with our regional allies in two nearly simultaneous regional conflicts. It continues our commitment to maintaining high levels of training and readiness for that force and to equipping it with technology second to none.

We need bipartisan cooperation to achieve a five-year agreement

And my fifth and final point is that, we need bipartisan cooperation to achieve a five-year balanced budget plan.

We obviously think that the President's budget is the best plan for reaching balance by 2002. And, we think his budget is the right starting point for our discussions. But we understand that the executive and legislative branches share responsibility for enacting a budget.

The time to balance the budget is now. Our economy is strong, so it can absorb the spending cuts that we would have to put in place. And the political stars seem to be lining up in the right orbit. Everyone learned the lesson of the last two years -- that conflict over the budget is not a path to success. Both the President and Congress have voiced their commitment to reach an agreement this year.

So I am cautiously optimistic. But I am realistic as well. Mr. Chairman, as you know, we have been down this road before. You know that agreements that seemed inevitable have eluded our grasp. If we are to avoid that fate, we have to work together, in good faith. I want to assure you this afternoon that, from the President on down, this Administration is prepared to do that.

* * *

Mr. Chairman, I would now like to shift gears a bit. I will discuss President Clinton's fiscal policy, compare it to the fiscal policy that dominated the 1980s, and highlight the achievements of each.

The 1980s-era fiscal policy held that tax cuts would generate greater saving, investment, and work effort, strengthening the economy and leading to more growth. The deficit, then, would take care of itself.

President Clinton's policy held that reducing the deficit would strengthen the economy, leading to more saving, investment, and work effort. His program was designed to reverse the unsustainable rise in our deficit and debt that began in the 1980s, end uncertainty in the financial and investment markets, and show the world that this Nation had the will to address its problems.

Now that we have tried the two policies, we can compare the results. And, as the record shows, President Clinton's policy worked. In fact, the program accomplished more of the explicit goals of the 1980s-era fiscal policy -- more saving and investment, higher growth, and lower deficits -- than that policy itself.

Saving. Economists agree that capital formation, a major goal of the 1980s-era budget policy, requires more saving -- putting aside some of what we produce to invest in the capital needed to raise future production. Advocates of the tax cuts of the early 1980s argued that when people paid less in taxes, they would save more.

The reasoning had a logical flaw, however; government, as well as households, can add to, or subtract from, the savings pool. If tax cuts raised the Federal budget deficit dollar for dollar, thus reducing the Nation's saving, then taxpayers would have to save every penny of their tax cuts just to hold national saving constant.

In contrast, the President proposed to increase national saving by decreasing Federal *dis-savings* -- that is, by reducing the budget deficit that was subtracting funds from the savings pool. His 1993 program relied on both spending cuts as well as tax increases, the latter geared largely to the most well-off Americans.

The result is clear, as seen in the chart on national saving. Net national saving averaged 9.3 percent of GDP from 1960 through 1980. It fell to 5.4 percent from 1981 to 1984, mainly

because Federal saving fell from -0.8 percent of GDP in the 1960-to-1980 period to -3.7 percent in the 1981-to-1984 period.

Rather than rising, private saving actually fell after the 1981 tax cuts -- from 8.1 percent of GDP from 1960-to-1980, to 7.3 percent from 1981-to-1984. Americans chose to consume, rather than save. From 1984 to 1992, national saving continued to fall. By 1992, net national saving was only 2.4 percent of GDP; private saving was only 5.5 percent, and Federal dissaving was -4.5 percent.

National saving has risen in the last four years (though it has not yet regained its pre-1980s form). From 1992 to the third quarter of 1996, net national saving rose from 2.4 percent of GDP to 5.4 percent. Federal dissaving fell from -4.5 percent to -1.8 percent, accounting for most of the improvement. And, although high-income taxpayers faced an increase in their marginal tax rate, private saving also rose a bit -- from 5.5 percent of GDP in 1992 to 5.9 percent in the first three quarters of 1996 -- surely aided by the big increase in corporate profits under this Administration.

With greater saving, we have greater potential capital formation, greater future productive capacity and productivity, and faster potential economic growth. In this important respect, the President was clearly successful.

Investment. The second essential for capital formation is strong business investment. Economists generally agree that a larger and newer capital stock will raise our productivity and our productive capacity in the coming years, boosting prosperity and growth. The tax policies of the 1980s were designed to increase business investment; tax incentives for business, such as more generous depreciation allowances and an investment tax credit, were expected to induce greater investment spending.

The Clinton philosophy was very different; while the President proposed more investment expensing allowances for small business, he relied mostly on a lower deficit and, thus, lower Federal credit demands and lower interest rates.

Again, the record is clear. The 1980s witnessed a typical fall in investment with the 1981-82 recession, and then a typical recovery of investment. But historical patterns changed little. By the end of 1992, the ratio of our equipment investment to our GDP was little more than when the 1980s began. As a share of real GDP, real equipment spending rose from 5.7 percent in 1977-to-1980 to 5.9 percent in 1981-to-1984, and then to 6.3 percent in 1985-to-1988. But by the last year of the previous Administration, real spending on producers durables was still only 6.2 percent of real GDP.

The Clinton years, though, have broken the mold. Real business investment in equipment has grown 2-1/2 times faster than in 1981-to-1988, and five times faster than in 1989-to-1992. Real equipment spending has risen from 6.2 percent of GDP in 1992 to 8.4 percent in 1996 -- a

record level for this measure of investment spending. The four-year increase in investment spending of over 2 percentage points of GDP is the largest rise in equipment investment in the post-World War II period, and it will pay dividends in the form of greater future productive capacity, productivity, and prosperity.

Work. Another fundamental of economic growth is work effort; labor must complement the greater capital that results from saving and investment in order to produce growth. Over much of our recent economic history, labor force participation has followed a steadily rising path, apparently impervious to policy. Much of the change has come from increased participation by married women, and experts have anticipated that, at some point, that trend would have to reach its limit.

Starting in the mid-1960s, labor force participation in the United States began to rise sharply, mainly due to the rising participation rate of women. The average annual rise in the labor force participation rate over this period was 0.3 percentage point, and the cumulative increase sent labor force participation from 58.6 percent of the working age population in January 1965 to 63.8 percent in August 1981. At that point, the large tax cut was designed to increase the after-tax reward to work effort, thus increasing the supply of labor.

Labor force participation continued to rise after the 1981 tax cut -- but no faster than during the previous 15 years. From 1981 to the end of 1988, the increase averaged the same 0.3 percentage point a year. From 1989 to 1992, labor force participation dropped even though marginal tax rates remained low for most workers, probably due to the recession and the poor prospects for finding a job.

But, under this Administration, the stall has ended. As the chart shows, labor force participation has resumed its increase in the last four years, and the ratio of employment to the adult population has reached a record level. In other words, the President's policies of the last four years have worked even better to achieve the goals advocated by those who pursued the policies of the 1980s.

In the last four years, employment has grown by over 11.5 million jobs -- over 93 percent of them in the private sector. The Council of Economic Advisers recently reported that two-thirds of them are in employment and occupation categories that pay greater than the average wage.

Growth. Higher economic growth was the ultimate goal of the 1980s-era policies, but private-sector growth in Clinton years has exceeded growth in the 1980s. And growth under this Administration has followed the fundamentals of saving, investment, and work effort. More saving has led to more investment, concentrated in high-productivity private business equipment. This increased investment has facilitated the higher employment levels I just mentioned.

As the chart shows, private-sector GDP — the portion originating outside of government — has grown more rapidly under this Administration than under either of its predecessors. The Federal Government component of GDP has actually shrunk at an annual rate of 2.6 percent; Federal employment has shrunk by 263,500 full-time equivalent positions, or 12 percent, since this Administration took office. Also noteworthy, business investment in equipment has been the leading growth sector in the economy by a wide margin under this Administration.

Other economic indicators. Several noted, non-partisan economic experts have observed that this economy is the best of any in decades. Their comments reflect both the phenomena that I have discussed above, as well as other phenomena. Generally speaking, the major economic indicators today suggest that this expansion is extraordinarily solid, and can continue for some time.

As a corollary to higher national saving, *interest rates* remain low. What has been remarkable about the economy under this Administration is the combination of high employment and low interest rates, as the next chart highlights. At times in the 1980s, the unemployment rate has been as low as under this Administration; at other times, interest rates have been as low. This Administration is unique for having low interest rates and low unemployment at the same time. In fact, the last time unemployment was as low as now, the 30-year Treasury bond rate was about 1.5 percentage points higher.

Another indicator of long-term macroeconomic health is the modest rate of *inflation*. Since the start of this Administration, and despite low unemployment and solid growth, the core rate of inflation has fallen to its lowest rate since the mid-1960s. The following chart shows this trend. Because of this low and stable inflation, many economic forecasters believe that our steady, solid growth can continue into the foreseeable future.

Thus, our economy is remarkably sound. Though we have not abolished the business cycle, no problem on the horizon threatens the current expansion. The President's fiscal policies would build on these accomplishments -- with continued deficit reduction to further facilitate business investment.

The deficit. With low interest rates and a strong economy, the budget deficit fell swiftly and more than we forecast. As I have said, the deficit now is at its lowest level since 1981 and, as a share of GDP, its lowest since 1974. Four straight years of lower deficits have brought debt service costs under control. The ratio of our debt to our GDP, which virtually doubled in the previous 12 years, has begun to decline. We have put the worst of the fiscal excesses of the 1980s behind us.

Some would argue that the President's program did not reduce the deficit; the economy did. To be sure, our brighter fiscal outlook is largely a product of the economy. But a key lesson of the last 16 years is that the economy cannot do its work when the Federal Government erects a barrier of fiscal uncertainty. The economy can work even better than we might have thought when the Federal Government gets its fiscal house in order.

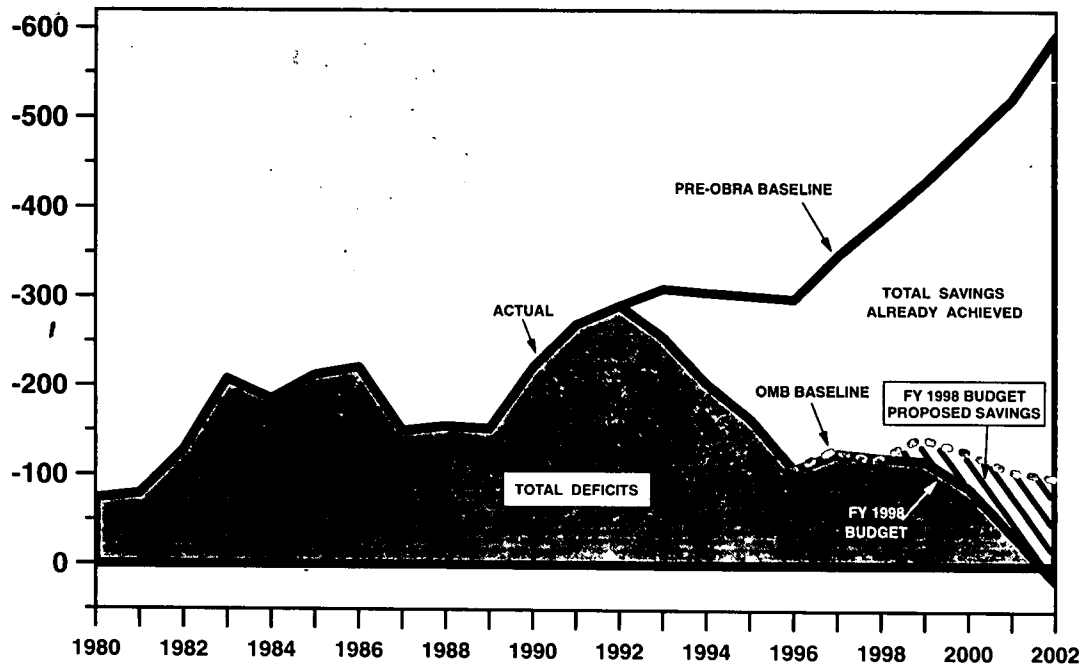
The last four years have shown what a responsible fiscal policy can do for our economy. And our progress to date gives us a second chance to reach agreement now on a plan to finally balance the budget. Such an agreement would enable us to reap the rewards of further economic progress.

* * *

Mr. Chairman, that concludes my remarks. I would be happy to take any questions that you have.

FINISHING THE JOB: BALANCING THE BUDGET AFTER DECADES OF DEFICITS

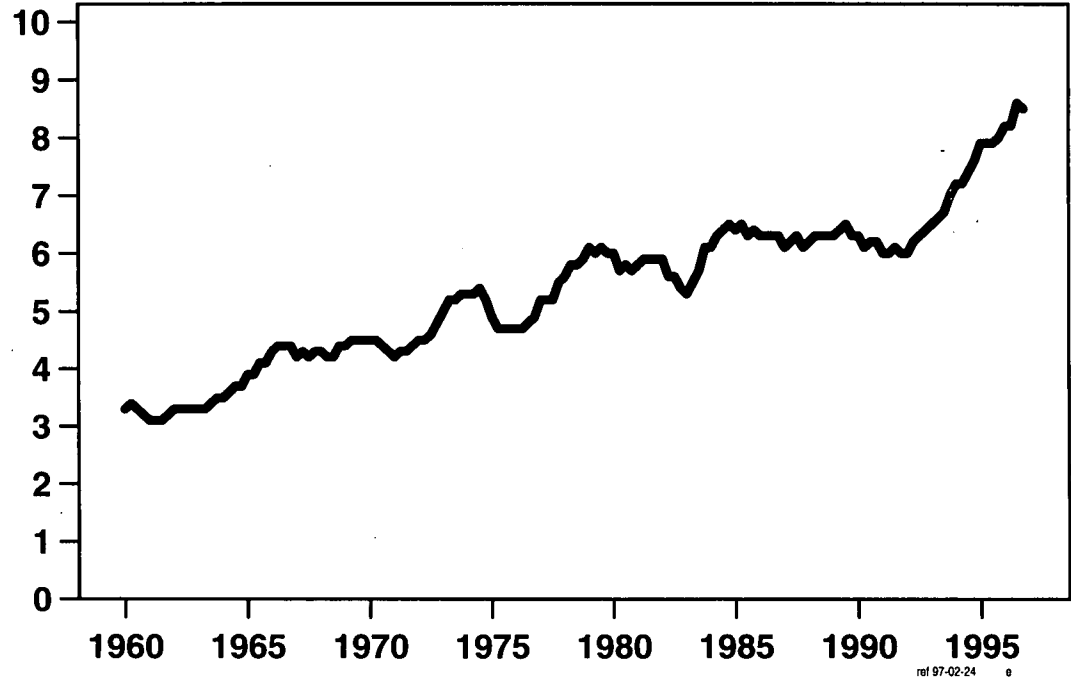
SURPLUS (+) / DEFICITS (-) IN BILLIONS



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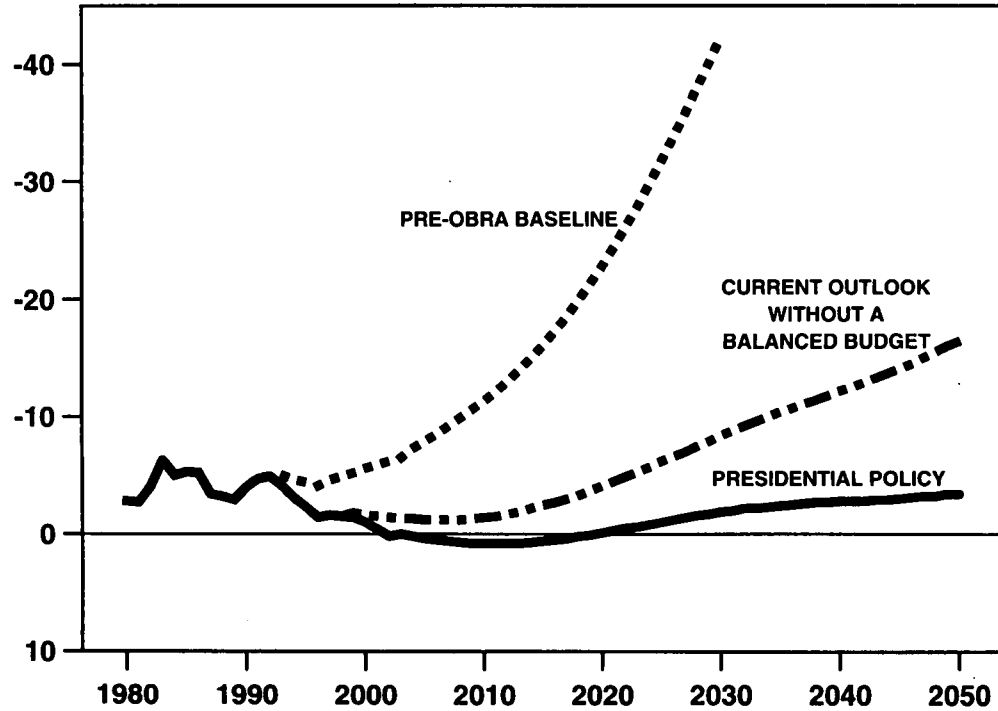
INVESTMENT IN PRODUCERS DURABLE EQUIPMENT

PERCENT OF REAL GDP



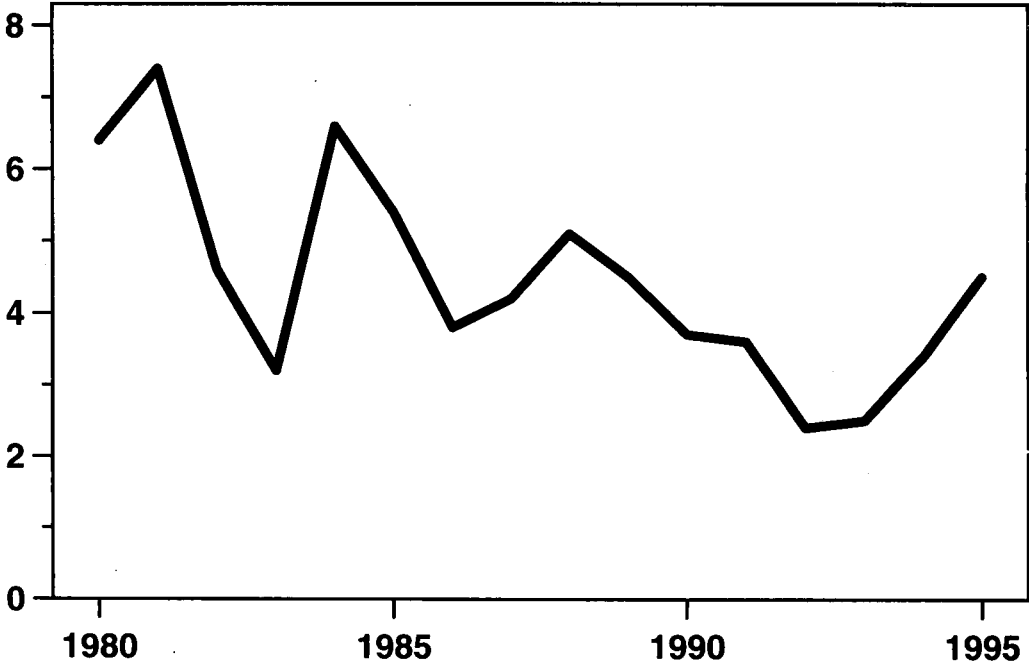
LONG-RUN DEFICIT PROJECTIONS

PERCENT OF GDP



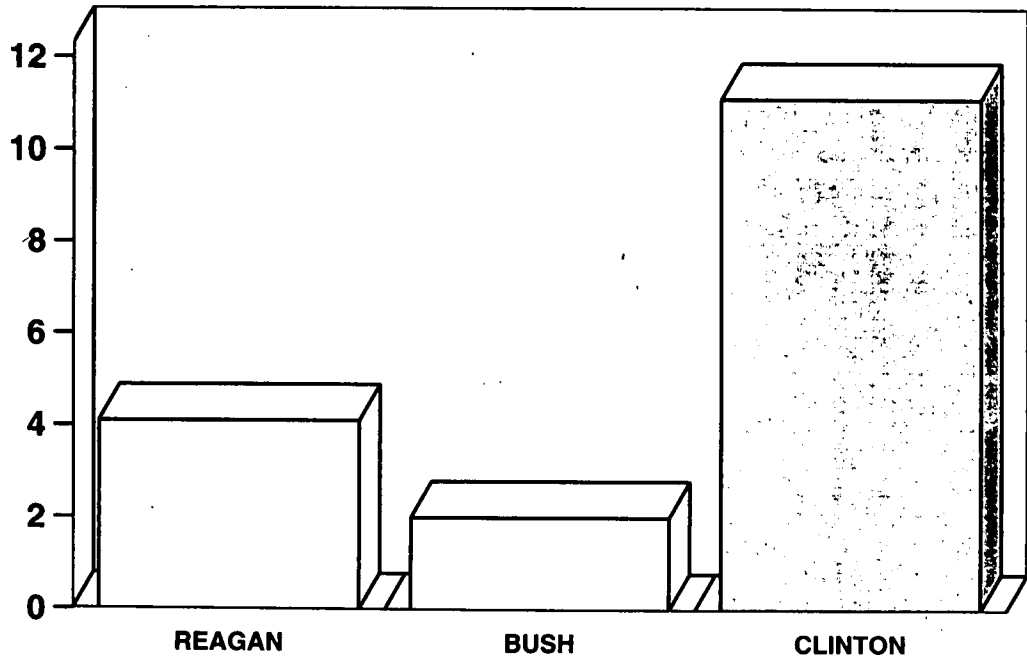
NET NATIONAL SAVINGS RATE

PERCENT OF GDP



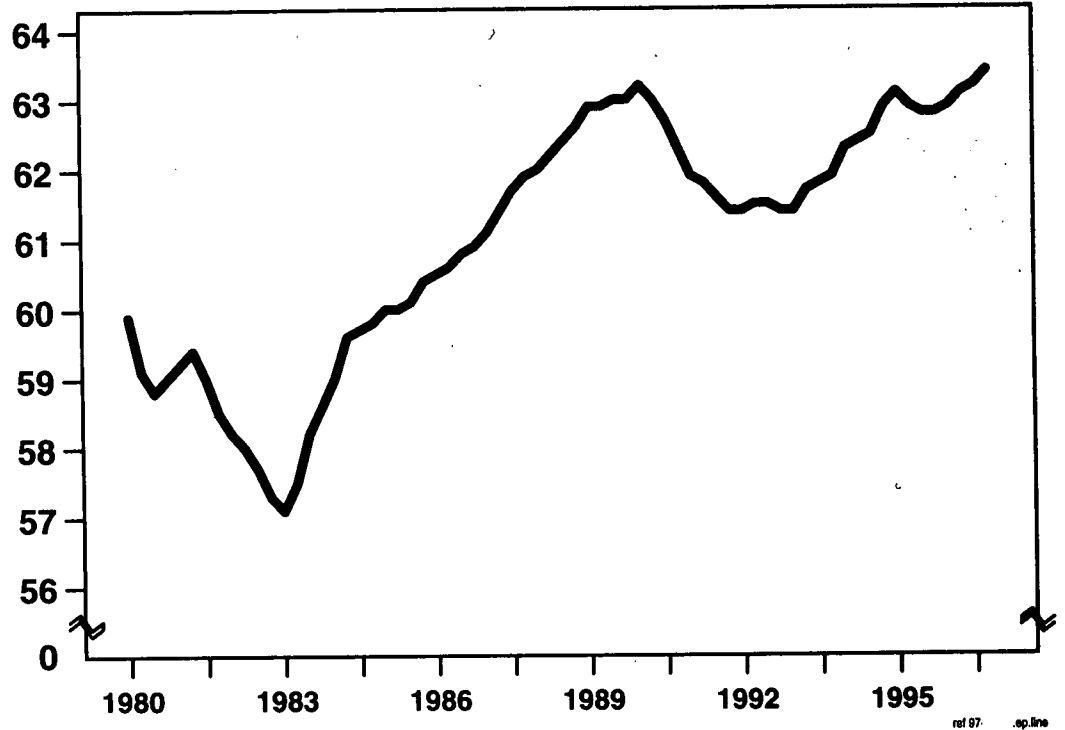
GROWTH OF REAL EQUIPMENT INVESTMENT

PERCENT, ANNUAL AVERAGE



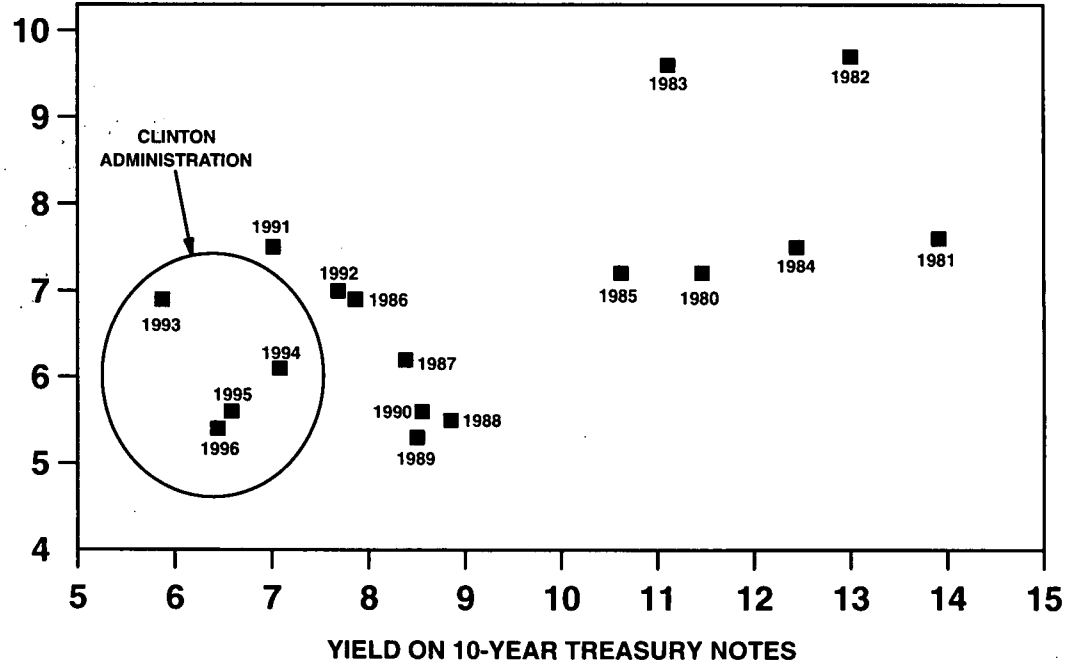
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EMPLOYMENT - POPULATION RATIO



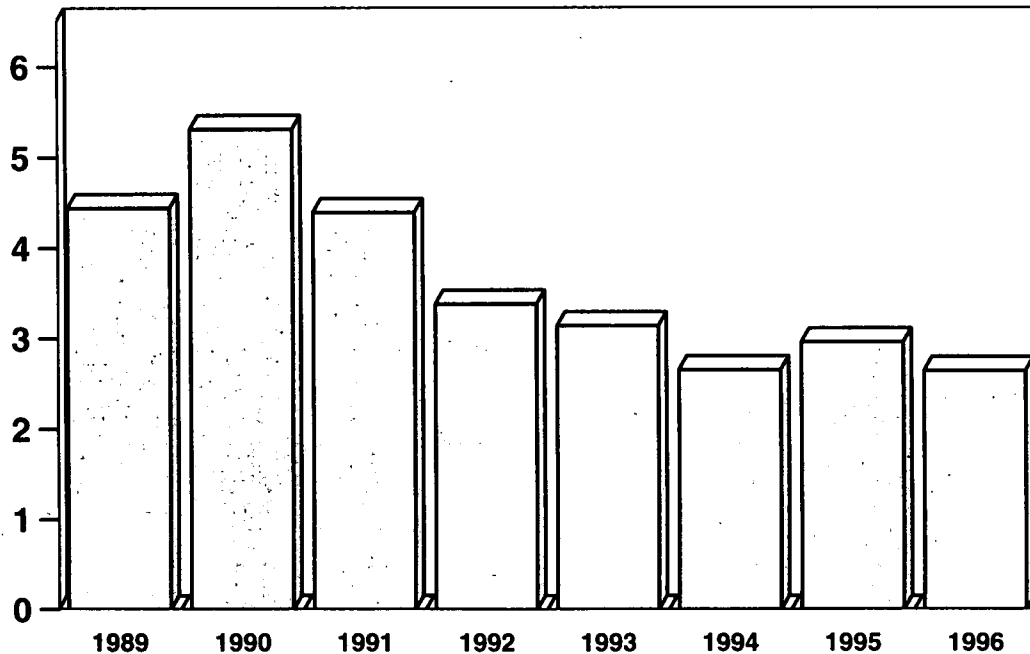
INTEREST RATES AND UNEMPLOYMENT

UNEMPLOYMENT RATE, PERCENT



CORE RATE OF CPI INFLATION

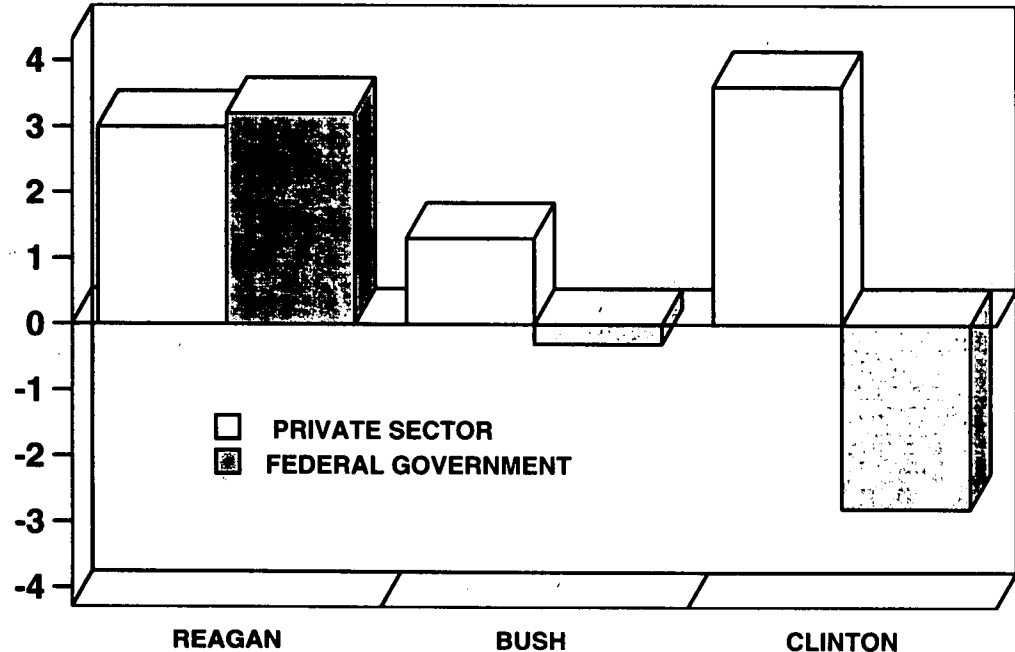
12-MONTH PERCENT CHANGE



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PRIVATE AND FEDERAL GOVERNMENT REAL GDP GROWTH

PERCENT, ANNUAL AVERAGE



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