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THE GRAMM-RUDMAN BUDGET PROPOSAL

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 11 AND 21, 1985

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MONDAY, OCTOBER 21, 1985

THE GRAMM-RUDMAN BUDGET PROPOSAL

FRIDAY, OCTOBER 11, 1985

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

The committee met, pursuant to notice, at 10 a.m., in room 2226, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Scheuer, and Fiedler; and Senator D'Amato.

Also present: Paul Manchester, Chris Frenze, and William Buechner, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. If we might get started, there is a quorum call going on in the House. I'm going to exercise my prerogative and ignore it this morning.

The House is going to consider today the message from the Senate on the adoption of the conference report on what is known as the Gramm-Rudman Deficit Reduction Act. The purpose of this hearing this morning is to examine the effectiveness, the wisdom, and the utility of that proposal.

As we all know, in 1981, the Congress and the President jointly took actions which over the last 5 years have cut revenues as a percentage of GNP far more than spending as a percentage of GNP was cut over that same period.

As a result, we have deficits in the stratosphere far above any we had known previously. I don't think that we really have those deficits because of any economic impasse. I think we have those deficits because we have been faced with a political impasse. Now, after 5 years of searching for something called the political will to deal with them, instead, Members of the Senate seemed to have desperately grasped at straws looking for some kind of institutional magic wand that can do what the politicians apparently don't have the guts to do, which is to deal with the problem at hand rather than structure formulas to require it be dealt with in the future in some massive way.

It appears that you have a number of conservatives who voted for that proposal because they want to get social spending under control. And it appears that you have had a number of liberals who voted for it because they wanted to get military spending under control.

It seems to me the question is whether or not this new institutional straitjacket will really break the political impasse.

I am personally disturbed by a number of things about it. I believe in truth in packaging. The problem is that while this proposal is masquerading as a deficit reduction act, if you read the fine print, it actually provides for higher spending levels for each of the next 2 years than the existing budget resolution.

The budget resolution calls for a deficit of about $172 billion and when you add the 7 percent asked for in the Gramm-Rudman proposal, we wind up really looking at an allowable expenditure figure here of $102 billion. In fact, the 2-year average spending under the proposal is higher than it would be under the budget resolution.

It is clear to me that there are some other problems as well. If the proposal would be followed—a big guess—it would seem to me that it would make it very difficult for the country, in a low-growth period, to do anything except tip the economy into a recession by the rigidities that it implies, if not actually imposes.

It is clear to me also that it's going to pass, or something like it is going to pass. Before we pass in blind fashion in the House something which the Senate has had at least 1 week to consider, we need to look just as hard as possible at three questions:

No. 1, Is it really real? No. 2, Does it make economic sense? And, No. 3, How might we fix it up so that we could support it with a straight face, and how you might change it so that it does not produce a significantly warped budget or significant damage to either the economy or to programs on either the military or economic side of the ledger which might on occasion be at least as important as the overall bottom line?

Before I ask the witnesses to testify, let me ask Senator D'Amato if he has anything he would like to say.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman, and let me commend you for holding this hearing. I think it's terribly important that we attempt to get as much information to the American people with respect to what the Gramm-Rudman-Hollings proposal is about. I share your concern, Mr. Chairman, that we not undertake precipitous action that will lead to a downturn in the economy.

That's why, Mr. Chairman, I agree with you wholeheartedly as it relates to our policy of taxation. We had better look at the economic consequences with respect to some of the legislation that is proposed.

I am aghast at the provisions, for example, that would do away with the ability of people to deduct local property taxes and at what the impact would be on the values of homes and home ownership in the future.

I'm aghast at some of the provisions, for example, that would tax life insurance savings on an annual basis and at what would be deprived from investment in the economy.

I think we should be concerned about the taxation of fringe benefits such as health insurance. I don't think that's a fringe benefit. I think we should be concerned when we begin to limit the deductions on mortgages for second homes. How many homes will not come into existence? What about the economic consequences, and what about the jobs that will be lost?

Having said that, Mr. Chairman, and I say that in a spirit that you and I, I think, have shared many concerns with respect to how to continue growth in our economy, I have to say to you that on September 25, this committee heard a number of well-known economists assess the economic outlook through 1986.

Mr. Beryl Sprinkel, Mr. Alan Greenspan, Mr. Lawrence Chimerine, and Mr. David Bostian, each one of them, as well as many other distinguished people in the business community, those charged with responsibility of raising revenues, have said the No. 1 problem facing this Nation is not the tax system.

Sure, we are for tax reform; sure, we can improve it. The No. 1 problem facing us is the budget deficit. We have been unable or unwilling to deal with the growing deficit that this Nation faces.

Now, I'm not suggesting that the Gramm-Rudman proposal, of which I am a cosponsor, may not have some faults. But I do believe that we simply cannot continue to do business as usual because the business of the people has not been done.

We lack the political will in Congress to make the necessary deficit reductions, to make the necessary cuts that are going to reduce the deficits. We just simply don't do it, and I believe that we have to have that kind of discipline which the Gramm-Rudman proposal mandates, which states that we acknowledge that there is a deficit and that we are going to have to cut these deficits evenly over the next 5 years. If the Congress can't do it, then the Congress will give that opportunity to the President.

The American people have the right to say that their representatives are going to make these difficult decisions, as difficult as they may be, and that it may be necessary to raise revenues. That's another area that this legislation does not preclude.

What it does say is if we don't hit these targets, there are going to be disciplines that we will have the opportunity of making. That opportunity will then go to the President.

I think it's a kind of discipline that the American people have been employing in their own homes and businesses for years. Can we, the Congress, continue to shirk our duty? I don't think so.

I believe, and I'm anxious to hear our expert witnesses here, Mr. Chairman, that if we get to the business of reducing these deficits, and the economic community both here in this Nation and throughout the world see that we are serious, and that we reduce these deficits the first year and the second year, that there can't help but be a corresponding reduction in interest rates; that we are going to help keep inflation rates down; that we're going to see more economic growth. That's the kind of thing that we're after. I don't want to see us return to the dark days of 1981 when we had soaring interest rates and inflation rates beyond our control. I think the prudent action is to say let's deal with it while we have a relatively strong economy.

Mr. Chairman, I commend you for calling this hearing so that we can get a divergence of views and hear from these experts. Thank you.

Representative OBEY. Thank you very much.

We have three distinguished witnesses this morning, who I hope will comment not only on what they feel about the specific proposal but also on whether they think it amounts to anything more than a New Year's resolution.

Let me start with Mr. Herbert Stein, senior fellow, American Enterprise Institute, and professor of economics emeritus, University of Virginia, and former chairman, Council of Economic Advisers under the Nixon administration, and you served in that capacity when I came to Congress.

Mr. Stein, I am very happy to have you with us this morning. Please proceed.

STATEMENT OF HERBERT STEIN, SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE, AND A. WILLIS ROBERTSON PROFESSOR OF ECONOMICS EMERITUS, UNIVERSITY OF VIRGINIA, AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. STEIN. Thank you, Mr. Chairman.

I welcome this opportunity to present an instant analysis of this bill.

I have a short statement which I have submitted.

The bill under consideration aims at achieving a balanced budget in 5 years, it contains the germ of one very good idea—the idea of a 5-year budget plan. But the idea is not developed, and unless developed further could be either ineffective or harmful.

To have an agreed-upon plan for the size of the deficit in the next 5 years would be helpful in Government and private decisionmaking. But there is no reason to think that this plan should balance the budget at the end of 5 years or at any other time.

The Government should make a deliberate decision about the size of the budget deficit it wants. To do that it must consider the steps that would be necessary, on the revenue and expenditure side of the budget, to achieve the deficit goal.

There are worse things than budget deficits, and we should make sure that in forcing the budget into balance we are not forcing even more important things, like the national defense, out of balance.

A rational 5-year deficit reduction plan would require congressional and administration agreement on a 5-year plan for revenues, defense expenditures, entitlement programs, interest, and at least one total for all other programs, which should add up to the target deficit path.

If this is not done, either of two results will follow. All revenue and expenditure programs will be forced into uncertainty and instability by the effort to squeeze them within the limits of the deficit targets.

Alternatively, and more likely, the system will be overridden because both the President and the Congress agree that there are many things more important to them than balancing the budget.

My main concern is with the possible effect of this legislation on the defense program. I fear that if the defense program is squeezed between arbitrary limits on revenues and arbitrary limits on borrowing the Nation's real security needs will suffer.

Estimates now available show that the effect of the legislation would be to cut defense substantially below recently agreed levels, which have already been cut below administration estimates of need.

The country is not facing a budget-deficit crisis. The congressional budget resolution adopted in August laid down a path leading to quite low and sustainable deficits. If Congress, backed by the Presidential veto power, would conform to that resolution we would be in good fiscal shape. If they cannot do that, the proposed legislation is unlikely to force them to balance the budget.

I would call attention to what seem to me two technical problems with the proposed legislation. As I understand it, if congressional action leaves the projected deficit for the next fiscal year above the target, the President is to cut all nonexempted expenditures equally across the board. I assume that means that each expenditure is to be cut by an equal percentage.

But it is not clear whether each of the hundreds of line items in the budget is to be cut by an equal percentage, or each of the 70 subfunctions, or each of the 18 functions, or each of the Departments and agencies. At one extreme we have a practical impossibility, at the other, large discretion to the President, which I don't mind but others do.

Moreover, it is not clear to me what the equal cuts are to be from. The most plausible interpretation is that the cuts are to be from the outlays implied by the appropriations that Congress has adopted. If that is the case, supporters of each program will have a strong incentive to make sure that their appropriation exceeds their real goal by a large enough percentage to make sure that after the cut their real goal is still achieved.

If I estimate that the sum of all other expenditures is going to run 10 percent above the goal and everything is going to be cut 10 percent, and if I want $10 billion for Amtrak I am going to insist on having $11 billion and possibly $11.5 billion, and this thing is going to escalate.

But if the sum of everyone's real goal exceeds the amount that is compatible with the budget target, which is the source of our present problems, there is no limit to this process short of infinite appropriations.

Now, the chairman has invited us to make some suggestions for fixing this bill up on the assumption that something like it is going to pass.

I would make two suggestions which I suppose are about as unlikely as defeating the bill in the first place. But anyway, my first suggestion would be to give the President discretion to make the cuts where he likes rather than equal percentages across the board.

Somebody, it seems to me, should make a decision, and we should not end up playing a game of musical chairs and cutting whatever is left out and has not yet received its appropriation up by October 1.

So if Congress is unwilling to make a deliberate decision about what to cut, I think they should give the President discretion to do so.

Second, I think Congress should give the President discretionary authority to impose income tax surcharges up to 2 percent across the board so that when he exercises this discretion to bring the budget into balance he will have some room to choose—and he could choose to raise taxes rather than to cut expenditures.

After all, we have to visualize the possibility that if this thing is enacted it will extend beyond the term of the existing President.

Thank you very much.

Representative OBEY. Thank you very much, Mr. Stein.

Next, we have Mr. Walter Heller, professor of economics, University of Minnesota, and former Chairman of the Council of Economic Advisers in the Kennedy and Johnson administrations.

Mr. Heller, please proceed.

STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA, AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. HELLER. Mr. Chairman and members of the committee, I appreciate this opportunity to present my views to the Joint Economic Committee on the Gramm-Rudman-Hollings bill, which is, of course, designed to bring our dangerous Federal deficits under control.

Clearly, Congress wants to tame the deficit in the worst way, and the Senate bill comes close to doing just that. As it stands, it is an economically disruptive, socially unfair, technically deficient, and politically timid formula for deficit cutting.

Politically timid? Well, Senator Rudman himself puts it more bluntly:

"Lowell Weicker says this is a substitute for guts and I agree with him." That is from an author of this proposal.

The truly tough ingredients of a balanced attack on the deficit—tax increases and Social Security curbs—are held harmless under the misshapen structure of this bill. And on defense, if I read it correctly, combat readiness will take a solid hit while the weapons systems that sometimes serve as a defense pork barrel will probably go unscathed.

I understand there was some little change in the Senate yesterday that would modify that.

One of the problems in testifying is that we are shooting at a moving target, although it is not moving very much.

What about vital social problems for citizens with the least political clout? Well, let's hit them again, harder.

Finally, while Gramm-Rudman barks loudly at our damaging deficits, it won't really bite, as the chairman pointed out, until the Congress is safely past the 1986 election.

And in a sense, I suppose, the worst copout of all is the bill's provision for across-the-board cuts without regard to need, merit, or quality of service, and without having to face the music for such cuts. It is kind of a "See, Mom, no hands" or "Who, me?" approach.

Well, so much for the politics of the matter. What about the economics of it?

Well, like any mandated and rigid formula, it would undermine, perhaps even pervert the role of the Federal budget as an economic balance wheel in the economy.

Rigid reductions of the deficit through thick and thin—through recovery and recession—could wreak havoc on the economy.

Now, granted, the Senate bill has a weak-kneed provision to give the President an extra 30 days to decide where to cut the budget or to call for suspending the amendment if the CBO and OMB predict a decline in real GNP for two successive quarters. But there are three fatal flaws in this formula.

First, economic forecasting, and particularly Government economic forecasting, has had a poor record in predicting recessions to come and, indeed, has at times failed to foresee a recession that was already underway.

And just parenthetically, forcing the CBO and OMB to come up with a single set of economic and budget projections—or splitting the difference between the two if they can't agree—looks like a sure-fire way to politicize the economic projection process.

Second, as the economy moves from recession to recovery, it can produce increases in GNP even while operating far below par. There would be no relief in the formula if GNP were rising.

Suppose a recession reduced GNP in 1987 but modest recovery raised GNP in 1988. Well, the Gramm-Rudman process would require that the budget deficit be only $108 billion in fiscal 1988 even if a $144 billion target for fiscal 1987 was suspended because of a projected drop in GNP.

Now, it would be damaging enough to have to put in a $72 billion deficit cut in 1988, but the cut would in fact have to be much greater under the Gramm-Rudman formula. Looking at the CBO numbers that were published in August for a scenario of a recession in 1987, with an average recovery performance in 1988, one finds that they project a $270 billion deficit in 1988.

Imagine the economic setback it would cause to slash spending and the deficit by $160 billion by 1988 to try to reach the $108 billion level fixed by the Gramm-Rudman formula, and as it stands, there is no escape under that formula.

I can't believe they would do it, but we are talking about a formula that is in the bill right now.

Now, I say "try" because the facts are that it couldn't be done. If the national economy starts to slide, joblessness rises, income and profits fall, the Federal budget automatically goes into deeper deficit as revenues shrink and spending rises.

Try to balance it by boosting taxes or forcing cuts in spending, and the net result will inevitably be to draw that much more purchasing power out of an already soft and sluggish economy. This would send the economy into a deeper tailspin, thereby throwing more people out of work, further cutting tax revenues, and boosting unemployment compensation, food stamps, and similar entitlement expenditures, thus throwing the budget even more out of whack.

A dog chasing its own tail comes to mind.

Third, consider the situation where there is no actual drop in GNP but a continuing growth recession; namely, where the growth rate falls below the level required to maintain or reduce the unemployment rate.

More specifically, suppose you had 2 years of very slow growth. Let's say the GNP for 2 years would fall 2 percent short of the growth rate needed to reach the projected high-employment level of about $5 trillion a year, projected out there by the CBO.

Well, that is a GNP shortfall of about $300 billion. About 20 percent of that shortfall will be reflected in lower Government revenues, producing a $60 billion added deficit.

Yet, the Gramm-Rudman formula would rigidly require that this $60 billion be made up in addition to the $72 billion cut under their formula.

Again, that would simply kick the economy in the groin and bring on an actual recession.

In failing to distinguish between deficits caused by economic recession and slow growth from those that are caused by tax and spending policy—that is the basic difference between cyclical and structural components of the deficit—the Gramm-Rudman plan takes us back to the dark ages of budget thinking and practice.

The technical problems of the Senate bill are legion, especially with respect to the definition of controllables and uncontrollables. Let me cite a couple of examples.

Spending out of prior years' contracts is considered uncontrollable and would therefore escape the budget ax.

I understand there was a little modification, although it was not all that much.

In the defense area, almost 100 percent of procurement, largely weapons systems, is under prior-year contracts and hence uncontrollable. In sharp contrast, one finds that 55 percent of research and development is under current contracts and hence controllable; 85 percent of maintenance and operating expenditures is current; and well over 90 percent of personnel expenditures is current. So the military share of the budget cuts would be heavily concentrated on military readiness expenditures.

Now, suppose that even the defense expenditures under past contracts were defined as controllable.

I gather, again, something was done to modify the bill in that direction yesterday.

Then, to bear their across-the-board percentage share of the burden, practically all current expenditures on past contracts would have to be wiped out.

If the whole budget appropriation were the base, the only way you could do a percentage of that base would be to wipe out current programs.

I go into this simply to make the point that rigid formulas are obviously the enemy of rationality.

Now, in the civilian budget, one finds that items like national parks would be hit very heavily because very little of their expenditure is under prior contracts. On the other hand, hospital construction, under long-term contracts, would hardly be hit at all.

Or to take another example, 80 percent of Peace Corps expenditures would be labeled controllable, but only 33 percent of Export-Import Bank expenditures would be subject to the budget knife.

Enough said. Capricious cuts would be the name of the game.

These examples relate directly to another critical issue; namely, that of the distribution of the cuts among entitlements, nonentitlement social programs, and the military.

In a way, it seems ridiculous to take all these things seriously but, after all, it's a bill passed by the Senate and with the danger it will be passed by the Congress. That's why I think it's worth going into some of the specifics, to show how ridiculous it is.

With interest on the public debt, Social Security, and prior-year contracts—covering about 40 percent of military expenditures—all off limits, one-third of the budget would have to take the brunt of the supposedly across-the-board cuts. That is, the "controllables" would be less than $300 billion out of a roughly $950 billion budget in the current fiscal year. Two-thirds of that is defense.

The remainder, under $100 billion, would be the focus of the hardest hits. After taking care of non-Social Security indexing adjustments, the rest of the impact would have to be borne by social programs. The cuts could be savage, whether administered by the President or by Congress.

I have long believed—and publicly documented and defended the position—that the Congress has been the more responsible end of Pennsylvania Avenue in coping with and cutting the deficit. I have several pieces that could be entered in the record to bear that out. But, rather than do that, I thought I would quote Norman Ornstein, the resident scholar of the American Enterprise Institute, who fully confirms this judgment in his indepth studies and particularly in his chapter on "The Politics of the Deficit" in AEI's "Contemporary Economic Problems, 1985."

Let's remind ourselves: In 1982, "It was Congress, in an approximation of congressional government, that defied conventional wisdom in an election year by slowing defense and raising taxes to reduce the deficit."

Still quoting him, "In 1983, Congress initiated an energy tax increase. In 1984, the Republican Senate once again moved into a policy vacuum, proposing a 'downpayment' on the deficit, including another significant tax increase, which the President once again belatedly endorsed."

And he goes on to say, "Through the broad sweep of American history, Congress has struggled to restrain the growth of Federal spending and to limit deficits and the public debt through direct action and through periodic adjustment of its own structures to minimize the deleterious effects of political pressures."

Well, now, even the Gramm-Rudman initiative, flawed as it is, came from the Congress and gained the President's support only after a period of White House hemming and hawing. And contrary to the view of the Senate, who airily dismissed the budget-and-deficit-cutting exercises now going on in the Appropriations Committees, those committees are conscientiously going through a painful process to carry out the sizable deficit cuts in the congressional budget resolution of last August.

Even if one lets the air out of some of the inflated estimates of deficit cutting in that effort, it appears that meaningful deficit reductions will emerge from this process.

I understand the frustration of Congress, not normally meant to be an instrument of national leadership—that's supposed to come from the White House—being constantly forced to take the lead in budget-and-deficit cutting to fill the policy vacuum left by the President. And all the while, the Congress is being berated and ridiculed by a popular President who turns reality upside down and pretty much persuades the public that Congress is the culprit, that Congress is responsible for his $200 billion deficits and $2 trillion debt.

Under these trying circumstances, and given the dangers of our obscene Federal deficits, it is not surprising that the Congress is drawn off course by the siren song of Gramm-Rudman. But, instead of joining a pellmell rush to fasten on yourselves a budgetary straitjacket and a lockstep deficit-cutting schedule, at the same time slicing off big chunks of your fiscal power and handing them to the President—and Herb, I worry more about that than you do—let me urge you to stop, look, and listen. The Congress should demand time to develop a fair and workable schedule for cutting the deficit without disrupting the economy and gutting social programs and then go to the American people with that plan to subdue the deficit.

Is the Gramm-Rudman formula so flawed as to be beyond redemption? Can one develop a viable substitute that will hold policymakers' feet to the fire and yet avoid the straitjacket and copout features of the Senate bill?

I have my doubts. But if the legislative juggernaut is relentlessly rolling to passage, what do you do to make the cure better than the disease, rather than worse?

Well, the obvious answer is to change the Gramm-Rudman prescription so as to maintain the central principle of progressive reduction of the deficit—progressive and one should say rational—but remove the dangerous side effects of that prescription.

How? Well, perhaps start with the Democratic alternative in the Senate and tighten it as follows:

First, provide sensible safeguards on the economic front by changing the unworkable antirecession provisions of the Senate bill, relating them not to forecasts of real GNP decline but rather to some reasonable growth rate of GNP and, preferably, to the rate of unemployment.

Second, open the budget-reduction process clearly and candidly to revenue increases, perhaps even providing for triggered tax increases under specified conditions.

I like Herb Stein's suggestion of a triggered surcharge on corporate and individual income taxes.

Mr. STEIN. I didn't include corporate.

Mr. HELLER. I missed that nuance.

Mr. STEIN. You just reminded me of it.

Mr. HELLER. I will incorporate the corporation tax in my proposal. A standby surcharge on corporate and individual income taxes would be a simple way to go.

Third, remove the absolute prohibition of any modification of Social Security indexing.

Four, remove the formula rigidities that now focus the firepower of deficit cutting on the social programs that have already been hit so hard.

And, finally, correct the technical anomalies in the Senate bill relating to the definition of controllables and uncontrollables that would have such a distorting effect on the allocation of cuts between military and civilian programs and within the defense budget itself.

In other words, change a rigid and Draconian formula into a flexible but still Spartan one. It's a tall order, but I sincerely hope that we have not passed the point of no return to rationality in coping with our monstrous budget deficit.

Thank you.

Representative OBEY. Thank you very much. Mr. Heller.

Next, we have Mr. Alan Blinder, professor of economics, from Princeton University, and visiting fellow from the Brookings Institution.

Mr. Blinder, why don't you proceed.

STATEMENT OF ALAN S. BLINDER, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY, AND VISITING FELLOW, BROOKINGS INSTITUTION

Mr. BLINDER. Thank you, Mr. Chairman and members of the committee. I want to particularly thank you for giving me the opportunity to appear here today to bad mouth the Gramm-Rudman proposal, even though I have never been the head of the Council of Economic Advisers.

As I do so, I'll try in passing to address your charge by suggesting how it could be improved. But I'm afraid that the best improvement would be to scrap it.

This amendment has taken many of us by surprise, and I have rushed to write down a few reasons why I think it is ill conceived and inadvisable. But I want to preface these remarks by making it clear that I do agree that congressional action is needed to reduce the budget deficit.

What the country does not need, however, is a panicky reaction that might have unintended and even unforeseen consequences.

I have five points to make about the proposal and I'll make them all brief. Let me list them first.

First, a goal of a zero-budget deficit by fiscal year 1991, or any year for that matter, makes no particular sense.

Second, the legislation courts disaster should the economy slip into recession sometime in the next 5 years, which is a very likely event.

Third, the feature of the bill that mechanically achieves deficit targets without touching taxes is, in my view, a mistake.

Fourth, the bill would produce budget cuts that are arbitrary, capricious, inequitable and, to some significant extent, unpredictable.

And, finally, this proposal has been put together in such haste that no one is quite sure what it means in detail. Congress should not rush through as major a piece of legislation as this one is without dotting the i's and crossing the t's.

Let me start with the issue of the goal of balancing the budget. I have never been able to figure out who it was that decided that zero is the ideal number for the budget deficit, measured in the particular way that we choose to measure it. But whoever it is, I disagree with him. It is well known by now, I think, that the budget deficit depends on the state of the economy.

A budget that is balanced, say, at 6-percent unemployment will have a deficit when unemployment is above 6 percent, as it is today. It makes no sense at all to shoot for a zero deficit regardless of the state of the economy.

The second problem is that, in terms of their basic macroeconomic effects, there is no important difference between Federal Government spending and State and local government spending, nor between Federal taxes and State and local taxes. So even if we have a fixation on a balanced government budget, it should be on balance in the combined budget of all levels of government.

Now, in recent years, State and localities have been running a surplus in the range of $30 to $50 billion. So, simple arithmetic suggests a target Federal deficit of something like $30 to $50 billion on this ground alone.

The third problem is that there is a well-known difficulty in measuring the budget deficit caused by the fact that the Federal Government does not adhere to the inflation accounting procedures recommended for corporations by the FASB.

In particular, part of what we count as interest payments in the Federal Government budget and other government budgets merely compensates bondholders for their loss of purchasing power to inflation, and is best thought of as an early repayment of principal.

This is no trivial matter. It will amount to an overstatement of the Government budget deficit of something like $60 billion in the next fiscal year. Why should we give such exalted status in legislation to a number produced by faulty accounting procedures?

A final reason is that everything grows in a growing economy. Mortgage debt grows, consumer debt grows, corporate debt grows. We do not find any of this growth in deficit alarming. Why should we find growth in government debt so alarming?

If we really have a need for a fixed numerical budget norm, I'd say that the real national debt per capita, or perhaps the ratio of the national debt to GNP should not be allowed to grow.

That does not mean that the budget should be balanced. If population grows at 1 percent per year and inflation is 4 percent, then a constant real debt per capita translates to a current deficit in the neighborhood of $75 billion.

A constant debt-to-GNP ratio translates to a larger deficit than that.

All of this adds up, to me, to the conclusion that while the current budget deficit is almost certainly too high, a zero deficit is probably too low—especially when you factor in the pain and suffering necessary to get from here to there. If we must inscribe some budget norm in the law, we might as well make it a sensible one, something like a zero structural deficit after adjustment for inflation accounting.

The second issue is one I really want to underscore, even though Walter Heller has said almost everything I want to say about it. I want to underscore it because it's really the most important. It's the problem of recession. Even the sponsors of this legislation recognized that balancing the budget in the face of a recession is a bad policy.

A recession makes tax revenues go down and expenditures go up, thereby raising the deficit—often quite dramatically. Actions that would then reduce the deficit can only make the recession worse.

Now, there is, of course, an escape clause in Gramm-Rudman that would give the President and Congress a few more days to propose and enact an alternative budget that exceeded the deficit limits if—and this is another big if—OMB and CBO predict a recession in the coming fiscal year.

Now, we cannot, of course, be sure that this escape hatch would be used. Recessions are rarely forecast in advance by Government agencies. Had I had more time to prepare the testimony, I might have said never. But I didn't have enough time to go back through all the CBO and OMB projections, so I'm not sure that that's true.

In any case, the Congress and the President, with the exception of what's going on this week, do not always act with blazing speed. But even if all goes well, the escape clause is just not enough. If we're coming out of a recession at budget time, the deficit will be way above the Gramm-Rudman target and the consensus forecast is likely to be for a growing economy. Therefore, the escape clause would not be triggered, and the Gramm-Rudman proposal would require massive reductions in spending, reductions which might well doom the recovery and create a really deep recession.

And, as Walter Heller just suggested, the potential magnitudes, when you look at the numbers, are quite impressive. I, too, was struck by the CBO's low-growth scenario, and was particularly struck by the fact that the required cuts under Gramm-Rudman under the scenario of recession in 1987 and recovery in 1988 would be $164 billion in fiscal year 1988.

I can hardly imagine, and hope I never witness, the kind of distress that would be caused by budget cuts of that magnitude just after the bottom of a recession. And similar, though less dramatic, problems arise in any year in which economic growth was expected to be weak, although still positive.

At the very least, if Congress must enact a mechanical rule like Gramm-Rudman, the escape hatch for a weak economy should be based on something like the unemployment rate, or the level of GNP relative to a predetermined trend, and not simply on the projected growth rate for the coming year.

If we don't do that, we are courting economic disaster.

The third problem I would mention, one to which both previous panelists have also called attention, is in deciding how to reduce the deficit. It may be useful to recall how we got into this mess in the first place. The chairman has already reminded us of that.

During calendar year 1981, the Federal deficit was 2.2 percent of GNP. During the first half of this year, it was 4.9 percent of GNP. That's a rise in the deficit equal to 2.7 percent of GNP, and that breaks down as follows: 1.5. percent of GNP is the drop in tax revenues, and 1.2 percent came from a rise in outlays. Now, if you examine the rise in outlays more carefully, you see that most of that came from the rise in interest payments required by the bigger deficits we had run in previous years, even though the interest rates were lower in 1985 than in 1981. Out of the 1.2 percent of GNP that was higher spending, 0.9 percent came from interest. Alternatively, you can look at the defense budget, which has risen by 1 percent of GNP.

Those two items, 0.9 percent and 1.0 percent, add up to 1.9 percent of GNP, which is bigger than the total spending cut. That, of course, is because the rest of the budget has been cut relative to GNP.

Now, if it was excessive tax cuts that caused the deficit, why should we resist raising taxes as a way to reduce the deficit? That, I think, is a good question for Congress to ponder every day. But it's particularly germane to the Gramm-Rudman procedures for mechanically closing the deficit, for they would hit only the spending side, and only part of that, while exempting taxes entirely.

Wouldn't it be better to use automatic increases in tax rates to close at least a part of the deficit, as Professor Stein and Professor Heller have already suggested?

And here's something they didn't mention, but I'd like to mention. Why should we trim explicit expenditures while leaving completely untouched all the tax expenditures, which are so large and which are growing so rapidly?

This last question is an appropriate one to ask at a time when Congress is also considering comprehensive tax reform that would strike at some of those tax expenditures—expenditures which, by the way, benefit mainly the rich.

I think it would be a shame if one side effect of Gramm-Rudman was to rule out future tax increases as a way to reduce the deficit. But that might very well happen.

Finally—or not finally, semifinally—there is the problem to which Walter Heller in particular devoted a lot of time, which is that there's almost a humorous whimsicality in the list of items that will be cut if mandatory reductions under the Gramm-Rudman formula were triggered.

The bill singles out cost-of-living adjustments, except for Social Security, as the first target. But if the budget reductions are at all sizable, only a trivial percentage could come from these COLA's because they are so very small.

Nonetheless, I would like to point out that 4 years without a COLA would be a severe blow to a poor person relying on supplemental security income [SSI]. Even at only a 4-percent inflation rate, 4 years without an increase translates to a 17-percent cut in real benefits. I think all of us can think through what it means to reduce our living standards—starting from our much higher levels, by the way—by 17 percent. That's enough to hurt.

Realistically, however, nearly all the spending reductions would come out of the portion of the budget considered controllable—a portion I now understand to be roughly 25 to 30 percent of the total budget. That, of course, would include all new programs. And it would also include rather arbitrary portions of existing programs.

The difficulties with the military budget have already been raised by Professor Stein and Professor Heller. They derive from the fact that procurement would be mostly uncontrollable while maintenance and personnel would be mostly controllable.

After a few years of having Gramm-Rudman cuts, would we have a great arsenal of unmaintained and rotting weapons and too few soldiers to man them? Does that make any sense at all?

Other anomalies are easy to find by flipping through the budget. For example, I noted that in the CBO budget for fiscal 1985, on the very same page there appears the Peace Corps budget and our contribution to the Asian Development Bank. They happen to be almost exactly equal in magnitude in fiscal 1985.

Yet, 84 percent of the Peace Corps budget is classified as new outlays and, thus, presumably subject to proportional cuts under Gramm-Rudman, but only 4 percent of our contribution to the Asian Development Bank is so classified.

Now, I have no particular opinion on the relative merits of spending on the Peace Corps versus spending on the Asian Development Bank, but I do wonder about the logic of cutting the former 21 times as much as the latter.

Problems like this are inevitable, I think, with any mechanical formula—especially one that relies so heavily on arbitrary decisions at OMB about what is controllable and what is not. I always thought that was why we gave detailed budgeting authority to congressional committees—to human beings with judgment—rather than to computers.

Gramm-Rudman, it seems to me, would give an impressive amount of power to the OMB officials who decide what is controllable and what is not. Why should Cognress want to do that?

My last point is that haste makes waste. Members of Congress should understand, as I think they do, that the Gramm-Rudman proposal is a very major change in the way the budget is put together—more sweeping, I would say, than the Budget Act of 1974. A major change like this should be thoroughly judged on its merits, and all its ramifications thought through.

As I have just indicated, I think the merits are few and the demerits many. But others may hold different opinions. What I cannot understand is the stampede to get this bill passed in a matter of days, before the loose ends are tidied up.

No national cataclysm will occur if the deficit remains at current levels for another month or two, or more. And, under the most likely economic forecast, Gramm-Rudman will not have much effect on the deficit for the next 2 fiscal years anyway.

Senator Dole was quoted the other day, and I hope misquoted, as saying, "The longer something hangs around here, the staler it gets. People start reading it."

Well, speaking as a citizen, I can tell you I prefer stale legislation any day, or at least bills that have been read before they are passed.

The confused discussions in the press and in Congress these last few days suggest that nobody really knows what Gramm-Rudman really means in fine detail.

For example, food stamps have a COLA, but the program is not considered uncontrollable by the OMB. So under which arm of Gramm-Rudman would food stamps be cut? Both? Neither?

A second example is the earned income tax credit for working poor. This is a tax provision that happens to be counted as an expenditure in the budget. Now, taxes and tax expenditures are exempt from Gramm-Rudman but, of course, regular expenditures are not. So would the EITC be cut or would it be exempt?

There are many, many other questions like these, others pertaining to the incentives the bill sets up for Congress and the administration to play games that Walter Heller alluded to, and many procedural issues that I can hardly begin to fathom, much less explain.

In time, these ambiguities and technical flaws could all be straightened out. But that's my point—in time. Rushing this thing through will create a host of problems, some of them big and some of them small, that we cannot foresee and that we do not need.

And, finally, I think both constitutional scholars and psychoanalysts of Congress will find in Gramm-Rudman a curious act of self-emasculation by Congress. While no one can really be sure, it seems likely that passage of the bill would transfer much of Congress' authority over the budget to the President. I don't understand the congressional urge to give away so much of its power, but I think the urge should be resisted.

Thank you.

Representative OBEY. Thank you, Mr. Blinder.

I am honestly baffled about where to begin with questions.

For the last 3 days I have participated, along with Tom Foley, Dick Gephardt, Marvin Leath, Leon Panetta, and a couple of others, in an effort to try to determine how we would change this product if we were going to make it more rational, because I do believe something is going to pass.

And I have to tell you that after 3 days of trying, we are still in a very difficult bind in terms of producing a rational response because even the authors of it can't tell us what it does.

Two days ago, one of the three Senate authors, who is a friend of mine, participated in a meeting with me, and I asked him questions about what was on the table and what was off the table, and we got into the question of prior obligations, for instance, and at that point they could tell me what their intention was but they could not tell me what numbers that intention resulted in.

I was told at one point in the discussion perhaps $92 billion of the prior year obligation part of $140 billion was off the table.

Second, I was told that maybe $109 billion and another staffer suggested perhaps $140 billion, and finally I was told, well, the answer is we don't know.

Now, the House probably is going to be asked to vote on a motion to instruct conferees to accept the Senate proposal even though we don't know what it does. I think that is the ultimate act of self-emasculation, as you indicated, Mr. Blinder.

But I note that Jack Kemp, with whom I do not often agree, has indicated that it is essential that we look not only at the budget deficit but also such considerations as economic growth and other programmatic concerns, including the deficit.

I think we have almost a cynical game of who is more shrewd going on here. I sense that a lot of people of my political stripe are voting for this turkey because they think that it cuts defense far more than it cuts social programs.

The President seemed to indicate that he thought—at least Saturday he thought that it allowed a 3-percent real growth in defense. The Budget Committee staff tells us the following: as they understood it—and admittedly this is a moving target—assuming that at sometime in the future—God knows not this year or next year because it doesn't require any cuts this year—but assuming there would be, say, a $20 billion cut required next year, they estimate about $4 billion of that would come from entitlements, about $6 billion would come from discretionary program reductions, about 33 percent of which would come from nondefense discretionary and 66 percent would come from defense, for a total of $6 billion for nondefense discretionary and $10 billion for defense.

If you start going down those counts on defense and you have excluded most, if not all, prior year contracting, you have yourself in effective trouble in what you are going to have to squeeze when it comes to manpower and readiness.

That really isn't in the form of a question. It is in the form of a frustrated statement, I guess. But let me ask you this.

On the trigger, I think it is important that you walk through again what would happen to drive the country into a recession in the second year of the scenario that you are talking about if we take this thing seriously and assume that it will really be followed.

In light of Jack Kemp's statement and some others, I think it is important that we do look at not just what happens to the deficit, but do we by setting up mechanistic approach on the deficit actually provide a nice, deep glide path for the submarine rather than a slower one?

Any of you want to comment and explain again what your concern is on getting into a recession in the second year under this scenario?

Mr. STEIN. I would like to comment on that because I think that what was said about it, like what is said about most things, is grossly exaggerated. If that were the only problem, I would not be opposed to this thing.

We really don't know very much about the relation between deficits and growth and deficits and recovery. At the moment we don't know whether the deficit is causing the economy to be very strong or very weak, and we have had that problem for the last 4 years.

I wouldn't worry about that very much. I think this bill does not rule out the deficits that result from a recession.

It asks the President to do something at the beginning of the fiscal year, but if during the fiscal year the economy declines and revenues fall and unemployment compensation rises, as far as I can see it does not require him to take any further action to achieve the deficit reduction to the level specified in the bill. In the subsequent year, when the fear is that he will then be forced to achieve a deficit level when the economy is recovering, well, the recovery will revive the revenues and will reduce some of the cyclically sensitive expenditures. We have a long run problem here; we have found it difficult for many years to manage the budget in such a way that deals adequately with recessions and booms. But that has not been a major source of our problem, and I don't think it would be a major source of difficulty under this bill.

I think, going back to a point you made about where you make cuts, a lot of the problem arises from the fact that Congress legislates appropriations, and this bill is intended to do something about outlays. You only get into that fix because there is an effort to do something year by year and set year-by-year targets for outlays.

Perhaps the whole thing would be much simpler if the President was given authority to cut appropriations by an equal percentage across the board. Then you would not have the problem of previously obligated funds and what to do about them. You would not have the immediate effect on outlays, but you would have the effect on outlays over a period of time, which is what we are really concerned about.

Representative OBEY. In response to that last point, the appropriations bill so far this year is $12 billion below the budget resolution, and in the case of my own bill, for instance, on foreign assistance, we are 21 percent below last year's level, half a billion below the administration's request—and not in funny money terms but in real terms.

The pressure I am getting from the administration on the appropriations bill that I deal with is to raise it, not lower it. So I don't know how to deal with a situation in which Congress is already below what the administration wants.

Mr. STEIN. Well, I hoped we wouldn't get into a debate about who is responsible for our present situation, which I don't think is a miserable situation anyway. I thought we would not debate about the relative responsibilities of the President and Congress, but if you want to do that we can. There is not much point to it.

Representative OBEY. Mr. Heller.

Mr. HELLER. On Herb Stein's last point, apparently his colleague Norman Ornstein at AEI doesn't agree.

There is some point, it seems to me, in fixing responsibility. If you are going to run a democracy, you ought to know who is responsible for the huge deficits we have, who has been trying conscientiously to cut them and who hasn't as between the Congress and the President.

I have no doubt that the fault lies at the White House and not——

Senator D'AMATO. Mr. Chairman, if I may.

You know, Mr. Heller, one time you talked about how we have got to be conscious of the economy, economic growth, unemployment——

Representative OBEY. Senator, could I ask——

Senator D'AMATO. I would like to——

Representative OBEY. I would like Mr. Heller to respond to my question. I would be happy to have him respond to your question on your time.

Senator D'AMATO. OK.

Mr. HELLER. To go on, I guess I am not as relaxed about the deficit as Herb Stein seems to be. Maybe I misinterpreted him.

It seems when we were running a deep recession you could say the deficit was a benign thing. I didn't complain about $150 to $200 billion deficits in 1982 and 1983.

I think, in terms of movie ratings, they had a G rating at that time. Then it sort of moved to PG, and maybe last year it was R, and now it seems to me the deficit is X rated. It is obscene.

And it is distressing. It is unsettling in terms of interest rates—after all, you can't have a deficit that absorbs half of the net savings of the country and not have it be damaging and also very dangerous for the future. Rising interest costs—they are already $140 billion a year—are going to absorb a huge percentage of the budget and absorb really all of the leeway that we might have for increasing social programs, defense expenditures, and the like. At the same time, we are underinvesting in plant and equipment and piling up these huge overseas debts, which after all are going to have to be paid out of the goods and services produced in the future, and that means a heavy burden on those future generations.

Somebody called it fiscal child abuse, and I think that is not a bad term.

So deficits are costly, deficits are dangerous, and under those circumstances, the desire to do something about the deficit is fully understandable. It is only a question of whether you want to lock yourself into something, as I said earlier, where the cure may be worse than the disease.

I don't know whether this is a possible way. You are asking, in a sense, how do you try to put together a formula that might work, that might put Congress' feet to the fire?

Representative OBEY. No. What I was asking, would you again describe the specific problem you see with this were we to follow it?

Mr. HELLER. OK. I am sorry. Let me do that very quickly.

As I read the bill—again, I don't agree with Herb Stein. I mean, the bill says $108 billion deficit in 1988, and unless the GNP is going down for two successive quarters, and in a second year of recession and recovery, the GNP might very well be going up, at least three out of four quarters. Yet, if you had the kind of a recession scenario that the CBO lays out, you are going to have another $60 billion added to the deficit from the cyclical slowdown factor—and this, as I say, goes back to the dark ages, not to distinguish between the structural and cyclical deficit—and literally it would call for this $140 billion—or my figure is $133 billion—cut in the deficit.

Now, maybe Congress wouldn't do it, but we are talking about what the formula requires, and the formula would require this staggering, gargantuan, ridiculous reduction in the deficit that would really throw the economy into a tailspin.

I was just going to add one thing. I don't know quite whether this is what Herb Stein is suggesting—were you suggesting that we cut all obligations rather the appropriations per se?

Mr. STEIN. No; that we cut new appropriations.

Mr. HELLER. Oh, cut new appropriations.

I am wondering whether there isn't an approach—and I am a former Chairman of the Council of Economic Advisers, not a former Budget Director, and I am not really real sure of this—but I am just wondering if the focus would be a little bit better if the cuts were in obligations rather than spending as such?

Mr. STEIN. Well, the obligations are made pursuant to the appropriations. So if you cut the appropriations, the authority to enter the new obligations would be cut. It wouldn't cut the outstanding obligations, but you have cut the ability to enter the new obligations that would affect expenditures in the future, although not in the particular year.

But I don't see why we should be concerned about the particular year.

Mr. BLINDER. I would just like to address your question very briefly because I think it's terribly important if you're right, as I assume you are, that this thing is going to pass in one form or another. The problem with not being able to get the economy off the floor of a recession comes from the fact that, given all the programs in place, the state of the budget—the budget deficit—depends on the level of the GNP, whether it's high or low, and not on the growth rate of the GNP.

If we start from a low level and begin to grow fast, the deficit is going to be tremendous. Efforts to make the deficit smaller are going to doom the recovery. Now, the problem is that the escape hatch for recession that's written into the current version of Gramm-Rudman is keyed only to the growth rate of the economy, not to the level.

Even if the economy has 11 percent unemployment but is growing—at any positive rate, it doesn't have to be a good rate—this escape hatch would not be activated. That is the difficulty.

Representative OBEY. Thank you. I'm going to ask Senator D'Amato to take the Chair until I get back from the vote.

Senator D'AMATO [presiding]. Thank you, Mr. Chairman. I'm going to do just that because, as you know, when we talk about the size of the current budget deficit, Mr. Heller, we're ready to affix responsibility on the administration, on the President, on the Congress. What about the economy?

My gosh, we came through a worldwide economic recession. If we didn't have some of the kinds of things that I'm talking about back in 1980 and 1981 we would be better off. It has taken us some time, as Mr. Blinder indicated, to begin to move our way out. We started at such a low ebb that, of course, we built up these incredible deficits.

So it just seems to me, let's have a little balance; let's not just say, oh, this President, he bears the responsibility for the huge deficit. That's just not the case.

Mr. HELLER. Well, I couldn't agree more with your fundamental point but you have to distinguish between those deficits that are the result of economic slack, slowdown, recession, what have you, and those that are the result of building in a structural deficit by the biggest tax cuts in all world history, coupled with the biggest peacetime defense buildup.

Senator D'AMATO. Let's talk about the tax buildup just a moment, Mr. Heller. I do my questioning and answering a little more free flowing than the structured, regimented setup where someone sits down and lectures for 5 minutes, and where I don't really get 5 minutes of questions or observation.

Mr. HELLER. Probably, we shouldn't give 5-minute answers.

Senator D'AMATO. As you mentioned, that last point, don't we also have to concede that during a time of deep economic recession we need a very positive stimulation to bringing us out. That is, we need to give industry and individuals the ability to retain some money, to cut taxes and then let them invest and spend the money that they otherwise wouldn't have?

Isn't that something that you yourself have advised at times?

Mr. HELLER. Yes. Although, remember that the tax cut of 1964 was undertaken in a period where we had price stability. The Federal Reserve was able to accommodate that tax cut. And, of course, we had previously put in the investment tax credit in 1962.

Senator D'AMATO. Let's talk about the tax credit of 1981. Wasn't the tax credit of 1981 a positive act in terms of producing economic growth and jobs and bringing us out of that recession?

Mr. HELLER. Of course it was a positive factor but it was too much of a good thing.

Senator D'AMATO. Well, how do you say to the 8 million jobholders who have jobs, that didn't have them before, that it was too much?

Mr. HELLER. Are you aware that the administration projected an 11 million jobs increase between 1981 and 1985, and we have only had 8 million? That 8 million is just part of normal growth factor and we are falling considerably short of all of the administration goals that were pushed as a basis for the tax reduction.

Senator D'AMATO. Let me first make an observation. My observation is that I think the American people, that the economists of this country, that the business community of this country, Mr. Heller, have come down very strongly, almost in a unanimous voice, and said, "By gosh, get those Federal deficits under control."

I think that it's an absolute fact that the Congress has lacked the courage to make the cuts that have to be made in terms of spending. People aren't saying, economists aren't saying and business leaders aren't saying that taxes should be raised.

What they're saying is let's get spending under control. Now, there's nothing in the Gramm-Rudman proposal that says or precludes—and I think it's important—a limitation in terms of taxes. Nothing in this legislative initiative does away with the ability of Congress or the President to recommend tax increases, whether or not it's under tax reform. I think there should be a tax reform. Let's see to it that the corporate America that is successful pays a minimum tax.

I wouldn't be opposed to using those revenues to reduce the tax burden. You can't justify General Electric or anyone else earning billions of dollars and getting a tax credit. You can't justify that to the average working family, that is paying 22 to 23 percent of their adjusted gross income. That's where I think the push for the so-called tax reform came about. That was the engine. The engine was when people saw a slice of America earning substantial sums in a healthy position, not paying any taxes, the people started saying, "My gosh, this is absolutely not fair."

I think we should let the record reflect the fact that nothing in this proposal, the Gramm-Rudman-Hollings bill, would preclude the Congress from recommending, as Mr. Stein indicated, possibly a 2-percent surcharge, et cetera, on income taxes, whether they be for individuals or corporations.

I think if you're going to hit individuals, Mr. Stein, you have to hit corporations. And I think it would be unfair to leave us in that position, to think that was the case.

Mr. HELLER. Well, I grant you, nothing precludes a tax increase, but all the fire power of Gramm-Rudman, all the specifics are focused on the expenditure side. There's nothing in it that says there should be an evenhanded increase in taxes or a cutback in tax expenditures.

Senator D'AMATO. Mr. Heller, you're right. I think what the American people are saying and what the business community is saying is, "Look, get your spending under control; get that under control and then, as a last resort, if we're talking about raising revenues, let's find out what the structural deficit really is."

You can't do it, however, unless you get spending under control, and I grant you, this may be imperfect. I have certain reservations but, as you know, 75 Members of the Senate did vote for it, 75–24—and I think maybe there can be some improvements in terms of tying in unemployment rates as the trigger, which would say that you would suspend the provision in terms of cuts.

I think some of the things you pointed out in terms of when do you begin to say you have strong GNP, but I have to tell you I've only been here 5 years, and you have been a student of the Congress, and you have been in during prior administrations for far longer than I have, but within this past 5 years, I do detect a lack of political courage and those who are politically timid, in terms of making the decisions that must be made.

Nothing is going to change. It's going to get worse. Now, we have put Social Security aside, which all of you have raised reference to. After all, if you put that aside, and that is a substantial part of your spending, not one of you really think that the House of Representatives or that anyone is ever going to do anything to limit Social Security in the real world, don't you agree?

Mr. HELLER. Well——

Senator D'AMATO. Let's talk about the real world. Let's not talk about theory.

Mr. HELLER. The Alan Greenspan committee managed to put some curbs in there.

Senator D'AMATO. In the real world, unless we are facing an absolute calamity, there is absolutely not going to be any Social Security cuts; we shouldn't talk about it because what that does is jeopardize any other areas where we can bring about fiscal restraint, and so on.

Then I read the newspapers and they say, "Well, you haven't included cuts in Social Security and you don't talk about interest."

Well, come on, gentlemen—you have all raised it—obviously, you can affect interest, can't you? Because if these cuts are made—and I put it in the form of a question—if these reductions are made, won't it have a positive impact in reducing the size of the interest payments that will have to be made otherwise?

Mr. STEIN. If this happens, you will reduce the size of the outstanding debt in addition.

Senator D'AMATO. What about the possibility of lowering interest rates? Let me ask you this. Mr. Stein, we'll start with you and then we'll give you all a whack at it. If the business community sees that we're serious about reducing expenditures, don't you think there's a good possibility that interest rates, as a result of this legislation, will go down? How much do you think they can go down?

Mr. STEIN. Well, they will see it when they see it. And that will be not when this bill is passed, but when they see the expenditures go down.

Senator D'AMATO. Well, if the expenditures go down, will interest rates go down?

Mr. STEIN. I believe they will.

Senator D'AMATO. What is the potential for that?

Mr. STEIN. I wouldn't estimate that.

Senator D'AMATO. You wouldn't estimate that?

Mr. STEIN. No. The quantitative relation between the size of the deficit and the level of interest rates is a very difficult thing and perhaps Mr. Heller knows, but I don't. In fact, CBO did produce a list of about 35 econometric studies of the relationship between the deficit and the interest rate and they ranged all over the lot, not only in degree but whether they were positive or negative. So I don't know which economist you want to listen to.

If you want evidence on that, don't ask me. I just wanted to say something just to clarify my suggestion about taxes, since this has come up. My two colleagues have referred to it as a trigger.

I'm not proposing that the tax increase should be automatically triggered. I'm only proposing the President should be given authority, since you're giving him all this other authority, that he should be given some authority on the revenue side.

And as far as this attribution of responsibility goes, I think, in my view, the President, at the beginning of this year, submitted a very sensible, courageous budget which would have reduced the deficit by the date we're talking about to something less than 2 percent of the GNP and we could have lived with that. And it made expenditure reduction proposals which were quite powerful, sensible, and protected the low-income people in this country.

I think that the congressional budget resolution, although not in the form that I would have liked, still is a proposal which would bring us down to a reasonable deficit amount by 1990, amounts in which the ratio of debt to GNP would be stable, if not, possibly falling. And we could live with that.

So that I do not think the situation is as hopeless as this bill seems to suggest. I think we were making progress before this bill came up and we should stick with that. And I think that many of the things that are being said about the impossibility of doing this or that really reflects the fact that, when you get right down to it, getting the deficit down to zero is not the important thing in the minds of anybody who has to make that decision in a concrete way, and we should recognize that.

Senator D'AMATO. What about my question with respect to what the impact will be if we begin moving these in the direction of reducing deficits? Won't they bring interest rates down?

Mr. HELLER. Oh, I agree about the direction. I thought you were asking me how much. I don't know how much.

At one time Paul Volcker said, "Reduce the deficit firmly by $50 billion a year, and that will translate into at least a 1 percentage point reduction in interest rates."

That was a bold thing to say. I don't know whether he would say the same thing today, but Herb Stein is absolutely right. There are so many other factors involved that you can't say exactly how much it will do.

Let me just go back for one moment. Why does it make sense to talk about responsibility of the two ends of Pennsylvania Avenue concerning the budget deficit?

What I am trying to say is that I think the Congress has been doing a much better job of cutting back the deficit. That was just reflected in what Herb Stein said. You know, in 1982, a little bit in 1983, again in 1984. Now they are doing it in 1985.

The cynics say it doesn't amount to a hill of beans. It does amount to a hill of beans, and after all, the Senate Appropriations Committee has been sweating blood trying to carry out the budget resolution. They are not going to do it fully. Farm expenditures are going to be too high, and so forth, but there is an honest to goodness attempt going on, and that goes directly to this question of whether you need to have a straitjacket like Gramm-Rudman to get something done.

I think that Congress, while not doing enough, has been doing something significant, and we ought not to make the easy assumption that Congress is an irresponsible body that won't do anything about the budget deficit unless they are forced to by Gramm-Rudman.

Mr. STEIN. Can I make another suggestion?

That is to remove the anti-impoundment features of the Budget Control Act of 1984, restore the situation in which the President could impound appropriations.

Senator D'AMATO. I would much prefer to see—and we are really moving to this in the Gramm-Rudman bill—to see to it that Congress gets the first opportunity to make the kinds of spending limitations that it should, because people elect us for that purpose.

If we then fail to meet those targets, I think we really move into the impoundment question, where the President gets the ability to make those decisions and make those cuts.

I have seen some of the manners and some of the programs in which OMB has sought to impound funds, and in many, many cases I have had to make strong objections to this.

That is my own feeling.

Mr. Blinder.

Mr. BLINDER. I would just like to address quickly the three questions that you raised. One was about the taxes.

You are perfectly correct that nothing in Gramm-Rudman precludes Congress from raising taxes. However, if I understand the bill—and it was changed last night—if the Congress should pass a tax increase and the President should veto it, which this President is not unlikely to do, then the Gramm-Rudman bill is triggered and spending will come down.

I don't think that is a very good feature of this bill, and it does create a bias, given who is in the White House, against using the tax side.

On interest rates, I have very little doubt that taking a large cut out of the deficit will bring interest rates down. But I share with my colleagues the view that it is very difficult to predict the amount. With a little more notice, I might have done better. But, off the top of my head, I hesitate to give you a number.

But I want to point to one big uncertainty in there, which is what Mr. Volcker and his colleagues at the Federal Reserve will do. They are holding the other lever on this, and if, for example, they were pursuing short-term interest rate targeting, then nothing you did to the deficit would change interest rates. If they are doing GNP targeting, that is another thing. If they are doing money growth targeting, that is another thing still.

Congress has less leverage over the interest rates than the Federal Reserve does.

And the third point I want to address is the Social Security issue. I have no doubt that you read the politics of the situation far better than we do. But, if I understood your argument for Gramm-Rudman, it was exactly that Congress lacks the political will to take all these sacred calves to the slaughterhouse and get the budget deficit down.

It seems to me that the logic of the same argument says that the sacred cow of Social Security could be treated in the same way. Gramm-Rudman is a way of saying, "I am not cutting this or that. Some mechanical formula is cutting everything fairly."

If there was a Gramm-Rudman II that put Social Security under the same rubric as everything else—I don't know if that would command a majority vote in the Senate. You know better than me—if it were——

Senator D'AMATO. There is one Senator who has to admit I would not support that.

Mr. BLINDER. I don't know, but it would at least be a symmetric treatment of Social Security with the other things.

I would also like to point out that SSI is included in the cuttable items, and a large part of that we should think of as Social Security for the very, very poor. So Social Security for the very, very poor is cut while Social Security for everybody else is not cut under Gramm-Rudman. I just don't think that is a good idea.

Senator D'AMATO. Mr. Chairman, first of all, let me commend you for calling these hearings when we all have a full schedule and outstanding witnesses.

I think that their admonition with respect to GNP and economic growth and the triggering mechanism, possibly the inclusion of unemployment rates, is something that really bears our looking at. I think the Gramm-Rudman proposal essentially will pass.

I also believe some very positive results will bring about a discipline that we have turned aside.

We have frequently asked for budget waivers since 1974. I think that it will bring a better synchronization between the Congress and the Federal Reserve, as Mr. Blinder has indicated, and hopefully reduce interest rates, creating more economic growth and employment and not turning back to those days of soaring inflation with it.

I think it is the tonic that we need because I do think we have to get these deficits under control.

Mr. Chairman, I certainly appreciate our distinguished panelists and their cogent observations. We may have some disagreements in certain areas, but I think there are several areas of perceived weaknesses where we can possibly do better, particularly when to make these cuts during a period of economic decline.

Thank you, Mr. Chairman.

Representative OBEY [presiding].Thank you very much.

Gentlemen, just one observation. One other question before we bring this to a close.

I guess what I find most frustrating about considering this is that when I came here to Congress 16 years ago most Members insisted on their prerogative to understand what they were voting on before they voted on it.

Today, we have a large number of people in both parties who are simply saying, boy, I have talked about deficit reduction for 10 years and now I don't want to go home this weekend without having voted for this.

And I guess what baffles me is that people understood, or seemed to, a few years ago in this institution, perhaps when turnover wasn't so rapid and they had more time to think things through, they seemed to understand that an election isn't held every weekend when you go home. Elections are held every 2 years, and people judge you on the basis of what you have done over that 2-year period, not on the basis of what you have done last week on a headline item.

I do think we are making some progress on this. I am heartened because when I went to the floor I discovered that the motion to instruct conferees to agree to Gramm-Rudman was not going to be offered and instead the motion simply is going to be offered to instruct the conferees not necessarily to bring back Gramm-Rudman but to review the proposal and report back as quickly as possible, in the sense it is nothing language on recommitment, just as I think a lot of this is nothing language unless you take it seriously.

But at least the sense of panic which I felt around here 3 days ago may not be of tidal wave proportions. It may only be a severe storm at this point, and we might get things simmered down so we can look at it.

Summing up, I will ask you two things. This isn't so much an economic question but a question of public credibility.

If the Congress really is serious about trying to find some way of applying a broadly based series of cuts on the spending side, do you think that we are really taken seriously? Do you think it is an intelligent act for us to say we are going to automatically put Social Security off the table, automatically put taxes off the table, yet by golly, we are going to keep on the table reductions for a paraplegic on SSI or programs of that nature?

Do you think that is an economically or politically credible thing to do if you are really trying to get at the guts of the problem?

Mr. BLINDER. Walter Heller just selected me to start because just as you walked in the room I was just bringing up the case of SSI and the contrast to Social Security.

I agree with you entirely that if something like that has to be done, I think Congress ought to take steps to make the reductions more broadly based than they are in the current law, including the things you mentioned, and especially including the tax side of the ledger. Congress should also make sure that the escape hatch for a weak economy is drawn differently than it is now in Gramm-Rudman.

Mr. HELLER. Let me just say that while the American people might momentarily toss their hats in the air, if a serious deficit reduction act was passed, they will eventually read the fine print too.

One perceives that in tax reform, for example. In the abstract, they are all for it; in the concrete, I think there would eventually be a very substantial backlash to see that Congress essentially relieves the middle and upper income groups from the main brunt of this deficit reduction and focuses so much of its impact on the lower income groups.

Just as you say, SSI, you know, open sesame for cuts; Social Security closed off, as are tax increases. Sure, you can make them, but all of the thrust of the Gramm-Rudman approach is against tax increases, and so I think the first reaction might be very favorable on deficits per se; the second reactions could cause quite a backlash.

Mr. STEIN. Well, the more I have listened to this discussion today, the more favorably disposed I am toward Gramm-Rudman. [Laughter.]

I think that if it's enacted, even if it is enacted, just as it is, that's not the end of the ball game. Difficulties will appear. I think it will serve a considerable educational function, including in the Congress in making people think about what is really involved in reducing the deficit and whether they want it and under what circumstances they want it and by how much they want it.

So then I think it will be beneficial, and I think that the country will think that you have done something. The country will be more favorably disposed to it than we are, and I don't see why the next time you pass a bill that has something about disabled SSI people, you will not put in a clause in that bill saying this shall be exempt from the provisions of Gramm-Rudman, and you will probably do that with practically everything you pass. [Laughter.]

But I think, as I said at the very beginning, there's the beginning of the idea we have to think about seriously.

Maybe now this is a project for your committee to try to think about what rules to follow, because that's what people are asking. I think what people are saying is, we reject all this fiddling; we'd like to live by some rules that we will stick with for sometime and maybe now you have time to devise better laws.

Mr. HELLER. The figure of speech that comes to mind, of course, is that rule that has just been smacked with a 2 by 4 to get his attention, and that's about what Gramm-Rudman is—it's a 2 by 4. I don't regard that as the best way to handle mules.

Representative OBEY. Let me ask just one other question.

Whatever comes out of it, would all of you take it more seriously and would you think it would be better if we wind up adopting something that is at least significantly related to the proposal in the Senate, but move up the timetable so that you would require additional specific reductions this year rather than waiting until after the election?

Mr. STEIN. You mean for fiscal 1986? We're about through with it.

Representative OBEY. No, for fiscal 1986, the House has passed all but two appropriation bills, but no appropriation bill has gone through the entire system, so we're operating on a continuing resolution until November 14, but the actual spending levels for fiscal 1986 are yet to be determined.

Mr. STEIN. You have a budget resolution. If you would just live by that, that would be quite an achievement.

Representative OBEY. What I'm getting at is the fact that this proposal raises the ceiling by $21 billion over the budget resolution for this year. It guarantees that nothing further need happen. My concern about this year is that it gives the public the impression that we have done something about the deficit. If we passed it without changing it, it would allow us to pose for holy pictures for this year on deficit reduction, but it would, in fact, endorse the status quo.

It would not require any additional action on anybody's part to reduce spending unless we went more than $21 billion over the existing budget.

Mr. STEIN. But it doesn't require you—those figures are limits. They don't require you to get up there to the allowed deficits.

Representative OBEY. That's right.

Mr. STEIN. You have a budget resolution which will keep you below the deficit allowed Gramm-Rudman this year. If you're saying, should we impose a little here before November 1986, beyond what now exists, that's a political question.

Representative OBEY. Any other comments?

Mr. HELLER. I agree with the point that you're making, that is a copout until after the election next year, and I guess the class of 1986 in the Senate would be home free under—that's the class of 1980, I guess—under this amendment, under Gramm-Rudman plan, and I would like to see a little bit of pressure exerted, if it's going to be done. I don't think it should be done, but if it's going to be done, I think some of that pressure ought to be exerted before November 1986 and not leave all of the—so to speak, "have the goodies" before 1986 and "the baddies" after.

Mr. BLINDER. I think that on the question of whether it's best to take the lumps before or after November 1986, I will yield to you—to your superior judgment on questions like that.

Representative OBEY. Well, I guarantee you, if they don't take the lumps beforehand, it increases the likelihood of taking them afterward.

I just want to say one thing, Mr. Stein, on your suggestion that we give the President the authority to move revenue levels around by a 2- or 3-percent surcharge. I have to say, I have come full circle on that. I used to oppose that idea. I remember my predecessor in Congress, Mel Laird, used to try to sell that idea and I thought it was an uncomfortable thing to do, but the more I think about it, the more I have come around to the view that to do that would be far less of an abrogation of Congress' power to the Executive, because all we would be doing is giving the President ahead of time standby authority to adjust. He wouldn't be allowed to adjust rates, as I understand it, but the rates would still be defined in the traditional process, but you're talking about some additional above those rates across the board, and I think that would be far less of an abrogation of power to the Executive than something that we are theoretically talking about here where we do not know the detail which would have to be taken into account in applying spending adjustments.

I don't know whether it's going to wind up requiring cuts on the basis of accounts or cuts on the basis of projects or of program levels, and we don't know what's going to be on or off the table.

I guess I'd like to think that any action that we might provide would provide some flexibility on the revenue side as well.

I think everybody in the room knows that that's probably not going to happen, but I think if you don't include the side of the ledger that affects revenues as well as the side of the ledger that affects spending, you're only dealing with half the problem, and that's part of our problem.

I thank you all very much for coming.

[Whereupon, at 11:40 a.m., the committee adjourned, subject to the call of the Chair.]

THE GRAMM-RUDMAN BUDGET PROPOSAL

MONDAY, OCTOBER 21, 1985

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

The committee met, pursuant to notice, at 9:55 a.m., in room 2118, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Stark.

Also present: Bill Buechner, Donald Terry, Paul Manchester, and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Good morning.

This morning we will hold the second hearing held by this committee on the economic aspects of the Gramm-Rudman proposal which is whizzing its way through the Congress. We have asked America's newest Nobel Prize winner in economics to be here to share his views on that subject with us.

Before asking the witness to testify this morning it ought to be pointed out that over the lask week we have been in conference between the House and Senate on the Gramm-Rudman proposal. During the two sessions we have had in conference so far, the House members of the conference have been briefed by the Senate Budget Committee staff and others on the content and effects of Gramm-Rudman. I think a fair summary of what we have been told in that conference so far by the Senate staff would be essentially this:

First, there was no evaluation of the impact of Gramm-Rudman on the economy before the Senate passed it.

Second, the President is required to submit and Congress is required to pass a budget meeting the specific numerical targets laid out in the Gramm-Rudman formula, and the President is required to sequester funds under that proposal. This is the case even if everybody from the White House on down expects a recession to take place, and even if there is a general agreement that meeting those targets would trigger a recession.

We were also told in the first meeting that there were no fair baselines which had been established. There was no judgment about what baselines would be used. There's no definition in the bill of which baselines would be used, from which the sequestering would take place, if, indeed, the President sequestered funds. I was personally told by one of the authors that the Senate was not exactly sure what contracts were or were not off the table, in terms of being included in any potential reduction.

It is safe to say that for the remainder of this week and, in fact for as much time as we have, the House conferees are going to try to specifically understand a number of these questions in much greater detail than we understand them now, before making judgments about how Gramm-Rudman ought to be changed.

We were also told, incidentally, by staff last week that there was no constitutional workup done on Gramm-Rudman before it was passed. Then it was suggested to us that since we couldn't figure out if it was constitutional before we passed it, we ought to pass it, and we could find out afterwards in the courts whether or not it was constitutional.

When you hear comments like that, you have the right to ask whether it is true that the Senate is the greatest deliberative body in the world.

There are many important questions we have to face on this issue, but I think one of the most important is what effect this proposal would have on the economy. And we have before us today a witness who can shed light on that.

We are very honored to have with us America's newest Nobel Prize winner in economics, Prof. Franco Modigliani, professor of economics and finance at the Massachusetts Institute of Technology.

Professor, let us first congratulate you on that remarkable achievement and, second, let me also express my appreciation for your stopping by in Washington today to testify even before you have picked up your winning check.

Please proceed and make whatever remarks you'd care to make on this project.

STATEMENT OF FRANCO MODIGLIANI, PROFESSOR OF ECONOMICS AND FINANCE, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, AND THE 1985 NOBEL LAUREATE IN ECONOMICS

Mr. Modigliani. I would like to thank the committee and the chairman for giving me this opportunity to report my views, first on the gravity of the U.S. deficit problem, a gravity which I believe supporters of the Gramm-Rudman amendment completely fail to appreciate. And I must explain why.

This is a subject to which I have devoted 35 years of my life. It is the work of mine that has been explicitly cited by the Nobel Committee in the award, and this resulted in my first article on the issue of the implication of the economics of the national debt, which was written in 1961.

I will try to indicate the manifold ramifications of the national debt which go way beyond what it does to us now. Much of the damage it does is, in fact, to young people who may or may not be here, but will be in the future, and to the rest of the world, developed and developing countries.

I will then try to give you some brief remarks on the Gramm-Rudman, and the remarks will be brief, for reasons that, in part, you have just stated. That it is really very hard to understand at this point just what that bill says. I have the version of September 30, and my reading of it is completely contrary to what you just said about what the bill says. So either there is a new version, or those who wrote it have a different understanding of English than I do.

But also for other reasons, I think it's really not worth spending too much time on it. In part, because I agree you with on the basic defects of the bill.

Let me first talk about the implications of our huge national debt. First of all, my work in this area simply supports both the view of classical economists over a century or more and the view of the common man that when people decide on their consumption and their saving, the last thing they do is to look up the latest figure of the CBO on the Government deficit. They don't even know it exists or know what it means. Their decision depends essentially on income, life cycle considerations which I have elaborated, but certainly not on the deficit.

That means that the Government deficit necessarily has the effect of diverting some of the savings that people make to accumulate a reserve for future use, from investment into paying our common deficit. To be sure, they might not be wasted, if they were used for very productive investments, but that isn't the issue here, because no one claims or could claim that we are building enormously productive things for the future.

That means then, when there is a deficit, the amount of funds which are available for capital formation for investment is reduced. Now we all know that investment is the essential ingredient for the growth and productivity of the economy. It is the basis of our exceptional standard of living. We have achieved that by use of capital. When the investment is reduced because of the deficit, there is less accumulation of capital, that simply makes future generations poorer.

It is an insidious kind of damage, because it does not reveal itself at once with a big bang. It is an effect that cumulates, and will get worse and worse as we move on.

The loss of income to future generations, incidentally, can be measured to a good proximation by the taxes that they will pay, in order to pay the interest on that debt. There is a 1 to 1 correspondence, roughly, between the income loss and the higher taxes paid.

There is one exception to this reasoning which has received some attention on the part of the administration, as though it changed things. And that is, that, as interest rates rise because of the scarcity of national saving, that may have the effect of attracting foreign capital, and the foreign capital can finance one portion of that investment, which we are no longer financing through domestic saving. It is true, that through this route, further generations may not lose as much investment as they would otherwise, but that will not help them, because they will now have to pay the interest and the principal on their foreign debt, and that additional taxation will be visited on them, just as surely as if the debt was internal.

So this, I think, is the main longrun effect of the deficit, whether it's financed internally, or whether it's attracting capital, it's going to make future generations poorer.

But in addition to this longrun effect, there are a whole series of shortrun effects, with which I believe Congress needs to be concerned now.

First, the enormously high interest rates created by the deficit are making the acquisition of a house, the American dream, if you like, impossible for young people. It has become almost impossible for a young man at the beginning of his career to acquire a house and cover the monthly payments. I say that he either cannot buy or he shouldn't because it is an impossible strain on the average person's resources or perhaps on those of his family, if he is lucky enough to have a rich family that will help him. This is an immediate consequence.

Second, as the high dollar attracts foreign capital, the mechanism through which this occurs is that foreigners, seeing high returns available in this country, try to buy dollars. They thus bid up the dollar and thereby make American goods expensive relative to foreign goods. That reduces exports and increases imports, thereby creating a new flow of goods, which is what finances the investment.

But this mechanism is precisely what has created the huge deficit in our balance of trade, which is now running at some incredible figure like $130 billion and the prospects are quite unfavorable. This huge deficit reflects the fact that our industries have been put in a position where they are unable to compete with foreigners. As a result, firms are closing or contracting, and jobs are being lost. To some extent, the loss of jobs there is made up elsewhere. But there is a huge displacement of people. Some people lose seriously in the process, as they can no longer can use their skills. And there are capricious distributions of profits between one industry and another.

This is a scourge which is so keenly felt by this country that it has given rise to a big wave of protectionist sentiment. This is a third tragedy which is produced by the deficit, because, as any one of us who studied history knows, protectionism solves nothing and only creates more problems. Why? Well, first of all, protection may not be as one thinks, because the protection, by discouraging capital imports, may lead to still higher interest rates and a still higher dollar, to some extent undoing the protection. But in addition to that, you can be sure, and I can promise you now, that American protectionism will invite retaliation which would invite counterretaliation, which would open a spiral of trade wars such as we have seen in the Great Depression. And, it is generally agreed that part of the sufferings of the Great Depression came from this wave of protectionism begun, by the way, by American legislation, and that the great unprecedented growth of income and welfare of the postwar period is due to the expansion of trade, under the leadership of the United States, which is one of the great merits of this country.

So the answer to the great trade deficit and to the dislocation of our factories and workers is not protectionism. The answer is in reducing the deficit quickly and deeply.

The third deleterious effect of the deficit concerns the so-called debtor countries. Their solvency and their viability is now in question. To be sure, they borrowed imprudently, and they used the proceeds of their loans not always in wise fashions, for which the blame goes to them, as well as to our bankers who lent to them. Let's not forget that it takes two to tango.

But what makes their problem so terrible today is the fact that they have borrowed at a floating interest rate and that rate has increased dramatically. When they initially borrowed there was inflation, and the real rates at which they borrowed were near zero—in part of inflation—so there was no real cost to carry the debt.

Now, under the impact of the U.S. deficit, they are paying interest rates, real interest rates which are unprecedently high, magnified by the fact that now there are heavy risk premiums which are imposed by the lender. It is this flow of interest service which is the foundation of their problem. They have responded in various ways, including contracting their economies to reduce their deficits. This is replacing growth with contraction, which, in turn, is creating serious social upheavals from which we also stand to lose.

If we fail to bring down interest rates promptly, by cutting quickly the deficit, we may still see repudiation of their debt with a serious implication this has for the future of international capital movements, an important mechanism for development. And we may see panics develop in this country, as people realize the heavy losses that the banks have, and we may even end up by having to fork out huge amounts of public money to save the system.

The last ill effect of our high interest rates is perhaps the least understood and has to do with the current plight throughout the industrial countries, and in particular among the members of the European Common Market. Those countries are in a very difficult situation, because our high interest rate policy in a world of free capital movements and floating exhange rates, our high interest policy forces them to pursue, also, a relatively high interest policy, in order to avoid further devaluation of their currency, imported inflation, further capital movements, and among other things, a further deterioration of our own balance of payments.

But the high interest rates under these conditions lead to a reduction in the aggregate demand and employment unless they were to offset them by a large deficit, American style, which they are not prepared to do, for understandable reasons.

Today, the common market unemployment is around 11 percent, a figure which is comparable to the figures of the Great Depression and corresponds to something like 14 percent in this country, if you allow for the differences in frictional unemployment.

It's a huge level and it is for this reason that the countries of the common market of the OECD have repeatedly pleaded with the United States to change policy, to cut out the deficit, to reduce interest rates. And, so far, we have answered with benign neglect.

Let me mention quickly that there are those inside the administration and outside, too, that occasionally deny that the deficit has all of these terrible consequences. They say that it does not decrease national savings, because when the Government runs a deficit, people respond by saving more.

This argument is based on what I call a wild fantasy about every person realizing that because of the deficit, his children will have to pay more taxes and, hence, he saves more in order to bequeath them capital large enough to pay for the higher taxes.

I enjoyed these ivory tower games. It's very nice to sit down and say suppose that people behave that way. One can even spend some interesting time thinking about it, but it has no bearing whatever on the world. And I have abundant evidence that this is not the case, that when the Government runs a deficit, national savings decline. If you want to have an immediate confirmation of this evidence, which is in several of my papers, you only need to look at what is happening to the savings rate in this country.

Look at the last 25 years and you can readily see that, since 1982, when the big deficits began, the savings rate is, if anything, lower than the average of the last 25 years. If these people were right, it would have to be twice as large; there should have been an enormous rise.

So, there's absolutely no question about it that deficits reduce national saving with all the consequences set out earlier.

Let me now come briefly to the question of the Gramm-Rudman amendment. The main reason I object to this amendment is that it does not accomplish the needed task, which is cut the deficit now and cut it deeply with no ifs, ands or buts.

I applaud, of course, the purpose of the amendment. Everybody agrees we should reduce the deficit. But I have objections first about the magnitude and timing of the cuts. In my view, and the chairman here has called my attention to this point, the amendment does not call for a large cut now. Indeed, as has been pointed out by the chairman, it mandates no cut at all.

On the contrary, it authorizes an increase in the deficit because there are various safeguards and clauses which, together, would permit maintaining a higher deficit than under current legislation. And it makes a minimal cut also for the next year.

So what does it do?

It's very clever what it does. It tells future Congressmen how they will go about doing what the current Congress does not have the guts to do now. That's all the Gramm-Rudman amendment does. But it's worse than that because, since they want to show how tough they are, their toughness consists in a whole series of minute rules as to how these future heroes are going to perform their act of heroism.

Half of these rules are, in my view, if I may quote my grandson, plain Mickey Mousing. The other half is mostly the wrong thing to do.

For instance, it has been shown, and I'll be glad during questions to develop this, that the rules about the conditions under which the reduction of the deficit can be suspended are calculated to create economic instability in this country. I would simply say that if you have to have a sound rule as to when to alter the ceiling, the only sensible one is the so-called full employment budget. That is, expenditure and taxes should be such as to meet the deficit target if the economy is operating at sustainable full employment.

There are also many other shoddy details which reflect the rush in which this legislation has been put together—to the point where there is wide disagreement as to how the procedure is going to work.

But I would say this to you, Congressman, if you're not going to cut the budget yourself, please don't bother to tell other people how to do it.

To conclude, my strong recommendation is: cut the budget now and cut it deeply. Don't waste your time and lose credibility by telling others what to do. Above all, don't be trapped in the taboo that taxes must not be raised, even if it means a continuation of the deficit.

American tax rates are not particularly high. And don't believe in the nonsense of the Laffer curve, at which you should laugh, as an overwhelming number of economists do.

Finally, remember, if you refuse to raise taxes in the presence of a deficit, you are raising taxes anyway. Of course, not your own, but those of your children.

Let me end with the sketch of a bill to replace Gramm-Rudman. It should establish a target for a large reduction in the deficit and state that whatever reduction has not been accomplished through pruning expenditures by some nearby date will automatically be made up by tax increases.

Thank you.

[The prepared statement of Mr. Modigliani follows:]

PREPARED STATEMENT OF FRANCO MODIGLIANA

Let me first thank you for this opportunity of presenting my deeply felt and long matured views on that scourge which is the current and prospective huge deficit, and on the Gramm-Rudman amendment recently passed by the Senate.

In my presentation I will first review the considerations that lead me to the conclusion that the current and perspective deficit of the US is of a magnitude such as to pause a clear and present danger and call for immediate remedial action. The threat is not so much perhaps to us present in this room -- middle aged Americans with access to secure jobs -- but to other groups which, even if not directly represented here, should be of concern to you, namely to the younger and future generations of Americans and to most of the other nations of this world both developed countries and those struggling to develop. This conclusion is the result of 35 years of research which has been singled out in the citation for the recently awarded Nobel Prize.

I will examine next why, in my view, the Gramm-Rudman is entirely inadequate to face the problem and is, in fact, actually mischevious in that it may lull you into believing that you have absolved your task and can forget it till after elections.

I. The US Deficit and the Threats it Poses

My analysis and empirical evidence support, without a shadow of a doubt, the traditional conclusion of both economists and common-sense people that individual and national consumption, and hence saving, is basically controlled by considerations other than whether the government happens to run a deficit and how large it is. This conclusion implies that when the government runs a deficit, or dissaves, national saving -- the sum of private and public saving -- declines by roughly a dollar for each dollar that the deficit is higher. But this, in turn, means that each dollar of deficit crowds out a dollar of private investment, except to the extent that it increases reliance on foreign capital.

How does the crowding out occur? Basically through interest rising enough to do two things: i) ration out among [redacted] investors the reduced flow of funds available, except to the extent that ii) foreign capital is attracted through a rise in the return available in this country relative to that available elsewhere. (Note that nothing says that interest rates must be higher than in years of lower deficit -- it just says that they will be higher than they would be otherwise.)

These immediate effects of a large (non cyclical) deficit -- and our deficit is enormous, especially in relation to our saving capacity -- are the cause of a series of ruinous consequences, both long and short run, both domestic and international.

<u>Long Run Consequences</u>

These are the most ~~dangerous~~ insidious because they come on gradually and hence are hard to detect in the beginning. They all work through the stock of national private capital. Capital in the form of plant, equipment, houses, inventories, is what makes our labor productive and supports the American standard of living. In so far as the deficit crowds out investment, it progressively reduces the capital available to future generations, making them poorer. One can show that the resulting loss of income is roughly equal to the higher taxes that future Americans will have to pay to service and repay the additional public debt.

In so far as the deficit attracts foreign capital and is thus financed by borrowing abroad, the effect is essentially the same, for though the stock of capital and before-tax income may be less seriously impaired, future generations will have to pay out of that income, through higher taxes, the resources needed to pay interest and principal.

Short Run Effects

But there are also important short run effects which are visible for any one who wants to see. First, the enormously high long term interest rates, even after adjustment for current and prospective inflation, are making it nearly impossible for young people to buy a house -- except perhaps with enormous strains on their finances -- or, for the lucky ones, on those of their parents. Don't let anybody tell you that the high interest is the fault of the Fed -- the Fed has no choice as long as it must avoid resurgence of inflation and the deficit is as large as it is.

Second, in so far as the high interest attracts foreign capital, this occurs through foreign investors endeavoring to buy dollars to invest in US assets, thus bidding up the price of the dollar. This makes American goods and services more expensive relative to foreign goods, reducing exports and increasing imports. The resulting deficit or net import of goods can be used for investment, replacing, accordingly, the reduced flow of national saving.

It is this mechanism that has given rise to the huge deficit in the current account balance now running at something like 130 billion per year and is playing havoc with these sectors of the American economy that are open to foreign competition. In addition to the mass displacement of jobs and capricious redistribution of profits, this phenomenon is creating, as is well known, tremendous pressure for protectionist legislation. Resisting such pressure will be hard as long as our deficit is so large, but giving in would be tragic. As we learn from history, protectionist measures are sure to lead to retaliation. The outcome will be an inversion of the trend toward the opening up of trade led by America which has contributed as much as anything else to the unprecedented growth of world trade, income and well being in the post war period. The answer to the trade deficit is not protectionism -- which, incidentally, would probably be only partially effective as it could lead to higher interest rates and a higher dollar. The answer is to cut the deficit deep and quick, before the protectionist wave overwhelms us.

The third deleterious effect of the deficit concerns the solvency and very viability of the debtor countries. These countries have no doubt overborrowed and not spent productively all the proceeds of their borrowing, for which blame goes to them as well as to the bankers that uncautiously lent to them. But the problem is immensely complicated by a circumstance for which they cannot be blamed. The interest rate at which they borrowed, which was low or even negative, has been raised to unprecedented levels by the US deficit.

If we fail to bring down the deficit and interest rates quickly, the consequences can be extremely serious. The economies of many of the debtor countries are cracking under the strain of servicing their debt, and growth has been replaced by contraction. This is bad per se, but in addition we remain under the risk of some form of default. Related to this is the risk of domestic bank panic because of the resulting bank losses, and of the need to intervene, to make up the losses, by public money.

The fourth ill effect of our high interest rates is perhaps the least understood and has to do with the current stagnation throughout the industrial countries, and in particular among the members of the European Common Market. In a world of floating rates and considerable capital mobility, our high interest rates force these countries into a matching relatively high interest rate posture.

This is necessary in order to prevent even more outflow of capital resulting in further devaluation of their currency, imported inflation and further deficit in the US current balance.

But a policy of high interest rates discourages investment and hence reduces aggregate demand and employment -- unless offset by a large deficit American-style -- something which, understandably, they refuse to do.

The result of this situation is that, today, the Common Market unemployment has reached levels approaching those of the great depression. It averages around 10%-11% -- with much higher rates for some countries -- which corresponds to something like 13%-14% in this country. It is for this reason that these countries have desperately tried to persuade our Administration to take some action to bring down the deficit and interest rates.

There are those inside and outside the Administration that, at least until recently, have tried to deny these ill effects essentially by arguing that the deficit does not reduce national saving. They maintain that as the government saves less the private sector will automatically consume less or save more out of net-of-tax-income. The argument is based on a wild fantasy about every person realizing that because of the deficit his children will have to pay more taxes, and hence saving more in order to bequeath to them enough capital to pay for the higher taxes. There is really no need to argue about this view, which, while it might have some fascination as an Ivory Tower exercise, has no empirical relevance whatever. This is shown by a large body of evidence both for the US and for many other countries, including some reported in several papers of mine, published and in course of publication. It is enough to look at the behavior of the saving rate in the US to find that since the big rise in the deficit in 1982 the saving rate has been, if anything, lower than the average in the last 25 years. It is equally sufficient to look around to see that all the phenomena that we expect to be associated with the crowding out of national saving have, in fact, occurred.

Let me finally note one paradox. Suppose the administration were correct in maintaining that the deficit leads people to consume less, just as though they were taxed. How can then the President argue that taxes must not be raised regardless of the deficit because of disincentive effects when not taxing has exactly the same disincentive effect?

II. The Gramm-Rudman Amendment

I come now to the question of why, in my view, that amendment cannot be regarded as adequate to accomplish the needed task -- cut the deficit now and cut it deeply, with no ifs, ands, or buts. I applaude, of course, the stated intention of the amendment, namely bringing the high deficits to an end. My objections are of three types: First, the magnitude and timing of the cuts; second, the way in which the cuts are to be executed. Finally, I have numerous detailed objections arising from the rush with which the bill has been put together:

i) The amendment does not call for a large cut now -- say 1/2 the deficit. Indeed, as Representative Obey has correctly pointed out, it does not call for any cut whatever this year and for hardly any cut next year. Rather than going through the painful exercise of cutting the deficit, it instructs future Congressmen to cut the budget -- if they feel like it -- for obviously a future Congress can readily revise the law and perhaps instruct a yet future Congress to do the unpleasant job!

ii) The supporters of the present amendment, after going through the nearly meaningless exercise of ordering future Congresses to cut the budget, endeavor to show how tough they are by placing an enormous number of detailed constraints on future Congressmen as to how they should go about cutting the budget. Many of these details are, in my view -- to borrow an expression from my grandson -- plain "mickey mousing". Others are positively harmful, like those establishing exceptions to the deficit cutting procedure when and only when, income is expected to decline. It has been shown repeatedly that such a formulation courts economic instability and that if the path of the deficit is to be prescribed in advance then the target should be something like a "full employment" deficit.

But, frankly, if you are not going to cut the budget yourself, I see little reason why you should dictate to others how to do it.

In the light of this view, I shall not waste time on some of the shoddy details of the bill -- a task which has been carried out quite adequately in several previous testimonies.

To conclude, my strong recommendation to you is cut the budget now and cut it deeply. Don't waste your time and lose credibility by telling others what to do, if you don't have the courage to do it yourself. Above all, don't be trapped in the taboo that taxes must not be raised, even if it means a continuation of the deficit. American tax rates are not particularly high. And don't believe in the nonsense of the Laffer Curve, at which you should laugh, as an overwhelming number of economists do. Finally, remember that if you refuse to raise taxes in the presence of a deficit, you are raising taxes anyway, though not those of our generation but those of your children.

Let me end with a sketch of a bill to replace Gramm-Rudman. It should establish a target for a large reduction in the deficit and state that whatever reduction has not been accomplished by some nearby date, through cutting expenditures, will automatically be made up by tax increases.

Representative OBEY. Thank you very much, Doctor.

It sounds to me like what you're saying is take the medicine now. Don't prescribe an elaborate Rube Goldberg contraption or process by which somebody else takes it, but let's take it now.

And I agree with that.

Doctor, let me ask, and I think you're correct to point out, that the so-called panacea which we are asked to pass in a week's blink, the Gramm-Rudman proposal, in fact would allow us to spend about $20 billion more this year than we would be allowed to spend under the budget resolution.

In fact, if you added together the deficits allowed under the budget resolution for the first 2 years, and if you then added together the budget deficits which would be allowed under Gramm-Rudman for the first 2 years, Gramm-Rudman would still allow us over the first 2 years to tolerate a larger deficit than with the budget resolution.

I would like to get into some specifics. Let me start by quoting you some time ago in your presidential address to the American Economic Association in September 1976. You wrote that, in your opinion, the fundamental message of Keynesian economics is, quote:

> That a private enterprise economy using intangible money needs to be stabilized, can be stabilized and, therefore, should be stabilized by appropriate monetary and fiscal policy.

Do you still hold that view?

Mr. MODIGLIANI. I certainly do. And I'm pleased to see that the present administration has been applying my principle very generously.

I think we're all familiar with the fact that the reason why we had such a rapid recovery is that the administration decided to have a very large deficit at the time of the sharp contraction. That was a very sound policy. We should have no deficit when we have close to full employment, at present, but we should have a deficit when the economy is in recession.

Similarly, with respect to monetary policy, it has by now become clear that the Fed is not monetarist and has never been. They used monetarism as an excuse—when they had held the line on money at the cost of a contraction. But it is clear that since then they have used monetary policy successfully to maintain the growing economy on an even keel.

I see absolutely no reason to doubt the proposition you quoted, and I believe that its full virtue will become clearer and clearer in the coming years as the problems of the oil crisis recede.

Representative OBEY. Thank you. I would also agree that the current recovery was rooted in the very large stimulus in demand because of the big deficits. But what I would like to get into for a few moments is whether the Gramm-Rudman proposal, if taken seriously, would deny us the ability to manage the economy in a way that would allow us to either avoid or get out of recession down the line.

To do that, I would like to repeat some questions that I asked the Senate Budget Committee staff in conference last week.

I asked them if it were true that if the economy was projected to go into a recession and unemployment was projected to rise, whether the President would still, under Gramm-Rudman, be required to submit a budget which met the maximum deficit target set out in the bill.

And the response to that question was yes.

Then I asked if the economy is projected to go into a recession and unemployment is projected to rise, would Congress still be required to pass a budget resolution which still rigidly met those tested targets.

Their response was yes.

I then asked who would make the recession projections which would determine whether the President would have to submit such a budget and whether Congress would have to pass it.

They indicated that a combinaton of the Congressional Budget Office and the OMB would have to make the projections.

I asked them then whether they could tell me if they could recall any instance in which an administration had actually predicted ahead of a recession.

They could not give me an instance.

Can you recall any instance in which an administration has predicted ahead of time, since 1947, that we would have a recession?

Mr. MODIGLIANI. A very interesting question. I never thought of that. It seems to me that I do recall some modulation in the forecasting, sometimes more, sometimes less optimistic. But I will agree with you that I do not recall any time in which the forecast was for a contraction. You're right.

Representative OBEY. Let me ask you this.

Mr. MODIGLIANI. Now, I say this. The reason there is one further complication in the way these triggers are set up, you have something like the problem of the regimental barber who was supposed to shave everybody except those who shaved themselves. Should the barber shave himself or not? You have the same problem here.

If OMB and CBO forecast a contraction, then there would be fiscal actions taken which prevent the contraction. Therefore, they should not forecast a contraction.

But, if they don't forecast the contraction, then there will be one and I should forecast it. So the whole thing is completely unclear. And that's what I mean about the Mickey Mousing. The specifications of what exactly the directors have to do at a certain time is a waste of time. It should be the administration and Congress to see what the best action is at any one point in time.

Representative OBEY. I agree with that.

Let me ask another question. As I read the Gramm-Rudman proposal, and this will take some time because we have to get the specific numbers, the maximum deficit that would be allowed in fiscal year 1987 would be $144 billion plus the 7-percent leeway factor.

The standard CBO projection with the existing budget shows a deficit for 1987 of about $163 billion. That would mean we would have to cut about $19 billion or about four-tenths of 1 percent of GNP in that year.

If we had a recession in 1987, of the type which the CBO projected in their low growth path, the deficit would be $259 billion. Under Gramm-Rudman, we would still have to meet the same dollar amount for the deficit target, which would mean we would have to cut about $115 billion at a time when the economy was sagging.

That would mean that at a time when we were in an economic slump, we would have to cut about six times as much as we would have to cut if the economy were reasonably strong.

In that kind of economic scenario, we'd have to hit about 2.5 percent of GNP in terms of the deficit reduction that would be required.

That means in plain English that this proposal requires us to cut more at a time when the economy is sluggish or weak, or actually declining, and it would require us to cut less at a point when the economy was reasonably healthy.

Does that sound like sound economic policy to you?

Mr. MODIGLIANI. First of all, I want to point out that your calculations are quite optimistic when you say 6 percent. Why are they optimistic? Because they're not allowing for the fact that the moment you cut expenditure, incomes are falling by a multiple of the cut, tax revenues fall, and, therefore, you must cut the budget even more because you have lost more revenue.

You see, one of the great absurdities of this legislation is that never are taxes mentioned as a possible lever, so that any time that something happens to your taxes, you can always respond by cutting expenditures, it's clear that the operation you described and the multipliers that I'm suggesting, which are uncertain, of course, because it's unclear whether the budget is supposed to make a forecast, given the implication of what the forecast is, or not given those implications.

So it's a really impossible game. This legislation is plainly forgetting all that we have learned in the postwar period. I think you will find that economists of all persuasions, including Milton Freedman, believe firmly that built-in stabilizers are one of the greatest inventions of the postwar period.

Built-in stabilizers mean that you make sure that the expenditure does not decline or respond cyclically while taxes go up and down because of cyclical variations in income.

This proposition is a fundamental lesson that I think we all agree we have learned, perhaps from Keynes, perhaps otherwise. But, certainly, it has a major main reason why, since 1950, our economy has been distinctly more stable than it ever has been before.

Representative OBEY. You mentioned something that some of us tried to bring out in conference last Wednesday. We tried to point out that the economy now has built into it some self-correcting modulators, so that if the economy starts to slide into a recession, there are some programs, such as unemployment compensation and so forth, which are countercyclical. This proposal appears to be procyclical—it helps to turn a shallow submarine dive into a crash to the bottom. When we mentioned this in conference we were accused by some of simply wanting to maintain an opportunity to prime the pump.

We weren't talking about priming the pump, we were talking about allowing the economy to self-correct itself.

There is only one difference under this proposal in the way we deal with the economy during a growth period and a recession period. The system will be given 30 days rather than 14 days to do something other than sequester these funds. And there is one point of order on which we allow in the House consideration of an alternative. But outside of that, there is no real exception. And the legislation says that you can take that very narrow exception only if we are projecting two quarters of less than zero growth.

I think a number of people are concerned that the proposal relies on projections. You've indicated that you can't recall, and I can't either, any instances in which any administration has projected ahead of time that we were going into a recession. I certainly don't know of any time that CBO and OMB agreed on that kind of projection. Thus the question is raised, if we are going to have any kind of a recession exemption at all, should that exemption be based on something other than projections? Should it be based, for instance, on existing economic experience at the time, or a combination of the two, so that you could take into account, in determining whether you wanted to meet those specific targets, whether or not the economy was actually experiencing at that time a drop or a rise in unemployment and a drop in economic activity?

Representative STARK. Would the chairman yield? Great minds run in the same direction, and I am sorry that I missed Mr. Modigliani's testimony, but I had a question that is very similar to yours, in the sense that we are likely to have something out of this conference, and you can't beat something with nothing.

Would you, as you comment on the chairman's question, suggest any ideas you might have as to what we would use as a triggering mechanism? If we have to have a triggering mechanism, is there one that is less objectionable than any other? And I wonder if you might add that to your question.

I thank the chairman for yielding.

Mr. MODIGLIANI. Let me first make one comment. As I read this bill, it does say that if there is a determination by the directors that there will be a contraction, then, in this case, the Congress is not bound to reduce the deficit to stay within targets. It seems to me clearly stated here now, unless they've changed it, it seems to me that this is very clear language. What happens there, it just says that you are bound by the States, unless there is a declaration.

Representative OBEY. The way it was explained to us, Doctor, is that even if there is a recession, the President is still required to submit a resolution which meets the targets. And the President and the Senate are still required to meet those targets in their actions, or the sequestering does take place. We're told that the only exception is that after the President has sequestered those funds, then during that 30-day period before that sequestering would take place, if there was an economic recession, then a point of order would not lie against Congress attempting to consider an alternative. But the damage would have to be done, the lockjaw would have to be imposed before the Congress could try, in a very short 30-day period, to overturn it.

Mr. MODIGLIANI. In any event, I think it just reflects on the difficulty of understanding this bill. It's also very stange that in that case, it doesn't give any indication at all as to what can be done. It just says, you are not bound.

Well, you've had testimony from such distinguished economists as Walter Heller and Alan Blinder, and so on, who have explained that the present combination is simply an order for disaster.

The whole structure is the wrong structure, and in part, it's the wrong structure, for precisely the reason I mentioned. It has in it the destructive characteristics of what happened during the Depression. Because of the Depression, you lose revenue, and because you lose revenue, you've cut expenditure. Because you've cut expenditure, you lose income and you lose revenue. So you get a vicious spiral. And there is nothing I can see that says that this will not happen with this bill.

So I think it's very unfortunate.

Representative OBEY. Walter Heller described it as the economy chasing its tail.

Mr. MODIGLIANI. Exactly. Now it seems to me, with the reservation I have mentioned before, I don't really believe much in these measures which are destined to bind future people.

Why don't you just bother with doing your own job and forget about what a future Congress will do. Let them use their conscience as you should use yours. If it makes sense to have a bill that has a sliding scale—you see, my view is, you should take off half the deficit now. Once you've taken half the deficit, $100 billion, then there isn't any great urgency to do anything else. You have had the impact, the shock effect. You have, I think, remedied most of the tragedies that are going on. I don't see any point in making a law about the future.

I'm against the balanced budget amendment, partly for the same reason, but in any event, if you want me to give you something that I would vote for that is the best that I could advise someone who asked me, I would say that the criterion should be: You have a deficit target, and let appropriations and tax rate be such that that target is achieved if the economy is at full employment.

Then let the world do what it wants, and if there is a depression, you will not meet the target. And if there is a very high level of activity, you will overshoot the target, you will, in effect, be reducing the deficit faster than expected.

If you get into a boom in this system, you are in a mess, because you're forced to spend more and more, because you have to have that deficit.

It seems to me that this is the device that gets you out of all these difficulties, because it makes the actual deficit automatically respond to the business cycle.

Representative OBEY. Again, I have to totally agree. If I had my druthers, instead of putting this cockamamie operation into the political hereafter, I would simply take the continuing resolution which Congress must pass by November 14 and move up the date. I would take it up early in the House, and I would meet this year the targets that Gramm-Rudman establishes for next year; that is, the $144 billion number. I would meet those reductions this year and would not bother with a Mickey Mouse proposal, but I doubt that that's going to happen.

That's what I'd personally prefer.

Let me ask you this. Even though you indicate very clearly that you think Gramm-Rudman is Mickey Mouse, if we were required to take the general outline, and if we were to try to fix up the recession exception, should we look at both sides of the ledger—spending and revenue?

Mr. Stark has an interesting concept in a bill which he introduced some time ago. I am wondering whether or not we couldn't apply it intelligently in this instance. If we're going to allow the President to sequester or rescind, say, 4 percent of spending across the board, wouldn't it be logical for us to also require him to rescind 4 percent of all tax expenditures across the board, so that you're saving on both sides?

Mr. Modigliani. Certainly the principle sounds very reasonable. I'm not sure how easy it is to do that, because tax expenditures by nature are estimates. We don't know exactly. It's not the case that I received, so much, but you have to make some estimate of what you, in fact, are giving. But I have read this proposal. It seems to me that you said something about preference items, about the sort of items in the tax bill where there are special exemptions.

Representative Stark. If you would, Doctor, in its simplest form for corporations, it would just take all deductions and other preferences, investment tax credits, and reduce their value. Again it's not reform, because it would increase distortions. But it impacts against people who pay the least tax rather than putting a surtax on income. It's more or less a surtax on deductions and exemptions. You would just take 10 percent of all corporate deductions and credits and impute a tax rate to it, so you impute a factor of a minimum tax. It's a meat-ax approach.

Mr. Modigliani. It seems to me that that this is a good idea. I don't know how easy it is to apply, but the principle strikes me as very good. You missed that suggestion of mine, which said that Congress should set a limit, a time limit, and if it does not cut expenditure by that limit, then taxes should go up. I think that is very important, because now the whole battle is conducted under the postulate that one thing we cannot do is to raise taxes.

Now, this is an absurd position. It simply weakens you, to begin with, because then you're only left with the choice that if you find that some expenditure is vital, then you are in favor of the deficit. So it seems to me extremely important to bring back taxes within the fold so what is automatic. We need that threat. If you don't want to cut the military, well, then, since we don't want to cut the rest, be prepared to raise taxes. That seems to me to be absolutely vital. Without that, we get nowhere.

Representative Obey. Congressman Stark.

Representative Stark. Thank you for leaving sunny Boston and coming down here and shedding some light on an otherwise obfuscated proposal. I think you're quite right. In reading your testimony—I apologize for not being here when you arrived, Doctor—but I think you're right on target.

I wanted to digress for just a minute, because you are an expert on the question of savings behavior, and in our so-called "tax reform" bill, which is sort of going on in another orbit or lunar cycle, as we work on this, we're having tremendous lobbying pressures to not tighten up on a variety of tax subsidies for retirement savings plans—IRA's, 401K's, and the like. Our evidence shows that these plans, we suspect, have not created a whole lot of new savings. There may have been some transfers from one savings account to another to take advantage of the tax exemption. But the people who sell the plans, they'll say, "we just haven't noticed increased savings yet, because interest rates have dropped." They have a whole host of excuses.

But I wonder if you could comment on, in general, what these various tax incentives do and what they do not do to create the kinds of savings that are important for the economic growth of this country.

Mr. MODIGLIANI. I have indicated on many occasions that I think that these measures—IRA, Keogh, even tax deferred annuities, are fundamentally, a fraud. Fundamentally, a fraud in the sense that they were sold on the grounds that they would increase savings. And you can readily see that is the last thing they do. They might reduce them, not increase them. Why? They do not increase savings, because you don't have to save to put money in your Keogh. All you have to do is to transfer money from somewhere else. And if you are anywhere above 30, you certainly have enough money to make that addition for quite awhile.

So they don't encourage saving. They might discourage saving, because anything that makes your retirement money grow faster leaves less need to save for retirement. So the effect may simply be that people save less, as a result of this.

Now, from the day they were started, I said this many times. Against my interest, of course. I have an IRA. I have a Keogh. I have a tax-deferred annuity. I have them all. I enjoy them. [Laughter.]

But when I wear my hat of an economist who is advising Congress, I have to be honest. I have to say it's not helping saving.

Now the introduction of those plans has not increased saving at all. Not at all. There is, of course, another aspect. You can justify some of those plans, but on very different grounds. Namely, that in a system of progressive taxation, you may want to give an opportunity to people to smooth out taxable income, so that the progressivity does not hit those whose income is uneven. You do remember, perhaps, the famous cartoon of the two prostitutes complaining that our laws weren't fair because they didn't allow them a deduction for depreciation.

That's exactly the point here. From the point of view of income averaging, this legislation makes some sense, but it seems to me that it should not be done in disguise. Of course, the one thing which could really be effective would be to tax consumption rather than income. It's not a simple matter. It would require some careful work, but in principle that would make sense.

But under current legislation we do not exempt saving from taxation, we exempt a particular form of asset from taxation. That doesn't make any sense.

Representative STARK. This is a delight, Doctor. I may follow on one more digression on something else that is before us at this point.

You touched on taxing consumption. These has been a suggestion that's been passed out of our committee, at least in conceptual form. We're faced with the funding of the Superfund, the money to clean up toxic waste sites. And there has been proposed a broad-based tax, which proponents are avoiding calling a VAT or a sales tax. I find that if it quacks like a VAT and wallows like a VAT, it probably is a VAT. They're trying to suggest it's an excise tax, which I always thought you paid on a commodity.

But there is some question. Should we just tax the oil and chemical companies, or should we go to a broader based consumption tax, which is a proposal that Congressman Jones and Congressman Fowler are putting forth.

I wonder if you have any thoughts on how we best want to fund this Superfund monster that's before us?

Mr. MODIGLIANI. I am aware of this proposal. I've read something about it. Let me say that I think you have to make a distinction between pollution from here after and the pollution that's already there, and we need to clean up.

It seems to me that there is no question the pollution from here on should be if possible charged to the polluting industry. This is a fundamental principle of economics; let the costs fall on those who are creating the problem. Among other things, that will tell you that we should consume less of polluting products, because they'll be more expensive, and they should be. That is, it comes down to the principle of trying to have the price reflect the social cost, which is the direct cost, plus the indirect ones like pollution.

Now, in the case of cleaning up the old mess, I think the situation is different, because his mess was presumably the result of behavior which, at least in part, was not illegal. That is, there was no specific provision. Of course, if it is illegal behavior, it should be charged to those who did it, but otherwise, it reflects general behavior, and it seems to me that at this level, the burden has to fall on the community as a whole.

When that is the case, I suppose that the general sales tax is as good as anything else. It's one of the devices which essentially taxes everybody.

Representative STARK. Thank you very much.

Representative OBEY. Thank you.

Doctor, just one other point. You said that if we are going to try to set up a formalized structure for targeting deficits, we ought to be aiming at the full employment deficit rather than the normal deficit, if our concern is to allow some flexibility in dealing with economic reality.

Mr. MODIGLIANI. That's right.

Representative OBEY. OK. One last question. I noted that the Wall Street Journal, in an editorial last week, congratulated you on winning your Nobel Prize in economics, and then seemed, in essence, to fire a shot across your bow, by suggesting that you ought to stick to questions of savings. They warned that you were fair game for criticism if you stepped across that line and had the audacity to use your expanded visibility to discuss questions of national public policy, for instance, as they relate to Reaganomics, tax reductions, and deficits.

I wonder if you would like to fire any shots across anybody else's bow. [Laughter.]

Mr. MODIGLIANI. I certainly would—first of all, let me say that, of course, I have no objection to their criticizing me. I have no objection to their finding something wrong with me. I'm ready to take them on, though I will certainly not spend too much time criticizing them, because among economists Wall Street Journal editorials are considered almost worthless. [Laughter.]

Nobody pay any attention to them. But on this particular issue, I think they showed a sort of prejudiced ignorance when suggesting that I should only talk about corporate finance. They didn't even read the citation. The No. 1 citation was work on savings. And if they know anything about the deficit, they know deficits and savings are the same thing. Deficits are negative savings. So that's to begin with.

Then if they had only taken a look at my bibliography, they would have seen that for 35 years I've been working on deficits, and in the last year I've written plenty of papers on deficits.

So I certainly hope that I have the right to speak on that subject, and I certainly hope that someone from the Wall Street Journal who is present, can report that I am not illiterate on the subject. [Laughter.]

Then there is the issue of my theory of finance. I have a very well-known theorem which bears my name—the Modigliani-Miller theorem—which says that the way in which a corporation is financed makes no difference for its valuation, that what matters is its income, its investment, not how it's financed, whether by debt or equity capital. They say that this should hold for the Government. As long as it spends well, it makes no difference how it's financed.

The first question I'd like to ask the Wall Street Journal is: The theorem says it makes no difference to use equity or debt.

Would you tell me what is equity financing of the Government? If they will come through and tell me that, they will do me a great favor.

But, if they mean to equate equity financing with taxes, they are wrong again. For taxes are paid by the current generations, debt by future ones. Thus, with respect to financing of the Government, the fundamental principle is: First, the Government must, of course, always spend well and efficiently. But, when it spends well, it then makes a difference if it spends in favor of the current people or in favor of future people. When it spends for current people, it should tax them and not use debt.

So I think this indicates a complete ignorance of the issues. It's too bad that the editorial of the Wall Street Journal is so much a failure for a first-rate paper. I admire the Wall Street Journal, and I read it regularly. I must say it is really one of the best papers in the world. [Laughter.]

Representative OBEY. Except for one page.

Mr. MODIGLIANI. Yes, except for one page, which is—it's not always bad. There have been circumstances where what they've said makes sense. But it's a very erratic process.

Representative OBEY. Doctor, I thank you very much for your testimony and for coming down here this morning. I think it's apparent that you have a very simple message, and that message is to the Senate and House and the President—if you want to do something about the deficit, the best way to take a cut out of the deficit, is simply to take a cut out of the deficit, and not setup a new Rube Goldberg contraption to expect somebody down the line to do something which might impose rigidities on the Congress.

Thank you very much.

[Whereupon, at 11:05 a.m., the committee adjourned, subject to the call of the Chair.]

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