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DEFICIT REDUCTION PROPOSALS

HEARINGS

BEFORE THE

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MONDAY, DECEMBER 12, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 2 p.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Danforth, Durenberger, Grassley, Matsunaga, Baucus, and Mitchell.

[The press release announcing the hearing and the prepared statements of Senators Dole, Mitchell, and Grassley follow:]

[Press Release No. 83-200]

SENATE FINANCE COMMITTEE SETS HEARINGS ON DEFICIT REDUCTION PACKAGE

Senator Robert J. Dole (R., Kans.), Chairman of the Senate Finance Committee, announced today that the Committee will hold hearings on December 12, 13, and 14, 1983, on the need for prompt enactment of a major deficit reduction package and on the specific contents of such a package.

The hearings will begin at 2:00 p.m. on December 12 in Room SD-215 of the Dirksen Senate Office Building and continue on December 13 and 14 starting at 10:00 a.m. each morning.

In announcing the hearings Senator Dole stated, "The Congressional Budget Office currently projects annual Federal budget deficits of approximately $200 billion or more through 1989. These hearings will attempt to answer three fundamental questions about these massive projected deficits:

"First, what are the economic consequences if the Administration and Congress do nothing to address the deficit problem?

"Second, do we need to act in early 1984 or can we afford to wait to address the deficits until 1985 or thereafter?

"Third, what specific legislation would the witnesses recommend that Congress enact to reduce the deficits?"

Senator Dole cautioned, "In formulating deficit reduction recommendations, I hope witnesses will present specific practical proposals that recognize the political realities that will necessarily shape any deficit reduction package. For example, the President and Speaker O'Neill have both categorically rejected reductions in Social Security Cost of Living Adjustments (COLA). Thus, suggestions that we freeze or reduce Social Security COLAs will not be very helpful to the Committee as it seeks to develop a bipartisan package."

STATEMENT OF SENATOR DOLE

The most important domestic problem facing Congress is how to deal with budget deficits. Ironically there is no issue on which there is a greater bipartisan consensus than the need to reduce deficits; yet Congress was unable to pass even the very modest $28 billion budget reconciliation before we adjourned in November.

There is a real danger of political stalemate in the coming year over the budget issue. Without strong leadership, neither those who favor budget cuts, nor those who believe in the need for tax increases, will budge. Both the President and the Speaker of the House will have to give some ground, because the fact is that only a balanced package of spending reductions and revenue increases has any chance of becoming law.

I voted against the fiscal year 1984 budget resolution last June because it relied almost entirely on tax increases, calling for $73 billion in new taxes but virtually no restraint on domestic spending. But just because the budget resolution was unbalanced, doesn't mean we can ignore the budget problem. The budget resolution was approved by Congress, so it is my responsibility as chairman of the Finance Committee to try to produce an alternative. These hearings, and our efforts to write major deficit-reduction legislation represent an attempt to comply with the reconciliation instructions of the budget resolution.

FINANCE COMMITTEE PACKAGE

The Finance Committee has been working to produce a balanced package that is big enough to make a noticeable dent in the deficits. The chairman and staff have been instructed by the committee to draft legislation that would reduce deficits by $150 billion over fiscal years 1984-1987, and that is evenly split between tax increases and reduced spending. In effect, we are just trying to balance the tax increases contained in the budget resolution with an equal measure of spending restraint.

Further, tax increases in the package will be contingent on the spending cuts being already in place, similar to the conditions laid out for the administration's contingency tax. Reflecting the strong view of the committee that early congressional action is essential, the staff is to report by February 15.

We are holding these hearings now in response to that instruction. I hope that these hearings will help maintain the momentum toward deficit reduction that was established before last month's recess.

I also hope that these hearings will raise the level of debate about budget deficits. In my view, little is accomplished by pointing fingers about responsibility for deficits. It is obviously true that the deficits would be lower if taxes had been reduced less in 1981. But it is also true that the current level of taxation would be more than adequate if Federal spending, with the help of many of today's harshest critics of the deficit, hadn't exploded during the 1970's. And while it cannot be denied that increased defense spending adds to the deficit, given a certain revenue level, current defense outlays as a percentage of the budget and GNP are well below where they were in 1969 when the budget was in balance.

SOLUTION NEEDED

We have not called these hearings to assess blame for our current predicament. The American public doesn't care how we got here; they want the problem solved so that they can feel confident about their economic future—not just in 1984, but for the rest of the decade and beyond.

Another goal of the hearings is to establish how serious the deficit threat is. There has been much confusion about the economic impacts of deficits. The danger is that many Americans see the current vigorous recovery and forget about the real, long-term dangers of deficits.

It is difficult to conceptualize the size of the projected deficits unless it is reduced to a personal level. The public debt now stands at about $6,000 for every man, woman and child in the U.S. If nothing is done to reduce the deficits over the next five years, the debt will grow to over $10,000 per person. At this level, by 1989 it will take about 50 percent of all Americans' personal income tax payments, or $1,100 per person, just to pay the Federal Government's interest bill.

Many Americans will find home-buying more difficult with higher deficits. Consider a family purchasing a home at today's current interest rate, averaging about 12½ percent, with a $55,000 mortgage. If the deficits push interest rates up, total interest costs over the 30-year term will be $15,500 more for each one percentage point increase.

At the national level, it is my belief that enormous deficits, extended indefinitely into the future, could cause real damage to the American economy. As the recovery matures, Treasury borrowing will compete more with private sector needs, crowding out investment, and leading to slower growth in living standards, productivity, and jobs.

The deficit also feeds upon itself, making the next year's budgeting that much harder. Each year of $200 billion deficits adds about $15 billion in interest costs to the following year's spending levels. This amount is nearly the size of the entire medicaid program.

It is my hope that these hearings will add to the weight of opinion favoring swift action on the deficit. But we have witnesses representing a wide variety of opinion—the entire political spectrum. Those who expect a unanimous voice will be disappointed.

STATEMENT OF SENATOR GEORGE J. MITCHELL

Mr. President: It would be ironic, if it were not so serious, that these hearings on the implications of the budget deficit will have the advice of witnesses representing virtually every facet of economic opinion and interest, with the one glaring exception of the Administration itself.

We will hear from the non-partisan Congressional Budget Office, from both its current and former director. We will hear from former members of this and earlier Republican administrations. We will hear from the academic community, the business community and from representatives of the elderly, taxpayers and workers. Yet the one group whose concern about the deficits should be most obvious—the Reagan Administration—will not appear.

It is hard to avoid the conclusion that this non-appearance is a politically motivated decision to subordinate the hard questions of the deficit to the forthcoming election campaign. It appears that a conscious risk is being taken with the economic future of our nation. It seems to reflect a hope that so long as the Administration can avoid appearing concerned about the deficit, its economic effects can somehow be avoided.

But such a hope is both irresponsible and misplaced.

The economy will not go on hold until November 1984 for the convenience of anyone. Businessmen will make decisions about investment and inventory. Consumers will make decisions about home purchases based on prevailing mortgage rates. Investors will make decisions based on their best judgment of future developments. All of them will act throughout the year, well before November, 1984. Their actions will be based at least in part on fiscal policy.

But taking credit for the good news about unemployment, inflation and economic rebound does not constitute a fiscal policy. Stifling differing opinions within the Administration raises the real fear that no voices of reason will be heard. And having the Secretary of Defense publicly demand a $55 billion spending increase next year reaffirms the impression that this Administration is simply not willing to make any choices whatsoever while the election hangs over it.

But the essence of governing and leadership is to make choices. In this instance, a lack of action will be as much a conscious choice as any other. But it is a choice that risks the economic recovery for all Americans, not only those in the Administration. In past years, even when budget deficits elicited howls of rage in political election campaigns, they never approached the relative size they are today. The 1983 deficit approaches 6 percent of GNP. In our postwar history, the highest comparable deficit—of 1976—was 4 percent of GNP. It took the previous Administration four years to rack up deficits of $134 million total—deficits which were then said to threaten our economic survival. In just three years, this Administration has produced deficits totalling $365 billion.

And in the face of these figures, the only response we hear from the Administration is that nothing can be done or needs to be done other than to "cut spending". Yet the Defense Secretary demands an additional $55 billion next year.

The reiterated claim that "cutting spending" can somehow transform this structural deformity in the budget has been disproven by the numbers from private, Congressional and Administration sources. They all demonstrate that there is no way to cut the deficit without taking action on all fronts. All fronts must include revenues, entitlements, discretionary spending and even discretionary defense spending. So the Administration's adamant position that it will accept no tax increases, that it must have its defense buildup at whatever the cost, and that the cuts have to come from discretionary spending is simply political posturing of the most misleading sort.

When the budget deficit steadily climbs to equal the amount of net savings in the economy, we face the prospect of government borrowing needs virtually absorbing most of the net new capital available for business investment. If the Federal Reserve maintains steady growth in the money supply, the credit requirements of an expanding business sector create a virtual certainty of hugely higher interest rates and an end to the recovery. If the Federal Reserve does not maintain a steady monetary course, the inflationary expectations of our investment community will send those rates up in anticipation, even though they are at unprecedently high real levels today.

The opinion of virtually all sectors of economic thought is that a slowdown in the economic recovery is inevitable—disagreement exists only over when it will happen, not if. And in a slowdown, our deficit can be expected to balloon to even more dramatic proportions. But the Administration is apparently willing to gamble that the slowdown and possible recession will not occur until after November 1984.

It may win its gamble. But at what cost?

The corrective actions needed in 1985 will be far more difficult, painful and costly to Americans than the actions we can contemplate today. The economic suffering toward which this gamble is driving us will be very real, whether the gamblers win their political bet or not.

The current reality of good economic news is being used to mask the future reality that it will not be sustained. But the future reality will be just as real, when it comes, as today's pleasant news is. The only difference will be then that instead of credit-taking by one side and another, we will be in for another round of finger-pointing as to whose fault it all was.

Surely the American people deserve better of their elected officials than this.

At the end of the recent session of Congress, the opportunity existed to vote for a deficit reduction package which had the bipartisan backing of the Budget Committee leadership. Unfortunately, it was roundly condemned by the White House, and failed to gain the bipartisan support of a Senate majority. That same unyielding administration opposition helped prevent this Committee developing a package for consideration as well.

I hope that the outcome of this series of hearing will, on the contrary, mark the beginning of a realistic effort by all parties involved—the Administration as well as the Congress—to take a serious approach to the deficit problem and join in developing a solution, instead of risking the nation's economic future on a political gamble yet again.

The CHAIRMAN. Before we call the first witness, if it is all right with you, Mr. Penner, we will just have brief opening statements. I think Senator Danforth has a statement.

Senator DANFORTH. Mr. Chairman, thank you very much. I think that these hearings promise to be very helpful in focusing on the problem of the Federal deficit. So often, we in Washington tend to pay attention to matters of immediate crisis; the difficulties that we are going to be facing over a period of weeks or months. It's my hope that during these hearings we will have the chance to look not only at short-range consequences but particularly at the long-range damage that we are inflicting on the country by these huge, growing deficits in the Federal budget.

Mr. Chairman, in 1981 the national debt for the first time exceeded $1 trillion. On the current trend line, by 1986, it will reach $2 trillion; and by 1990, it will reach $3 trillion. It is not only increasing, it is increasing in geometric proportions. The payment on the national debt, which is called for by these large increases of payment of interest on the national debt, is and will continue to be an increasing burden on our country for generations to come. Every year we will have to pay interest on the increase in the national debt, which is caused by this year's deficit.

The American people have a right to know what we in Washington are doing to correct this very damaging situation. And the answer is really a one word answer: we are doing absolutely nothing.

We tell ourselves that we can't do anything in 1984 because 1984 is an election year. And most people who think about the size of the deficit realize that reducing it by any significant amount requires some steps which are generally thought to be politically unacceptable. Reducing the deficit calls for increases in tax revenue, some moderation of the growth rate of very popular entitlement programs, and some trimming of proposed increases in defense spending.

And so because these are very unpopular, it's thought they cannot be touched in an election year. And we are even told by some that we should ignore the problem of the deficit in 1984. Ignoring the problem of the deficit in 1984 is somewhat like ignoring an elephant which happens to be in your living room. I don't think that it can be done. And as a matter of fact, just returning from my home State of Missouri, I find that the problem of the deficit is the No. 1 item on the minds' of my constituents.

For those who say that 1984 is not the year to deal with the problem, and that we should wait until 1985, I wonder whether 1985 is going to be any easier for us.

Let's assume candidates for the Presidency and candidates for the Congress, are, during the election year asked what they intend to do about the deficit. How many candidates, if they are true to form, true to political form, are going to run on a platform of increasing taxes? How many candidates are going to run on a platform of reducing the increase of entitlement programs?

And my concern, Mr. Chairman, is that in 1985 we might find ourselves with a Congress and with a President who have committed themselves to no increase in taxation or no trimming of the growth rate of entitlement programs. And, therefore, it's going to be very difficult immediately after election for people who have been successful to do an about-face. In other words, 1985 may not be any easier to address this problem. And, of course, 1986 is an election year.

I think that the people of this country understand the nature of the problem. I think that they understand that constant and growing deficits are very serious for America, and will be serious in the long term as well as in the short term. I think the people of America demand action, and that they are willing to accept the kind of leadership which has been forthcoming from you, Mr. Chairman, and from the Finance Committee.

The CHAIRMAN. Thank you.

Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman. I will be very brief.

I learned a lot in those 3 intense weeks where you kept us all together so we wouldn't do other things. And I enjoyed it a lot. I thought it was a great experience. I do not welcome coming back in the middle of the longest adjournment, but I compliment you for bringing us back.

Jack said it was $1 trillion and it is going to $2 trillion. I think what I learned from that experience, Mr. Chairman, that bothers me a great deal is not just the national, Federal governmental debt problem, but the enormity of the burden that we in this country are sending to our children. It is the $6 trillion debt that bothers me a great deal. And it is a fact that the service on that debt has risen in the last 30 years from something slightly over 1 percent of our capacity to generate income to pay for it, to over 11 percent. That is what is bothering me. And it is the fact that it isn't just Government spending that's a problem here. It's all spending.

And the problem is that it's the tax policy that generates all that spending. We are a spending, consumption-oriented society. Our tax policy has been designed to make us a consumption, spending-oriented society. It is designed to give all the benefits to borrowing and utilizing that borrowing in large part for consumption; to create a demand. So when the chairman says this is the committee to do something about the problem, he means a lot more than closing a deficit in the Federal budget of $150 billion. And I will look forward to the testimony here today in that larger sense that there are more important things this committee can contribute to the Senate as a whole, other than just closing the deficit in the national account.

The CHAIRMAN. Thank you, Senator.

We have an associate member today. Would you like to make a brief comment on the purpose of this hearing; not on your own plan?

STATEMENT OF SENATOR RUDY BOSCHWITZ OF THE STATE OF MINNESOTA

Senator BOSCHWITZ. I quite understand it. I thank you, Mr. Chairman. I find myself often here in the Finance Committee. Today you held a hearing that had to do with agriculture, so I was here this morning. And I'm on the Budget Committee, so I'm here again this afternoon. And I compliment you for holding these hearings. I hope that the witnesses will not just confine themselves to the consequences of deficits and the damage that they can create over a period of time. I hope they will give us an outline of how we can do something about the deficit, and I hope that outline incorporates some political realities. I hope their suggestions are not just generalities but specifics, having in mind the political difficulties that we have.

Actually, I think, on the Budget Committee we are making a little progress. Four years ago the budget was growing at an 18-percent rate compounded. And now it's growing at 9 percent per year. This is the first time in about 10 or 11 years that we've gotten under the double digits of growth.

On the other hand, the entitlement programs are still growing very rapidly, and have grown 850 percent in the last 16 years. The defense budget has grown about 260 percent during that period, but is growing more rapidly now. I hope all aspects of the budget and also aspects of revenue will be addressed by the witnesses; I hope they do more than just tell us how bad things are.

The CHAIRMAN. Thank you.

Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Mr. Chairman, I'm glad you are calling these hearings. I think we all are. I'm not going to review in great detail the degree to which debts are piling up, and the degree to which, if we don't get to work quickly, we are going to face that big cloud on the horizon much earlier than we expect.

But let me try to help illustrate the degree to which the debts are piling up. We are incurring the deficit, Mr. Chairman, at the rate of $22 million an hour. That means by the time these hearings conclude on Wednesday we will have incurred an additional $1 billion of national debt, $22 million an hour until Congress and the President figure out some way to reduce that rate.

I hope, Mr. Chairman, that as a result of these hearings, the American public will begin to understand even more graphically and dramatically than they already do, the problems the deficit creates. Unfortunately, during this Christmas season it's difficult to focus on the importance of getting deficits under control. But the more we can think about it, the more we can focus on it, the more there will be pressure on both ends of Pennsylvania Avenue—on the White House and on the Congress—to get the job done.

There is, too often, the feeling around here that we can wait until 1985. But I'm reminded of a Japanese poem. And that poems says that I have always known one day I would travel down this road, only I didn't know it would be so soon.

Mr. Chairman, I hope that, through these hearings, we can educate others about the problem and begin to develop the kind of consensus that will enable us to begin to solve before 1985.

The CHAIRMAN. Thank you, Senator Baucus.

I will just take about 2 minutes, Rudy, and then it is all yours or partly yours.

I just want to sort of set the stage for these hearings. There has been a lot of speculation as to why we are here, and whether we are here for any valid purpose or whether it's something else. I think it's well to point out, as has been mentioned by other Members of the Senate who are here today, that the deficit must be the most important domestic issue we are facing. And even though there is a lot of agreement among Democrats and Republicans, we still haven't been able to put it all together. I think there is still a great possibility to do that. But despite all the agreement in principle, we couldn't even do a $28 billion budget reconciliation bill before we adjourned. That's largely because of procedural matters on the House side, but I think we will be able to address that.

I think also it's fair to say that we need strong leadership. We need it from the President; we need it from the Speaker of the House; and we need it from this committee. I don't suggest that that's not possible in every case.

Many of us on this committee—in fact, there are 20 members—11 voted against the budget resolution because it called for $73 billion taxes, and only $12 billion in spending reduction over a 3-year period. But not withstanding that, we have an obligation on this committee after Congress takes action to try to put together some alternatives. And we are working on those alternatives.

That alternative, I think, was stimulated by the efforts of Senator Danforth, Senator Wallop, and Senator Boren who suggested a plan that we looked into, and I think led to the adoption of a resolution the in agency of the problem, leading to the next step in this process, and that's trying to put together this package. Senator Baucus and others—in fact, I think Senator Baucus almost insists—we vote on something when the members come back in February. In fact, the full committee by a vote of 15 to 1 has instructed us by February 15, 1984 to bring back to the committee some package of balanced spending and revenue changes. So just to make the record clear, we are under some obligation. We are not trying to point the finger of blame. There's enough of it for everyone. Those who say we ought to raise taxes only, you know, they have their constituency. Those that say cut spending have their constituency. In my view, it will take a more balanced approach to do the job.

So we are acting in response to the instruction. I also believe, as Senator Danforth pointed out, that it's our hope that these hearings will raise the level of debate about budget deficits. We have some outstanding witnesses. And we believe there is a lot of interest. I visited my State recently. Cattle loans are still 14 percent. Mortgage interest loans are still 13½ percent. And as Senator Baucus indicated, there are some who believe that it may start to deteriorate earlier than others believe.

There are all kinds of figures, but in addition to the one that Senator Baucus pointed out, it's difficult to conceptualize the size of the projected deficits unless it is reduced to a personal level. The public debt now stands at about $6,000 for every man, woman, and child in the United States. If nothing is done to reduce the deficits over the next 5 years, that debt is going to go to about $10,000 per person. And at this level, by 1989, will take about 50 percent of all Americans' personal income tax payment or $1,100 per person just to pay the Federal Government's interest bill. I think it's obvious that we must do something.

Many Americans will find home buying more difficult with higher deficits. Consider a family purchasing a home at today's current interest rate, averaging about 12½ percent with a $55,000 mortgage. If the deficits push interest rates up, total interest costs over the 30-year term will be $15,000 more per each 1 percentage point increase. So it's a matter that ought to affect consumers, and it's my hope that we can have some discussion. I know there will be some good questions.

It is now my pleasure to welcome for the first time since you have assumed your new responsibilities as Congressional Budget Office Director, Dr. Rudolph Penner to the Finance Committee. You may proceed in any way you wish, Rudy. Either summarize your statement or read it in its entirety, but it will be made a part of the record.

STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, D.C.

Dr. PENNER. Thank you, Mr. Chairman. I will just summarize it for now.

I am pleased to have the opportunity to testify on the economic and budgetary outlook. As you know, economic conditions have improved greatly since the end of last year. The economic recovery is proceeding at a rapid pace, about in line with past recoveries. Unemployment has already declined substantially though it remains high. Inflation was greatly reduced during the recession, and while it has not declined further in recent months, the recovery has not generated any significant acceleration in the rate of price increases. The near-term economic outlook also looks favorable. Although economic growth is not likely to proceed at the brisk pace of the last two quarters, most forecasters expect it to be substantial.

The horizon is clouded, however, by large Federal deficits, which have not yet been dealt with decisively. The first budget resolution for fiscal year 1984 took an important step toward reducing future deficits, but the resolution has not yet been fully implemented. Consequently, many fear the deficits will not decline significantly as the recovery proceeds.

Nevertheless, the short-run forecast that we published in August looks pretty accurate with real economic growth and prices close to their projected paths. The one inaccuracy is a happy one. Unemployment has fallen much more quickly than expected, and has already reached 8.4 percent, a level that we earlier did not expect to reach until well into 1984.

To the extent that the very large deficits have caused crowding out, it seems to have focused on the trade sector, and to some extent on housing, which is absorbing less of the GNP than would normally be expected at this stage of the business cycle. Otherwise, the recovery is proceeding normally, aided in no small part by borrowing from abroad with funds attracted by our abnormally high real interest rates.

As usual, a number of uncertainties cloud the short-run outlook. Four risks in particular are noteworthy. The interest rates in the CBO forecast were based on the assumption that the deficit reduction program of the budget resolution would be implemented. However, whether that will actually occur is an open question today, and, thus, higher rates are a real possibility.

Prices could be more sensitive to economic growth than assumed in the CBO forecast. Also, the prospect of large Federal deficits could have more serious effects on inflationary expectations. In addition, the forecast assumes no inflationary shocks such as another bad harvest, a serious interruption in oil supplies, or a very rapid depreciation of the dollar in foreign exchange markets.

The debt problems of a number of developing countries seem to have eased at least temporarily, but remain serious. Even a small increase in interest rates or a further delay in the recovery of the industrial countries could tip the balance with serious consequences for U.S. exports. A loss of confidence in the dollar because of dismay over U.S. fiscal policy or other factors could significantly raise interest rates and inflation.

The longer run economic projections shown in table 3 in my prepared statement were originally prepared for the House Budget Committee staff to show what might happen if productivity rebounded to its historical growth rate. The figures for 1985 through 1989 are thus not a forecast. Rather, they are noncyclical projections that assume the economy moves gradually toward higher employment levels without price shocks.

The growth implied in this projection may be optimistic. Economic growth has become slower in advanced economies generally, and some economists believe that the conditions that gave rise to the rapid growth in the fifties and sixties are no longer present. The heavy debt burdens of some developing countries endanger the short-run forecast, but they are a long-run problem as well. In addition, current U.S. monetary and fiscal policies are unusual and may not be consistent with the projected growth path.

Finally, if recovery should threaten to spark renewed inflation, the Federal Reserve might take anti-inflationary steps that could temporarily slow economic growth. Perhaps the greatest uncertainty is in the interest rate projection. It was made on the assumption that the Congress would take deficit reducing measures in the last session. A serious prospect of permanently large deficits would intensify pressures on U.S. capital markets, and risk a loss of confidence in the dollar, which could raise interest rates and inflation rates above those in the projections.

Using the CBO August short-run economic forecast, and the longer run economic assumptions in table 3, we recently prepared some preliminary baseline budget projections for fiscal years 1985–89. With real defense growth assumed to continue at 5 percent per annum, table 5 in my complete testimony shows the assumed budget picture through 1989. Under our preliminary baseline assumptions, both revenues and outlays keep pace with projected GNP growth. Revenues as a share of GNP remain slightly under 19 percent, and outlays hover around 24 percent. As a result, the budget deficit remains at about 5 percent of GNP through 1989.

The composition of spending, however, is likely to change substantially over the next 5 years. As shown in table 6, defense, medicaid and medicare, and net interest all grow faster than GNP while other items grow at a slower rate.

The risk associated with these baseline deficits are hard to assess accurately because the ratio of the deficit to GNP will be far higher for a sustained period than anything experienced since World War II. When policy variables move outside the range of historical experience, analysts can no longer assume with confidence that empirical relationships estimated on the basis of past data will remain relevant to analyses of the current situation.

Clearly, however, unless current taxing and spending policies are changed, the budget deficit will grow and add to interest rate pressure. The CBO projections assume that interest rates will decline gradually, in part as I already noted, because we assumed the implementation of the budget resolution. High interest rates could have serious adverse effects. For example, as the recovery continues, business capital formation may experience more crowding out than has occurred thus far in the cycle. The potential for economic growth will then be reduced, and standards of living will be lower in the long run.

Conversely, growing capital inflows from abroad may offset to some extent the reduction in U.S. capital formation. But this implies an increasing commitment to pay interest and dividends to foreigners which likewise will reduce future U.S. living standards. As noted earlier, heavy reliance on foreign capital also leaves the United States vulnerable to changes in the psychology of foreign investors.

While controversy will undoubtedly continue regarding the magnitude of the risks described above, one effect of large deficits is almost inevitable. The net interest bill on the national debt will grow and grow. Table 6 shows the net interest bill under baseline assumptions. Even with declining interest rates, the net interest bill grows by $73 billion between fiscal years 1984 and 1989 or by 70 percent. If instead we assume that interest rates remain constant at the levels of October 1983, the net interest bill would rise about $131 billion between 1984 and 1989, or by $58 billion more than the baseline projections.

A further 1 percentage point rise in interest rates would raise the 1989 net interest bill by still another $31 billion. These numbers show, Mr. Chairman, that the debt has just gotten so large out there that even small changes in your interest bill can significantly alter the outlook.

In other words, the large, current deficits limit your future spending options. More important, large, current deficits have a way of generating increased future deficits. Even with the interest rates assumed in this analysis, the net interest bill grows faster than the GNP in our projection. The tax increases or other spending cuts necessary to offset this rise become more and more arduous as time passes. Eventually, financing the U.S. debt could become so burdensome that some would urge that the Federal Reserve absorb a portion of the deficits in order to avoid the necessary budgetary actions to reduce the debt burden.

But if the Federal Reserve succumbed to such pressures, and Chairman Volcker has strongly stated that it will not, the money stock would grow rapidly and sharply higher inflation would follow.

While large deficits may create major risks, abrupt or poorly designed measures to reduce deficits can also be a threat to economic efficiency and to the health of the economic recovery. Ideally, major spending cuts and tax changes should occur gradually or with long advance notice so that individuals and firms dependent on current tax and spending policies have time to adjust. Moreover, those affected must have some confidence that the changes will not be reversed at the last minute or soon after they have been implemented.

The first budget resolution attempted to invoke such a gradual strategy by putting off major tax increases until 1986. Any analysis of the potential for reducing deficits in a major way by cutting spending must start with the fact that a large portion of Federal outlays is devoted to only a few budget categories, as is shown in table 6. Defense, entitlements, and net interest constituted 86 percent of outlays in 1983, and that proportion is expected to grow to 88 percent by 1989.

In turn, social security and medicare and medicaid constituted 63 percent of entitlements in 1983, growing to 73 percent by 1989. Note that by 1989 defense, social security, medicare, and medicaid, and the net interest will absorb almost 100 percent of the revenues that we project for that year.

The possibility of cutting other programs should not be ignored, but since they have already been declining relative to GNP, it seems reasonable to believe that major changes in defense, social security or medicare will be required if the course of total spending is to be altered significantly.

If changes in spending laws are deemed desirable, they should be undertaken soon. Cuts in defense procurement, for example, show up in reduced outlays only after a long time lag. Cuts in social security and medicare ought to be phased in gradually so that beneficiaries and providers of health care services have time to adjust.

My complete testimony goes into a number of possible spending options in some detail. I won't do that here. But the basic message, I repeat, is that if spending is to reduced significantly in the future, like Willie Sutton, you have to go where the money is. And that is defense, social security, and medicare.

Other areas should not be ignored, but cuts there could not be expected to contribute in a major way to deficit reduction.

CBO has started its annual review of possible strategies and options for reducing spending, and will present the results to the Congress within a few months. We are also taking a close look at the major recommendations of the President's private sector survey on cost control, known as the Grace Commission, and will publish a separate analysis of these with the assistance of the General Accounting Office.

On the revenue side, there are basically three broad classes of options. One can raise tax rates; one can broaden the base of the existing tax system; or introduce new taxes.

Again, my testimony looks at some of these things specifically. I would be glad to discuss them in more detail, if you like.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Penner follows:]

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to have the opportunity to testify on the economic and budgetary outlook. As you know, economic conditions have improved greatly since the end of last year. The economic recovery is proceeding at a rapid pace, about in line with past recoveries. Unemployment has already declined substantially, though it remains high. Inflation was greatly reduced during the recession and, while it has not declined further in recent months, the recovery has not generated any significant acceleration in the rate of price increases. The near-term economic outlook also looks favorable. Although economic growth is not likely to proceed at the brisk pace of the last two quarters, most forecasters expect it to be substantial.

The horizon is clouded, however, by large federal deficits, which have not yet been dealt with decisively. The first budget resolution for fiscal year 1984 took an important step toward reducing future deficits, but the resolution has not yet been fully implemented. Consequently, many fear that deficits will not decline significantly as the recovery proceeds.

In a report issued last August entitled The Economic and Budget Outlook: An Update, the Congressional Budget Office (CBO) provided the Congress with revised economic and budget estimates based upon the policies of the first resolution. My testimony today will summarize and update that report and comment on the risk that may arise if the Congress and the Administration fail to implement the policies of the resolution.

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Recent Economic Developments

While the combined effects of the 1980 and 1981-1982 recessions led to the highest unemployment rate in the post-World War II period, the recovery has since been vigorous. Real gross national product (GNP) increased at an average annual rate of 8.7 percent in the last half year, and industrial production increased at a 20 percent annual rate (see Table 1). As a result, the civilian unemployment rate, which was 10.8 percent last December, had declined sharply to 8.4 percent by November. In terms of aggregate growth, the recovery now appears to be proceeding at a rate near the average of other postwar recoveries (see Figure 1 at the end of this statement). At the same time, inflation rates remain very moderate relative to the high rates of the past several years. In the last half year, the GNP fixed-weight deflator, a broad measure of price behavior, has increased at about a 4 percent rate, only slightly higher than the low point in inflation last winter. While inflation certainly has not been cured, the improvement since 1980 and 1981 has been dramatic. Productivity growth, while not quite as high as typical for a recovery period, has also been encouraging after a decade of very poor productivity performance.

In one respect, however, this business cycle is not typical. As shown in Figure 3, interest rates remained at remarkably high levels in the recession and continue so in the recovery. Interest rates also appear to have remained high in real terms (that is, adjusted for inflation). Most analysts believe that the very large increase in the actual and projected deficits has

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

	1981	1982	1982 Q3	1982 Q4	1983 Q1	1983 Q2	1983 Q3
Real GNP	2.6	-1.9	-1.0	-1.3	2.6	9.7	7.7
Final sales	1.8	-0.7	-1.5	4.5	0.6	6.8	5.1
Consumption	2.7	1.4	0.9	3.6	2.9	10.0	3.0
Business fixed investment	5.2	-4.7	-8.8	-6.6	-1.5	7.9	16.3
Residential investment	-5.2	-15.4	-13.0	53.2	57.3	79.5	30.1
Government purchases	0.8	1.8	9.4	10.6	-8.8	-1.1	5.3
Inventory Change (billions of 1972 dollars)	8.5	-9.4	-1.3	-22.7	-15.4	-5.4	3.9
Net Exports (billions of 1972 dollars)	43.0	28.9	24.0	23.0	20.5	12.3	10.4
Industrial Production	2.6	-8.2	-3.4	-8.4	9.9	18.4	21.5
Payroll Employment (millions)	91.2	89.6	89.3	88.8	88.8	89.5	90.2
Civilian Unemployment Rate (percent)	7.6	9.7	10.0	10.7	10.3	10.1	9.4
Inflation Rate							
CPI-U	10.3	6.2	7.7	1.9	-0.4	4.3	4.7
GNP deflator (fixed weight)	9.5	6.4	5.9	4.7	3.4	4.3	4.4
Productivity a/	1.9	-0.1	2.3	1.3	3.7	6.6	3.1
Interest Rates (percent)							
Treasury bill rate	14.0	10.6	9.3	7.9	8.1	8.4	9.1
Corporate AAA bond rate	14.2	13.8	13.8	11.9	11.8	11.6	12.3

a/ Output per worker hour, nonfarm business sector.

contributed to the high rates. The federal deficit was about 108 percent of net private saving during fiscal year 1983, a record for the postwar period. Of course, deficits increase automatically in recessions and this is thought to retard the fall in economic activity. But in 1983 there was a sharp rise in the structural deficit—that is, the deficit that would be experienced at high levels of employment. (Putting this in technical terms, the standardized employment deficit rose from 0.9 percent to 2.8 percent of potential GNP.) It is this increase in the structural deficit that is worrisome.

Attempting an explanation of the evolution of economic activity this early in the recovery is somewhat risky. Certain patterns are emerging, however, and they may give us some insights into the "crowding-out" effects of high interest rates resulting from unusually high deficits.

Thus far, business fixed capital formation is following a normal cyclical pattern and does not seem to be adversely affected by the high level of interest rates (see Figure 4). This might suggest that the negative impact of high real interest rates on investment is being offset by the net favorable effects of the tax acts of 1981 and 1982—the Economic Recovery Tax Act (ERTA) and the Tax Equity and Fiscal Responsibility Act (TEFRA). Housing has also recovered at a normal rate, even though owner-occupied housing received little in additional tax benefits. However, the housing industry started at such a low trough that residential investment still constitutes an unusually low share of GNP for this stage of the business cycle (see Figure 5). In addition, there are growing signs that housing activity may have reached a plateau.

Net exports have declined dramatically (see Figure 6). This implies that a significant portion of the budget deficit is being financed, directly and indirectly, by foreign capital inflows. High real interest rates here and political and economic uncertainties abroad are making the United States a relatively attractive place to invest. Foreigners must acquire dollars to purchase U.S. securities, and in doing so they bid up the exchange value of the dollar. This makes it harder for our export industries to compete abroad and for our domestic industries to compete with imports. In other words, our trading industries are bearing a significant portion of the crowding-out effect of federal deficits.

The CBO Short-Run Forecast

The CBO August forecast, made under the assumption that the first budget resolution would be implemented, shows real GNP growing at a rate of 5.8 percent in the current calendar year (fourth quarter to fourth quarter) and 4.3 percent in 1984 (see Table 2). The civilian unemployment rate is projected to average 9.7 percent in 1983 and 8.4 percent during 1984. Prices, as measured by the GNP deflator, are projected to rise by 4.6 percent this year and by 5.0 percent in 1984. The small increase in inflation next year results from increases in Social Security taxes and an assumed decline in the value of the dollar in international exchange markets, as well as some tightening of labor markets and restoration of profit margins. Treasury bill rates are projected to average about 8.8 percent in 1983 and close to that in 1984.

TABLE 2. THE CBO SHORT-RUN FORECAST

	Actual 1982	Projections 1983	1984
Fourth Quarter to Fourth Quarter (percent change)			
Nominal GNP	2.6	10.6	9.5
Real GNP	-1.7	5.8	4.3
GNP Implicit Price Deflator	4.4	4.6	5.0
Calendar Year Average (percent)			
Civilian Unemployment Rate	9.7	9.7	8.4
Three-Month Treasury Bill Rate	10.6	8.8	8.6

The economic information that has become available since this forecast was prepared in early August is consistent with the short-term story told in the forecast. The unemployment rate has declined considerably faster in recent months than expected and we have already attained the average rate expected earlier for 1984, but prices and real GNP, seem likely to be very close to the forecast for 1983. Both consumption and federal spending in the third quarter came in a little lower than CBO had expected, but inventory investment and investment in producers' durable equipment were a little stronger than anticipated. Some interest rates have fallen a little faster than forecast. But the main lines of the economic situation are much as expected in early August.

As usual, a number of uncertainties cloud the short-run outlook. Four risks in particular are noteworthy:

- The interest rates in the CBO forecast were based on the assumption that the deficit-reduction program of the budget resolution would be implemented. However, whether that will actually occur is an open question today and thus higher rates are a real possibility.

- Prices could be more sensitive to economic growth than assumed in the CBO forecast. Also, the prospect of large federal deficits could have more serious effects on inflationary expectations. In addition, the forecast assumes no inflationary shocks, such as another bad harvest, a serious interruption in oil supplies, or a very rapid depreciation of the dollar in foreign exchange markets.

- The debt problems of a number of developing countries seem to have eased at least temporarily, but remain serious. Even a small increase in interest rates, or a further delay in the recovery of the industrial countries, could tip the balance—with serious consequences for U.S. exports.

- A loss of confidence in the dollar because of dismay over U.S. fiscal policy or other factors could significantly raise interest rates and inflation.

Longer-Run Economic Projections

The longer-run economic projections shown in Table 3 were originally prepared for the House Budget Committee staff to show what might happen if productivity rebounded to its historical growth rate. The figures for 1985-1989 are thus not a forecast; rather, they are noncyclical projections that assume the economy moves gradually toward higher employment levels without price shocks. Economic recovery continues at a moderate and gradually slowing pace in the projections. Productivity growth moves close to historical norms, with a trend growth rate approaching 2 percent annually by the end of the period—a rate viewed as optimistic by some economists.

TABLE 3. LONGER-RUN ECONOMIC PROJECTIONS

Economic Variable	1983	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)	3,313	3,644	3,972	4,307	4,651	5,028	5,425
Real GNP (percent change, year over year)	3.1	5.0	4.0	3.5	3.4	3.4	3.3
GNP Implicit Price Deflator (percent change, year over year)	4.5	4.8	4.8	4.8	4.4	4.6	4.4
Consumer Price Index, CPI-U (percent change, year over year)	3.2	4.7	4.7	4.7	4.5	4.6	4.4
Civilian Unemployment Rate (percent, annual average)	9.7	8.4	7.9	7.5	7.1	6.9	6.6
3-Month Treasury Bill Rate (percent, annual average)	8.8	8.6	7.7	7.4	6.9	6.9	6.7

The unemployment rate declines gradually, to near 6½ percent for 1989. Inflation declines very slowly after 1986, to about a 4½ percent rate by the end of the period. The three-month Treasury bill rate declines to about 6½ percent by the end of the period.

How would this economic growth performance compare with historical experience? One perspective on this question is provided by data on the average annual rate of growth for seven-year periods following the trough quarters of postwar recessions (see Table 4). The projected growth would be about average. (The average for the six postwar recoveries is 4.0 percent, and for the projection is 3.9 percent.) There is a substantial variation in the averages for different periods, however, ranging from near 5 percent in some to near 3 percent in others.

TABLE 4. AVERAGE REAL GNP GROWTH DURING POSTWAR CYCLICAL RECOVERIES (In percents)

Trough Quarter of Recession	Average Growth During Seven Years Following Trough
1949:4	4.7
1954:2	3.1
1958:2	4.6
1961:1	5.0
1970:4	3.6
1979:1	3.1
Average recovery	4.0

The growth implied in this projection may be optimistic. Economic growth has become slower in advanced economies generally, and some economists believe that the conditions that gave rise to the rapid growth in the 1950s and 1960s are no longer present. The heavy debt burdens of some developing countries endanger the short-run forecast, but they are a long-run problem as well. In addition, current U.S. monetary and fiscal policies are unusual and may not be consistent with the projected growth path. Finally, if recovery should threaten to spark renewed inflation, the Federal Reserve might take anti-inflationary steps that could temporarily slow economic growth.

Perhaps the greatest uncertainty is in the interest-rate projection. It was made on the assumption that the Congress would take deficit-reducing measures in the last session. A serious prospect of permanently large deficits would intensify pressures on U.S. capital markets and risk a loss of confidence in the dollar, which could raise interest rates and inflation rates above those in the projections.

Preliminary Baseline Budget Projections

Using the CBO August short-run economic forecast and the longer-run economic assumptions in Table 3, we recently prepared some preliminary baseline budget projections for fiscal years 1985-1989. These projections show that, under current taxing and spending policies, the federal budget deficit will remain around 5 percent of gross national product, or higher, for the foreseeable future.

Table 5 depicts the budget outlook under current taxing and spending policies through fiscal year 1989. Although these preliminary baseline projections do not reflect all of the Congressional actions taken in the last session, subsequent developments have not changed the situation substantially. On the one hand, cuts in Medicare and delays in cost-of-living adjustments for federal retirees were not enacted in a reconciliation bill, but on the other hand, appropriations for both defense and nondefense discretionary spending were less than assumed in the first budget resolution. Also, the slowdown in spending that occurred in 1983 is expected to continue to hold down outlays in 1984. As of today, we estimate that 1984 outlays will total about $850 billion and that the unified budget deficit will be about $185 billion with an additional $15 billion of off-budget financing.

Our baseline projections for 1985-1989 assume no changes in current laws governing taxes and entitlements and other mandatory spending. The outlay projections for national defense assume 5 percent real growth in annual appropriations, as contained in the first budget resolution, and zero real growth for nondefense discretionary appropriations.

Under our preliminary baseline assumptions, both revenues and outlays keep pace with projected GNP growth. Revenues as a share of GNP remain slightly under 19 percent, and outlays hover around 24 percent. As a result, the budget deficit remains at about 5 percent of GNP through 1989.

TABLE 5. PRELIMINARY BASELINE BUDGET PROJECTIONS (By fiscal year)

	1983 Actual	1984 Est.	CBO Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
Revenues	601	665	733	796	857	928	998
Outlays	796	850	925	993	1,084	1,177	1,278
Deficit	195	185	192	197	227	249	280
			As a Percent of GNP				
Revenues	18.6	18.7	18.8	18.9	18.8	18.8	18.7
Outlays	24.6	23.9	23.8	23.5	23.8	23.9	24.0
Deficit	6.0	5.2	4.9	4.7	5.0	5.1	5.3
Reference:GNP ($billions)	3,230	3,562	3,890	4,222	4,563	4,930	5,325

The composition of spending, however, is likely to change substantially over the next five years. In our preliminary projections, domestic spending (entitlements and nondefense discretionary spending combined) declines from 15.2 percent of GNP in 1984 to 13.9 percent by 1989. Certain programs, notably Medicare and Medicaid, are an exception to this generalization. Spending for national defense, however, grows from 6.6 percent of GNP to 7.4 percent, and net interest outlays increase from 2.9 percent of GNP to 3.3 percent. These spending trends are displayed in Table 6.

TABLE 6. COMPOSITION OF BUDGET OUTLAYS (By fiscal year)

	1983 Actual	1984 Est.	CBO Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
National Defense	211	235	265	295	328	360	396
Entitlements and Other Mandatory Spending							
Social Security	169	177	189	202	215	230	246
Medicare and Medicaid	76	86	98	108	123	140	158
Other	142	124	126	131	135	140	148
Nondefense Discretionary Spending	143	154	164	169	179	186	194
Net Interest	88	105	116	128	144	160	178
Offsetting Receipts	-33	-31	34	-40	-39	-40	-42
Total	796	850	925	993	1,084	1,177	1,278
			As a Percent of GNP				
National Defense	6.5	6.6	6.8	7.0	7.2	7.3	7.4
Entitlements and Other Mandatory Spending							
Social Security	5.2	5.0	4.9	4.8	4.7	4.7	4.6
Medicare and Medicaid	2.3	2.4	2.5	2.6	2.7	2.8	3.0
Other	4.4	3.5	3.2	3.1	3.0	2.8	2.8
Nondefense Discretionary Spending	4.4	4.3	4.2	4.0	3.9	3.8	3.6
Net Interest	2.7	2.9	3.0	3.0	3.2	3.2	3.3
Offsetting Receipts	-1.0	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8
Total	24.6	23.9	23.8	23.5	23.8	23.9	24.0

Consequences of High Deficits

The risks associated with these baseline deficits are hard to assess because the ratio of the deficit to GNP will be far higher for a sustained period than anything experienced since World War II. When policy variables move outside the range of historical experience, analysts can no longer assume with confidence that empirical relationships estimated on the basis of past data will remain relevant to analyses of the current situation.

Clearly, however, unless current taxing and spending policies are changed, the budget deficit will grow and add to interest-rate pressures. The CBO projections assume that interest rates will decline gradually, in part because we assumed implementation of the budget resolution. But so far, full implementation has not occurred, and without further deficit reductions a somewhat higher interest-rate path may be likely.

High interest rates could have serious adverse effects. For example, as the recovery continues, business capital formation may experience more crowding out than has occurred thus far in the cycle. The potential for economic growth will then be reduced, and standards of living will be lowered in the long run. Conversely, growing capital inflows from abroad may offset to some extent the reduction in U.S. capital formation, but this implies an increasing commitment to pay interest and dividends to foreigners, which likewise will reduce future U.S. living standards.

Heavy reliance on foreign capital also leaves the United States vulnerable to changes in the psychology of foreign investors. If, for one reason or another, confidence in the U.S. economy fell and foreign capital inflows were reduced, real interest rates would rise, all else equal, so that the crowding out of U.S. capital formation would be intensified. In addition, higher real interest rates would aggravate the already fragile debt situation in the developing countries.

While controversy will undoubtedly continue regarding the magnitude of the risks described above, one effect of large deficits is almost inevitable: the net interest bill on the national debt will grow and grow. Table 6 shows the net interest bill under baseline assumptions. Even with declining interest rates, the net interest bill grows by $73 billion between fiscal years 1984 and 1989, or by 70 percent. If instead we assumed that interest rates remain constant at the levels of October 1983, the net interest bill would rise by $131 billion between 1984 and 1989 or $58 billion more than the baseline projections. A further one-percentage-point rise in interest rates would raise the 1989 net interest bill by still another $31 billion. Thus, large current deficits limit future spending options.

More important, large current deficits have a way of generating increased future deficits. Even with the interest rates assumed in this analysis, the net interest bill grows faster than the GNP in our projections. The tax increases or other spending cuts necessary to offset this rise become more and more arduous as time passes. Eventually, financing the U.S. debt could become so burdensome that some would urge that the Federal Reserve absorb a portion of the deficits in order to avoid the necessary budgetary actions to reduce the debt burden. But if the Federal Reserve succumbed to such pressures—and Chairman Volcker has strongly stated that it will not—the money stock would grow rapidly and sharply higher inflation would follow.

Major Options for Reducing the Deficit

While large deficits may create major risks, abrupt or poorly designed measures to reduce deficits can also be a threat to economic efficiency and to the health of the economic recovery. Ideally, major spending cuts and tax changes should occur gradually or with long advance notice so that individuals and firms dependent on current tax and spending policies have time to adjust. Moreover, those affected must have some confidence that the changes will not be reversed at the last minute or soon after they have been implemented. The first budget resolution attempted to invoke such a "gradualist" strategy by putting off major tax increases until 1986.

Any analysis of the potential for reducing deficits in a major way by cutting spending must start with the fact that a large portion of federal outlays is devoted to only a few budget categories, as is shown in Table 6. Defense, entitlements, and net interest constituted 86 percent of outlays in 1983, and that proportion is projected to grow to 88 percent by 1989. In turn, Social Security and Medicare and Medicaid constituted 63 percent of entitlements in 1983, growing to 73 percent by 1989. Note that by 1989, defense, Social Security, Medicare and Medicaid, and net interest will absorb almost 100 percent of revenues under current laws. The possibility of cutting other programs should not be ignored, but since they have already been declining relative to GNP, it seems reasonable to believe that major changes in defense, Social Security, or Medicare will be required if the course of total spending is to be altered significantly.

If changes in spending laws are deemed desirable, they should be undertaken soon. Cuts in defense procurement show up in reduced outlays only after a long time lag. Cuts in Social Security and Medicare ought to be phased in gradually so that beneficiaries and providers of health care services have time to adjust.

If the Congress wishes to restrain the growth in spending for Social Security, it could restrict the automatic cost-of-living adjustments (COLAs) for current and future recipients, limit eligibility for certain types of benefits, or reduce benefits for some recipients. For example, delaying Social Security COLAs for three months would save about $2.1 billion in 1985, and reducing them by one percentage point would save about $1.3 billion in 1985 and an additional $3.2 billion in 1986. Eliminating certain benefits—such as those paid to the children of early retirees—or reducing the maximum benefits paid to survivors and to families of retired workers to the maximum now allowed for disabled-worker families are examples of the

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other two approaches. They would, however, save only relatively small amounts compared to modifying the COLAs.

Spending for Medicare and Medicaid has been growing rapidly, largely because of rising hospital costs. Three broad strategies are available within the Medicare program to reduce the federal deficit. First, significant spending reductions could be achieved by enacting further limits on payments to providers of medical care services. Options of this type include restraining growth in payments to physicians by freezing current reimbursement rates or establishing a fee schedule. Savings from this approach might range up to $900 million in 1985. Over the longer run, substantial savings also could be achieved by reducing the growth in recently established prospective hospital payment rates. Second, several approaches could be used to require beneficiaries to assume a greater share of their health care costs. These include raising premiums and increasing deductibles—both of which were recently recommended by the Advisory Council on Social Security—as well as increasing coinsurance. Federal savings would depend on the extent to which costs were shifted to beneficiaries. A third deficit-reduction strategy would be to raise the Hospital Insurance (HI) payroll tax, which finances almost 70 percent of total Medicare costs. Increasing the payroll tax rate in January 1985 by 0.25 percent for both employers and employees would raise trust fund revenues by about $6.5 billion in fiscal year 1985, for example.

The national defense projections shown in Table 6 are derived from the first budget resolution for 1984. The resolution provided for 5 percent real growth in budget authority for 1984-1986 and our projections assume the same rate of growth for 1987-1989. Past Administration budgets have asked for more; last year's budget, for example, asked for real growth averaging 8.7 percent a year for 1984-1986. Thus, the Congress will probably have to cut from the Administration's defense budget substantially just to keep defense spending to the resolution level. A further slowdown would be needed if defense is to contribute to reductions in the baseline deficits discussed earlier.

The nondefense discretionary programs will continue to be a focus of attention as a source of savings, but the likely reductions in this area will not suffice in themselves to balance the budget.

CBO has started its annual review of possible strategies and options for reducing spending and will present the results to the Congress within a few months. We are also taking a close look at the major recommendations of the President's Private Sector Survey on Cost Control, known as the Grace Commission, and will publish a separate analysis of these with the assistance of the General Accounting Office.

On the revenue side, there are basically three options: to raise tax rates, to broaden the base of existing taxes, or to introduce new taxes. The first option would be to raise rates under the existing corporate and personal income tax system—for example, by means of a surtax raising rates across the board, or by modifying the indexing of the personal tax rate structure. These options are simple and could raise substantial revenue, but they would mean an increase in marginal tax rates on the current tax base, which would magnify existing inequities and inefficiencies in the tax system.

Broadening the base of existing taxes would hold marginal tax rates down and so might reduce some of the inefficiencies inherent in the tax system, while at the same time making taxes more equitable and simple in the eyes of the taxpayers. But the transition to a broader-based tax system could be disruptive for particular groups or sectors of the economy that have made plans based upon present tax laws. Moreover, in order to raise sufficient revenues through this device alone, the special treatment that the Congress has given in the past to activities it deemed to have special social significance—such as health care and homeownership—would have to be reconsidered.

Finally, introducing new taxes could raise substantial revenue. One approach would be a proportional tax on consumption in the form of a national sales tax or a value-added tax. An excise tax on oil, such as that proposed by the Administration on a contingency basis last January, could also be considered, as could a fee confined to imported oil. Another alternative would be an excise tax on energy regardless of source. The advantage of such taxes is that they would encourage saving and the conservation of energy. However, they might have an adverse effect on prices, at least temporarily. Many also object that the burden of such taxes tends to fall less on high-income individuals than on lower-income groups, but if this is deemed a problem it could be approximately offset by modifications in the personal income tax and welfare system.

FIGURE 1. RECOVERY IS NEAR AVERAGE OF POST-WAR RECOVERIES

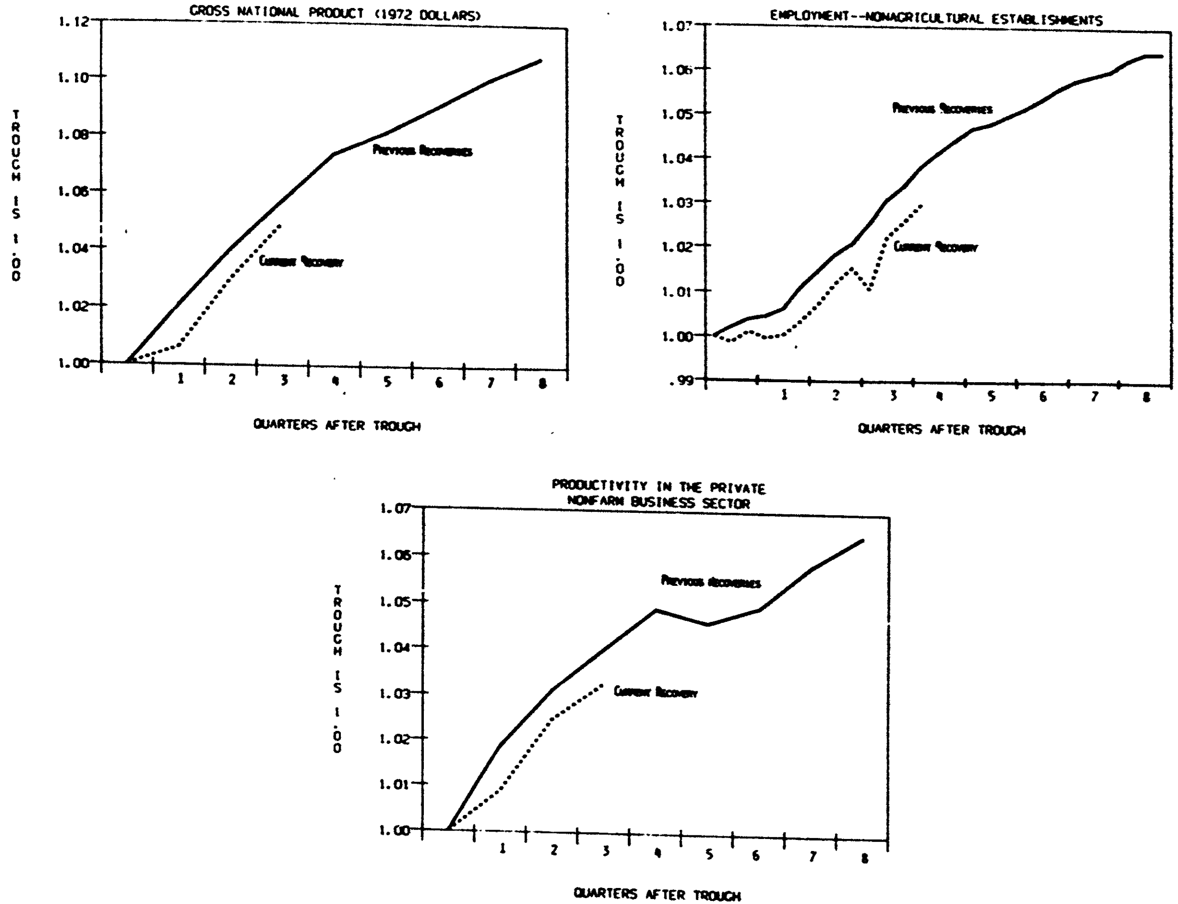
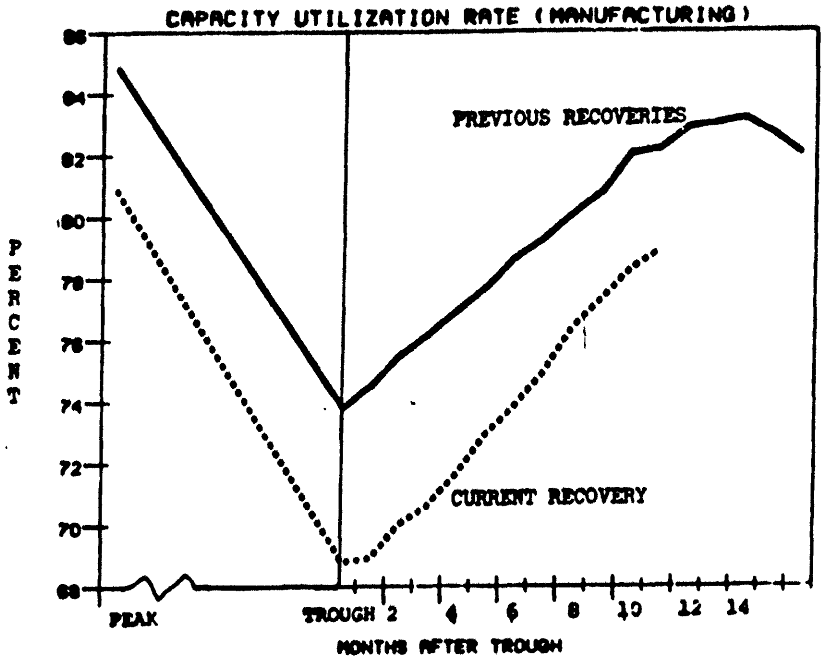


FIGURE 2. MEASURES OF RESOURCE UTILIZATION



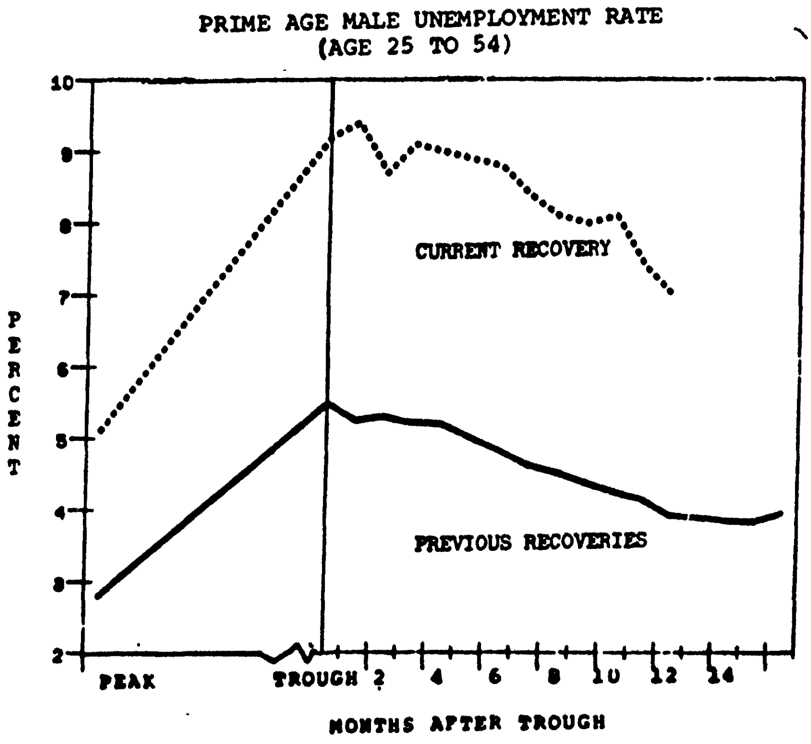


FIGURE 3. INTEREST RATES REMAIN HIGH

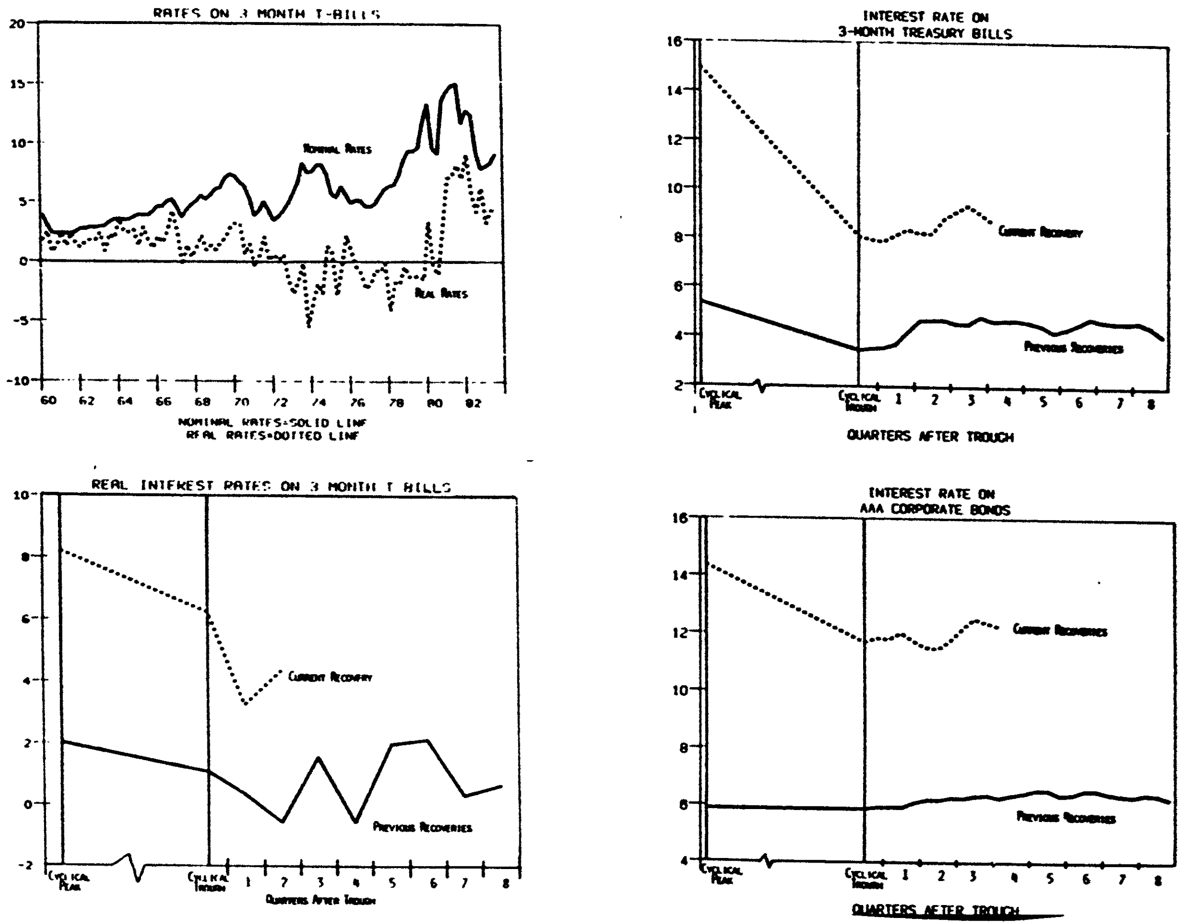


FIGURE 4. BUSINESS INVESTMENT HAS GROWN ABOUT AS USUAL

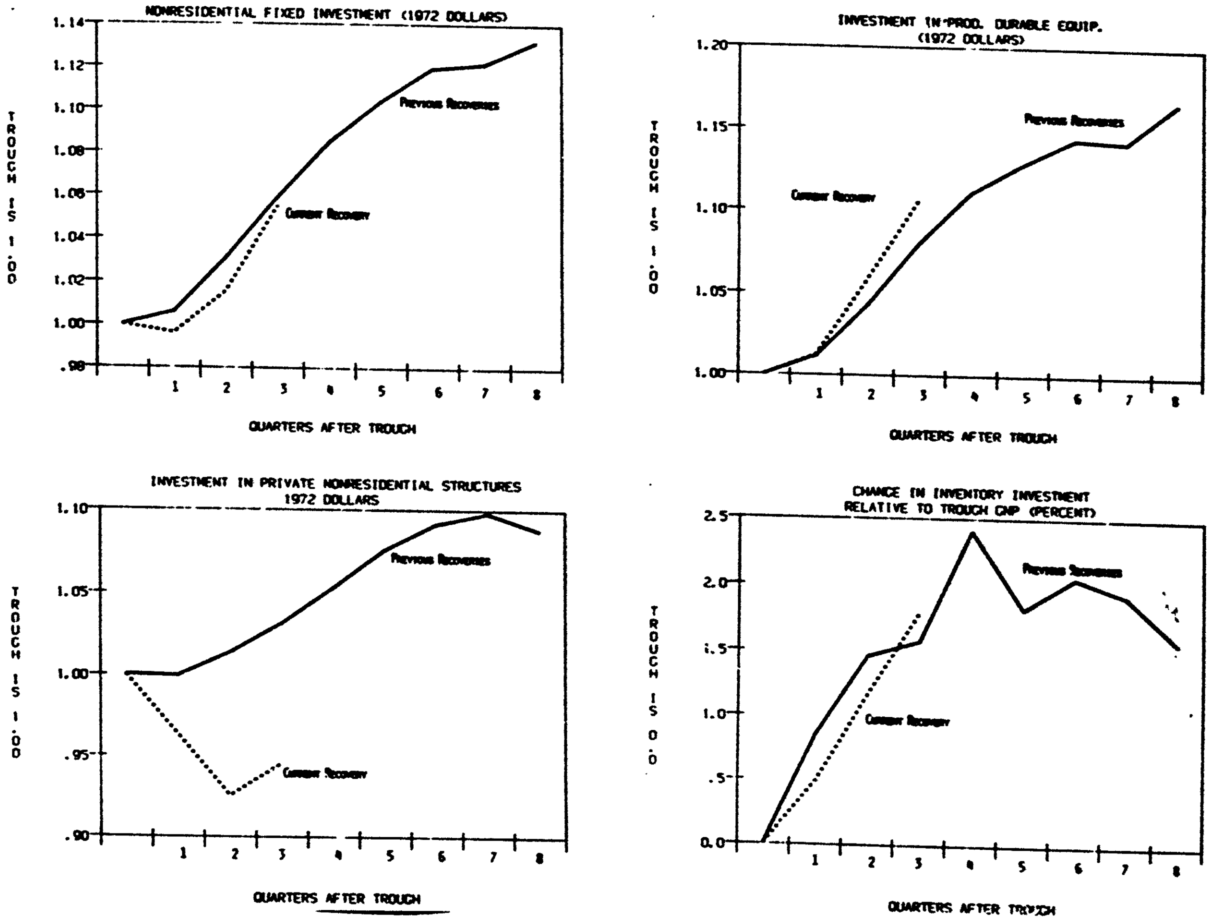
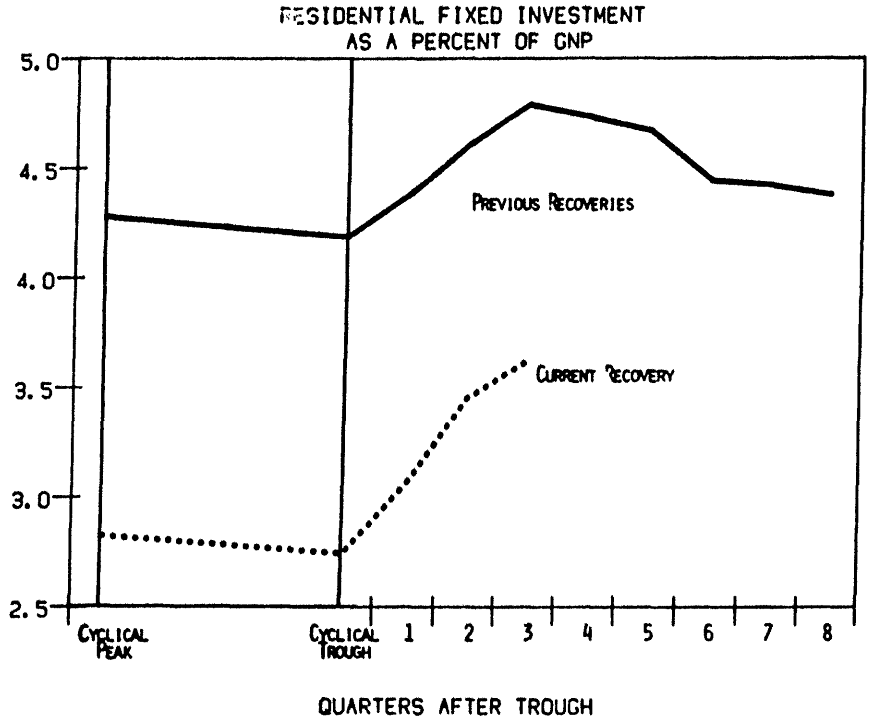


FIGURE 5. HOUSING INVESTMENT: RECOVERING FROM A LOW BASE



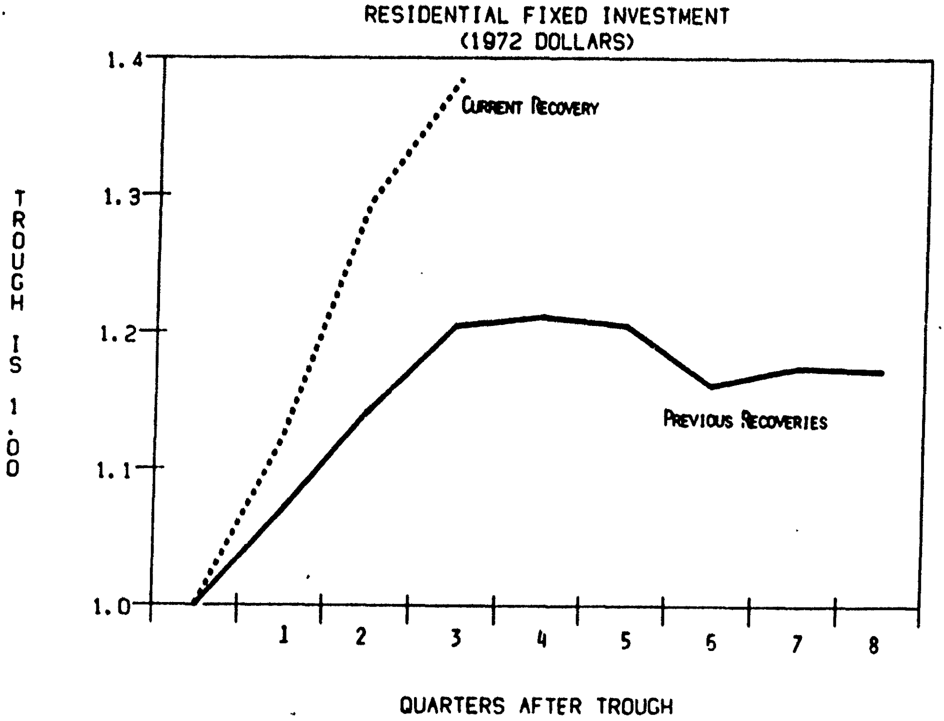
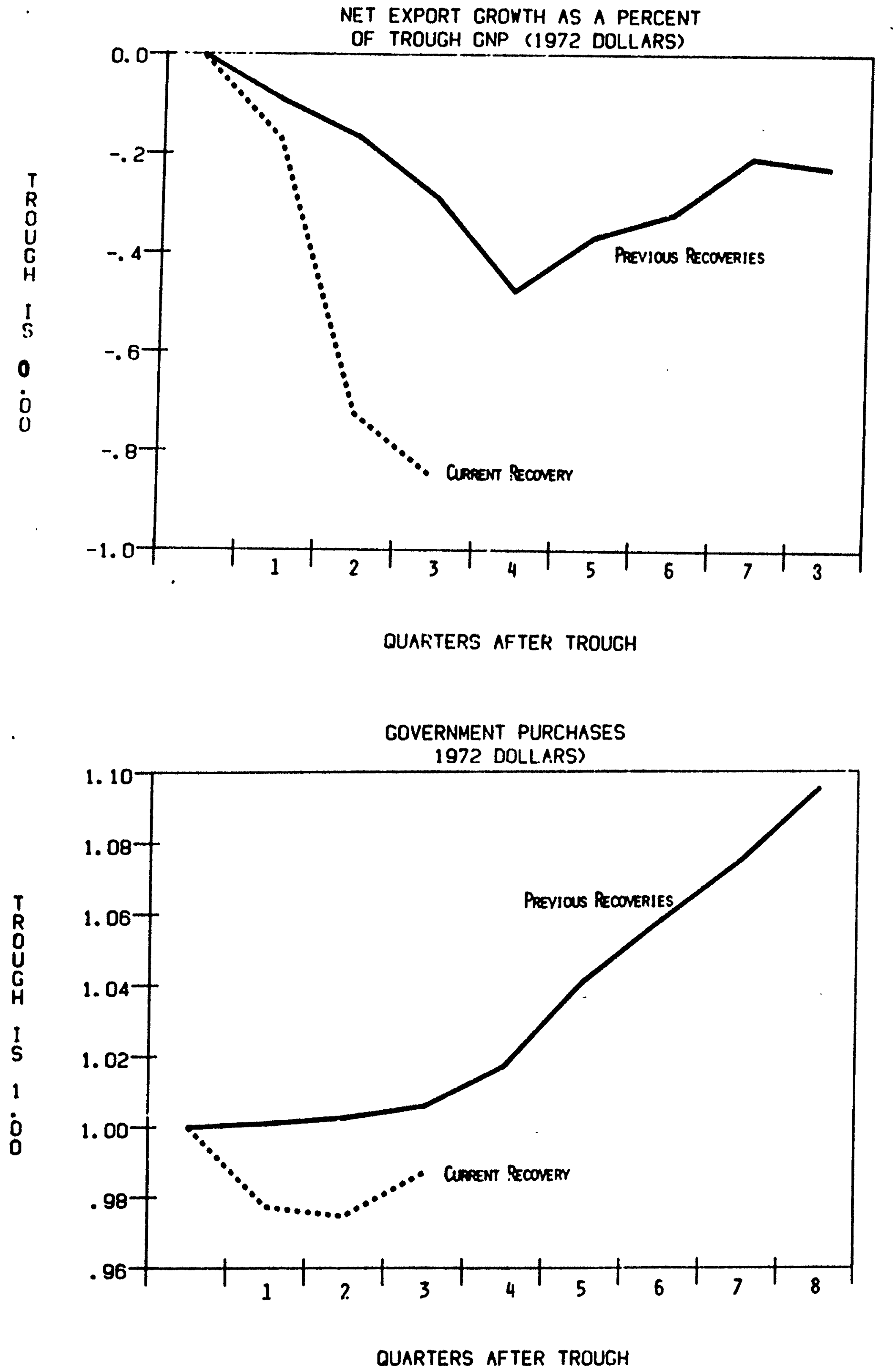


FIGURE 6. NET EXPORTS AND GOVERNMENT PURCHASES ARE WEAK



The CHAIRMAN. I just have one question before I yield to Senator Danforth under the early bird rule. Is it fair to assume that based on your testimony you believe that we should take some action, and the sooner the better?

Dr. PENNER. That's exactly right, Mr. Chairman. I think speed is important really for two reasons. As I said, sometimes there is quite a lag between when you enact the law and when it actually affects the outlays and receipts. Second, as I also pointed out, the longer we wait the harder it is because that interest bill is accumulating out there.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Penner, some have said that we are undergoing an economic recovery now and that we can grow out of our deficit problem; that if the recovery expands, tax revenues increase, the cost of various welfare programs and so are reduced, that will pretty well take care of the problem for us. Is that a very strong reed to lean on?

Dr. PENNER. Not very strong at all, Senator. On page 9 of my testimony, I look at the average growth rate experienced during 7 years following each trough of the business cycle. You will see there that it varies quite a bit, but the average recovery since World War II is 4 percent. Now that, in essence, is what our projections assume as well—something very close to an average long-term recovery. We assumed no business cycle in the intervening years, which itself is pretty courageous given the average length of a recovery is only 3 years. But, nevertheless, that's what we assume.

Now if you look there, the most robust recovery over in the postwar period occurred in the 1960's at a 5-percent rate. If you remember, that recovery also ended in accelerating inflation in the late sixties. But even were we to assume a 1 percentage point increase in our growth rate, the deficit in 1989 would be reduced by $100 billion, which is a lot. But it would still leave us with the deficit only slightly below $200 billion, which would be nothing to cheer about. Moreover, it is very difficult to conceive of attaining that kind of growth rate if you have deficits over that period equal to something like 30 percent of gross private savings.

Senator DANFORTH. A lot of people would like to believe that we can cut the deficit simply by cutting waste out of the Federal budget; that the Government does a lot of things which are generally viewed as being silly; that if we cut out the silly things that will have a very substantial impact on the size of the deficit; that we can thereby reduce the deficit in a painless way; that we can do so without either an increase in taxes, or doing anything to reduce the growth rate of the entitlement programs, or to reduce the growth rate of national defense. Do you think that we can base a strategy of reducing the deficit largely on aggregating lists of wasteful Government spending, and cutting back on that spending?

Dr. PENNER. I think if we could, Senator, it would have been so easy that we would have done it long ago. That is not to deny that there isn't a lot of waste in the Federal Government. Obviously, there is. I should note that rooting out waste also costs money in terms of hiring auditors, and investigators, and so on to do the job for you. But even though, for example, the Grace Commission has produced some very large numbers which some have interpreted as showing how much could be saved by reducing waste and inefficiency in the Government, in fact the vast bulk of the savings would come from real policy changes. That is, from things like changing military retirement. That would be a policy decision, not just a matter of efficiency.

The same would be true of cutting food stamp benefits, and cutting fringe benefits for civilian employees, and so on. As I say, we will be looking at options like that in our study, but one shouldn't fool one's self—those will involve not waste and inefficiency but policy changes that would hurt somebody.

Senator DANFORTH. Do you believe that there is a significant likelihood that we can reduce the deficit below $150 billion?

Dr. PENNER. Because of the numbers that I gave you, Senator, it would be an extraordinarily difficult thing to do. One, in theory, obviously, one could do it. One could look at defense. It would take a radical change in our defense posture. One should not ignore the nonentitlement part of the budget. But there is just not a lot left there.

I had noted that defense, entitlements, net interest goes close to 90 percent of the budget out there. Well, that means that you could do away with the whole rest of the Government without really balancing the budget.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman. The Secretary of the Treasury was of the opinion that it is better for the economy for us to borrow to finance our spending over the next 18 months than it is to tax the economy. I have a two-part question, which is, No. 1, is he correct in that? And, second, part of his premise is an article that appeared in the Wall Street Journal that says American businesses are awash in cash and can't use all of it for reinvestment so there is an available market for Treasury bonds. The second part of my question then, is whether, in American business today there is a two-tiered economy? Is there is a part of American business that is awash in cash and ready to invest for example, in Treasury bonds, and another part of our economy that because of high interest rates is in relatively difficult shape? This second part of our economy would include the basic industries or those that come to Congress for IDB's and MRB's and a variety of other tax breaks. Do you understand the two parts of my question?

Dr. PENNER. Yes; well, sir, if you look at the total supply of savings and investments over the period through 1986, at least, it does not look bad in the following sense. That is to say the deficit, the Federal deficit, though at astounding levels compared to past history during peacetime recovery is not predicted to rise a lot so I would personally associate the high level of real interest rates with that high level of the deficit. But given that is not expected to increase a lot, I would not expect further big increases due to that source alone.

State and local surpluses also have been growing very rapidly during the recovery. Our own forecast, however, thinks that they will deteriorate as spending catches up with the inflows of revenue.

As you point out, corporations are experiencing a very heavy cash flow right now. And that would be expected to recover. I guess the part of your statement I might not agree with is that they can't figure out anything to do with it. In other words, I think very clearly if we could cut the Federal deficit and provide even more credit flows out there it could be put to good purposes. I mean we can hardly be pleased at the level of real interest rates that we are experiencing right now, which are just far out of line with the level that we have experienced in the typical postwar recovery.

So while I'm not one that is predicting doom and gloom in the short run—indeed, I think the problem with the deficits, as Senator Danforth hinted, is in the longer run. That does not mean that one should be pleased with the current situation at all.

Senator DURENBERGER. Could you address yourself to my concerns about a two tiered business economy. Businesses with access to capital and those without it. Is that a reality?

Dr. PENNER. Well, obviously, some firms have a lot more trouble than others in raising capital. It is often said that the smaller firms experience particular difficulties. That is something of a problem. And now, of course, firms that have a lot of debt are a little shakey because of the very level of interest rates. I think the basic point, however, is that if we could figure out a way to get these interest rates down, they would be down to the benefit of all small and large alike.

Senator DURENBERGER. That reality gets to the immediate question. I mentioned IDB's as only one example of U.S. corporate and individual tax expenditures that totaled $273 billion in 1983 alone. Now, among your choices of increasing rates, broadening the base, or introducing new taxes, is it fair to make the assumption that increasing rates is the easiest because there are some less obvious ways we can do that? Introducing new taxes is a little more difficult because it involves finding the right one. And broadening the base is probably the most difficult. Is that a correct assumption? And what would you say to us about the need to broaden the base and the components of the base to which the present rates in this country are applied, and what that says about fairness and equity in the business system or any other part of this country?

Dr. PENNER. Well, sir, I think you are making a series of political judgments there. And, luckily, I don't have to make political forecasts. I think basically that is your job.

But in terms of the economics of it, it is—I think 90 percent of the economists would agree with this statement—that the single most serious problem with our tax system today is that we have over the years invented such a long string of deductions, credits, exemptions, et cetera, that we are taxing less and less of the Nation's income all of the time. And, therefore, to get our revenues we have to apply a higher and higher marginal rate of taxation to what is left over.

And it is, of course, the marginal rate of taxation that causes economic inefficiency. That's what discourages work efforts, savings, et cetera. Even worse, we tax very similar activities very differently; particularly, capital investments where we have tax rates ranging all over the place, depending on the type of investment, depending on the way it is financed, debt of equity, more generally depending on the industry and so on.

So this is a serious efficiency problem. On the other side, of course, each of these special provisions of the tax law had advocates at one time. Those advocates were persuasive. In large measure, they attempt to achieve some social or redistributed purpose. And I guess that's what makes them so tough politically.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Penner, you stated generally that you believe Congress should act sooner rather than later. Could you explain the degree to which we should act in this upcoming year? That is, by how much should we try to get these deficits reduced. As you know, the committee is very generally talking about a package of $150 billion deficit reduction over the next 3 years. In your judgment, is that too high, too low? What are the numbers?

Dr. PENNER. Well, Senator, it's a bit hard to respond to your question because I think one of the problems we face today is the lack of any sensible rules governing these matters. In the good old days we used to think it was a good idea to balance the budget at least over the business cycle. We are so far from that that we can't even raise that flag any more in a practical way.

I would suggest as a more limited and perhaps practical goal the notion that we should at least during this recovery attempt to get the debt to gross national product ratio falling. And I'm afraid that we are very, very far from that.

Senator BAUCUS. What would that take over say, the next 2 or 3 years? How many dollars in deficit reduction would it take to turn the ratio around?

Dr. PENNER. Well, I'm afraid the bad news is that by 1987, that single year, it would take about $150 billion of deficit reduction. Not quite that much given our projections. But to have some margin, that's the order of magnitude that we are talking about. Between $100 and $150 billion.

That is the debt in the hands of private investors. That's the key thing in determining the interest bill. So what that implies to me is that we should be on that track anyway. It may not be necessary to achieve that by 1987, but that should at least be our limited goal. And if we reach that, we can then talk about how much farther should we go.

I think the point is, as the Finance Committee proposed package suggests, is that when you do make these policy changes they do work gradually on the outlay and the receipt side. So that's why I say it is very important to get them in place quickly, though it's not quite as important to have the actual deficit reduction as quickly. But some fear I guess for Keynesian-type reasons that a very abrupt change in the deficit might abort the recovery, I certainly don't see any problems in that regard with the package, say, about the size.

Senator BAUCUS. Let me ask you another question, one about the composition and the mix of the deficit reduction. Your tables show essentially that revenues as a percent of GNP are roughly constant, constituting about 18.8 or 9 percent through 1989. Outlays as percent of GNP roughly constitute about 24 percent. But the deficit as a percent of GNP rises slightly.

How do we get the deficit down? That is, do we do it only by reducing spending? Or do we also do it by raising revenues? If revenues and outlays are basically constant, but if deficits are going up as a percent of GNP, doesn't that argue that the way to reduce the deficit is by an evenhanded reduction in spending and increase in outlays?

Dr. PENNER. Well, before answering your question——

Senator BAUCUS. In other words, an evenhanded decrease in outlays and increase in revenues.

Dr. PENNER. Before answering your question, I should point to a very important assumption underlying these tables. And that is that defense continues to grow at 5 percent per year in real terms. That we interpret as the intent of the budget resolution, though the appropriation is lower than that.

The question as to how much you should take from outlays and how much you should add to revenues is really in my view a very political question about how big the Government should be and what should it do, a question that can only be answered on value grounds. I think as an economist I feel fairly secure in saying that in current circumstances whatever we decide government should do, it should be paid for up front in the tax system. I think from the point of view of economic efficiency it matters as much as to what your mix of spending cuts or tax increases is as does the global picture. For example, if you cut all public investment spending, and R&D spending from the Federal budget, that would have an implication for longrun efficiency. If you, on the tax side, chose to raise your taxes in a way that increased marginal rates terribly on this shrunken base, particularly as focused on capital income, for example, that, too, would have effects on longrun efficiency different than certain basebroadening effects.

I don't think you can generalize about these matters. And, of course, economic efficiency is a small part of the question. I mean the Government is always trading off between economic efficiency and certain social and political goals, redistributive goals that it has.

Senator BAUCUS. So, looking only at the economic consequences, does it matter whether the deficit reduction package consists entirely of spending cuts or instead consists of half spending cuts and half revenue increases?

Dr. PENNER. Well, as I said, I think the mix of both is more important. If you were talking about across-the-board cuts in spending, to the extent that's practical—which it isn't very as we know—but to the extent that is practical, or just increases in marginal tax rates on this shrunken base—increasing marginal tax rates does tend to lead to some economic efficiency. Base broadening, if you included base broadening in your tax increases, that would have some efficiency effect, but not in my judgment as much as just increasing the tax rates.

Senator BAUCUS. A quick question here as followup, Mr. Chairman.

As I hear you Dr. Penner, you are saying that, from an economic point of view, it doesn't make that much difference whether half of the deficit reduction is achieved through revenue increases.

Dr. PENNER. While it makes some difference, the political value judgment——

Senator BAUCUS. I'm not talking about politics. I'm talking about economics.

Dr. PENNER. In terms of reasonable options, in terms of the affect of the longrun growth rate, I'd say the difference is small.

Senator BAUCUS. Is what?

Dr. PENNER. Is small.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Well, thank you, Mr. Chairman. I was not here at the outset so I did not have the opportunity to make a statement. I would like to insert a statement in the record. I also want to commend you, Mr. Chairman, for your continuing effort in this important area and to note with regret that we will not be hearing from any representatives of the administration. I understand the reason from the newspapers, but I think it's ironic that we will hear from the current and former director of the CBO, former members of this and earlier Republican administrations, the academic community, the business community, representatives of the elderly, taxpayers and workers, and yet the one organization or institution whose concern about the deficit should be the most obvious and perhaps the highest, the present administration, will not be represented. And I regret that even while understanding the reason for it.

The CHAIRMAN. Just let me say they will have an opportunity later on. I think we will be having a hearing on our package itself as a bill. And at that time we will have the administration.

Senator MITCHELL. I think that's very welcome news, Mr. Chairman.

Mr. Penner, I would like to ask about a specific proposal in the package that is now before the committee. As you know, the proposal currently has a 2-percent energy tax and reduction in tax indexing. My own preference, which I have previously expressed to the Chairman, is to substitute for those a further modification in indexing; that is a CPI minus 3 percent, for brackets only. That would produce almost exactly the same amount of revenue. And I would ask you to assess those two proposals against the criteria that have commonly been used to judge taxes in our society, and any others you choose. And the three I'm specifically asking you to judge it by are the fairness of the tax, the economic impact, particularly in its relationship to possible inflation, and the ease of administering the tax.

Dr. PENNER. You were talking, sir, about a 3-percent reduction in the CPI adjustment of the width of brackets and the basic exemptions.

Senator MITCHELL. Yes; which would produce an almost identical amount of revenue to the proposal now before us.

Dr. PENNER. Well, the modification of indexing is a way of raising tax rates on the tax base that we have today. It does that in terms of percentage increases in the tax burden. It does that—the highest percentage increases are on the lower income groups. And then, of course, they diminish as you get on. One of the nice things about being in the top bracket of the income tax is that inflation can't put you into higher brackets anymore. So, in terms of the tax burden way out there, it has not very large effects in percentage terms. In absolute dollar terms, obviously, it's different.

Senator MITCHELL. Is it fairer if you compare a 2½-percent energy tax which applies equally to all consumers as opposed to a modification of indexing, which is, in effect, an across-the-board income tax? Which would you say is fairer?

Dr. PENNER. Well, just continuing on the income tax for a while, it may be better to judge it from the point of view of the change in after tax income. Their modification of indexing affects the upper middle classes somewhat more.

An energy tax, as you say, increases the burden on consumers of energy, obviously. That over the longer haul tends to vary pretty much with income. I don't have the exact distributional effects of that as compared to indexing. We could do some work on that for the record, if you like.

Senator MITCHELL. Well, doesn't commonsense tell you that a tax which is applied uniformly on all consumers is regressive in the sense that it is disproportionately higher for persons in the lower income brackets?

Dr. PENNER. Well, in the very short run that can be right. In the longer run, consumption as a proportion of income tends to be more uniform across the income classes. But the important point here is the consumption of energy intensive commodity with respect to income, presuming it was shifted forward in the price. And that I don't have good data on right now as compared to proportionate changes in the tax bill resulting from the indexing.

Senator MITCHELL. Is it possible for you to give me an answer of yes or no? Is the energy tax more or less fair than an across-the-board income tax increase?

Dr. PENNER. In terms of fairness, you have to judge that yourself, sir.

Senator MITCHELL. Let me ask you a second question. Ease of administration. Would it be easier to administer the energy tax as proposed or to make the modification in indexing that I have suggested?

Dr. PENNER. The change in indexing would, at first sight, be very easy to administer because, obviously, it would just be increasing the rate on the existing tax base. Some people think, however, that increases in marginal tax rates do increase evasion, tax evasion. I don't really have a good judgment as to how much. It's a very hard thing to track down, obviously. That, on the other hand, could increase administration.

I guess I'm not absolutely certain I understand the full details of all of the 2½-percent tax, energy tax. I gather it is essentially a BTU tax, is it? Any new tax would have to, obviously, involve a whole new set of laws and regulations and so on.

Senator MITCHELL. Doesn't commonsense really tell you that ease of administration would be much simpler, much less expensive than simply changing the indexing, than to implement an entire new tax?

Dr. PENNER. Well, you would have a big front-end cost with a new energy tax. And then I think once you got it established, I think it would be fairly easy to administer.

Senator MITCHELL. Could I ask the final question?

The CHAIRMAN. I would just say in that regard that we have made some other changes to offset some of the concerns reflected in the questions, very good questions, raised by Senator Mitchell. We are going to increase the zero bracket amount to offset some of the energy costs for low income. And, again, we are still fine tuning or whatever we are doing to our own efforts. But I think there are some other factors you might want to consider. If you are going to make an analysis, maybe we could give you all the material on it.

Senator MITCHELL. Mr. Chairman, I agree. I would like that. As you know, while I think you are doing an outstanding job in raising this issue, I simply do not agree on all of the components of the package. And I understand that is the purpose of this hearing—to explore the relative merits. And I would like to have that kind of an analysis because I detect some reluctance on Mr. Penner's part to get out too far here before the committee.

I would like to ask finally on the economic impact of the tax—that has a potential effect on inflation. Could you evaluate the two?

Dr. PENNER. Normally, one would expect the energy tax to create a jump in the price level which might have some reverberations through COLA clauses to other wages and so on which would tend to make it more inflationary. It would be wrong, however, to assume that none of it would be borne by producers of energy, and so have some effects on them as well.

Senator MITCHELL. However, is it fair to say that effect would not be the same with respect to the modification of the indexing?

Dr. PENNER. That is the usual assumption. Though, again, it would be not fair to say that it would not have any effect on wages. There is some evidence of minor affects of income tax changes on wage settlements.

Senator MITCHELL. I think I'm zero for three, Mr. Penner.

Dr. PENNER. I told you what I know. I don't want to pretend to know more than I do.

Senator MITCHELL. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Mr. Penner, the current Chairman of the Council of Economic Advisors, Dr. Martin Feldstein, has estimated that the net savings rate to the United States is only 6.7 percent of GNP, which is roughly half of the average of other major industrial countries. Now, according to Dr. Feldstein, large budget deficits are absorbing virtually all net private savings and are outweighing the favorable effects of tax incentives for greater savings and investment. Do you foresee the same connection between budget deficits and private savings? And what suggestions, if any, do you have toward encouraging private savings and investment in our economy in the light of our large budget deficit?

Dr. PENNER. Well, sir, the numbers are correct. That is to say that if we run deficits equal to very corruptly speaking 5 percent of the GNP, that is a very, very large proportion of what we had saved domestically traditionally between net bases between 6 and 7 percent.

On a gross basis, closer to 15 percent. Now not all of that money comes from domestic savings sources. As I noted in my testimony, we are relying on foreign sources of savings as well.

In terms of altering the savings behavior of the American people, that is no easy trick. We have implemented a number of savings incentives into recent law as compared to the past. I think it's too early to say how those things will work out. They, obviously, if you look at the numbers, have not had an overwhelming effect in the short run.

The studies of the effects of the changes in after tax rates of return on savings behavior are all over the map. The highest show a small positive effect, which means that it's very hard to change this behavior in an important way, but it doesn't mean that it isn't necessarily wrong to try to reduce the burden on the rate of return to savings.

I guess my bottom line is that we have moved the tax system in that direction quite a bit over the last number of years. I think we should take a good careful look at how that has worked, and see if there are good reasons for doing more in that regard.

Senator MATSUNAGA. What about incentives for investments? It appears that this administration for some reason is solidly set against tax incentives for development of alternative energy. Do you feel that—and perhaps this is the thinking on the part of the administration that tax incentives in this area will mean less revenue. Do you see it that way?

Dr. PENNER. Well, Senator, I think to step back and look at the question a little more broadly, as I noted before, one of the great problems with our tax system today is that it is so complicated, and it taxes things so differently, that one has to look very carefully at new complexities and new incentives. It's not to say that they should always be ruled out. But I think one wants to be very sure that one is doing the right thing, if one wants to invent new incentives.

With regard to energy incentives, in particular, do I think they would lose revenues? Yes; I would think they would lose revenues.

Senator MATSUNAGA. In what way? When you provide incentives, you provide for additional investments, more business, which means greater base for taxation. The experience, I think from your office, from your CBO, is that for every dollar of tax incentive given for the past 3 years we have experienced a $9.50 revenue increase. How could we lose? It's an investment on the part of government by providing tax incentives. Meaning, of course, bigger investments.

Dr. PENNER. I'm not sure which numbers you are referring to, Senator. I will have to go back and check on that.

Senator MATSUNAGA. I wish you would because I think here is an area where the administration has misconceived and where we—there is a great possibility for increase in revenues. If I may proceed on this point, Mr. Chairman, since all of us have been allowed to.

The CHAIRMAN. We are going to try to work that out for you. As long as it doesn't unbalance the budget.

Senator MATSUNAGA. The trade deficits which we today suffer, and we never did until 1974, has come about as a result of the increased amounts we have been paying for energy. In 1974, you will recall, we paid $7.6 billion for foreign imports of oil. In 1978 up to 1980, that jumped up to $90 billion because of the price increase of a barrel of oil from $2.40 in 1972 to $48.00 a barrel in 1978 through 1980.

Now if we had through tax incentives had gotten private industry to produce even one-half or one-third of that amount which we were paying to foreign countries for energy, we would have wiped out our trade deficit.

Dr. PENNER. Well, let me point out, Senator, that that investment in energy production is not a virgin birth. It doesn't come from nowhere. It has to come from somewhere, given the level of economic activity. So that if the economy is at full employment or even in a situation where we are at now where there is constraint on an expansion path by the Federal Reserve for reasons of wanting to keep this recovery under control, anything you do to increase economic activity in one sector of the economy has to come out of some other sector.

Senator MATSUNAGA. Is that necessarily true?

Dr. PENNER. I would say it is essentially necessarily true; yes. Now you might be able to rig it very cleverly so that it comes out of consumption or something like that, but it would be quite a trick to pull that off.

Senator MATSUNAGA. Well, I tell you, I'm not an economist, but I can agree with you. It's not necessarily true. We have proven that in Hawaii. Unfortunately, we had a change in administration, but if it hadn't been for that change, we would well be on the way to energy self-sufficiency. See, we pay about $1½ billion for energy annually, practically 100-percent dependent upon foreign imports. We have reduced that dependency. On the Island of Hawaii, for example, from 100-percent electricity being produced by burning imported oil now to 41 percent being produced by burning sugarcane waste. On the Island of Kauai, 56 percent. And we were well on our way, but then comes the new administration and it does away with tax incentives, which canceled out wind energy programs, and solar energy programs, et cetera, which had been on the planning boards. And we could have saved ourselves, we figure, by 1990 as much as a half a billion dollars in the purchase of foreign imports.

I'm sorry I exceeded the time.

The CHAIRMAN. I'm not certain Mr. Penner is the best one to address that specific question. But I think you raised it with Secretary Regan, and we are trying to pursue it because I think it should be resolved.

Senator MATSUNAGA. One short question on the complexity of our tax system. Would you go for a graduated growth income tax?

Dr. PENNER. That has different meanings to different people—that term. If you mean essentially a transaction tax on individual firms, I would have some trouble with that. That existed in Europe before World War II. If you are talking about just a simple base broadening of the type Bradley-Gephart, not a gross income tax, but a tax that focuses on economic income after the costs of doing business are taken out, it does have a great deal of appeal. You lose the—the very thing you lose is the ability to do exactly what you were trying to do in your previous question, and that is to move production into something like energy or oil or timber or what have you. So it's at exact variance with your other intent.

The CHAIRMAN. Well, I think we are going to have to move on because we have four outstanding witnesses and Senator Grassley wants to ask questions.

Senator GRASSLEY. First of all, Mr. Chairman, I would like to submit a record for the statement.

The CHAIRMAN. Happy to.

Senator GRASSLEY. And you have been asked a lot of political questions. I would like to avoid those that you had to plead there was a political answer for, and that you could not or did not want to answer. That's our problem and I can appreciate that.

I would like to bring up the technical aspect of being able to predict a little more accurately the future or at least if we can't predict it more accurately as we would like to at least being less wrong than we have in the past. And I speak not only about the long-term but the short-term as well. It was only probably on the part of the administration less than 6 months ago that they were suggesting that in 1985 they would be presenting a budget with a $170 billion deficit. It is my understanding now from newspaper reports that it's going to be in the neighborhood of a $190 billion deficit. And as a member of the Budget Committee as well as a member of the Finance Committee wrestled with trying to get accurate projections.

And I'm not talking about where there is a planned policy within a department having inaccurate figures, as I would suggest very adamantly that is the case with the Defense Department that they have a planned policy of low-balling just to get programs started, and then coming in with more accurate figures as the years evolve, but in the case of government generally or even the ability of your staff to guess into the future.

Now I don't have charts with me, but if I had charts showing what we predict over the next 5 years as we have done each year of the 3 years I have been on the Senate Budget Committee, we would always show spending to trend lower in the outyears. We would always show spending as a percent of GNP to decline. And we would show revenues increasing. And we would show deficits shrinking as a result of all those factors working together.

And then if we had a chart showing what actually happens, in almost all cases we would show that spending has superceded our expectations. We'd show that spending as a percent of gross national product has actually gone up. We would show that revenues have fallen below projections. That's the most obvious one. And as a end result, we would show deficits expanding.

You could almost say that it's a predictable pattern that things are going to work out worse than we anticipated they would. As an example with deficits, all of our outyear projections—we would show them declining and the opposite exactly happened. All future spending is underestimated. Almost all revenue projections are overestimated. And all projections of outlays as a percent of the gross national product decline, and exactly the opposite happens.

And what we are doing is we are making present day decisions based upon the predictions of very unrealistic figures, or at least an unrealistic future. And our present day decisions, therefore, as a result of the figures we are working with, are very unsound decisions. And yet we have to make decisions. And these result from time to time in larger and larger deficits. So my question is: What can we do about it? It's a technical question. Just so we are doing what we say we are going to do.

Dr. PENNER. Well, I understand your frustration with this, Senator. It's a very difficult problem. The situation is one in which our programs are extremely sensitive to economic events out there. With entitlements taking a growing portion of the budget—well, let me backtrack. I mean growing over the longer haul; not necessarily in these projections. With the debts getting so large out there that a small change in interest rates changes your costs a great deal, any projection of the outlays is bound to be subject to the vagaries of economic forecasting, which we all know we don't do very well.

Moreover, we also know that we have had a tendency over the past—not last year—but over the past to be overoptimistic. And, frankly, as I noted, I worry some about the projections that I just gave you because those projections do assume a steady growth rate through over almost a 9 year period when we know that the average recovery lasts only 3 years.

But there is no way that we can look into the 1980s and forecast the exact path of the business cycle. That is simply beyond our knowledge.

Senator GRASSLEY. Is it unrealistic for me to think in terms, though, that a projection of a $170 billion deficit 4 or 5 months ago shouldn't be showing up as a $190 billion deficit today? That's only 3 or 4 months.

Dr. PENNER. Well, I, unfortunately, have just had the newspaper accounts of that. I suspect some of it—well, I just don't know the root of those changes.

The one thing that we can do for you, sir—it doesn't help you an awful lot—but the one thing that we can do for you is to provide you with the sensitivity of the budget to changes in the various economic variables, and we do that as a matter of course in our annual report. So if you don't trust our particular projections of the economy, you can take these tables we give you and readjust them, and you can get some good sense of the risks that you face. There are some risks that aren't covered by that. We make no attempt to give you sensitivity tables to the affects of hurricanes, droughts, things of that type which impinge on the budget. We don't make any attempt to look at crop yields although that has been a very important element of uncertainty in the very last budget projections. That is why we, for example, were—in part, overstated spending in August. We didn't get the full effects of the drought in there. Those sorts of things are very difficult, but the fact of the matter is that we have built a set of laws on the spending side and obviously on the tax side where the numbers are just very sensitive to an extraordinary array of events that is beyond a human's capability of forecasting.

Senator GRASSLEY. I guess I'm not frustrated because we are wrong occasionally, because I would expect that in predicting. But it seems to me like over these last several years we have been so consistently wrong in what we have been predicting in the way that I demonstrated. And I think you would agree with that.

Dr. PENNER. Certainly, we have made some very large mistakes. Now there is a tendency, it has to be admitted, to be overoptimistic. And we have to try and resist that.

Senator GRASSLEY. Is that a political decision or is that a technical decision?

Dr. PENNER. I think that as far as we are concerned it's a technical. That is we, as the CBO, it's the technical.

Senator GRASSLEY. Have you been encouraged by politicians appointed and elected to trend in that direction so that your technicians are overly influenced by the optimism that politicians wish for?

Dr. PENNER. There is always a lot of discussion back and forth on these matters. We try to carry it on at a purely technical level. And we get technical help from staffs all over the place. I think, frankly, sir, we try very hard to follow a middle course, and to avoid strong biases in either direction. Some people have argued that we should try and bias the projections purposely in the negative direction, in a pessimistic direction. I'm not sure that that would be sensible either because that could mislead your decisions as much as being too optimistic.

The CHAIRMAN. Let me ask just a couple of questions. I want to get the other panel on within just a few minutes, and Senator Boschwitz, unless there is some objection, would like to make an observation or two.

I just want to make it clear for the record that we are trying to figure out what we can do under the present limitations. We are told on the one hand by the President we can't or shouldn't touch defense, although I think the suggested 22-percent increase for next year's budget is going nowhere. And we are sort of told again by the President and the Speaker that we shouldn't touch social security. And, of course, we can't touch interest on the debt. Now that doesn't leave very much, and we are trying to put together a $150 billion package over a 4-year period. So we are trying to keep within that framework. I don't expect you to comment on that, but it does—it would be fair to say that does reduce our options.

Dr. PENNER. Yes, sir. Rather explicitly.

The CHAIRMAN. Takes about 78 percent of the budget, I think. And so we are criticized for not cutting spending in the Congress, but we are told that most of it is off limits. And maybe that is something we can figure out.

Are you going to raise your interest rate assumptions because of our failure to act on the last budget resolution?

Dr. PENNER. We are just discussing that now, sir. You've caught us at a very bad time. We are just absolutely in the middle of redoing our forecast now.

The CHAIRMAN. That would be helpful. And I must say that was the administration's concern. If they came up here now, we would be looking at next year's budget. We wouldn't really be addressing the problem.

Also, is it fair to assume that all these—you mentioned $58 billion is going to be added to annual interest costs by 1986—all those assumptions plus the $200 billion deficit assumption is based on the assumption that things are going to be pretty good. Isn't that correct? I mean if we have a little down turn, that $58 billion is going to be higher and the $200 billion is going to be higher. Is that correct?

Dr. PENNER. Very certainly. This assumes continued recovery through our forecast period.

The CHAIRMAN. I don't want to frighten people by talking about $200 billion deficits, but I think when we are doing that we are suggesting the economy is going to stay fairly stable. And if it should change, if interest rates go up, or something happens on inflation, then we have another problem altogether.

Another area that I think we haven't looked at and don't have any jurisdiction in our committee would be in the credit areas. A lot of the budget now is Federal credit policies. It seems to me that it is just as important to address Federal credit policies as it is Government spending. I'm not certain whether you are doing that in your analysis, but it seems to me that many Federal credit activities are just an elaborate way to get around the budget process.

Dr. PENNER. Well, sir, we have argued that a lot of those things that have become off budget, most in particular the activities of the Federal financing bank in buying loan guarantees, should be brought into the budget one way or another.

The CHAIRMAN. I think we have to address that.

Of course, we can't do all the spending reduction, this committee. If we do the revenues and the $40 billion and the $75 billion in spending reduction over 4 years we believe that there are other areas in defense, agriculture, where other committees can come up with the remainder.

I have other questions I will submit for the record because I do want to get to the next panel, but I do have one more question now.

How would you put the deficit problem in terms which can be readily understood? There may even be things reported on this hearing. And they can say, well, we are going to have a $200 billion deficit. How can you explain that to my mother-in-law or someone like that?

Dr. PENNER. I think that is one of the greatest challenges. To try and convey how big a number——

The CHAIRMAN. You don't know my mother-in-law. [Laughter.]

Dr. PENNER. Don't know your mother-in-law. That's right. That is certainly one of the biggest challenges to convey what a large number $200 billion is. It's a metaphysical concept. I think one way to do it is to start looking at the radical nature of the policy changes that would be necessary to get to a balanced budget. You know, you are talking about 5 percent of the GNP, and I know a lot of people don't know what the GNP is.

The CHAIRMAN. Just hope it's not catching.

Dr. PENNER. But roughly speaking if you were to solve the whole problem on the tax side, and we could say that that wouldn't have behavioral effects, which, of course, is pretty ridiculous all by itself, you are talking about roughly between a 25-percent and a third increase in tax burdens across the board. And I think people do understand what that is. That's an enormous policy change. Or, conversely, if you think of doing it all on the spending side, you are talking about between the 20- and 25-percent cut in everything. And we know you can't cut everything. You can't cut interest.

The CHAIRMAN. I think there are other areas. If we talk about just interest on the new debts, say it's $15 billion a year in new interest payments, that exceeds the cost of the foodstamp program. It's almost as much as the cost of the medicaid program. I think people must understand it is a serious problem. And it's not a matter of politics, supply side economics versus something else, or that we shouldn't do anything on the revenue side, or we do it all on the spending side or vice versa.

But it's not going to go away—I would hope it would, but then I think we are going to have to act on it.

The CHAIRMAN. Senator Boschwitz.

Senator BOSCHWITZ. Thank you, Mr. Chairman. I will just make an observation because Mr. Penner will come up to our committee, the Budget Committee, I presume fairly shortly.

The cuts, Mr. Penner, are not 20 or 25 percent. If we could cut 25 percent from the budget, we could balance it. If we cut 5 percent a year for a few years, then we could also balance it.

But let me observe, Mr. Chairman, that I hope Mr. Penner is more specific when he comes to the Budget Committee. His testimony is 21 pages long, and on page 14 he is still talking about generalities of projections. He said that high interest rates could have serious adverse effects. That's about as specific as we get in this testimony. How much will be taken from outlays and how much added to revenues, he was asked. He said that was a political question. And it is, but I hope that when Mr. Penner comes to the Budget Committee he will be specific, and tell us what the options are; I hope he will not just give us a whole bunch of economic projections. Those could be found, as the Senator from Iowa suggests, at every corner. What we need is a series of suggestions of what can be done with respect to slowing the growth or cutting various programs. We need to know what can be done, and what the options are with respect to raising revenues.

I note on page 19 you spend about two pages in a very general way saying what could be done about cutting expenses. But on page 19 you say you have started your annual review of possible strategies and options for reducing spending, and will present the results to the Congress within a few months. I hope that that will be done quickly because as I understand the CBO, you should help us, bring to us, some of the tools for bringing the budget into balance. And I hope that's the kind of things that you will address when you come before the Budget Committee.

Dr. PENNER. Well, sir, at the beginning of February you will have a very thick book called Budget Reduction Options which look at a great number of options on the spending side, and options for broadening the base of the tax side. As I say, it's a very thick book. There is one from last year as well. The numbers are out of date, but the ideas are not necessarily obsolete now.

In addition, this year, as I pointed out, we are looking at about 200 of the options that were presented by the Grace Commission so a little later in February you will have that at your disposal as well.

The CHAIRMAN. Thank you.

Senator MATSUNAGA. Incidentally, Mr. Chairman, the figures which I quoted—$1 tax incentive bringing in $9.50—is from a joint economic committee study, I am told.

The CHAIRMAN. We will also check into that.

I wanted to thank you, Mr. Penner. And, of course, we understand this is not an easy task you have, and we appreciate your willingness to come.

I also want to put in the record—there are some who say we are not cutting spending in the Congress—this committee alone enacted spending reductions in fiscal years 1982 to 1985 totally about $66 billion over a 4-year period. It's $91 billion dollars. Trade adjustment assistance, social security, unemployment compensation, AFDC, social services grants, supplemental security income, medicare, medicaid, and then we get a little credit for debt service of $1.8 billion.

But, again, to make the record complete, this shows that we are willing in this committee to make some hard choices, and we have already made a number. Second, in the case there may be additional questions from other Senators in writing, if that is satisfactory.

And I would like to now call on the following distinguished economists. We are going to hear from 18 economists in the next 2½ days, and if they don't confuse each other, we will try to help.

Our panel is: Benjamen M. Friedman, professor of economics, Harvard University; Lawrence Klein, professor of economics and finance, University of Pennsylvania; Alan Meltzer, John M. Olin professor of political economy and public policy, Graduate School of Industrial Administration, Carnegie-Mellon University, Pittsburgh; and our friend Murray Weidenbaum who has been before this committee a number of times—director of Center for the Study of American Business, Washington University.

Unless someone has a plane to catch, we will go down in the order they were called. Mr. Friedman, then Mr. Klein, Mr. Meltzer, and Mr. Weidenbaum. I would ask that if you can to summarize your statements so we can get to questions at the earliest time. I know a number of members have questions for this distinguished panel.

Mr. Friedman.

STATEMENT OF DR. BENJAMIN M. FRIEDMAN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Dr. FRIEDMAN. Thank you, Mr. Chairman. It is an honor to be here today to present my views to this committee. I have submitted a lengthy statement with a substantial amount of——

The CHAIRMAN. Could you pull that mike up? You have to be very close.

Dr. FRIEDMAN. I have submitted a lengthy statement with a substantial amount of supporting materials for the record. I would like, very briefly, to summarize the highlights of that statement.

The main conclusion is that there is a very serious problem today, and that we should not let the current euphoria over the economic recovery now in process to detract our attention from what today's economic policies are doing to the Nation's economic future.

I believe that under a continuation of current Federal tax and spending policies the effects of Government deficits in the financial and the foreign exchange markets will pose a major threat to the economic well-being of the United States.

The specific problem is that we will have unprecedently large Federal deficits; not just as a percent of gross national product, but even on a full employment basis. The fact that these deficits will represent a structural or fundamental imbalance between the Government's taxing and spending even calculated at full employment is the major point. And I think that many of the confusions in the current debate over whether Government deficits are harmful or not represent the failure to take account of the unprecedented situation into which we will now be moving, with some 4 percent of the gross national product being absorbed year after year into Government deficits, even after we get back to full employment.

The chief reason why this is such an unfortunate situation is the effect of this government deficit on our country's ability to undertake fixed capital formation. By that I mean both business investment in plant and equipment, which after all is what delivers the productivity and eventually the higher standard of living that our Nation's citizens expect, but also residential construction which provides housing for a growing population.

The basic way to think about this problem is that the Government deficit will be absorbing well in excess of half of the Nation's net private saving. If we did not have Government deficits, we would be able to invest about 7 percent of our gross national product every year in building our Nation's business and residential capital stocks. That is small by comparison with other countries. But we would at least be able to do that.

In the current climate and the climate that we face in the balance of the 1980's if we do not make major policy changes, more than half of that available 7 percent of our Nation's output will be drained off year after year into funding the Government deficit. It therefore will not be available to finance new investment.

Another way of looking at exactly the same problem is to consider the ratio of Government debt to GNP, which a number of Senators on the panel have already mentioned. In a chart which follows page 9 in my prepared testimony I have tried to exhibit exactly what our problem is in terms of the rising Federal debt.

This chart goes back only to the end of the Korean war, but I could well have drawn it much further back. The basic point is that in peacetime in the past we have always had a Federal deficit small enough that the outstanding Federal debt shrank in relation to a growing economy. To be sure, in many years there was a positive deficit so that the amount of debt outstanding grew, but always by less in percentage terms than the economy grew. This is no longer true today. It is not likely to be true next year, and it is not likely to be true during the balance of the 1980's in the absence of a very substantial restructuring of our policies.

We are now headed for a distinctly rising Federal debt to GNP ratio in the United States. I believe that that will cause the availability of financing to the private sector to diminish. And in the absence of that private financing, we can only look for a further deterioration in both business investment and residential investment.

The largest part of the prepared remarks I have submitted focuses on three answers that I consider to be easy, but wrong answers to the problem we face. Whenever a problem is as serious as this one, it is almost inevitable that people will suggest that the problem will take care of itself through one or another painless mechanism. I have devoted some substantial material in my prepared remarks to attempting to rebut three of these answers that I label as easy but wrong answers. I will enumerate them very quickly, and I will be happy to answer questions on them later.

Easy answer No. 1 is that the lower tax rates legislated in the Economic Recovery Act of 1981 will sufficiently stimulate personal saving to enable the economy to finance both enlarged government deficits and an increase in net capital formation. That would be nice if it were true, but the sad fact is that the Economic Recovery Tax Act contained fairly little in the way of actual saving-stimulative measures in comparison with the overall amount of revenue foregone.

Easy answer No. 2 is that the large amount of business profit generated during the recovery, together with liberalized depreciation allowances, will enable the business sector to finance its expansion without turning to the credit markets. Again this would be nice if it were true. The fact is that there is no one for one relationship between business cash flows and business investment. And in the absence of being able to raise external funds, the outlook for business investments is poor.

Easy answer No. 3 is that the United States can finance both its Government deficit and substantial net capital formation by selling securities to foreigners. It is true that this solution would work in part, but the problem here is that a capital inflow from abroad is simply the mirror image of a current account deficit. It makes no sense to be pleased that next year we will finance an amount of our Government deficit equivalent to 2 percent of GNP by borrowing from abroad, and at the same time to bewail the fact that our merchandise trade deficit next year will approach $100 billion. Those are exactly the same phenomenon and it makes no sense to be pleased at one and displeased at the other.

Finally, what should we do? I believe that the right approach to the policy problem that we face is to make sufficient adjustments in our budget policy to stabilize the Government debt ratio, that is outstanding Federal Government debt as a share of GNP, at approximately 30 percent. Thirty percent is the recent high mark before the 1980's. Doing so will call for reducing the Government budget deficit to the range of $80 to $85 billion on average over the next 5 years. If we believe that that is too ambitious a goal——

The CHAIRMAN. What was it over the next 5 years?

Dr. FRIEDMAN. An average of $80 to $85 billion deficit each year over the next 5 years would result in returning the Federal debt to GNP ratio to 30 percent by the end of that period.

If we believe that that is too ambitious a goal, we might then, at the very least, try to stabilize the Government debt to GNP ratio at 34 percent which is where it is today, again well above anything in our recent experience. That objective would require reducing the deficit to the range of $110 to $115 billion per year in each of the next 5 years.

I think it is very clear that no one deficit-reducing measure is capable even of achieving this more modest objective, and therefore I favor an approach which combines three elements: First, further reductions in the growth of Federal domestic spending, especially in the major entitlement programs; second, a defense build-up which proceeds less rapidly than what the administration has proposed, and, finally, a tax increase designed in ways least likely to reduce savings. The specific tax increase I would propose would be simply to reverse the third notch of the tax reduction legislated in 1981, which became effective only this past July.

Thank you very much, Mr. Chairman. I am grateful to have been here to express my views.

[The prepared statement of Dr. Friedman follows:]

December 12, 1983

TESTIMONY BEFORE THE UNITED STATES SENATE

COMMITTEE ON FINANCE

Benjamin M. Friedman

Professor of Economics
Harvard University

Mr. Chairman:

I am grateful for the opportunity to present my views to this committee as it assesses the prospects for the U.S. Government's budget deficit in the years immediately ahead and considers ways of narrowing that deficit. Under a continuation of current federal tax and spending policies, the effects of the government deficit in the financial and foreign exchange markets will pose a major threat to the economic well-being of the United States. This committee's search for a solution to the problem is an effort well undertaken.

Widespread concern, even alarm, over the U.S. Government's budget deficit has become one of the leading public policy issues of the decade. Talk about large federal deficits that will persist throughout the 1980s now dominates discussions otherwise intended to focus on specific spending needs — defense, for example, or medical care supports — or on tax restructuring. It also now dominates discussions about the proper course for monetary policy, about the effect of the dollar's international exchange rate on U.S. competitiveness, and about the outlook for the U.S. economy's continued expansion.

These fears are warranted, at least in part. To be sure, much of the discussion has not been carefully put, and some of the ideas expressed have been simply wrong. The chief problem in this regard has been the failure to distinguish clearly between passive deficits that emerge as a result of depressed levels of economic activity and fundamental deficits that persist even when the economy's labor and capital resources are fully employed. Many of the most frequently expressed criticisms of the U.S. Government's deficit during fiscal years 1981-83, when economic weakness accounted for much of the deficit that the government then ran, were either largely or wholly misguided. By contrast, the deficits in prospect for fiscal years 1984-88 are indeed cause for concern.

The basic problem is that, under current policies or most of those now under active consideration, during 1984-88 the U.S. Government will continue to run budget deficits at or near the recent unprecedented levels, even if the economy returns to a fully employed condition. (This prospect actually extends well beyond the next half-decade, but official estimates are available only through fiscal year 1988.) Increasingly during these years, the deficit will reflect a fundamental imbalance between the government's revenues and expenditures at full employment, rather than a passive response to economic weakness as was the case during the past several years. If for some reason the U.S. economy continues to fall well short of full employment of its resources, then the average deficit realized during 1984-88 will be all the greater.

The principal reason why this indefinite continuation of unprecedentedly large U.S. Government budget deficits is a problem is that, by sharply curtailing or even eliminating altogether the economy's net investment in new plant and equipment, it will cut deeply into the economy's ability over time to achieve improved productivity and hence a higher general standard of living. The U.S. economy's net capital formation rate is already low in comparison either with the economy's own past experience or with that of major industrial economies abroad. A further erosion, of the magnitude likely to accompany the government deficits now in prospect for the balance of the 1980s, will be a step in the wrong direction.

A second important reason why the deficits now in prospect represent so great a problem is that their effects in the foreign exchange markets will continue to keep the dollar at a value highly disadvantageous to U.S. businesses either exporting goods abroad or competing at home against foreign imports. The recent sharp rise in the dollar's real exchange rate is almost surely the chief reason (although there are others as well) underlying the flagging international competitiveness of the U.S. economy. All current signs indicate that this problem will become worse, rather than better, in the near term. Continued large federal budget deficits as the economy expands will further exacerbate the already serious difficulties of the economy's international sector.

What is the Problem?

Even after the recent improvement in the U.S. economic outlook, there appears to be little prospect for a significant reduction in the U.S. Government's budget deficit during the remainder of the 1980s unless tax and spending policies change sharply (see Table 1). Current services baseline projections show an increasing deficit until 1988. The alternative policy proposals advanced either in the Administration's Budget message or in the Congressional Budget Resolution, once adjusted to eliminate new tax plans as yet commanding uncertain support, preclude further deficit growth but provide little shrinkage either. Further adjusting either set of proposals to allow for a realistically likely amount of slippage in holding to the stated spending targets would only worsen the

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TABLE 1

PROSPECTS FOR THE U.S. GOVERNMENT DEFICIT, 1984-88

		1984	1985	1986	1987	1988
Current Services:	Budget Proposal	$249	$267	$284	$308	$315
	Midsession Review	217	220	233	244	224
Reagan Budget:	Budget Proposal	203	205	157	152	126
	Midsession Review	194	181	139	128	91
Adjusted Reagan:	Budget Proposal	203	205	203	201	177
	Midsession Review	194	181	182	177	144
Congressional Resolution		200	190	157	—	—
Adjusted Congressional Resolution		212	205	203	—	—

Notes: Deficits in billions of current dollars.
Deficit totals include "off-budget" outlays.
Years indicated are fiscal years.
Source: Office of Management and Budget, Congressional Budget Office.

corresponding deficit prospects. The deficits projected today are also extraordinarily large even in comparison to the U.S. economy's expanding total size (see Table 2). None of the projections that are most relevant shows a deficit materially below 4% of gross national product before 1988.

Sustained government deficits of this magnitude, either in dollars or in relation to gross national product, will be unprecedented in U.S. peacetime experience. Despite the often expressed claim that the government's budget has "always" shown a large deficit, in fact persistent deficits larger than 1/2 % of gross national product have been a feature of U.S. fiscal policy only since the 1970s (see Table 3). Until 1982 the deficit had exceeded 3% of gross national product only during 1975 and 1976, in the wake of the severe 1973-75 business recession. Analogous effects of the 1981-82 recession have now swollen the deficit to more than 4% of gross national product in 1982, and more than 6% in 1983. Unlike these relatively isolated episodes of large deficits in the past, which largely reflected the shortfall of tax revenues and increase in transfer payments due to declining employment, incomes and profits in times of recession, the deficits now projected for the balance of the 1980s will increasingly represent a budget that will be unbalanced even at full employment. By contrast, economic weakness has accounted for some three-quarters of the total cumulated deficit run during the last three decades, leaving only one-quarter as a result of expenditures and revenues that would have been unequal at full employment (see Table 4).

This difference between the actual and high employment budget concepts is especially important in determining what magnitudes constitute the outer limits of the U.S. economy's prior experience. In 1975 and

TABLE 2

PROSPECTIVE DEFICITS AS PERCENTAGES OF GNP, 1984-1988

		1984	1985	1986	1987	1988
Current Services:	Budget Proposal	7.1%	7.0%	6.9%	6.8%	6.4%
	Midsession Review	6.1	5.7	5.5	5.3	4.5
Reagan Budget:	Budget Proposal	5.8	5.4	3.8	3.4	2.6
	Midsession Review	5.5	4.7	3.3	2.8	1.8
Adjusted Reagan:	Budget Proposal	5.8	5.4	4.9	4.5	3.7
	Midsession Review	5.5	4.7	4.3	3.9	2.9
Congressional Resolution		5.6	4.9	3.7	—	—
Adjusted Congressional Resolution		6.0	5.3	4.8	—	—

Notes: Deficits as percentages of projected gross national product.
Deficit totals include "off-budget" outlays.
Years indicated are fiscal years.
Source: Office of Management and Budget, Congressional Budget Office.

TABLE 3

HISTORICAL U.S. GOVERNMENT DEFICIT, 1951-1983

	Deficits in Billions of Current Dollars	Deficits as Percentages of GNP
Average, 1951-60	$ 1	0.0%
Average, 1961-70	6	0.5
Average, 1971-80	31	2.4
1971	23	2.2
1972	23	2.1
1973	15	1.2
1974	6	0.4
1975	53	3.6
1976	73	4.5
1977	54	2.9
1978	59	2.8
1979	40	1.7
1980	74	2.9
1981	78	2.8
1982	128	4.2
1983	195	6.1

Notes: Deficit totals include "off budget" outlays.
Years indicated are fiscal years.
Source: Office of Management and Budget.

TABLE 4

HISTORICAL DEFICITS ON A HIGH EMPLOYMENT BASIS, 1955-1983

	Deficits in Billions of Current Dollars	Deficits as Percentages of Potential GNP
Average, 1955-60	-$ 6	-1.0%
Average, 1961-70	-0	-0.1
Average, 1971-80	13	0.8
1971	9	0.9
1972	10	0.9
1973	14	1.1
1974	5	0.3
1975	15	1.0
1976	21	1.2
1977	19	1.0
1978	20	1.0
1979	2	0.1
1980	18	0.7
1981	-7	-0.2
1982	19	0.6
1983	n.a.	n.a.

Notes: Deficits are on a national income and product accounts basis.
Negative values indicate surplus.
Years indicated are fiscal years.
Source: U.S. Department of Commerce.

1976, for example, the actually realized deficits of $53 billion and $73 billion corresponded to high employment deficits of $15 billion and $21 billion, respectively. In 1981 the budget would have shown a small surplus if the economy had been fully employed, and in 1982 the actually realized deficit of $128 billion would have been only $19 billion at high employment. In comparison to the economy's size, the largest high employment deficits run during the last three decades were 1.5% and 1.9% of potential gross national product in 1967 and 1968, respectively. It is clear that prospects for the remainder of the 1980s are well outside this prior experience.

What is extraordinary about the U.S. Government deficits now projected for 1984-88, therefore, is not just that they will be large but, more importantly, that they will represent a fundamental imbalance between the government's revenues and its expenditures. It is not possible to dismiss them simply by assuming that rapid growth will quickly restore the economy to full employment. The projected deficits are increasingly deficits at full employment, and in the absence of a return to full employment the deficits that actually emerge will only be larger. The issue now facing U.S. fiscal policy is not the familiar one of the role of automatic stabilizers, or even the desirability (or lack thereof) of temporary active deficits as discretionary stabilizers, but rather the effects of sustained deficits at full employment as a permanent feature of the economy's ongoing development. Among the most important of those effects is the impediment that such deficits will place in the way of the economy's ability to undertake capital formation.

Why Deficits Matter: Saving and Investment

The economy's net private saving, consisting of personal saving plus corporate retained earnings, represents the share of total output that the private sector as a whole makes available to finance new investment beyond what is necessary simply to replace depreciating stocks of business and residential capital. Despite substantial variation since World War II in such factors as tax rates, price inflation, real rates of return and income growth trends — all of which could in principle affect saving behavior — the U.S. economy's net private saving rate has remained very steady throughout this period (see Table 5). Its post-war mean has been 7.2%, with a standard deviation around the mean of only 1%, and it has displayed no significant time trend during this period (once the data are corrected for cyclical variation). It has varied in a modestly procyclical pattern, however, which accounts for the slightly higher than average saving rate during the 1960s and (in part) for the distinctly lower than average saving rate thus far during the 1980s.

If government budgets were always balanced (and if the foreign account were balanced too), the share of the economy's output available for net capital formation would simply be the share set aside as net private saving. Given the experience since World War II, that would mean a relatively steady 7% of gross national product over time. In the presence of government surpluses or deficits, however, what is available for net investment is net private saving plus any government surplus, or less any government deficit.

In recent years public sector saving and dissaving has played an increasingly prominent role in affecting the U.S. economy's overall saving and investment balance (see again Table 5). Since the 1970s state

TABLE 5

U.S. NET SAVING AND INVESTMENT, 1946-83

	1946-50	1951-55	1956-60	1961-65	1966-70	1971-75	1976-80	1981	1982	1983
Total Net Saving	10.3%	6.8%	6.9%	7.4%	7.6%	6.4%	5.7%	5.1%	1.5%	1.1%
Net Private Saving	7.6	7.2	7.1	7.8	8.1	7.6	6.5	6.1	5.3	5.1
Personal Saving	4.0	4.7	4.7	4.3	5.0	5.6	4.2	4.6	4.1	3.3
Corporate Saving	2.6	2.5	2.4	3.5	3.1	2.0	2.3	1.5	1.2	1.8
State-Local Govt. Surplus	0.1	-0.1	-0.2	0.0	0.1	0.6	1.2	1.2	1.0	1.4
Federal Govt. Surplus	2.6	-0.3	0.0	-0.4	-0.6	-1.8	-2.0	-2.2	-4.8	-5.4
Total Net Investment	9.6%	7.4%	6.6%	7.6%	7.3%	6.7%	5.8%	5.0%	1.5%	1.0%
Net Foreign Investment	1.4	0.1	0.5	0.8	0.2	0.3	-0.2	0.1	-0.3	-0.6
Private Domestic Investment	8.2	7.3	6.1	6.8	7.1	6.4	6.0	4.9	1.8	1.6
Plant and Equipment	3.8	2.8	2.6	2.9	4.0	3.1	2.9	3.0	1.9	n.a.
Residential Construction	3.3	3.4	3.0	2.9	2.0	2.6	2.4	1.2	0.7	n.a.
Inventory Accumulation	1.2	1.0	0.6	1.0	1.1	0.7	0.7	0.6	-0.8	-0.8
Memoranda: Capital Consumption	7.7%	8.5%	9.3%	8.5%	8.4%	9.3%	10.5%	11.2%	11.7%	12.8%
Gross Private Saving	14.4	15.7	16.4	16.3	16.4	16.9	17.0	17.2	16.9	16.7

Notes: Data are averages (except for 1981-83) of annual flows, as percentages of gross national product.
Data for 1983 are for first half only.
Total net saving and total net investment differ by statistical discrepancy.
Detail may not add to totals because of rounding.
Source: U.S. Department of Commerce.

and local governments, in the aggregate, have run ever larger budget surpluses on a consolidated basis, as current pension surpluses have grown faster than operating deficits. By contrast, during this period the budget deficits run by the federal government have grown progressively larger in relation to gross national product. These two trends have been in part offsetting, but increasingly unequal. By the early 1980s the federal government's deficit had grown far beyond the aggregate surplus of state and local governments. Under any currently relevant projections, it will remain so.

The U.S. economy's total net saving, consisting of the relatively steady net private saving plus government saving or dissaving, has therefore declined sharply since the low-deficit days of the 1950s and 1960s. The economy's total net investment (which differs from total net saving only by a fairly small statistical discrepancy) has, of course, declined in equal measure (see again Table 5). Because of a change from positive net foreign investment on balance before the mid 1970s to negative net foreign investment on balance thereafter, the deterioration of net domestic investment has been less severe than that of total net investment. Even so, net domestic investment has declined from 6.9% of gross national product on average during the 1960s to 6.2% on average during the 1970s, and only 3.0% thus far during the 1980s. All components of net domestic investment — business plant and equipment, residential construction, and business inventory accumulation — have shared in this decline.

In the context of this historical experience of the U.S. economy's balance of saving and investment, the implications of the current outlook for the U.S. Government deficit are clear enough. If the deficit remains in the range of 4-6% of gross national product, as now seems likely, it will absorb substantially in excess of half of the private sector's normal net saving. In the absence of a vast expansion in government saving at the state and local level, which appears highly improbable (indeed, the opposite is more likely), the federal government's deficit will therefore keep the U.S. net capital formation rate depressed throughout this period.

Once the economy returns to (or nearly to) full utilization of its resources, this problem will bear little resemblance to the decline in U.S. capital formation experienced during 1981-83. With ample unemployed resources available throughout the economy, and the budget nearly balanced on a full employment basis, it is implausible to suppose that the federal deficit was responsible for the low rate of capital formation during these years. The opposite is a better description, as weakness in the investment sector both fed upon and added to weakness elsewhere in the economy, and therefore caused tax revenues to fall and transfer payments to rise. Even larger deficits, representing an active fiscal response to the 1981-82 recession, would probably have led to more capital formation rather than less in the preponderance of industries in which inadequate product demand constituted the chief impediment to investment.

As the economy now recovers toward full employment, however, the situation will change. Fewer unemployed or underemployed resources will be available. Product demand will not be weak. The source of the budget deficit will be not economic slack but a fundamental imbalance between the government's expenditures and its revenues. In the absence of some break from historical experience that is now difficult to foresee, the continuation of large government deficits under these conditions will then constitute a substantial impediment to capital formation.

Why Deficits Matter: Public Versus Private Debt

An alternative way of considering the threat posed for U.S. capital formation by these prospective federal deficits is to focus on relationships involving the economy's stocks of assets and liabilities outstanding. The chief regularity that stands out in the U.S. economy in this regard is the close relationship of the total debt outstanding, issued by all U.S. borrowers other than financial intermediaries, to U.S. gross national product. The U.S. economy's total debt ratio has displayed essentially no trend, and only a limited amount of cyclical variation, throughout the post World War II period. More importantly for the purpose at hand, the stability of this relationship between outstanding debt and nonfinancial economic activity has not merely represented the stability of a sum of stable parts. Neither private sector debt nor government debt has borne a stable relationship over time to economic activity, but their total has.

The heavy solid line at the top of Figure 1 shows the total credit market indebtedness of all U.S. nonfinancial borrowers as of the end of each year since the Korean War, measured as percentages of fourth-quarter gross national product, as well as the corresponding total indebtedness as of midyear 1983, measured as a percentage of gross national product in the second quarter of the year. The lines below divide this total into the respective indebtedness of each of five specific borrowing sectors: the federal government, state and local governments, nonfinancial business corporations, other nonfinancial businesses, and households.

The strong stability of the total nonfinancial debt ratio stands out plainly in contrast to the variation of the individual sector components

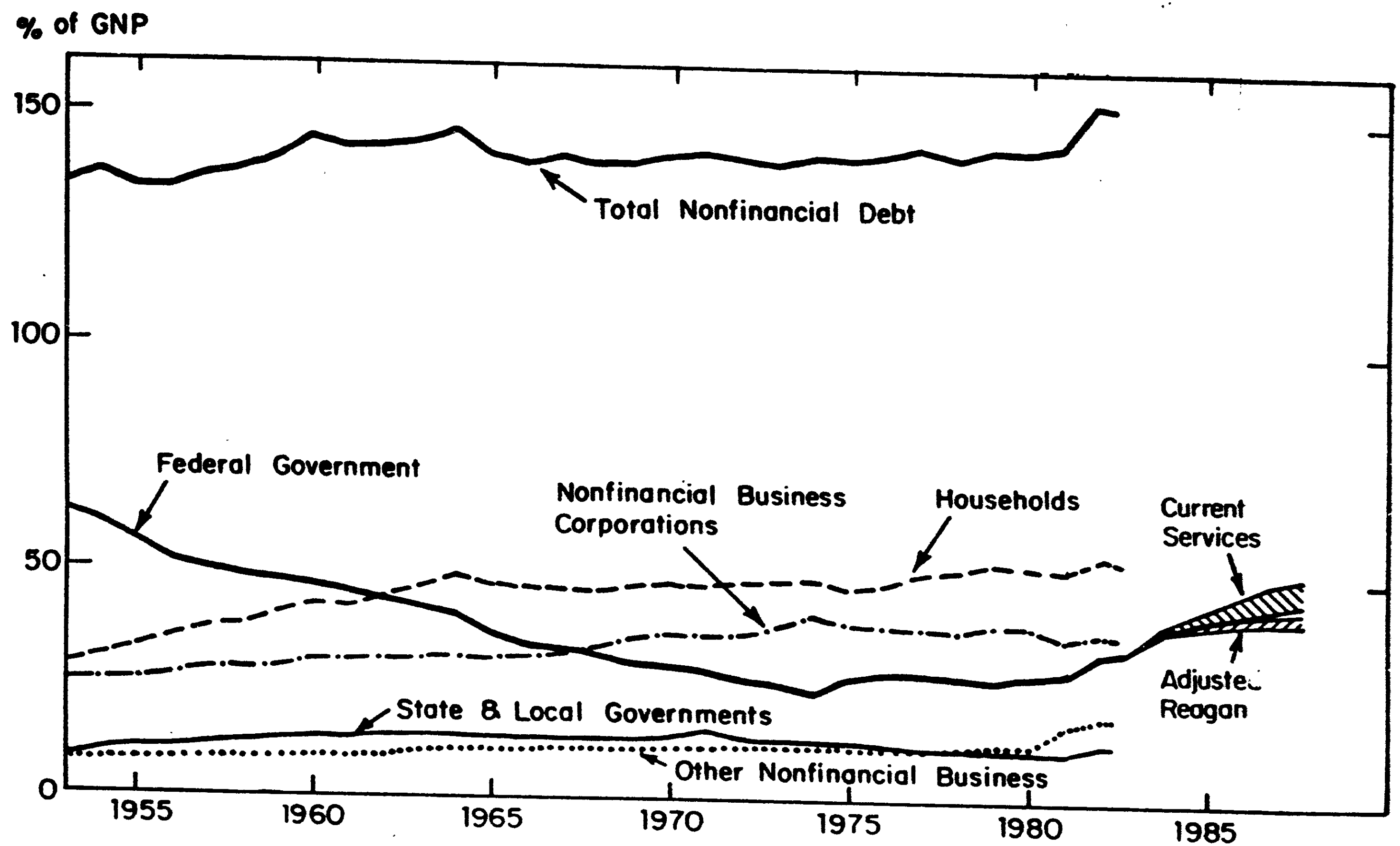

FIGURE 1
OUTSTANDING DEBT OF U.S. NONFINANCIAL BORROWERS

shown below. Although the total debt ratio rose sharply during the most recent business recession, as gross national product in the denominator weakened while substantial credit expansion continued, data for the first half of 1983 already show the beginning of a return toward the historical norm of about $1.45 of debt for every $1 of gross national product. The experience of a similar, though less pronounced, cyclicality in prior recessions also suggests that the 1982 bulge does not represent an interruption of the basic long-run stability. Moreover, the stability of the U.S. economy's total debt ratio is of longer standing than the three decades plotted in Figure 1. With the exception of a sharp rise and subsequent fall during the depression of the early 1930s (when much of the debt on record had defaulted de facto), and to a lesser extent during World War II, the total debt ratio in the United States has been roughly constant since the early 1920s.

By contrast, the individual components of the total debt ratio have varied in diverging ways both secularly and cyclically. In brief, the post World War II secular rise in private debt has largely mirrored a substantial decline (relative to economic activity) in public debt, while cyclical bulges in public debt issuance have mostly had their counterpart in the abatement of private borrowing. Most importantly, except only for 1975-76 and 1980-83 — years marked by large deficits due to recession and its aftermath, as Tables 3 and 4 show — the federal government has reduced its debt ratio in every year to date since 1953, although this relative debt reduction has also been slower in years when even milder recessions have temporarily inflated the government's deficit.

Given the long-standing stability of the U.S. economy's total debt ratio, the evolution of the federal government's debt ratio provides a useful perspective on the magnitude and import of the federal budget deficit. During the post World War II period as a whole, the federal debt ratio has declined not just from 62.9% in 1953 but from 103.4% in 1946. Indeed, the 24-29% range in which the federal debt ratio fluctuated during the 1970s, and until 1982, corresponded favorably to the 27.4% value in 1918. The past decade has already marked an important departure from prior experience, however. The years 1975 and 1976 were the first since 1953 in which the government debt ratio rose, and the renewed decline during 1977-79, which was subsequently reversed by the recession years 1980-82, was not sufficient to reduce the ratio to its 1974 low. The government debt ratio rose still further during 1983, and current deficit projections indicated that it will continue to do so for the foreseeable future.

This increase in the federal government's debt ratio is relevant to the implications of fiscal policy for private capital formation because, in the context of a stable economy-wide total debt ratio, it represents a useful summary measure of the net impact of federal deficits on the environment for private financing. If the government deficit were sufficiently small, or if either real economic growth or price inflation were increasing the gross national product sufficiently rapidly, then the government debt ratio would be falling — as it was, almost continuously, throughout the first three decades following World War II. Conversely, when the deficit is sufficiently large in relation to the economy's size and growth, then the government debt ratio will be rising — as it was during 1975-76, and has been during 1980-83. Moreover, the nature of this stock-flow relationship is that, by comparing the nominal stock of outstanding government debt to the nominal gross national product, it implicitly allows not only for economic growth but also for the real capital gain that the government earns by inflating away its prior debt obligations. (An incidental, but also helpful, result of focusing on the government debt ratio measure is that it also readily illustrates the lack of fundamental importance to be attached to a precisely balanced government budget in a growing economy.)

If the economy's total outstanding debt remains approximately stable in relation to gross national product over time, then a sustained movement in the government debt ratio implies an offsetting movement in the aggregate debt ratio of the private sector. A falling government debt ratio like that experienced during 1946-74 implies a rising private debt ratio, while a rising government debt ratio like that during 1975-76 and 1980-83 implies a falling private debt ratio. The relevance in turn of a rising or falling private debt ratio for the economy's ability to undertake capital formation stems from the traditionally close connection in the United States between debt financing and net private investment, including both homebuilding and investment in new plant and equipment.

In the absence of a major change in financing patterns, therefore, the economy's ability to achieve a greater capital intensity — that is, to increase its capital stock in relation to total output — depends at least in part on the private sector's ability to increase its debt in relation to gross national product. Over time, however, the private sector's debt ratio moves inversely with the government debt ratio. In the end, the rise or fall of the *government* debt ratio is therefore likely to be an important factor shaping the relationship between growth of the capital stock and growth of the economy's total output.

The shaded extensions to the "Federal Government" line plotted in Figure 1 indicate the respective implications for the government debt ratio associated with several familiar projections of the U.S. Government deficit for 1984-88. Under the Administration's current services projection, the U.S. Government's outstanding debt will rise from 33.4% of gross national product as of midyear 1983 to between 44.5% and 51.0% at the end of fiscal year 1988. Under the budget proposals submitted by the Administration in February, "adjusted" only by removing the "contingency tax plan" which has lately received so much attention, the projected deficits imply increases in the government debt ratio to between 39.5% and 42.4% at the end of fiscal year 1988.

The main point of this set of comparisons is that the ranges for both the current services and the "adjusted Reagan" deficit projections will continue to carry the government debt ratio further upward, instead of returning it toward the 24.8% post-war low reached in 1974, or stabilizing it at the 1982 level of 30.1% or even the midyear 1983 level of 33.4%. These projected further increases will raise the government debt ratio to levels last experienced two decades or more ago — the early 1960s under the "adjusted Reagan" projection, or the 1950s under the current services projection.

A sustained increase in the government debt ratio of anything like these magnitudes will be unprecedented in the U.S. economy's post-war experience. If the economy's total debt ratio continues to remain near its historical norm, this increase in the government debt ratio therefore implies a comparably unprecedented decline in the private sector's debt ratio. As of midyear 1983, the debt ratios of the household and combined (corporate and unincorporated) nonfinancial business sectors were 53.2% and 53.0%, respectively — already down from 53.9% and 54.5%, respectively, at yearend 1982. A decline of 15-25%, applied either to households or businesses alone or to both together, will represent a substantial readjustment. The market forces (chiefly high real interest rates) which constrain the private sector to limit its debt expansion to a slower pace than that of nonfinancial economic activity — and not as a temporary retrenchment in recession, but on a sustained basis at full employment — will probably also affect private sector capital formation.

Although a renewed depression of residential construction could perhaps be sufficient to reduce household mortgage borrowing by enough to absorb the entire required decline in the private sector's debt ratio, especially under the smaller "adjusted Reagan" deficits, even that extreme outcome would probably not permit any growth at all in the business sector's debt ratio — nor would sacrificing homebuilding to such an extent be desirable anyway. More probably, business debt relative to income will also have to decline in order to make room for the ballooning federal government debt.

Without the ability to raise external funds in the credit market, the business sector will largely have to forego taking advantage of the recently legislated investment incentives unless it turns massively to equity financing — an unlikely prospect in light of long-standing U.S. business financing patterns. In terms of the factors directly confronting business investment decisions, the problem will be that the increased real cost of financing (and, for some companies, reduced availability) will outweigh the added attractiveness of new

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investment due to the large favorable tax changes. After the early stages of the current economic expansion, business net capital formation will probably begin to decline once again.

The conclusion of this analysis from the perspective of stock-flow relationships therefore matches the conclusion reached above on the basis of flow-flow relationships. In the absence of some break from historical patterns of economic behavior that is now difficult to foresee, the continuation of large government deficits now projected even for after the economy's return to full employment will constitute a substantial impediment to the U.S. economy's net capital formation.

Some Easy But Wrong Answers

When problems are as serious as this analysis indicates that the U.S. Government deficit problem will soon be, there are rarely any easy answers. If there were, they would already have been adopted and the problem would not be so serious after all. Nevertheless, hard problems that are resolvable only by hard policy choices almost inevitably elicit suggestions that no such tough choices are necessary, either because some easy solution is readily available or because the ordinary course of events will provide one on its own.

The threat to American business capital formation posed by the U.S. Government deficit in the 1980s is no exception in this regard. Three supposedly easy answers have dominated much of the public policy discussion of this issue to date. All are unsatisfactory.

Easy Answer #1 is that the lower tax rates legislated in the Economic Recovery Tax Act of 1981 will sufficiently stimulate personal saving to enable the economy to finance both enlarged government deficits and an increase in net capital formation.

Such an outcome is conceivable, of course, but it is unlikely for several reasons. To begin, a priori reasoning alone cannot even indicate the direction of the effect of higher after-tax returns on personal saving. The reason for this seemingly startling result is that higher after-tax yields affect the incentive to save in two potentially offsetting ways. Higher yields increase the reward, in terms of spending made possible later, for not spending today. This change in the terms on which consumers may substitute future for current spending increases the relative attraction of future spending, and hence unambiguously encourages saving out of current income. Higher yields also increase the rate at which savings grow, however, thereby making it possible to maintain desired spending levels in the future on the basis of less put aside today. This increase in lifetime total spending possibilities enables consumers to spend more both currently and in the future, and hence unambiguously discourages saving out of current income. Which of these two opposing effects is predominant can be determined only by resort to empirical evidence.

The problem here, however, is that the evidence on this question is ambiguous to say the least. Many important economic relationships have theoretically undetermined directions as well as magnitudes, but in the case of the effect of after-tax yields on saving the available evidence still provides essentially no ground for confidence about even the sign, much less the magnitude, of the net effect. Some studies have shown positive effects of a magnitude that would be meaningful in the context of the prospective deficit problem, while many others have shown no noticeable effect at all. At best, relying on a large saving response to the 1981 tax changes is hardly a prudent basis for sound public policy.

Further, despite the rhetoric that accompanied it, the 1981 tax bill contained few specifically targeted saving incentives. The reduction from 70% to 50% in the maximum marginal rate applicable to "unearned" income applies to relatively few taxpayers. The new IRA and expanded Keogh account provisions are potentially more important, but for many individuals they will only affect infra-marginal rather than marginal saving flows (and hence, by the reasoning outlined above, will unambiguously reduce those individuals' total saving). By far the greatest part of the personal tax reduction enacted in 1981 and implemented during 1981-83 has consisted of general across-the-board rate cuts, which are unlikely to have much impact on saving behavior even on the most optimistic rendering of the available evidence.

Finally, because the projected government deficits for the balance of the 1980s are so large, even a doubling of the personal saving rate — from the 1951-80 average of 4.8%, to 9.6% — would merely finance the likely deficit, without leaving anything in addition to increase the economy's net capital formation. Only an extraordinary increase in personal saving, to magnitudes approximating that of several countries abroad, would meet both needs. Although the reasons why the U.S. personal saving rate is so low in comparison to that of some other countries remain imperfectly understood, they almost certainly involve some fairly fundamental aspects of societal arrangements rather than just marginal tax rates. Indeed, the simple cross-country correlation of growth rates and marginal tax rates is more often positive than negative (see Table 6).

Easy Answer #2 is that a combination of large profits during the economic expansion and the liberalized depreciation allowances legislated in 1981 will still provide business with a sufficient internal cash flow

TABLE 6

TAX RATES, ECONOMIC GROWTH, AND CAPITAL FORMATION

	Overall Effective Marginal Tax Rate on Corporate Sector Income	Average Growth of Real Capital Stock in the Corporate Sector	Average Growth of Real Gross Domestic Product
Germany	48.1%	5.1%	3.7%
United States	37.2	3.7	3.5
Sweden	35.6	4.7	3.2
United Kingdom	3.7	2.6	2.3

Notes: Growth rates are averages, per annum, for 1960-80.
Effective tax rates are based on average 1970-79 inflation rates.
Source: M.A. King and D. Fullerton, The Taxation of Income from Capital: A Comparative Study of the U.S., U.K., Sweden and West Germany — Comparisons of Effective Tax Rates. (National Bureau of Economic Research, 1983).

both to boost the historically small corporate saving rate and to enable business to undertake increased net capital formation despite the likely reduction in its relative indebtedness.

The problem here is that there is no one-for-one correspondence between increased business cash flow and increased net investment. At the most immediate level, the typical corporation is likely to pay out some fraction of the increased after-tax cash flow, either by raising dividends or by buying shares in other corporations in the course of mergers and acquisitions. There has already been some evidence of such activity, although corporate dividend payouts usually respond to changes in cash flows only with a lag.

Further, even that part of the increased cash flow which corporations retain still does not bear any direct correspondence to overall business investment. Net private saving in the United States is quite stable as a share of gross national product (see again Table 5). This relative constancy suggests that, on balance, respective fluctuations in corporate saving and in personal saving about offset one another, as shareholders adjust their own direct saving for the saving that corporations do in their behalf. More sophisticated statistical analysis confirms this result, typically indicating a personal saving response great enough to offset more than half of whatever variations occur in corporate saving. The basic point is that what constrains net private investment (apart from government and foreign deficits) is net private saving, and rearranging the <u>composition</u> of net private saving is not the same as raising its total.

A closely related line of reasoning is that, because price inflation raises the effective tax rate on business investment, the recent slowing of U.S. inflation will reinforce the effect of liberalized depreciation allowances and hence boost business cash flows (and after-tax rates of return) still further. In fact, however, recent studies have shown that the overall effective marginal tax rate on income generated in the U.S. corporate sector is relatively insensitive to inflation. Inflation clearly distorts the allocation of capital by widening the dispersion among the different marginal tax rates applicable to different forms of corporate sector investment. At the average inflation rate prevailing in the United States during 1970-79, for example, the range of marginal tax rates on income generated in the U.S. corporate sector extends from -105% (that is, a 105% subsidy) on machinery financed by sale of debt to pension funds and used in the commercial sector, to +111% (that is, more than full confiscation of proceeds) on buildings financed by sale of equity to households and used in commerce or industry. Nevertheless, inflation does not much affect the overall tax rate in a way that would plausibly reduce the total amount of capital formation.

Easy Answer #3 is that the United States can finance both its government deficit and its net capital formation with foreign capital inflows, as investors abroad increasingly see both high U.S. interest rates and the stable American political and economic environment as strong attractions for their saving.

Further increases in foreign capital inflows (corresponding to a negative net foreign investment position in Table 5) will no doubt occur. Indeed, for 1984 it is likely that such inflows will increase to 2% or more of U.S. gross national product — enough to finance one-half to one-third of the government deficit. Moreoever, such inflows do constitute a direct addition to the internally generated net saving available to finance both government deficits and private domestic investment. Why, then, are still further increases in foreign capital inflows not the most straightforward way to deal with the problem?

Especially in the context of concerns about the U.S. economy's international competitiveness, foreign capital inflows score points only by giving away the game. An inflow of capital from abroad is simply the mirror image of a balance of payments deficit on current account. Foreigners hold an increasing amount of dollar assets (net of U.S. holdings of foreign currency assets) because Americans are buying more from abroad than foreigners are buying from the United States. The resulting imbalance of payments on current account inevitably makes foreigners net investors in dollar assets and, correspondingly, inevitably produces a negative U.S. net investment flow.

The direct counterpart to these capital inflows, therefore, is exactly the deterioration in U.S. net exports which has produced such widespread concern about American business competitiveness in recent years. The U.S. balance of merchandise trade has deteriorated from a seemingly invincible surplus before 1971, to a mixed pattern of relatively small surpluses and deficits during 1971-76, to continual deficits of $25-35 billion per year during 1977-82, to a likely deficit of $60 billion in 1983. Because of a positive balance in services, together with substantial net investment income, the U.S. current account balance is typically more positive than the merchandise trade balance by $30-40 billion per year. A current account deficit equal to 2% of gross national product, or more than $60 billion, as is likely for 1984, therefore means merchandise imports in excess of exports by about $100 billion. In fact, the U.S. merchandise trade deficit will almost certainly set a new record again in 1984. Capital inflows and current account deficits in the range of 5% of gross national product, as would be necessary to finance the entire U.S. Government deficit during the remainder of the 1980s, would imply merchandise trade deficits of $250-300 billion per annum throughout this period — an enormous sum in comparison with the $250 billion of imports and only $217 billion of exports traded last year.

The chief market mechanism by which these large capital flows would have such devastating effects on U.S. net exports is the effect of real exchange rates on product demand and market share. If foreigners were willing to invest in the United States in such volume — and, just as improbably, if their governments were willing to permit it — their actions would further raise the international exchange value of the dollar after allowance for cross-country inflation differentials. The resulting higher real dollar exchange rate would in turn further erode the ability of U.S. exporters to compete in world markets, and a wide variety of other U.S. businesses to compete against foreign producers for domestic sales. In large part, this process has already accounted for much of the accelerated decline of U.S. competitiveness since 1980.

In addition, if a policy of large foreign capital inflows were maintained for very long, it would sharply change still further aspects of the U.S. economy's international economic balance, like the positive net flow of investment income. After all, borrowing from foreigners is fundamentally different from borrowing from ourselves. The United States' total net international investment position — that is, U.S. holdings abroad less foreign holdings here — officially stood at $200 billion as of yearend 1982. (After allowance for relevant "errors and omissions," the actual total was probably more like $100 billion.) Only a year or so of net capital inflow equal to the government deficit would entirely wipe out this net position, and subsequent inflows would increasingly make the United States a net debtor nation.

Solving the government deficit problem with foreign capital inflows would merely substitute a crowding out of the economy's foreign sector, via high real exchange rates, for the crowding out of the investment sector that would otherwise occur via high real interest rates. From the perspective of the economy's internationl competitiveness, that would hardly represent a satisfactory development.

In sum, none of these three "easy answers" represents an adequate response to the threat to American business capital formation posed by the U.S. Government deficit in the 1980s. A hard problem requires harder choices.

Tough Choices for Public Policy

What options are available, then, for preventing the U.S. Government deficit in the 1980s from having the adverse effect on business capital formation, and the economy's productivity and competitiveness, that is likely under a continuation of current tax and spending policies? The time has come — to be accurate, it is well past due — to search seriously for ways to reduce the deficit. To be successful, such an effort will probably require a willingness to compromise on other objectives also valued by important constituencies.

In terms of the balance of saving and investment, what is required is, at the least, to reduce the deficit to 2% of gross national product — in other words, some $84 billion on average during fiscal years 1984-88. Deficit reduction of that magnitude would at least restore the availability of net private saving as it stood in the 1970s. Alternatively, in terms of the outstanding stock of U.S. Government debt, returning the government debt ratio to its midyear 1983 level of 33.4% by the end of fiscal year 1988 would require shrinking the deficit to $118 billion on average during 1984-88, while returning the government debt ratio to an even 30.0% (the upper limit of its range during the 1970s) would require shrinking the deficit to $83 billion on average during this period. Either cutting the absorption of net private saving to its 1970s level or stabilizing the government debt ratio at the upper end of its 1970s range would therefore require very major changes, even in comparison with the Reagan Administration's budget proposals, not to mention currently existing tax and spending legislation. The important question is what changes.

The standard trio of suggested ways to reduce the federal deficit in the medium-run future includes cutting entitlement program benefits, slowing the scheduled acceleration in defense spending, and eliminating either the reduction in individual income tax rates which took effect in 1983 or the indexation of the tax code scheduled to take effect in 1985. The magnitude of the change involved in reducing the average 1984-88 deficit to the $84 billion level (or even $118 billion) is such, however, that no one among these three steps would by itself be sufficient. On the contrary, some combination involving major elements of all three is almost surely necessary.

Table 7 shows a decomposition of the U.S. Government budget position (including off-budget outlays) into components roughly corresponding to these three policy options, plus an additional expenditure category for net interest payments, measured throughout as percentages of gross national product. The table applies this decomposition to the actual outcomes for fiscal year 1970 (arbitrarily selected as a convenient benchmark), 1979 (the last in which the federal deficit did not exceed 2% of gross national product) and 1983, as well as to the projected average annual outcomes for 1984-88 on both the current services and the "adjusted Reagan" budget bases.

This decomposition shows that the substantial swelling of the U.S. Government deficit as a percentage of gross national product during the 1984-88 period reflects a combination of (1) a reduction in revenues of about 1% in comparison to either 1970 or 1979; (2) an increase in defense spending of about 2 1/2% in comparison to 1979, but not 1970; (3) an increase in net interest payments of about 1 1/2% in comparison to either 1970 or 1979; and (4) an increase in all other spending of about 4% in comparison to 1970, but not 1979. Such comparisons can never serve to resolve issues that depend so heavily on value judgments, of course, but they at least help to place in perspective the nature of the policy choices to be made.

Finally, difficult as it would be to reduce the federal deficit to $83-84 billion on average during 1984-88, even this magnitude of budgetary change would still provide not <u>zero</u> absorption of private saving and a <u>falling</u> government debt ratio, as in the earlier postwar decades, but

TABLE 7

COMPOSITION OF U.S. GOVERNMENT BUDGET AND BUDGET DEFICIT, 1970-1988

	Actual 1970	Actual 1979	Actual 1983	Projected 1984-88
Revenues				
Historical/Current Services	19.9%	19.7%	18.6%	18.6-18.8%
Adjusted Reagan Budget	-	-	-	19.2-19.4
Defense Expenditures				
Historical/Current Services	8.1	5.0	6.5	7.5-7.7
Adjusted Reagan Budget	-	-	-	7.5
Net Interest				
Historical/Current Services	1.5	1.8	2.7	3.0-3.3
Adjusted Reagan Budget	-	-	-	2.9
Other Expenditures				
Historical/Current Services	10.6	14.5	15.4	14.2-14.6
Adjusted Reagan Budget	-	-	-	13.4-13.6
Deficit				
Historical/Current Services	0.3	1.7	6.1	5.5-6.8
Adjusted Reagan Budget	-	-	-	4.4-4.8

Notes: Data are annual flows (for 1984-88 averages of annual flows), as percentages of annual gross national product.
Military retired pay is included in "other expenditures," not in defense expenditures.
Other expenditures include off-budget outlays.
Source: Office of Management and Budget, U.S. Department of the Treasury.

merely a 2% absorption of saving and a stable government debt ratio as in the 1970s — hardly an enviable era for federal budgets, corporate finance, net capital formation, productivity growth, and the U.S. economy's international competitiveness. Setting the stage for a restoration of the more favorable pre-1970 environment is almost certainly beyond reach in the foreseeable future.

* * *

Mr. Chairman, thank you for the opportunity to present my views to the committee.

The CHAIRMAN. Mr. Klein.

STATEMENT OF DR. LAWRENCE KLEIN, PROFESSOR OF ECONOMICS AND FINANCE, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Dr. KLEIN. Thank you, Mr. Chairman, for asking me to come. I would like to join the other sentiments and congratulate you on undertaking these hearings because the issues are, indeed, very important.

I've submitted a statement for the record, and I simply want to summarize some of the points made there.

There are two reasons why the deficit is a serious issue. The first is that the deficit really is the bottom line of Government activity, and it's a terrible bottom line that we are being presented with. I think personally that that reflects somehow on economic efficiency or inefficiency, and we would say that the Federal Establishment just isn't being run well if it's generating a $200 billion deficit.

To some extent, the previous discussion which dealt with the Grace Committee reports attacks that problem, but that, I think, is only a part of the issue.

The second reason why the deficit is very serious is that there is great fear about crowding out of private-investment activity. Now I presented in my report a table on what has just happened, as far as sources and uses of funds in the economy are concerned and what my own group, the Wharton Econometrics Group, have projected for the next 2 years with regard to the sources and uses of funds.

I think that there is an issue, and it is very important to try to get the facts straight. A great deal of the difficulty of the last year has been the making of poor forecasts on the part of some people and just using slogan words that there will be crowding out, without looking at the numbers.

There are three reasons why there hasn't been crowding out so far and why we don't expect to see crowding out in the immediate future. The first reason is that—and it has already been mentioned to some extent—there is a great increment in retained earnings of corporations. We expected that, and it is coming on stream. There is also a great increment in capital recovery allowances. That, in particular, is due to the 1981 tax provision. But, in general, we are having some very big gains in funds. Those to some extent offset the need for the Federal Government to come into the capital market and borrow.

A second way in which we could avoid crowding out is through accommodation, by the monetary authorities. There has been significant accommodation over the last year and a half, at least compared with what it was before. And we can only surmise that there will be some continuing accommodation at least to the extent of not letting interest rates get back to the kinds of levels that we saw in 1981 and 1982, until the end of the summer of the latter year.

The third reason is that there is an inflow of foreign capital. That is primarily attributed, in many discussions, to the relatively higher interest rates or attractiveness of interest rates in the United States compared to other countries. But I think that view neglects looking at the extent to which a great deal of that money has come into the United States—as a safe haven. We can't do anything about that. We shouldn't make ourselves an unsafe haven, but there it is.

Just to give you some numbers, this year we should see corporate savings up by $12 billion, and next year by about $25 billion before it levels off. But as the increments to corporate savings level off, then we find corporate capital consumption allowances growing very strongly at $20 billion this year, $28 billion estimated next year, and $30 billion in 1985.

If the Federal Reserve authorities stick to their stated targets, as far as monetary growth is concerned, if we have the projection of recovery that we are making with about a 9-percent increment in business investment and 7 percent the following year, 1985, then I would say that there will be some slight upward growth in interest rates, but not enough to cut off the recovery.

Nevertheless, it is worthwhile asking what can you do to make the situation better. What can you do by way of policy to bring down the deficits?

Senator Danforth asked a question earlier—will the growth in the economy make the problem fade away? I made calculations of the following sort: Modeling exercises of the economy to attain 6 percent unemployment rates by 1986 through a combination of policies, at best could be expected to yield a deficit as low as $100 billion.

You might consider that an enormous achievement, but it still leaves us with a very big deficit figure.

Formerly, say 5 years, 10 years ago, in undertaking such studies, we went into strong surplus with that kind of a calculation. But the tax system has been so weakened and cut back in the last 2 or 3 years that now an enormous effort in getting to a very favorable figure of unemployment by 1986 still leaves us with a very significant deficit.

Now that says that we can't just sit back and watch it go away. We are not necessarily likely to get to that favorable point. And even if we did, we would still have a very significant deficit. In my recommendation, I would say the obvious thing to do is to change the policy mix. The policy mix should change toward an easier monetary policy, and a stricter fiscal policy, which would mean some tax increases. I'm not going to take time at this moment to recommend one particular tax increase over another. And, also, there should be expenditure cuts. It's simple arithmetic. You've got a difference between revenues and expenditures. You cut expenditures, you increase revenues, and it's as easy as that.

But at the same time we don't want to do that—cut expenditures; increase revenues and spoil the level of economic activity. That would call for a compensating move on monetary policy. So an easier monetary policy with a stricter fiscal policy, would, indeed, improve the budgetary situation, and one could find mixtures that would leave the level of growth where it is.

I think a more fundamental issue, if you are not just looking at what you can do today or tomorrow—but the more fundamental issue is to improve American productivity and competitiveness. Particularly we must lower the enormous merchandise deficit that we are faced with, externally. That balance should never be in the neighborhood of $100 billion or $70 billion—in that range. We should try to get the merchandise deficit down to about $30 billion through, in my terminology, industrial policies that would improve our competitiveness.

Thank you.

The CHAIRMAN. Thank you, Dr. Klein.

[The prepared statement of Dr. Klein follows:]

The Deficit and Economic Performance

L.R. Klein

The public have been conditioned to accept a large federal deficit as an ordinary part of the economic landscape. At first, the prospect of a $100 billion deficit and subsequently a $200 billion deficit was contemplated with great horror and fear. The unwillingness of policy makers to do anything about this enormous gap and the apparent economic recovery have led people to accept the present deficit numbers as something that they can accept, however reluctantly.

Since the deficit is a simple arithmetic balance between receipts and expenditures it is clear that the only way to change the situation is to increase revenues or decrease expenditures or have some combination of both; it is as easy as that.

Of course, receipts or expenditures may change automatically, as a consequence of overall economic performance, but it is surely wishful thinking to expect that the deficit will simply wither away without our doing something about it.

When the deficit is in the neighborhood of $200 billion, we recognize and applaud great achievement if it could be brought to the neighborhood of $100 billion, but this would be a poor target that can only be accepted in a state of despair.

Will the deficit cause harm to the economy, perhaps even choking off the recovery that many are relying upon to bring the deficit down? There are two senses in which the existence of a large deficit brings harm to the economy. In the first place, the deficit is a "bottom-line" on the books of the federal government establishment. A good bottom-line near zero indicates that the establishment is being run efficiently, much as a private company's bottomlir^ is used as an indicator of efficiency in the private sector. By forcing adherence to overall budget balance in department after department, the chief executive can monitor economic efficiency, for this is the executive's only accounting measure of how well the management job is being done in the federal establishment. We are now witnessing the worst imbalance in our peacetime history, and there is a painful lack of response to the prevailing inefficiency in the federal government bureaucracy. Budgets are for the management of enterprise in either the public or private sectors and the failure to adhere to budgetary discipline, allowing the imbalance to soar, must be laid at the foot of the administration.

The second source of economic harm of the deficit is its possible "crowding out" of private investment activity in the present recovery. It is more than one year since the recovery began, and private investment has not been crowded out, it is still recovering briskly and expected to continue; therefore, we lack concrete evidence that the existence of the large imbalances does indeed crowd out private investment threaten the choking off of the present recovery. Nevertheless, we still have the future to contend with; the recovery has not yet run its full course, especially the course that would be normal for business cycle experience, which is what we should rightfully expect.

The crowding out scenario runs as follows: Large credit demands by the federal government for the purposes of deficit financing absorbs large amounts (some $200 billion) of funds from the money market. In order to induce lenders to part with this sum, with due allowance for risk in an environment where default has become a fact of life, high interest rates must be paid. This will drive up the cost of capital to investors, who will then retrench and send the economy into a relapse.

The Wharton Forecast does not accept this scenario. It fully recognizes the huge borrowing requirements of the federal government -- now, as well as from the very beginning of the present administration's fiscal/monetary program -- and projects a sources and uses statement of funds flows that permit the recovery to continue with only moderate increases in interest rates and a steady revival of capital spending. The latter is absolutely necessary for confirmation of the second stage of recovery. The first stage having just been completed.

There are three factors that enable the economy to absorb the large credit demands of the federal government:

(i) large increments in gross national private savings, providing corporate liquidity, especially through retained earnings and capital consumption allowances.

(ii) monetary accommodation by the Federal Reserve System

(iii) an inflow of foreign capital.

All three items can be seen in the statistical summary of the sources and uses statement as projected in the latest Wharton Forecast.

Table 1. Sources and Uses of Gross Savings

	1983 Q2	Q3	Q4	1984 Q1	Q2	Q3	Q4	1985 Q1	Q2	Q3	1982	1983	1984	1985
	Billions of Current Dollars, SAAR													
Gross Saving............	419.3	452.2	490.8	508.9	531.1	553.4	575.1	588.9	602.3	612.0	405.7	440.2	542.1	604.7
Gross Private Saving....	533.7	585.4	623.9	638.2	650.3	665.0	682.3	715.3	731.5	723.5	521.5	571.1	659.0	726.3
Personal Saving.........	91.5	115.5	137.0	136.8	134.4	134.9	139.3	160.0	163.3	152.2	125.4	116.4	136.3	158.5
Undistr Corp Profits...	55.2	68.2	74.1	77.5	80.8	86.1	89.5	91.7	92.9	93.8	46.4	58.6	83.6	86.5
Corp Inven Val Adjust..	-10.6	-15.6	-18.3	-16.9	-17.3	-18.8	-21.0	-23.3	-24.3	-24.8	-8.3	-12.3	-18.5	-24.6
CCA Adjust. Corp Prof..	25.6	38.2	41.2	44.2	49.2	52.2	54.2	61.2	66.2	71.2	-1.1	29.7	50.4	68.5
Capital Cons Allowances	373.3	382.5	389.9	396.6	403.4	410.6	418.0	425.7	433.3	441.1	359.2	379.1	407.1	437.3
Wage Accruals Less Disb	-1.3	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	0.0	0.0
Gov Surplus or Deficit..	-114.4	-133.2	-133.1	-129.3	-119.3	-111.5	-107.2	-126.5	-129.2	-111.5	-115.3	-130.9	-116.3	-121.6
Federal..................	-166.1	-188.5	-192.5	-189.3	-178.5	-170.5	-166.6	-186.4	-189.9	-171.3	-147.0	-182.6	-176.2	-181.3
State and Local........	51.7	55.3	59.4	60.0	59.2	59.0	59.4	59.9	60.6	59.8	31.2	51.7	59.4	59.8
Cap Grants Recd by...... U.S. (Net)..............	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Investment........	417.1	453.0	480.8	498.9	521.1	544.4	567.1	581.8	596.2	607.0	406.2	437.1	532.9	599.2
Gross Private Domestic.	450.1	498.2	532.7	551.7	573.0	593.7	616.1	631.3	647.6	657.8	414.5	471.3	583.4	649.8
Net Foreign Investment.	-33.0	-45.2	-51.9	-52.8	-52.0	-49.2	-49.0	-49.3	-51.4	-50.8	-8.3	-34.2	-50.8	-50.6
Statistical Discrepancy.	-3.5	1.1	-10.0	-10.0	-10.0	-9.0	-8.0	-7.0	-6.0	-5.0	0.4	-3.4	-9.3	-5.5

Corporate savings are moving up smartly now because overall profits are strong in this environment of wage moderation. In the recession, this figure declined. Now we look for increments of $12 billion this year and $25 billion next year, before leveling off in 1985. Simultaneously, capital recovery comes alive as a result of the favorable rates of capital write-off, that were introduced in the tax legislation of 1981. We expect to find an increment of $20 billion this year, $28 billion next year, and $30 billion in 1985. This source of funds begins to take over when the increment in undistributed profits begins to falter.

The federal deficit is but one component of national savings. It is inadequate to analyze the capital market situation in terms of this item alone; the whole savings picture must be pieced together. People tend to look primarily at personal savings flows. These are important but pitifully small in this country, and we make up for this deficiency by providing corporate cash flow on a large scale. We would like to see households spend now, in any case, in order to stimulate aggregate demand. Thre is also some increment in the stat./local surplus, which helps a bit in 1983.

The Wharton Forecast factors in moderate growth in money aggregates permitted by the overall policy of the Federal Reserve System. On a yearly basis, we are looking for M1 and M2 growth within their stated bands. This is prudent accommodation. For the near term, we see no reason why the monetary authorities would want to jeopardize our national recovery; it is crucial to the whole world recovery movement, and all our partners are depending on it. Moreover, a monetary squeeze that would generate higher rates would place such an excrutiating burden on heavily indebted countries that it would put the whole world monetary system in a state of panic, and I am sure that our authorities do not want to make this mistake a second time.

Finally, there has been a large flow of foreign funds into the United States, an increase of some $26 billion are estimated to have crossed our shores (net) in 1983. Wharton projects an increment of $16 billion in 1984 before the total stops growing significantly. Some of these funds come in search of high interest rates, but a great deal come in search of a safe haven, to earn potential profits in business ventures, and to set up production on our land in order to forestall movements towards protectionism.

This is the Wharton picture of the near term. We are looking for real gains in business investment of more than 9 percent in 1984 and 7 percent in 1985. These contribute to continuing overall (estimated) cyclical recovery rates of 5.9 percent (year-over-year) in 1984 and 3.7 percent in 1985.

The economy can move forward despite the ludicrous deficit figures. It is an unhealthy situation inspired by the excesive tax cuts of 1981-83 and the large scale spending programs. Again it has been a simple matter of arithmetic -- too few revenues; too much spending. What can be done to bring down the deficits to more manageable levels?

Apart from the obvious techniques of raising taxes and cutting spending we can seek policies that attempt to achieve a better fiscal/ monetary mix, stimulate activity and affect the revenue/expenditure balance. Prudent tax increases and expenditure cuts can do some good, but they do restrain economic activity and thus make only limited contributions to deficit reduction.

It used to be the case, some five t ten years ago that stimulative policies (scenarios) applied to the Wharton Model generated high employment activities and quickly brought the federal budget towards balance. The fiscal structure has been so severely changed since 1981 that the Model no longer has that resiliency. Policies that aim to bring the economy to about 6 percent unemployment by 1986 reduce the deficit from its present level of about $200 billion to figures near $100 billion. This is no mean achievement, in the circumstances; although it leaves us far from balance, as in the good old days.

A combined monetary and export expansion program that would lower interest rates by about 200 basis points and close the merchandise deficit by about $40 or $50 billion would be the main ingredients of a policy mix that would provide better growth, less unemployment, and a smaller deficit. The deficit would fall, on the expenditure side through lower interest and personal transfer outlays. It would expand on the revenue side through the provision of a better tax base.

It would not be inflationary because interest costs would fall, and because the primary way to promote exports is through the pursuit of policies to raise productivity by our becoming more cost effective in the world market place. Appropriate introduction of industrial policies would be an important measure for progress along this line of development.

The CHAIRMAN. I will next call on Dr. Meltzer. And I'm hoping when we finish the panel we might get into such questions as whether we ought to do it in 1984 or wait until after the election. Now maybe that's not a judgment for you to make, but do you think we are better off doing it earlier than later. And, second, if we could do something in the neighborhood of $150 billion debt reduction package over a 4-year period, which would take effect in 1985, would that have any impact on interest rates. Questions of that kind.

Dr. Meltzer, last time you had a story about supply siders, which I have used, which has now been attributed to me. Have you any update on that bus accident?

STATEMENT OF DR. ALLAN MELTZER, PROFESSOR OF POLITICAL ECONOMY AND PUBLIC POLICY, GRADUATE SCHOOL OF INDUSTRIAL ADMINISTRATION, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PA.

Dr. MELTZER. I think the bus, Senator, is still in the ravine and your committee is trying to get it out.

The CHAIRMAN. Still three empty seats?

Dr. MELTZER. I think that's right. There are still three empty seats. In fact, there may be a few additional. Many of the people who have talked so much about supply side tax cuts don't want to understand that a tax cut that gives the public more savings, which are then borrowed to finance consumption in the spending part of the budget, hasn't really increased the net amount of saving available to finance capital spending at all. But I don't have as good a story to illustrate that, I'm sorry to say, this time.

I join all the others who have applauded you and the members of your committee for continuing to focus attention on this very important issue. People invariably describe fiscal deficits by using words like "unprecedented," "massive," "unsustainable." It's important to continue to think about what are the options that are available to us for reducing the fiscal deficit.

The policies that we have pose a challenge; not just for us, but for every developed democratic country in the world. In each of these countries government spending rises relative to income and rises relative to taxes. In the world economy and in the world marketplace we have not only our own deficit to be financed, but own deficits which are large relative to the GNP's of Germany, France, Japan, and other countries.

The challenge for us and for everyone else in the democratic-developed world is to bring spending down. Long ago, John Maynard Kanes, whose name is commonly associated with deficits, remarked that what the Government spends, the public pays for. It's only a matter of how those payments are to be made. The issue that comes before this committee is not just the deficit. It is the amount of spending, and how we choose to finance it; how much we want to finance by selling bonds, by printing money, by taxing. What do those choices do to the consumption and investment balance in the country.

It is, in my judgment, correct to recognize that the current deficit and future projections cannot be ignored. But it is wrong to think that we should look at the deficits and say that we must eliminate the deficit. What we have to do when we look at those deficits is ask what is it that this country is going to do with the resources it has. If it is going to run deficits, how should they be financed? Should we go back to high inflation? That would be a mistake. Should we continue to finance them with the sizable increases in the public debt that have been described? I believe that that would be better than to return to inflation, but by no means ideal.

Should we raise taxes to prevent the crowding out caused by debt? Tax increases are not going to prevent crowding out. They are going to assure it because they will make sure that the Government gets the resources that it needs to finance the level of spending that the Government has elsewhere decided upon. And that level of spending, currently, is mainly spending for consumption. It gives for defense, which is largely current consumption. Defenses leaves us with no large capital stock to be used for productive purposes. Large amounts of spending go to health care, income security and the like. And, of course, as we have pointed out many times, there are large outlays for interest on the debt, and in anticipation of the future years' debt because those future debts have an effect on real levels of interest rate and add to the burden of financing.

The current level of spending for consumption poses serious problems, and we need to address them. But we must not look at them primarily as a question about whether we should have a deficit. First, we must look at how much income redistribution we want. One of the main decisions that the Congress makes when it passes the budget is who pays and who receives.

Second, we have to decide how much public goods we want—spending for pollution, police, defense and the like, the legitimate, historic functions of Government, called public goods.

And, finally, Congress decides on what the consumption investment balance in the country is going to be by giving incentives to various activities. Now when we remove taxes and encourage saving, we do not, as I said, assure that we are going to have more investments if the Government then borrows a large part of the increase in savings to finance consumption expenditure for defense, public goods of various kinds, redistribution to social security and the like. If we want to get this economy back to a high growth with low inflation, the best way to do it is to get as large as possible a cut in those spending programs that sustain or increase consumption.

There are things which could be done that have not been done. For example, I estimate that if we had indexed Government bonds when the British did it, we might now be saving something on the order of $5 to $10 billion in gross interest costs each year. If we would lower the variability of monetary policy by improving Federal Reserve control procedures, we could lower short-term interest rates by 2 to 3 percentage points. A 2-percentage points reduction in rates paid on the debt under 1 year is $7½ billion in interest savings per year.

The Grace Commission report suggests other savings. And many of those savings should be made. But we cannot, I believe, end the deficit just by those savings or solve our problems just by those savings. There must be additional cuts, I believe, in the Government's spending for consumption.

Thank you.

The CHAIRMAN. I will just say as a matter of information that we are going to have hearings on that portion of the Grace report, over which we have jurisdiction, so they should probably come in February or early March.

[The prepared statement of Dr. Meltzer follows:]

Closing the Deficit

by Allan H. Meltzer

Statement Prepared for the Senate Finance Committee

December 12, 1983

Are deficits a problem? A year ago, the dominant view of Wall Street economists, the media and prominent politicians was that deficits would produce rising inflation, slow growth and a hesitant recovery in 1983. Interest rates could not decline, we were told, in the face of projected Treasury borrowing. Virtually every blip in interest rates was attributed by commentators to changing views about the possibility of financing a $200 billion deficit. A member of the Council of Economic Advisers who suggested, at one point, that there was no accurate or reliable evidence relating deficits to interest rates was made humble for his apostasy.

Now that many of these forecasts have been shown to be wrong the rhetoric has changed. Tub-thumping about the deficit continues, but most financial market forecasters do not predict a prompt return to high inflation, recession, stagnation or a rise in interest rates to the levels of 1981. The locus of concern about deficits and their effect on interest rates and inflation has changed markedly. Now, it is the administration, or parts of it, that expresses concern about the effects of the deficit on interest rates, the trade balance the level of investment and the continuation of the recovery into 1985.

These are important concerns. In view of the claims and counter-claims, it may be useful to set down some of what is known about the relation of deficits to inflation, interest rates and economic activity.

Four Propositions

Four propositions summarize some principal findings about deficits based on experience here and abroad.

First, there is no reliable evidence that the size of the budget deficit has any effect on interest rates, and there is no reason to expect to find evidence of an effect. Interest rates are determined by spending decisions on one side and by decisions about asset portfolios on the other. The size of the deficit, interest rates, income and other variables are determined simultaneously for given tax rates, fiscal rules, monetary policy, anticipations and the like. Studies that fail to show a relation between deficits and interest rates – and there are now many such studies – simply confirm this implication of economic theory. There is no reason to be surprised by these findings. But, they should not be misread. People who look for a relation between the size of the budget deficit and the level of interest rates are looking in the wrong place.

Second, the way a deficit is financed affects interest rates, prices, exchange rates, exports and imports. If the deficit is financed by issuing money, prices rise. Sustained high rates of money growth permit real incomes to rise more rapidly for a time, but this effect terminates relatively quickly and is replaced by a more lasting effect on inflation. Interest rates rise with sustained high money growth and inflation. The dollar depreciates on the exchange market if the domestic rate of money growth exceeds rates of money growth abroad.

In the twelve months ending June 1983, the Federal Reserve purchased 7% of the increase in public debt held outside Treasury trust accounts. This rate of purchase required the Federal Reserve to increase its holdings of debt by 11%. If the Federal Reserve finances projected deficits of $200 billion per year to the same extent, money growth will remain high, inflation will return to double digits, and market interest rates will rise.

Current deficits do not require the Federal Reserve to inflate. To prevent inflation, the Federal Reserve must finance a smaller share of the deficit. More must be financed by selling bonds to the domestic public or to foreigners. These sales of debt on the market raise real interest rates. Capital flows in from abroad, attracted by the rise in real rates. The dollar appreciates. The offset to the capital inflow is a current account deficit; exports are lower, and imports are higher. Domestic industries that export or compete with imports have lower sales. We buy foreign goods and services and export our bonds.

The rise in real rates does not require a rise in market rates of interest. If money growth and inflation remain low, a decline in inflation premiums can more than offset the effect of the debt sales on real rates. It is the rise in real rates, however, that causes the current account to remain in deficit.

There are not many reliable estimates of the effect of debt on real rates of interest. Some of my own work suggests that each one percent rise in the amount of debt held by the public raises short-term interest rates by nine basis points. Using this estimate implies that the approximately 25% increase in the stock of privately held public debt raised short-term real rates by more than two percentage points in the year ending June 1983.

Third, high real interest rates raises costs for all borrowers. The Federal government, as a major debtor, cannot avoid these costs. If after-tax real interest rates remain high relative to the growth of real income, the real interest cost of servicing the debt can rise faster than tax revenues; the debt can rise without limit relative to income.

A fiscal policy that requires the debt to grow without limit cannot continue. A policy of this kind is infeasible. If the government fails to act, the public can act on its own. Experience in countries like Chile under Allende or Argentina in the mid-seventies suggests that when the public becomes convinced that government lacks the determination to end the fiscal crisis, by reducing spending or raising taxes, there is a flight from money and other nominal assets. Tax payments are delayed, the deficit widens, interest rates and inflation rise rapidly. In Mexico, Brazil and Argentina, we have seen a similar process operate with respect to foreign debt.

Real interest rates cannot be measured precisely but, on reasonable measures, current after tax real interest rates are high enough relative to the prospective growth of real income to suggest that projected growth rates of government spending and taxes may produce a crisis. We know that interest payments have increased relative to nominal budget receipts and outlays for several years. Gross interest payments, in current dollars, have doubled in the last four fiscal years.

Currently, there is no sign of a flight from the dollar or other indication that we are on the edge of a crisis. We should not take too much comfort from that. Several other countries have similar problems, so concerned investors may be uncertain about who will and who will not solve the fiscal problem. There should be no doubt that our problem is serious. In the three most recent years ending in June, private ownership of public debt rose by 13%, 15% and 25% respectively. In contrast, for the four years ending in 1980, the average growth of debt, measured in current dollars, is 10%. Since inflation was 10% or more in the past, the real debt did not increase, or increased slowly. Now inflation is lower, so the growth of real debt is much greater relative to the past.

Fourth, current fiscal policy shifts spending from investment to current consumption. Much of the government's spending, including defense spending, is used to maintain or increase consumption spending.

Deficit finance is not the issue here. A central issue that Congress and the administration must decide when they choose fiscal policy is how much they want to favor current consumption at the expense of investment and future consumption. This decision is not made by setting taxes alone. Deficits financed by inflation are a tax on wealth. In our tax system this tax has fallen heavily on saving and productive capital. Deficits financed by issuing debt allocate domestic and foreign saving to current consumption if, as is true in our system, Congress and the administration choose to spend mainly for consumption.

A major problem with popular versions of supply side economics is the neglect of government spending. The proposition that taxes affect the allocation of spending is a half truth. It is true that taxes can shift the balance between consumption and saving. We cannot neglect the other half of that truth – that the allocation between consumption and investment is not much affected if the government reduces taxes and borrows the additional saving to finance consumption.

What Should Be Done?

Concern about fiscal policy should not focus on the narrow issue of the deficit. Closing the deficit by increasing taxes substitutes tax revenues for bond finance. The taxes crowd out private spending to maintain government spending. The main effect on government outlays comes from the reduction in interest payments resulting from the reduction in the projected size of the debt and the fall in interest rates induced by the reduction of debt. Any positive effect on private investment depends on the type of taxes and on the relative effects of lower interest rates and higher taxes.

Changes in fiscal policy should be undertaken with a clear understanding of their effects on resource allocation. Current fiscal policy encourages consumption. If the public, Congress and the administration are content with an economic expansion in which investment spending for plant and equipment remains relatively low, debt finance can continue as long as the debt does not rise so fast relative to output as to make the policy infeasible. If a higher rate of investment and lower inflation is desired, Congress and the administration must reduce spending.

Most reductions in spending must come from health, pensions, social security and defense. The relative size of these programs makes them the obvious targets if reductions in the aggregate are to reach $50 or $100 billion. These are not the only place for budget reductions, however. Spending on agricultural programs has nearly doubled in the last two fiscal years. Reducing the appropriation for agriculture to the level of fiscal 1981 would reduce spending by $20 billion or more.

There are other opportunities that have not been exploited. The Treasury Department has refused to consider indexation of long-term debt. As a result, they are now paying billions of dollars of interest that could have been avoided. Between June 1981 and December 1982, the Treasury issued $170 billion in debt with more than three years to maturity at an average interest yield in the neighborhood of 13%. Inflation in 1983 is at least 4 or 5% below the rates of inflation anticipated at the time much of this debt was issued. A saving in gross interest cost of $7 to $8 billion would have been achieved in 1983 if these issues had been indexed. And, if inflation remains low or falls, additional savings of the same, or greater, magnitude would be achieved annually.

The computation overstates the true saving by neglecting taxes on interest, by using gross rather than net interest cost and by assuming that the entire $170 billion would have been sold as indexed debt. But the computation also underestimates potential interest reductions that the Treasury could have achieved.

The Treasury had the opportunity to offer holders of outstanding high coupon bonds the opportunity to exchange their bonds for indexed debt when inflation was high. If this offer had been made in 1981, when fears of continued inflation remained strong, it is not unreasonable to believe that the taxpayers would now pay billions less for interest expense.

The British government introduced indexed bonds in 1981, on a limited scale, and later opened their offers to all market participants. Currently, ten per cent of the British debt is held as indexed bonds, so taxpayers as a group benefit from the fall in inflation by spending less for interest on new and older debt issues.

A further, substantial reduction in interest cost could be achieved by reducing the variability of monetary policy. Estimates prepared for the Treasury suggest that the increased variability of unanticipated changes in money growth raised short-term rates in 1979 to 1982 by three percentage points. Variability had declined recently, so the risk premium in short term rates is somewhat lower.

If improvement in monetary control reduced variability of money growth to the average levels of the 1970s, short-term interest rates would fall approximately two percentage points below current levels. Currently, there is more than $370 billion of privately held debt due within one year. A two percentage point reduction in interest cost saves approximately $7.5 billion of interest payments annually. Additional savings would be available on longer-term debt.

These examples are taken from one part of the government budget, the part I know best. They suggest that opportunities for cost saving budget reductions are available if the Congress and the administration are willing to make desirable reforms. The Grace Commission presented a long list of additional savings. Many of their proposals also require desirable changes in administrative practices and established ways of conducting public affairs. These opportunities should be taken if the proposal reforms are considered desirable.

Democratic governments face the challenge of returning to price stability within an environment in which private firms provide high employment and use savings to finance investment, growth and rising standards of living. I believe it is a mistake to see this challenge as a problem of closing the deficit. It is a mistake to believe that these objectives are best achieved by raising taxes. It is a mistake to believe that our current fiscal problems can be solved once and for all.

The central fiscal problem in democratic societies results from the increase in the share of our output taken by governments. This share has increased from decade to decade in all developed, democratic countries. The challenge is to cut back that share or keep it from rising. To do so, the public must be willing to tolerate and the Congress and the administration must offer reductions in spending for defense and social services as the main elements in a program to shift resources from consumption to investment.

The CHAIRMAN. Dr. Weidenbaum, we are pleased to have you back before the committee. I don't know whether you are pleased, but we are pleased to have you back and appreciate your testimony.

STATEMENT OF DR. MURRAY WEIDENBAUM, DIRECTOR, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO.

Dr. WEIDENBAUM. Mr. Chairman, I'm delighted to be back as a private citizen.

The CHAIRMAN. There is a difference.

Dr. WEIDENBAUM. The adverse consequences of wall-to-wall deficit financing at the annual level of $200 billion are, in my judgment, serious in terms of interest rates, investment, foreign trade, and economic growth. But these consequences are not so terrifying that any way of reducing the deficit should be adopted.

Tax increases, especially those reducing saving and investment, would be counterproductive. To increase taxes at this time is also a confession of failure to control Government spending. There is literally a San Andreas fault in current budget policy. It is the failure to match the 1981 tax cuts with spending cuts. However we measure it—in real terms or percent of GNP—Federal spending is still a growth area of the American economy.

Opportunities for budget savings abound in every department. For example, a recent GAO report chastised the Department of Defense for not being able to spend effectively the large budget that had been given to it. That underscores the concern I've raised repeatedly—that the current military buildup is so rapid that it may not be feasible.

The shift by the administration from 5-percent annual growth in real military spending to 10 percent or more has never been convincingly explained. Surely our military posture has not deteriorated in these last 3 years. A return to the 5-percent target is appropriate. We do not promote the national security by showing the Russians how fast we can spend money.

On that front, I cite the frantic end-of-fiscal-year buying by the Pentagon this fall—57,000 softballs, a 14-month supply of paper, and piles of icecube makers, video cassette players and similar weapon systems. [Laughter.]

Dr. WEIDENBAUM. Turning to entitlements. The fastest growing item is farm subsidies, which have risen by over 700 percent in the last 2 years. There is no economic justification for dairy subsidies, sugar subsidies, and similar payments at the expense of consumers and taxpayers.

And then there is the all other category. That part of the budget recently has been elevated to sacred cow status because either the total is declining or supposedly it's too small to fuss with. That is a copout.

Let us look at the specifics, such as the public works projects just endorsed by the Senate Public Works Committee. At a time when the Treasury is paying 12 percent for its long-term money, the committee and the Corps of Engineers are using a discount rate of less than 8 percent. Despite that disguised subsidy, we find new projects with the most marginal ratios of benefits to cost: 1.1, 1.08, and 1.0. In plain English, this means that Congress is scraping the bottom of the pork barrel. Why increase taxes to cover that sort of spending even if we label it "investment"?

I have other examples in my written statement. What should be done?

The CHAIRMAN. Do you have any on Congress?

Dr. WEIDENBAUM. Yes, I do. I mention the Love Boat bill, for example.

We need a comprehensive round of spending cuts based on that old but neglected principle—good budgeting is the uniform distribution of dissatisfaction. Not enough of the spending agencies are dissatisfied.

As I reflect on the budget process as a private citizen, it becomes clear that there is another basic imbalance in the way Congress considers the budget issues. Just think how much time in committee hearings is devoted to proposals for raising taxes, and how little to specific ideas for cutting budgets. Virtually all of the appropriation hearings are devoted to agency representatives defending their increases. I suggest a radical change.

Schedule at least 1 day of public hearings for each department of government at which the proponents of budget cuts present and defend their ideas. The Grace Commission reports provide an initial basis. But don't do them all at once. Do them department by department. And include also the menus of budget cuts being prepared by CBO.

Advocates of economy in government often bemoan the lack of public support for specific budget cuts. That's not surprising. Such support will only be forthcoming if the public gets the opportunity to learn about and debate specific alternatives for achieving budget savings. The Congress now has the opportunity to exercise bipartisan leadership in launching that vital educational effort.

Thank you.

[The prepared statement of Dr. Weidenbaum follows:]

THE WAY OUT OF THE BUDGET QUANDARY

by Murray L. Weidenbaum

Testimony before the Senate Finance Committee,
Washington, D.C., December 12, 1983

The prospect of wall-to-wall $200 billion deficits for the next several years is one of the few dark clouds in an otherwise upbeat economic environment. Yet these outsized budget deficits do not mean, as some observers seem to fear, that the end of the world is approaching.

Polar alternatives and dramatic extremes are always more likely to attract public attention. The federal budget is no exception. On the one hand, there are many economists and others who contend that deficits do not matter at all. They cite as evidence the current robust recovery in the face of $200 billion of annual Treasury borrowing.

On the other hand, there is no shortage of financial and economic authorities who point to the same deficit as the source of high interest rates, large foreign trade deficits, and sluggish business investment in new facilities. Because of these factors, they expect the recovery to lose steam early next year.

The more likely result -- as is so frequently the case in economic disputations -- falls in that dull middle area. When the government runs a deficit, that does make a difference, in both financial markets and in the pace of business activity. But surely deficits are not the only factor that matters. The underlying strength of the private sector is a far more basic determinant. In that regard, a strong recovery in the private economy is underway.

According to my foggy crystal ball -- and that of most experienced forecasters -- this recovery will last at least until the polls close that Tuesday in November in George Orwell's year. But the current expansion may not be as strong or as long-lasting as we would like. There are two major clouds on the economic horizon. The first is the possibility that monetary policy will veer either to excessive tightness or to excessive ease. The second danger is that fiscal or budget policy will continue to generate unusually large deficits even as the economy continues to expand.

With reference the first problem area, my standard advice to the Federal Reserve Boar. is straightforward and hardly novel. It is to follow a path of moderate, stable, and predictable growth of the money supply. One such sensible path is the middle of the Fed's own target range for growth in M1, which is a bit above where monetary growth is now.

The second problem area is the more difficult one. Let us turn to the genesis of the budget quandary facing the United States. To put it in a nutshell, the fiscal problem arises because the 1981 tax cuts have not been matched by the reductions in federal spending which were anticipated when the tax cuts were proposed in early 1981. In effect, we still have not earned the tax cuts. Surely, the view that cutting taxes was the fundamental way to control spending has proven incorrect. The events of recent years have underscored the old truth, that the only way to reduce or slow down the growth of federal outlays is to get the Congress to appropriate less.

I will note in passing that another possibility for deficit reduction is to broaden the tax base. This is, of course, the basis for the various flat tax proposals. However, their proponents find it more convenient to stress the pleasant or benefit side of their proposals -- tax rate reductions -- rather than the painful or cost side represented by increasing the proportion of income which is taxed. In any event, raising revenues from broadening the tax base is as much a tax increase as raising the rates on the existing base.

But what about all the spending cuts that have been made? On the surface, the growth in federal spending has been slowed down in the past several years -- in nominal terms. The substantial progress in bringing down inflation has kept nominal spending down (but it has had a larger downward effect on the flow of revenues from the progressive federal income tax).

Government spending in real terms is continuing to rise. The estimates of real budget outlays for fiscal years 1982-86 contained in President Carter's swansong budget were lower than the estimates for the same period contained in the Reagan Administration's most recent budget report (see Table 1). Another way of looking at the budget situation is to note that federal outlays in fiscal 1980 were 22 percent of GNP and in 1983 they were 25 percent (see Table 2).

To be sure, tens of billions of dollars of reductions have occurred in proposed Federal expenditures. Yet those unprecedented cuts (mainly reductions in proposed increases) have been made entirely in a few civilian areas, such as grants to state and local governments and selected social welfare programs. But those decreases have been more than offset by the simultaneous rapid expansion in military outlays, farm subsidies, and interest payments and the continuing and almost inexorable rise in "entitlement" outlays. The initial budget report of the new Administration (issued in March 1981) had a line for "unspecified savings," a large amount of budget cuts

Table 1

COMPARISON OF THE CARTER AND REAGAN ADMINISTRATIONS'
PROJECTED BUDGET OUTLAYS FOR FISCAL YEARS 1982 TO 1986
(in billions of dollars)

	1982	1983	1984	1985	1986
From President Carter's Last Budget					
Nominal Outlays	739.3	817.3	890.3	967.9	1050.3
Real Outlays (1972 Dollars)	345.0	351.7	355.4	361.2	368.8
From President Reagan's Latest Budget Review					
Nominal Outlays	728.4	809.8	848.1	918.3	990.9
Real Outlays (1972 Dollars)	351.7	373.7	373.6	385.7	397.8

Source: Budget of the United States Government, Fiscal Year 1982 (Washington, D.C., Government Printing Office, January 15, 1981); Office of Management and Budget, Mid-Session Review of the 1984 Budget (Washington, D.C., July 25, 1983).

Table 2

FEDERAL SPENDING AND THE GNP

Fiscal Year	Federal Outlays as a Percentage of GNP
1980	22.4
1981	22.9
1982	24.0
1983	25.2

Source: Budget of the United States Government, Fiscal Year 1984 (Washington, D.C., Government Printing Office, January 1983).

presumably to be specified at a future date. What ensued reminds me of the words of the old song, "Tomorrow, I'll be leaving, but tomorrow never comes." I am not attempting to identify culpability, but surely there is substantial responsibility for the diminished ardor for budget cutting at both ends of Pennsylvania Avenue and on both sides of the aisle.

In any event, the 1981 tax cuts have not been accompanied by comparable spending cuts. That is the basic fault -- a sort of San Andreas Fault -- in our current budget policy. It is the fundamental reason for the large budget deficits that are in prospect. When we include off-budget financing -- that portion of government spending which Congress arbitrarily has moved out of the budget but which must be covered by Treasury borrowing -- most public and private forecasts show a continuing level of deficit financing in the neighborhood of $200 billion. In terms of the economic impact in the next several years, that is a rough neighborhood.

What should be done about those deficits? As seen from a distance, there are two contending viewpoints in Washington, D.C. One downplays the significance of the deficits, while the other urges tax increases to bridge the financing gap. While neither approach is devoid of merit, both possess basic shortcomings. My fundamental objection to them is that they both divert attention from the third alternative that I will develop in a moment.

With reference to these first of these two views, deficits will not bring the end of the world, but they do matter. This economy would be much healthier if the deficits were half their present size. Lower deficits would help achieve lower interest rates, a more competitive dollar in world markets, and, thus, an improved outlook for the basic industries that have been so hard-hit by foreign competition. Less federal borrowing would also free up more funds for housing and business expansion. Although I cannot pinpoint the exact amounts involved, the direction of change seems clear.

On the other hand, with reference to the second viewpoint, I believe that a general tax increase would be misguided. To state the matter bluntly, deficits are not so undesirable that we should ignore the costs of proposals to reduce them. There are ways of curbing the deficit that would do more economic harm than good, and a general tax increase is a prime example. It would signal to the advocates of more government spending that they now have a clear field. But, more basically, it would reverse the beneficial effects of the 1981 tax cuts. I call the Committee's attention to a study by Allen Sinai and his associates in the September 1983 issue of the National Tax Journal, which shows the positive effects of the 1981 tax cuts on saving, investment, and economic growth.

There is a third and more satisfying -- although more difficult -- response to the budget problem facing the nation. That is to move ahead with a comprehensive round of budget cutting. I take as my inspiration the old motto of the budget office, "Good budgeting is the uniform distribution of dissatisfaction." The truth of the matter is that not enough of the spending agencies are dissatisfied. Far too frequently, pleas for additional spending cuts are brushed aside by pointing out that defense is too important to cut, entitlements are too difficult to change, and the "all other" category is not big enough to bother with. Anyone who has participated in budget reviews must be convinced, as I am, that opportunities for serious and careful budget pruning abound in every department, military and civilian, social and economic. I would like to illustrate that key point.

Controlling Defense Spending

Let us turn to the admittedly difficult subject of defense budgeting. At least since the early 1970s, I have written about the need to bolster our defense capabilities. Thus, I strongly support the need for a military buildup. But, I do not see the desirability of exempting the defense establishment from the rigorous budget review that civilian agencies undergo. A recent report on the Department of Defense's budget problems by the General Accounting Office (GAO/PLRD-83-62) underscores this point. Here is a typical quote from the report:

> Last year we also reported that DOD did not have a well-planned strategy and priority system for applying increased funding to O & M programs. As a result, funds were applied to some programs in excess of what could be absorbed efficiently and effectively.
>
> DOD still does not have a well-planned strategy for applying increased funding to O & M programs.

GAO went on to point out specifics:

--At Fort Lee $2.7 million was received during September 1982 to be obligated before the fiscal year ended on September 30. The money was used to finance projects that had not been validated, were not in the approved backlog, and were not in the 1982 or 1983 work plans.

--At Fort Stewart year-end funding amounting to $92,000 was used to construct a bicycle path while more mission-related projects were not funded.

--At Little Creek Naval Amphibious Base, $300,000 was used to resurface tennis courts, widen sidewalks, and paint signs while roof repair projects went unfinanced.

Here is a sampling of other shortcomings found by GAO:

--As much as 36 percent of the flying done by Navy tactical and patrol squadrons is for nontraining activities; however, the budget is based on training for primary mission readiness.

--Each year millions of dollars "migrate" from mission-related programs to real property maintenance. Because much of these budget transfers occur in the last months of the fiscal year, projects of questionable need are sometimes funded in an attempt to spend the money before year-end.

In my own research, I have questioned -- not the desirability -- but the economic feasibility of the rapid buildup on which the Pentagon has embarked. Studies such as the GAO's confirm this concern. More recently, we have seen reports of the Defense Department's rush to spend all its available money before the fiscal year ran out on September 30, 1983. Hasty procurement moves included buying 57,600 softballs, a 14-month supply of paper, and piles of ice-cube makers and video-cassette players. I suggest that tighter reins on defense spending will do more than contribute to a smaller budget deficit. Such improved managerial controls will solidify the necessary public support for the continued high level of military strength that is required for the dangerous world in which we live.

The rationale for shifting from 5 percent annual growth in real military spending, which was a key point of the 1980 Presidential campaign, to 10 percent has never been convincingly explained. Surely, our military posture has not deteriorated in these last three years. I suggest that a return to the 5 percent target is now appropriate. A more measured attitude to military preparedness avoids crash programs; it opposes the view that every nickle appropriated must be spent at all costs. We do not promote the national security by showing the Russians how fast we can spend money.

Controlling "Entitlement" Outlays

The largest category of federal spending is the "entitlements," which are dominated by Social Security outlays. Here I find it useful to analyze the problem in terms of three generations. The first is represented by that of my father, who is on Social Security. For most of their working life, he and his counterparts were told that they were earning a Social Security pension. In fact, the government set up account numbers to record all of their contributions, and those of their employers. You and I may know that those contributions, including the interest earned, do not begin to cover their monthly Social Security checks. But the recipients do not know that nor do they want to learn that bad news.

Frankly, I do not have the nerve to tell my own father that each month he is receiving the economic equivalent of welfare, and I do not expect any elected official to be more foolhardy. The inescapable fact is that this nation has made a moral commitment to my father's generation to pay at least the current level of monthly payments and probably some allowance to cover inflation. Advocates of budget restraint must accept that.

But my own generation is very different. We have the opportunity to adjust to changes in future Social Security benefits -- provided the shifts are phased in gradually. At least some of us are sophisticated enough to understand that retroactive benefits, by their very nature, must represent a hidden subsidy paid by someone else and thus are the economic equivalent of welfare outlays. Key long-term changes in benefits are, therefore, feasible.

But the most basic changes can be made in the generation of which my children are a part. Only recently have they left college and entered the workforce. Retirement benefits are very far from their minds. Provided taxes are not increased in the process, these younger people will likely go along with a variety of reasonable changes in the entitlement programs. This represents the long-term opportunity to reduce the welfare (or inter-generational transfer) aspect of these outlays.

Controlling Other Spending Programs

It has become fashionable to deduct defense and entitlement spending from the budget total and show that the remainder is either too small to fuss with or already declining. I find such an approach far too gross for a satisfactory analysis of the budget quandary. It ignores the important cross-currents that are occurring within the "all other" category.

For example, the fastest growing area of spending in recent years is neither entitlements nor defense. Rather, it is a component of "all other" -- farm subsidies. This category of federal spending rose from $3 billion in 1981 to $21 billion in 1983. Moreover, recent Congressional action on the dairy program ensures that the U.S. Department of Agriculture will continue subsidizing some of the wealthiest farmers at the expense of taxpayers and consumers.

An effective budget restraint effort must be comprehensive. Sacred cows are not limited to the dairy industry. Take the National Endowment for the Humanities. To urge a cut in that agency surely sets you up as a "heavy" who cares not a whit for culture. But an examination of the details is revealing. When I looked at how such money was to be spent in my own state, I found a portion going to finance a history of each of the fourteen branches of a municipal library. I do not believe that you have to be a Philistine to have the gumption to say that such expenditures show that we have not cut too much from civilian budgets, but far too little.

By no means do I intend to let the Congress off the hook. After all, each Federal outlay is made pursuant to an appropriation enacted by Congress. According to a recent report, the House Rules Committee took action to eliminate a supposed inequity: the members of the Committee were approving trips by members of other committees, but had not gone on any themselves. The chairman proposed to remedy this discriminatory state of affairs -- at the expense of the taxpayers, of course -- by a bus tour across the Potomac to Alexandria, Virginia. That suggestion failed to win sufficient support, but he persevered and succeeded in gaining approval for a trip to South America, Costa Rica, and Jamaica.

I do not mean to ignore the tax-writing committees either. In late 1982, the New York Times reported that the Congress had adopted the "love-boat" bill. Professionals who like sunbathing and shuffleboard while attending floating "seminars in the Caribbean" can now write off those so-called business expenses -- provided they take one of the four cruise ships that fly under the American flag. Such displays of patriotism are truly touching.

As long as Congress keeps taking actions like these, it is hard to expect the executive branch to adopt a parsimonious attitude. Far more depressing, such actions make it hard for the public to take our government and its budget problems seriously.

Conclusion

There is plenty of blame to go around. It is the President who submitted the $200 billion deficit budgets, and it is the Congress who is going along with them. Yet, it is the average citizen who generates the pressure for more government spending -- when he or she says "I'm all for economy in government . . . but don't cut the special project in my area or the one benefiting my industry, because that is different." I vividly recall my meeting with an interest group pleading for a bailout from the government. When I said, "That's just a form of welfare," the group protested vehemently: "Welfare is for poor people."

As I said at the outset of my testimony, this is no forecast of doom or gloom. With an expanding economy and a rising pool of saving, the budget deficits will, over time, shrink in importance. But meanwhile, if they force the Federal Reserve System to maintain excessive monetary stimulus, the deficits contribute to another round of inflation. If the Fed does not so monetize the deficits, the resultant Treasury borrowing will keep interest rates unduly high. Housing and business investment will increase more slowly than would otherwise be the case. Thus, economic growth and the rise in living standards will be more modest -- unless we take the necessary course of engaging in another round of comprehensive budget cuts.

In the current environment, an increase in taxes is a confession of failure to control spending. Effective expenditure control truly requires a bipartisan approach. When the conservatives want to cut the social programs in the budget, we should support them. The public must understand the realities of the entitlement programs: the beneficiaries are receiving far more than they are "entitled" to under any insurance concept that links benefit payments to contributions (including employer contributions and earnings on both). These programs contain a major component of subsidy -- from working people to retirees.

When the liberals want to limit the rapid defense buildup to the generous rate that candidate Reagan campaigned on (5% a year in real terms), we should support them, too. But we should part company with both groups when each tries to use its budget savings to restore the budget cuts made by the other. The budget quandary is no arcane matter. It simply represents our unwillingness as a nation to make hard choices. We can earn the 1981 tax cuts by matching them with spending cuts -- or continue to suffer the consequences.

Recommendation

The current public dialogue on the budget is unbalanced. In Congressional hearings as well as in professional publications, a great deal of attention is given to proposals for new taxes and increases in existing taxes. Very little consideration is given to ideas for reducing government spending. Just compare how much time the tax committees spend examining suggestions for increases in taxes with how little time the appropriations committees devote to considering proposals for reductions in expenditures. It may be an underestimate to say that 99 percent of the time spent at appropriation hearings is devoted to listening to agency representatives defend their requests for higher budgets.

The Congress now has one of those rare opportunities to redress this imbalance. A blue ribbon commission of private citizens has just completed a detailed analysis of possibilities for reducing federal spending. I am referring to the reports of the thirty-six of so task forces of the President's Private Sector Survey on Cost Control. To be sure, I am not now urging adoption of the Survey's proposals, but merely a public examination. I suggest that Congress devote one day of open hearings for each department of government during which the proponents of budget cuts could advise the Congress -- and in the process the American public.

Frankly, I do not know whether each of the Survey's proposals is necessary, but I do believe that a systematic examination of proposed budget cuts -- department by department -- is long overdue. The Congress might wish to expand the hearings to cover other suggestions for budget savings, such as those that have been compiled by the Congressional Budget Office.

Advocates for economy in government often bemoan the lack of public support for specific budget cuts. That should not be surprising. Such support will only be forthcoming if the public gets the opportunity to learn about, consider, and debate specific alternatives for achieving budget savings. The Congress now has the opportunity to exercise bipartisan leadership in launching this vital educational effort.

The CHAIRMAN. Thank you very much.

I am going to turn first to Senator Danforth under the early bird rule.

Senator DANFORTH. Gentlemen, I think most citizens believe the deficits are a serious problem, and most would like to believe that they can be reduced to a responsible level in a painless fashion. In your opinion, would it be possible to bring deficits to a responsible level if both tax increases and entitlement changes in the formula were placed off limit?

Dr. MELTZER. In a word, "no."

Dr. WEIDENBAUM. Definitely not.

Dr. FRIEDMAN. No.

Dr. KLEIN. No.

Senator DANFORTH. Now if taxes and entitlements are not placed off limit, that means that we, as politicians, most go to the American people and ask them to do something that hurts. That is to say that we cannot say to the American people, hey, there is some painless way to do this; there is some little program that doesn't effect you; there is some change in the government programs that has no impact on your life.

Could you in about 1 minute each, because that's about all the time I have in a round of questions—could you please do your best to explain to the American people why they should be willing to make some sacrifice in either increased taxes or some change of entitlements? Most people would say, well, we are in a recovery now; we are doing all right; unemployment is down; things are looking fine; why should I be asked to do something that affects me in the pocketbook?

Dr. MELTZER. I'll start, if I may. The basic answer is because we want to look beyond the current recovery to the future. And the basic issue is how much investment we are going to have. It is not true in my opinion, and on the basis of correct economic analysis, that the deficits will cause the economy to abort or to prevent the recovery from continuing except under very extreme circumstances. So that isn't the problem.

The issue is whether the economy is going to grow faster or slower or whether it is going to grow at all. Whether the people who are your constituents and whether their children are going to have jobs at higher or lower real income. There is no magic in that. The only way we are going to do that is by investing more. And those investments have to come and have to be financed by private saving. We have to get more of our private savings to finance those investments.

The way to do that is to cut back on the consumption which is being financed by the government.

Now we will not do that by taxing. All the taxing is going to do is to finance consumption spending. We have to have less debt and not more taxes and less spending for consumption. We have to cut back on the amount of current spending—defense and nondefense spending. And that should be something which would appeal, and must appeal to those constituents. Otherwise, we are not going to be able to solve the problem, Senator.

Senator DANFORTH. All right.

Dr. WEIDENBAUM. I would say that a fundamental problem is that we haven't earned the tax cuts of 1981 with offsetting spending cuts. And there are too many Federal spending programs that just clearly aren't worth it. And if I were back in Missouri—when I am, I point out that the National Endowment for the Humanities is financing a history of each of the 14 branches of the St. Louis Public Library.

Senator DANFORTH. That would seem to be a painless kind of thing. Everybody would say, oh, sure, we agree with that, and we want to cut things that are painless. What I am asking is that if we are saying to the American people that the numbers are so great that you have to be willing to make a sacrifice, why should they? How do you say to Mr. and Mrs. Average Citizen that you have to either pay more taxes, which I understand you are not advocating, or that you have to do something on the entitlements? That there is something that really affects them. Not something on the St. Louis Public Library.

Dr. WEIDENBAUM. If it's an unemployed autoworker in St. Louis or Kansas City for that matter I would emphasize the effect of those deficits via interest rates, and the value of the dollar on something very basic—the competitive position of the United States in world markets and domestic markets

Dr. FRIEDMAN. Senator, I think that the public ought to be able to understand the choices to be made. Life is full of opportunities to do things that are fun while they last, but that create all sorts of problems for the future. What we are talking about here is a set of policies in which we are, in effect, going to run down rather than build up the Nation's capital stock. That is really the same question as why shouldn't the farmer eat his seed corn instead of holding it for planting? Or shouldn't an individual go on a binge and run down his life's saving, and leave nothing for paying the rent next month? These are problems that at an individual level people solve every day. And most mature citizens seem to handle them at the private level pretty well. I think the problem is an educational one of making people aware that what we face at the Government level today is simply the equivalent of eating the seed corn or spending the life's saving, and that it has just the same kind of damaging implications for the economic health of all of us that those private actions would have for the individuals who take them.

Senator DANFORTH. And not just for a year from now but for our children and our grandchildren.

Dr. FRIEDMAN. Exactly so, Senator.

Dr. KLEIN. Well, I think the fact of the large deficits means that we are running a very lopsided economy. It's lopsided in terms of the deficit numbers, in terms of the kinds of interest rates that go with that. And while we can argue that it isn't necessarily going to cut off the present recovery, I think we can say that it does keep us from lowering rates and enjoying a better growth rate over the next decade.

I think we are causing enormous problems throughout the world for our partner countries, our partner countries in the democratic alliance as well as the developing countries. And the only hope for getting down to rates that they can live with is for us to reduce the deficit. And there we come back to the simple problems of arithmetic. We have to increase revenues or decrease expenditures.

But the only way we are going to get the revenues up is to have some tax increases. The only way we are going to get the expenditures down is to attack the big expenditures. Doing those things does not necessarily mean that we send the economy into a tailspin, because we can do compensating things to go along with that. In particular, we can change monetary policy.

Senator DANFORTH. Gentlemen, I think one thing that people understand is that they are willing to make sacrifices for the sake of their children. Now Professor Friedman stated this more clearly than anybody, but is it not the case that when we build a $200 billion deficit, adding that to the national debt, creating an additional debt which must be serviced every year for the rest of the future of the country, we are, in fact, passing on a legacy of bankruptcy to our kids? We are creating a problem for them which they will have to deal with year after year for as long as we have a country. That we are not only diverting funds from capital formation today, but we are creating a problem which will always be with us.

Isn't the clearest way to put it to the American people whether they want a country which is strong and solid and growing for their children? Whether that is the kind of heritage that they want to pass along.

Dr. MELTZER. Yes, Senator. I think the answer is we need more capital; we need to salvage some of the industries that we have. I think we have only touched on a part of the problem of the deficit here. We have, of course, a shrinking steel industry. We have a shrinking machine tool industry in this country. The steel industry may be going to shrink, but it doesn't have to shrink as fast as it is. It would shrink more slowly if we had fewer imports and more exports from this country. We would get that improvement in the steel industry if we had lower real interest rates. And we could do that by improving our fiscal position. That would require, again, cuts in spending.

We are not going to save those industries by taxing them. We are going to save them by cutting the amount of spending.

Dr. WEIDENBAUM. I would add the very great concern that it's not just the mammoth size of that $200 billion deficit, but where the money is going. I must admit if I thought that the defense program, for example, was following a more feasible path and still cost that kind of money to meet our national security needs, I wouldn't be criticizing it. If I thought all of the suggestions and urgings for infrastructure investment really contributed to the productivity of this country, I wouldn't put in the needlings that I did in that statement. But I have added up the really marginal Corps of Engineer projects in that new Senate bill and, if I have got the arithmetic correct, it comes to over $1 billion.

To put it bluntly, that's economic waste. Those resources would be so much more productive in the private sector.

The CHAIRMAN. Senator Mitchell.

Senator DANFORTH. Could I ask the other two on that?

The CHAIRMAN. Oh, excuse me.

Dr. FRIEDMAN. Senator, I am very sympathetic to your statement about the damage that we are doing to the economy we will bequeath to our heirs. Perhaps a helpful way to bring home these ideas to citizens everywhere is to emphasize the power of what compound growth rates are about over long periods of time.

In the 1880's, Great Britain was by far the wealthiest society and the greatest military power on Earth. And by the 1980's, Great Britain has become a third-class country in the industiral world in terms of economic income levels. How did that happen? Very simply by having a productivity growth rate approximately 1 percent less than everybody else's, sustained over 100 years. Differences that do not look big in terms of this year or next year or even the year after start to become much larger when we talk about a decade at a time. And by the time we get out to two decades and more, these differences can compound themselves into overwhelming impacts on our whole way of life.

Dr. KLEIN. Well, the American public were conditioned to accept $100 billion and were reconditioned to accept $200. It's a question of reversing that process.

You may very well have a good package for doing it. I think what you are saying is essentially in agreement with what the panelists have said, by pointing out that they are more worried about the medium term or the longer term and the growth prospects than about prospects for the next year or two. And that is equivalent to saying that we want to look for a better economy to pass on. You may be able to appeal emotionally to the public by putting it in terms of what we leave for our children and grandchildren.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

I think Senator Danforth's questions were pertinent and to the point, but incomplete because it excluded—and that really brings to mind the institutional substantive problem we have of what do we do with the defense budget as we are dealing with entitlements? Raising taxes and reducing entitlements would be painful, but I just want to tell you an instant that happened just recently. I spent the past 2 weeks traveling from one end of my State to the other holding meetings with all types of groups, as many of us have.

And on the very day that Secretary Weinberger announced that we needed a 21-percent increase in the defense budget, I appeared before a group of senior citizens. And I tried as responsible as possible to discuss the problems of the medicare situation, what we are prepared to do about it. And the very first question that set the tone of that meeting and every other one was: Senator, how can you possibly talk about cutting medicare for us when we read where the President and Secretary of Defense want to raise the defense budget to $305 billion. And we all know what that does.

I think Dr. Friedman's example was an eloquent one compared to the individual family, but the element missing is the necessary component of shared sacrifices that is required in any Government policy of this type. And the difficulty we are having here, I think, Mr. Chairman, is illustrated by your opening remarks that we are not going to be able to do anything about the defense thing in here. Here we are limited to having to deal with programs within our jurisdiction. And I thought you very aptly pointed out the major reductions we have already made, at least slowdowns in the increases. Here we are dealing with further reductions, the majority of which will come from programs under our jurisdiction. And at the same time elsewhere in this building, elsewhere in this Government we are confronted with the possibility of a truly massive rise in defense spending. And the best we can do is to hope to slow it down modestly.

I know Dr. Weidenbaum mentioned that repeatedly in his remarks. And I commend him for it. So I would like to amend the question and say can we do it without raising taxes, cutting entitlements or cutting—and I use "cutting" in the sense not only of an absolute reduction in which most people perceive it to be but also slowing down the rate of increases—the defense budget.

Dr. MELTZER. I certainly have emphasized and I would emphasize that there is no program that should be sacrosanct, Senator, and certainly not defense. I share your view that cuts should be distributed across the budget, if necessary, uniformly across the budget to the extent that is possible later rebuilding those programs where Congress believed that there was some urgent need and some program had been redueed too much. But there is certainly no case for sparing defense.

Dr. WEIDENBAUM. I agree. And there is even a more vital point. In the dangerous world in which we live, we have seen in the last 3 years a very basic deterioration in public support for greater defense spending. And I think that a more measured approach to the Pentagon's budget would restore that necessary public support for a long-run expansion in our military capability.

Senator MITCHELL. Dr. Friedman.

Dr. FRIEDMAN. I agree entirely with what you have said, Senator. I would just like to make a comment elaborating on what Mr. Weidenbaum said.

I have been surprised myself at the small extent of apparent support for the speed of the administration's proposed defense buildup among defense industry and other major business leaders. I consider that one of the interesting things I have learned within the past few years. I would have thought before that it would be difficult to find a level of proposed defense buildup which defense executives would not enthusiastically support. That turns out to have been wrong. I have found very surprisingly the number of defense industry executives and other business leaders who say flatly that they believe that the proposed speed of defense buildup is too rapid to be efficiently deployed.

Dr. WEIDENBAUM. By the way, it shouldn't really be surprising because—being concerned with the long-run public support for defense—they see that this is eroding that very public support.

Dr. KLEIN. But if you say we are looking for a better balanced economy, not what I call a lopsided economy, then it makes good sense to approach it with balanced policies. And that would mean some in tax increase, some in entitlement slowdowns, and some in military slowdowns. That makes a very good package.

And if we are in this altogether, there is no reason to place the burden in one part of the economy rather than another.

Senator MITCHELL. I would like to ask, if I might, Mr. Chairman, just to pursue with Dr. Friedman briefly, a question because I agree with his views, and therefore I tend to be more interested in them.

Why did you suggest that—you suggested a three point program: Reduce the growth in domestic spending, a less rapid defense buildup, and a tax increase, and you expressed a preference for repealing the third year of the tax cut. Would you elaborate please on why your personal preference was the latter in terms of a tax. Why do you prefer that as opposed to some other form?

Dr. FRIEDMAN. The basic reason, Senator, is that I think if we increase taxes we ought to be careful to do it in a way that least damages saving incentives in our economy.

Now I think that there were a few elements of the 1981 legislation which are likely to have some favorable impact on saving incentives. For example, reducing the top marginal rate to 50 percent I would include in that category. Also, for example, the expanded IRA and Keogh account provisions.

But I do not believe that the broad across-the-board rate cuts that we had put in place will have any meaningful impact on saving incentives, and I do not believe that reversing the most recent 10-percent cut would in turn damage saving incentives. At current rates of economic activity, looking to the current fiscal year, that third element of the tax cut is worth about $40 billion. As we look to a growing economy going out through the balance of the 1980's, it would be more nearly $50 billion per annum. That would be a sizable contribution to be made from the tax side toward reducing the problem we have before us. And I think it is a convenient point that people can readily understand. We say that in 1981 we legislated a 3-year tax cut; we took all three parts; it was simply too much; and we are going to reverse one part out of the three.

Dr. MELTZER. Senator, if I may, I would like to disagree with that. I would think that in this economy with the lowest saving rate of any major developed economy, if we have to increase taxes, we should choose a tax increase that would not fall on saving at all. It should fall mainly on consumption.

Dr. FRIEDMAN. I don't disagree, Senator. What Allan Meltzer just said is quite consistent with the overall thrust of my point. The problem is that, in our tax code as currently structured, there are some devices that are much more damaging to saving than others. Especially now that we have expanded IRA and Keogh provisions for the great bulk of the taxpaying public, what we have done is to convert the income tax into a consumption tax. And, therefore, higher rates on the income tax across the great majority of the taxpaying public really do simply amount to higher rates of a consumption tax.

Senator MITCHELL. I know you have the least enthusiasm of the four, I might say, for tax increases. Dr. Weidenbaum, maybe you would want to comment on that.

Dr. WEIDENBAUM. Thank you, Senator.

That's absolutely right. Why? Because in practice I see starting off with a carefully constructed package of tax increases, which is relatively easy to do, means you wind up soft-pedaling the more difficult task of developing the specific spending cuts. It's much harder to dig out the spending cuts. By placing tax increases on top of your policy agenda, I greatly worry that you are going to wind up with a lot of tax increase and a relatively small amount of spending cuts. What I'm really urging is reversing that—starting off with the spending cuts, and then see if you can do the job totally that way. Then if not, look for, as the two gentlemen have said, the least worse tax increases, those on consumption rather than on saving.

Senator MITCHELL. Dr. Klein.

Dr. KLEIN. I would rather recommend either cutting back or doing away with indexing. That's a part of the 1981 package. I think indexing is inherently a destabilizing device, and some of the worst experiences that we can observe in the world now are in countries that are indexed very heavily, more than in taxes. I think it's something we should stay away from. It gives us a very simple formula for having a tax increase.

The CHAIRMAN. Go ahead.

Senator MITCHELL. I don't want to hold you up, Mr. Chairman. I just had one more.

The CHAIRMAN. Go ahead.

Senator MITCHELL. The one element that has been missing about the tax increase question—and I ask both Dr. Meltzer and Dr. Weidenbaum, acknowledging their reluctance in that area in any event—is the question of the timing of when tax increases would take effect. There has been much discussion. As you know, the administration's budget called for $13 billion to go into effect immediately, and $46 billion to be so-called contingency to go in effect in the third year of a 3-year cycle.

Can any of you comment briefly on what you would favor for the timing of the taking effect of any tax increase, whatever the form?

Dr. MELTZER. If there were to be a tax increase, of course, as soon as you announce it, the present value of that tax increase will affect current spending. There is no way in which you can put the tax increase off until 1986, let us say, and not have an affect on economic activity in 1984. So that it's only a question of how you are going to distribute the effect. If you put all of it onto 1988, investors are going to work back to the present. They are going to put some share on current spending. The issue about the careful timing of tax increases is less important than it is made to be. And I would say that there isn't a great deal of expertise that can give a precise answer to your question such as two-thirds of it today and one-third 2 years from now. One reason is that we don't know what conditions are going to be when those tax increases actually occur.

We can guess that there will be a recession sometime between now and 1989 just on the basis of historical freuency.

I must add that I share Mr. Weidenbaum's view that the worst tax is to end the indexation. That would encourage Congress to go back to the bad old ways of inflating its way out of these deficits. It would solve nothing and only make the economy worse.

If there is to be a tax, the best thing to do is to have a consumption tax. And I would phase it in with whatever speed you can provided you are going to have to do it. The more revenues you get, the sooner you get them, the smaller the amount of debt. To go back to an earlier question, you are going to have a smaller amount of interest payments on that debt. The more quickly real interest rates come down, the better our prospect of returning to a stable, long-term growth path which is better than the one we are on now.

Dr. WEIDENBAUM. I really worry about that, and disagree with it. A national broad based consumption tax is such a powerful revenue raiser. It will seem easy to support just another 1 or 2 percentage points, and you are going to wind up with a much larger public sector than you otherwise would.

In any event, however, to get back to your timing question, uncertainty is something that does great damage to the investment process. So I'm not advocating tax increases, but if you are going to get it over with so to speak, make a decision, so that business planning can be made in the context of some certainty as to what the tax structure is.

I do tell my classes that maybe one form of new tax that is desirable is the one device by Jonathan Swift, the author of "Gulliver's Travels." He called it the ideal tax. It's a tax on women's beauty, self-assessed.

The CHAIRMAN. I thank first my colleagues who have been here off and on during the day, and we appreciate that very much.

I can't find agreement with the four committee members on the panel. We have 20 on this panel, and I have got to have 11 or I don't go anywhere. Eleven is the magic number. And we are not burdened with all the knowledge that you have, which is probably a good thing. It's good that you have it, but if we had it, I wouldn't ever get more than one vote. So I guess mine is a practical question. We don't know who is right. We have had some good discussions. I think it's fair to say the deficit is a matter of concern, if it continues to grow. Is that a fair assessment? Is there agreement on that?

Dr. KLEIN. Even if it stays at $200?

The CHAIRMAN. Yes. Even if it doesn't grow, it's a matter of concern.

Dr. KLEIN. I would say even $100.

The CHAIRMAN. You understand the parameters. Defense spending is off limits. It's not really off limits. Obviously, Congress will reduce it. We did fix social security earlier this year. I was there; I got one of the pens; and I know it was fixed. And so we are told by the Speaker and the President we can't touch that, and it's a very sensitive political issue.

And I guess the question is, under those constraints, plus the interest on the debt, even if we took back all those softballs, 57,000 softballs that the Defense Department bought, we would still be short of $150 billion.

Dr. WEIDENBAUM. You have to play hardball. [Laughter.]

The CHAIRMAN. Softball is good for the Defense Department because that's all they have had up here.

Dr. WEIDENBAUM. Precisely. But no department should be made off limits to budget restraint. The timing is vital. The longer you wait, the more of those defense contracts are awarded, the more difficult and more costly it is to control military spending or any kind of Government procurement program.

The CHAIRMAN. But let's say that we are going to do something on deficit reduction. And it's questionable you are going to do it in 1984 or 1985. And we are looking at a $150 billion package, which may or may not happen, over a 4-year period. Is there any disagreement that the sooner it is done the better, or should we wait until after the elections?

Dr. KLEIN. Economics would say do it definitely and do it fast. Politics are different.

The CHAIRMAN. Dr. Friedman?

Dr. FRIEDMAN. Mr. Chairman, I was puzzled by something you said that seemed to imply that among the four of us there had been a lot of disagreement. If anything, in view of the——

The CHAIRMAN. I think generally there is some, but there are different shades of differences, and it only takes a little shade to turn a "yes" vote into a "no" vote up here.

Dr. FRIEDMAN. But from the perspective of what the economics rather than the politics has to say, and especially in view of the range of the economic spectrum that you have represented on this panel today, I find it interesting that there is essentially no disagreement that the deficit ought to be reduced, and there is very little disagreement with the idea that a broadly based program that would combine some nondefense cuts of major magnitude and a slowdown in the defense budget of major magnitude, and along with that some tax increases, is a good way to go about it. If anything, it is remarkable that four such diversely oriented economists all have converged on exactly that view.

The CHAIRMAN. I think that's accurate. I probably did misstate the conclusion. And, of course, we are looking for the unity and strength and agreement that we ought to do something. I guess the primary purpose of this hearing is to try to get people to tell us who really understand it better than we do that time is running out. Now maybe it won't run out until maybe, what, in 1985 or some time?

Dr. WEIDENBAUM. It will be harder to control the military budget in 1985 than in 1984. In fact, it's hard already because of the commitments made, which will have to be changed to reduce the flow of spending from those commitments. Delivery schedules and production schedules will have to be revised.

The CHAIRMAN. Maybe we could help Paul Volcker, which is what Dr. Meltzer said, if, in fact, we had some fiscal restraints. It might make his job a little easier.

Dr. MELTZER. It would make all of our jobs easier.

I would like to answer your question in a slightly different way from the way in which perhaps some of the other panelists may have answered it. It does make a difference if we put a $75 billion tax wrench into the economy in 1 year rather than another. And it does make a difference whether we take $75 billion out of people's spending. And I personally believe the deficits are a problem, but I don't believe they are a problem that require that kind of a wrench. The committee's approach, which is to phase in these changes, and allow people to adjust to them, is exactly right. I would think that I would like to see much more, as I have emphasized, on the spending side, and less on the tax side. And more in defense than you are capable of delivering from your committee.

But with that proviso, I think the answer is you want to phase change in so that people have a chance to adjust their habits and get onto a different path. You want to make changes without causing a major wrench in the economy, which would occur if you suddenly put $150 billion worth of tax and spending cuts onto the public.

The CHAIRMAN. Even though we don't have jurisdiction on defense or agriculture, which is out of hand too—in fact, it has risen faster than the rate in defense spending. If we could find agreement on this committee, I believe the great majority would also be on the floor and voting to cut other areas. I mean we don't shirk from our responsibility, but we can't do it all in this committee. And we are not quarreling with other committess, but we can't just assume their jurisdiction. But we can help restrain the growth of programs in our votes in the Senate.

Dr. WEIDENBAUM. Some of us on this panel really want to lighten the load on the Finance Committee, Mr. Chairman, by emphasizing the spending reductions. And even if it isn't an either/or, it is a question of degree of emphasis, and I do worry when I hear about tax increases and then the spending cuts. When I see the composition of Federal spending, that marginal spending item, which is submarginal in any economic sense, just isn't worth it by any economical analysis.

The emphasis needs to be, aside from the committee jurisdiction, the emphasis, I suggest, needs to be on the spending cuts, and any tax increase be the residual.

The CHAIRMAN. I share that view. In fact, as I indicated in my opening statement, 11 of the 20 members of this committee voted against the budget resolution because it was $73 billion taxes, and $12 billion spending reduction. And then even fewer than that voted for the real thing when they offered a package of taxes on the floor. About half those who voted for the numbers voted against the real thing.

So I think there is a general feeling that it ought to be—at least the President suggests that it ought to be contingent. Now you can't make it so hokey that the contingency never happens. I think that's the other side of the coin. So we have been working with the Congressional Budget Office and Treasury trying to come up with some mechanism that if, in fact, you had your spending reduction in place, then you would have the tax changes. Would that be better?

Dr. WEIDENBAUM. Frankly, I think so. Let me add that at a time when it is fashionable to dump on the Congress and to criticize the White House for failing to cut spending, the real problem, I think, is at this side of the table. We, educators, communicators, we haven't convinced the public to change their attitude from supporting spending cuts in general but opposing any spending cut affecting their district, their special interest. It's still foolhardy for a Member of the Congress to run for reelection saying how much spending he or she wants cuts in his or her district or State. When that becomes fashionable, then we will really have succeeded in our educational mission.

But don't wait for that. [Laughter.]

The CHAIRMAN. Any other advice you have for those on the political side. I mean we really appreciate your input. And I think Dr. Friedman is right. I guess what I had in mind was that you would do away with the third year; somebody else would modifying indexing. I wouldn't want to do away with either. I might be willing to modify indexing a little bit in order to put together a package, but certainly not repeal it. So those are differences that we would have to adjust in this committee. But I think generally there is a concern about the deficit. I think Dr. Meltzer thinks a little more flexible monetary policy might avoid some of the problem. I do believe, though Paul Volcker hasn't said so, that we could be very helpful if we could tighten up a little on the fiscal side.

Anybody else on the panel want to make any closing comments?

Dr. WEIDENBAUM. One point on indexing. I think it's true tax reform. I hope you don't kill it. But if worst comes to worst, consider postponing it for a finite time so that it can be earned by spending cuts. Thus, the public will see for once a direct relationship between those tough cuts in spending and the benefits in terms of tax reductions.

The CHAIRMAN. Now all of you agree that we ought to continue base broadening or loophole closing, and there is no problem there on the revenue side. I mean whether you have got a recession or a recovery, if there is an egregious loophole out there, it's like a lot of the spending that you alluded to. We ought to address it in our committee. And I think, according to Treasury, $18 billion of this $70 something billion dollar package is in that category so it's significant.

Dr. KLEIN. I would like to emphasize something that Murray Weidenbaum said. Whatever you do, be very definite. And I think the concept that has surfaced from time to time of contingent taxes provide a very poor way to go. To leave decisionmakers, business decisionmakers, in a state of uncertainty as to what the tax system it is going to be is probably one of the worst things that could be done.

The CHAIRMAN. We agreed to that earlier on.

George, do you have any more questions?

Senator MITCHELL. No. I just want to say again, Mr. Chairman, I think you are really doing the right thing. I would just say in response to Dr. Weidenbaum though that I think public people are ahead of us on that. I think what they have to be persuaded of is not that they must sacrifice, but that everyone is sacrificing. It is the concept of shared sacrifice that is absent from the public's belief today. I think the overwhelming majority of Americans, of whatever political status, are prepared and willing to accept and make sacrifices if they can be persuaded that everyone else is being asked to do so. That's the biggest education. It's a substantive problem, I might say.

Dr. WEIDENBAUM. That's why I urged the hearings on every single department and not to rule out any at the outset.

The CHAIRMAN. Well, thank you very much. We will start again tomorrow morning at 10 with a panel consisting of Alice Rivlin, and Herbert Stein, and we will have other panels throughout the morning and afternoon.

Thank you.

[Whereupon, at 4:53 p.m., the hearing was recessed, and scheduled to reconvene at 10 a.m. on Tuesday, December 13, 1983.]

DEFICIT REDUCTION PROPOSALS

TUESDAY, DECEMBER 13, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:02 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Baucus, and Mitchell.

[The opening statement of Senator Dole follows:]

STATEMENT OF SENATOR DOLE

I was greatly encouraged by Treasury Secretary Regan's statement yesterday that the Administration's 1985 budget will include "some type" of tax increase proposal contingent on cutting spending.

Although we will have to await further details, I believe that the Administration's reaffirmation of the contingency tax concept will make it considerably easier to reach a bipartisan consensus on a major deficit reduction package early next year.

The Senate Finance Committee has been pursuing a $150 billion deficit reduction package that will require at least one dollar in spending cuts for each dollar in revenue increases. Under the Finance Committee's package, all taxes other than pure loophole closers will be made expressly contingent on the targeted spending cuts actually being achieved. This will guarantee that the promised spending cuts will be in place before any new taxes are initiated.

Thus, the Senate Finance Committee's contingency tax proposal sounds very similar in concept to the tax proposal that Secretary Regan now endorses. That is not surprising since the Finance Committee's contingency tax proposal is essentially a modification of the contingency tax advocated in the President's 1984 budget. The President's 1984 contingency tax proposal contained a $5 per barrel excise tax on crude oil. The Senate Finance Committee proposes a 2½-percent tax on all forms of energy. The President's 1984 contingency tax contained a 5-percent income tax surcharge on both individuals and corporations. The Senate Finance Committee's contingency proposal has a 2½-percent surcharge on high income individuals, a slight modification to the tax indexing formula and a 2½-percent additional tax on corporate economic income.

Secretary Regan made it clear that the Administration will not necessarily submit the same contingency tax that they proposed last year. Thus, there seems to be a great deal of room for Congress and the Administration to work out the details of this and the other elements of a mutually acceptable deficit reduction package.

The CHAIRMAN. Let me just quickly indicate that this morning we will have three panels, two witnesses in each panel. We have some very distinguished witnesses again this morning. We will meet again at 2 this afternoon. We will have a number of business groups testifying. And then we will be in session again tomorrow morning.

I would just say before calling on the first panel that I was greatly encouraged by Treasury Secretary Regan's statement yesterday that the administration's 1985 budget would include some type of tax increase proposal contingent on cutting spending. Although we will have to wait for further details, I believe that the administration's reaffirmation of the contingency tax concept will make it considerably easier to reach a bipartisan consensus on a major deficit reduction package early next year.

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The President's 1984 contingency tax contained a 5-percent income tax surcharge on both individuals and corporations. The Senate Finance Committee's contingency proposal was a 2½-percent surcharge on high income individuals, a slight modification to the tax indexing formula. And a 2½-percent additional tax on corporate economic income.

Secretary Regan has made it clear that the administration will not necessarily submit the same contingency tax they proposed last year. Thus, there seems to be a great deal of room for Congress and the administration to work out the details of this and other elements of a mutually acceptable deficit reduction package. I'm hopeful that that will be the final result.

Well, first this morning we are privileged to have two witnesses who have been before this committee a number of times. First, Alice Rivlin, former CBO director, Economic Studies Programs, The Brookings Institution, Washington, D.C; and Herbert Stein, now a senior fellow of the American Enterprise Institute, Washington, D.C.

Alice, you want to lead off. Your entire statement will be made a part of the record. If you can summarize, or whatever you wish to do is fine.

STATEMENT OF DR. ALICE RIVLIN, DIRECTOR, ECONOMIC STUDIES PROGRAM, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Dr. Rivlin. My statement is short, Mr. Chairman, and I think I will just read it in its entirety.

I'm delighted that you are having these hearings, and I'm very pleased to be back before the Senate Finance Committee as you focus on the urgent question of how to bring the Federal budget deficits down. I believe that the deficits now in prospect could have serious consequences for the economy. There is a significant risk that the high real interest rates resulting from the deficits could cause the current expansion to stall as early as 1985. Even if this does not happen, the high rates will discourage the investment we need to increase productivity and, by keeping the value of the dollar high, reduce our competitiveness in world markets.

I believe that the Congress should act quickly, before the election, to enact a comprehensive deficit reduction plan that slows the growth in both domestic and defense spending, and increases future revenues.

One might ask: Why do anything? Right now the economy is recovering strongly from the deep recession of 1981 and 1982. Consumers are spending at high rates, production is up, unemployment is down, and growth seems likely to continue at least through 1984, although at a slower rate than in 1983. So why worry? Won't the deficit come down as the economy improves? And isn't the deficit stimulating the recovery anyway?

Recessions normally cause the Federal budget to go into deficit. Revenues drop sharply as unemployment rises, and profits and incomes decline. Spending rises for unemployment insurance, and other recession related programs. This automatic deficit helps cushion the effects of the recession and tends to disappear as the economy improves. But the deficits now in prospect are different. They are increasingly structural. That is, not related to the level of the economy. If the economy continues to grow over the next several years, revenues will indeed rise and recession related expenditures will fall. Indeed, this is already happening.

But at the same time, with current policies, other expenditures will rise. Increased spending for defense, entitlement programs, especially medical care, and interest will keep up with the rise in revenues and the deficits will not decline. The most recent CBO forecast, based on quite optimistic assumptions about growth, inflation, and interest rates, shows deficits continuing at about the $200 billion level over a 5-year period.

Won't the fact that the Government is spending $200 billion more than it is taking in stimulate the economy and keep the expansion going? By itself, of course, it would. But the Government has to borrow the $200 billion in the financial markets. In a recovering economy, it has to compete with the private sector, which is also seeking funds to finance the expansion of plant and equipment essential to an expanding economy. This competition for funds puts upward pressure on interest rates.

The Federal Reserve can relieve this pressure by allowing the money supply to rise more rapidly, thereby monetizing the debt, but only at some risk of future inflation. High deficits in an expanding economy force the Federal Reserve to make a difficult choice between the risk of slowing or reversing the recovery, and the risk of future inflation.

This Federal Reserve Board has brought inflation down at great cost by limiting monetary expansion, and seems unlikely to take major risks of inflation reescalating substantially in the future.

We have never had a recovery at the high real rates of interest we are now experiencing, and no one can claim to know exactly what will happen. At best, if the Federal Reserve is very successful in its balancing act, the economy could continue to grow for some time. But interest rates would remain much higher than they would be with lower deficits. The interest-sensitive sectors of the economy, especially housing and investment, would likely grow relatively slowly. Slow growth in investment may retard the growth in productivity which is essential to a rising standard of living.

Moreover, high real rates of interest in the United States increase the flow of foreign capital into the United States. This helps us finance our deficit, but it also keeps the value of the dollar very high in international currency markets. The highly valued dollar in turn makes it expensive for foreigners to buy from us, and cheap for us to buy from them. It injures both exporters and industries that compete with imports, including such basic industries as steel, autos, and electronics.

At best, then, high deficits are compatible with continued growth, but likely to harm investment, housing, and our ability to compete in world markets. At worst, the Federal Reserve could become concerned about too rapid growth in the money supply, tighten too hard, and precipitate another recession.

Lowering the deficits, on the other hand, would take the pressure off the Federal Reserve, allow interest rates and the value of the dollar to come down, encourage investment, and improve our competitive position in world markets. Many of the pressures on Congress for protectionist legislation or industrial policy would recede in a world of lower interest rates and more favorable exchange rates. Lower interest rates would also reduce the cost of servicing the Federal debt, which has become a huge and growing item in the Federal budget. World interest rates would follow the U.S. rates down, and ease some of the burden on debt-ridden Third World countries.

The United States has chosen a high deficit, high interest rate policy in preference to a low deficit, low interest rate policy. For a country which is worried about its level of investment and productivity, its competitiveness in world markets, the health of its basic industries, and the ability of Third World nations to pay their debts to its banks, this is the wrong choice.

Moreover, not all the reasons for concern about the deficits are strictly economic. You should pardon such an old-fashioned sentiment, but I believe that people and businesses and Government should live within their means. This certainly does not rule out prudent borrowing. Individuals with good incomes should borrow to finance houses and cars. Businesses in sound shape should borrow for capital expansion. The Government should borrow to offset the impact of temporary economic setbacks on the economy. But a government which is running a rising structural deficit in an improving economy and adding rapidly to the burden of its interest charges is not setting an example of prudent management.

But why act now? No one would seriously propose bringing the deficit to zero in 1 year. The problem is too large to be solved immediately. The required increase in taxes and spending would be too disruptive. What is needed is a firm plan to bring the deficit down substantially over several years and enable interest rates and the value of the dollar to fall gradually at the same time.

The time to enact such a plan is now. The economy is growing strongly. A phased program of tax increases and spending cuts could be absorbed without risk to continued expansion. Reduction in interest rates and more favorable exchange rates would stimulate investment, housing, and net exports, offsetting the slower growth and consumption in government spending, and insuring more balanced and sustained growth.

Waiting until after the election, which realistically means mid-1985, to enact such a plan is risky. No one can be sure that the expansion will continue to be vigorous for another 18 months, especially in the face of high real interest rates. Recent recoveries have tended to be short. One could not have a high degree of confidence in a prediction that this one would be likely to be going strong well into its third year. It seems more likely that by the spring of 1985 growth will have slowed substantially and perhaps even turned negative. If the economy is sluggish or entering recession, it would be both economically undesirable and politically impossible to raise taxes or cut spending in order to reduce the deficit. Waiting until 1985 to take action on the deficit entails the risk of having to wait until after the next recession.

What to do? The deficits in prospect have no single cause and should have no single cure. To blame the deficit problem solely on tax cuts or defense spending increases or domestic spending growth is to oversimplify recent history. Over the last two decades the Federal Government took on substantial new spending responsibilities in the domestic arena. Spending for nondefense programs rose from about 9 percent of the gross national product in 1961 to about 16 percent in 1976. Most of this increase was for payments to individuals, especially social security and other pensions, and for health care for the aged, the disabled, and the impoverished.

For a while, we paid for these increases in part by shifting resources out of defense. Outlays for defense declined from 9 percent of gross national product in 1961 to about 5½ in 1976. But in the late 1970's we began the expensive process of modernizing our Armed Forces and reversed the decline in defense spending. We paid for simultaneous increases in defense and domestic spending by allowing Federal revenues as a percent of gross national product to creep up, mostly through the impact of inflation on a progressive income tax.

Then we ran out of patience with high taxes and cut tax rates substantially. We also cut domestic spending significantly, but not by enough to offset the combined increases in the deficit brought about by tax cuts, defense spending increases, and continued increases in entitlement spending and interest charges on the debt.

That's how we got the deficits. What can we do about them? Recent CBO projections suggest that without further action of the Congress, the deficit for fiscal year 1986 is likely to be about 4.4 percent of the gross national product in that year. My guess is that this is optimistic, but it's a good starting point. Reducing this 1986 deficit to 2 percent of the gross national product, the ratio that was obtained in 1981, would be an ambitious but not unreasonable goal. It would imply cutting the deficit to about $84 billion in fiscal year 1986 or finding about $100 billion in spending reductions or revenue increases in that year.

Such a program is only realistic if the Congress acts decisively early in the next session. It would send a strong signal to financial markets and the voting public that the Congress is determined to reduce deficits, and it could bring about substantial preelection reductions in interest rates.

Such a plan would have to be extremely simple and perceived as fair. It would have to spread the pain over a large number of taxpayers and recipients of Government spending so that no one group or type of program bore the brunt. It would have to be perceived as an emergency belt tightening, in which everyone is asked to give up something. And not as an effort to restructure the Federal tax system or redesign Government spending programs.

I share the widespread view that Government spending programs both defense and domestic could be made more effective and that the Federal tax system could be redesigned to make it both fairer and more conducive to balanced economic growth. With respect to taxes, for example, I believe that either of two types of major tax reform—a substantial shift to consumer taxation or broadening the base of the income tax with a lowering of the rates—could give us a substantially better tax system than we have now.

Over the next several years I believe that we should move in one of these two directions. But doing so will take time and thought and serious deliberation in this committee and elsewhere. The deficit crisis is too urgent to be put off until that deliberative process can bring us an improved tax system.

Therefore, I believe it's appropriate to enact a near-term temporary revenue increase in a way that would not involve restructuring the tax system through, for example, an income tax surcharge or a delay of indexing, or both.

Let me make it clear that I do not regard either of these suggestions as desirable long run tax policy. They would, however, be legislatively simple across-the-board ways of raising temporary revenue while the more difficult process of restructuring the tax system proceeded.

Similarly, on the spending side, I believe a spending reduction package to be enacted in the next session of Congress would have to consist of rather arbitrary across-the-board cuts, some of which might be of a temporary nature pending restructuring of major programs. For example, a moratorium on cost-of-living increases in all programs might be combined with a moratorium on medical fee increases in medicare and medicaid, and a percentage cut in other appropriations, including defense, in which the size of the cut was related to the rapidity with which the program has been growing. Such a program might seem draconian, but its size should not be exaggerated. According to CBO estimates, Government spending will be close to $1 trillion in 1986. Cutting $50 billion from this anticipated spending level would involve cutting about 5 percent of Government spending and would still leave that spending at more than 22 percent of the gross national product.

Similarly, on the tax side, a tax increase of $50 billion in 1986 would increase revenues about 6 percent, would bring revenues as a percent of gross national product back up to 20 percent, but still below the 21 percent it reached in 1981.

Enactment of such a program would only be possible if there were a strong will in the Congress to show that the Congress can function effectively and responsibly to solve serious problems. I believe that the risk of delaying action on the deficits is great enough to justify a maximum effort on the part of the Congress. I also believe that the conventional wisdom about the politics of the situation may be wrong. It's just possible that the voters would admire and reward a courageous demonstration of bipartisan determination to get the finances of the U.S. Government back on a sound footing.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Rivlin follows:]

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Statement of

Alice M. Rivlin
Director
Economic Studies Program
Brookings Institution

before the
Committee on Finance
United States Senate

December 13, 1983

The views expressed in this testimony are those of the author and should not be ascribed to the officers, trustees, or other staff members of the Brookings Institution.

Mr. Chairman:

I am delighted to be back before the Senate Finance Committee as you focus on the urgent question of how to bring the federal budget deficits down. I believe that the deficits now in prospect could have serious consequences for the economy. There is significant risk that high real interest rates resulting from the deficits could cause the current expansion to stall as early as 1985. Even if this does not happen, the high rates will discourage the investment we need to increase productivity and, by keeping the value of the dollar high, reduce our competitiveness in world markets. I believe that the Congress should act quickly--before the election--to enact a comprehensive deficit reduction plan that slows the growth in both domestic and defense spending and increases future revenues.

Why Do Anything?

Right now, the economy is recovering strongly from the deep recession of 1981-82. Consumers are spending at high rates, production is up, unemployment is down, and growth seems likely to continue at least through 1984, although at a slower rate than in 1983. So why worry? Won't the deficit come down as the economy improves? And isn't the deficit stimulating the recovery anyway?

Recessions normally cause the Federal budget to go into deficit. Revenues drop sharply as unemployment rises and profits and incomes decline. Spending rises for unemployment insurance and other recession-related programs. This automatic deficit helps cushion the effects of the recession and tends to disappear as the economy improves.

But the deficits now in prospect are different. They are increasingly "structural," that is, not related to the recession. If the economy continues to grow over the next several years, revenues will indeed rise and recession-related expenditures will fall. Indeed, this is already happening. But, at the same time, with current policies, other expenditures will rise. Increased spending for defense, entitlement programs (especially medical care), and interest will keep up with the rise in revenues, and the deficits will not decline. The most recent CBO budget forecast, based on quite optimistic assumptions about growth, inflation, and interest rates, shows deficits continuing at about the \$200 billion level over a five-year period.

Won't the fact that the Government is spending \$200 billion more than it is taking in stimulate the economy and keep the expansion going? By itself such spending would be a stimulus, but the Government has to borrow the \$200 billion in the financial markets. In a recovering economy it has to compete with the private sector which is also seeking funds to finance the expansion of plant and equipment essential to an expanding economy. This competition for funds puts upward pressure on interest rates. The Federal Reserve can relieve this pressure by allowing the money supply to rise more rapidly (thereby monetizing the debt), but only at some risk of future inflation. High deficits in an expanding economy force the Federal Reserve to make a difficult choice between the risk of slowing or reversing the recovery and the risk of future inflation. This Federal Reserve Board has brought inflation down at great cost by limiting monetary expansion and seems unlikely to take major risks of inflation re-escalating substantially in the future.

We have never had a recovery at the high real rates of interest we are now experiencing, and no one can claim to know exactly what will happen. At best, if the Federal Reserve is very successful in its balancing act, the economy could continue to grow for some time, but interest rates would remain much higher than they would be with lower deficits. The interest-sensitive sectors of the economy, especially housing and investment, would likely grow relatively slowly. Slow growth in investment may retard the growth in productivity which is essential to a rising standard of living.

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This helps us to finance our deficit, but also keeps the value of the dollar very high in international currency markets. The highly valued dollar, in turn, makes it expensive for foreigners to buy from us and cheap for us to buy from them. It injures both exporters and industries that compete with imports, including such basic industries as steel, autos, and electronics.

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The United States has chosen a high-deficit, high-interest rate policy in preference to a low-deficit, low-interest rate policy. For a country which is worried about its level of investment and productivity, its competitiveness in world markets, the health of its basic industries, and the ability of Third World nations to pay their debts to its banks, this is the wrong choice.

Moreover, not all the reasons for concern about the deficit are strictly economic. You should pardon such an old-fashioned sentiment, but I believe that people, businesses, and governments should live within their means. This certainly does not rule out prudent borrowing. Individuals with good incomes should borrow to finance houses and cars, businesses in sound shape should borrow for capital expansion, the government should borrow to off-set the impact of temporary economic set-backs on the economy. But a government which is running a rising structural deficit in an improving economy and adding rapidly to the burden of its interest charges, is not setting an example of prudent management.

Why Act Now?

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If the economy is sluggish or entering recession, it would be both economically undesirable and politically impossible to raise taxes or cut spending in order to reduce the deficit. Waiting until 1985 to take action on the deficit entails the risk of having to wait until after the next recession.

What to Do?

The deficits in prospect have no single cause and should have no single cure. To blame the deficit problem solely on tax cuts, or defense spending increases, or domestic spending growth is to oversimplify recent history. Over the last two decades, the Federal Government took on substantial new spending responsibilities in the domestic arena. Spending for nondefense programs rose from about 9% of the gross national product in 1961 to about 16% in 1976. Most of this increase was for payments to individuals, especially social security and other pensions, and for health care for the aged, the disabled, and the impoverished. For a while we paid for these increases by shifting resources out of defense--outlays for defense declined from 9% of gross national product in 1961 to 5.5% in 1976. But in the late 1970's we began the expensive process of modernizing our Armed Forces and reversed the decline in defense spending. We paid for simultaneous increase in defense and domestic spending by allowing federal revenues as a percent of gross national product to creep up, mostly through the impact of inflation on a progressive income tax. Then we ran out of patience with high taxes and cut tax rates substantially. We also cut domestic spending significantly, but not by enough to off-set the combined increases in the deficit brought about by tax cuts, defense spending increases, and continued increases in entitlement spending and interest charges on the debt. That's how we got the deficits; what can we do about them?

Recent CBO projections suggest that without further action of the Congress, the deficit for fiscal year 1986 is likely to be about 4.4% cf the gross national product in that year. My guess is that this is optimistic, but it is as good a starting point as any. Reducing this 1986 deficit to 2% of the gross national product--the ratio that was obtained in 1981--would be an ambitious but not unreasonable goal. It would imply cutting the deficit to about $84 billion dollars in fiscal year 1986, or finding about $100 billion in spending reductions or revenue increases in that year. Such a program is only realistic if the Congress acts decisively early in the next session. It would send a strong signal to financial markets and the voting public that Congress is determined to reduce deficits and it could bring about a substantial pre-election reduction in interest rates.

Such a plan would have to be extremely simple and perceived as fair. It would have to spread the pain over a large number of taxpayers and recipients of government spending so that no one group or type of program bore the brunt. It would have to be perceived as an emergency belt tightening, in which everyone is asked to give up something, and <u>not</u> as an effort to restructure the federal tax system or redesign government spending programs.

I share the widespread view that government spending programs, both defense and domestic, could be made more effective and that the federal tax system could be redesigned to make it both fairer and more conducive to balanced economic growth. With respect to taxes, for example, I believe that either of two types of major tax reform--a substantial shift to consumer taxation or broadening of the base of the income tax with a lowering of the rates--could give us a substantially better tax system than we have now. Over the next several years, I believe we should move in one of these two directions, but doing so will take time, thought, and serious deliberation in this Committee and elsewhere. The deficit crisis is too urgent to be put off until that deliberative process can bring us an improved tax system. Therefore, I believe that it is appropriate to enact a near-term temporary revenue increase in a way that would not involve restructuring the tax system, through, for example, an income tax surcharge or a delay of indexing or both. Let me make clear that I do not regard either of these suggestions as desirable long-run tax policy. They would, however, be legislatively simple across-the-board ways of raising temporary revenue while the more difficult process of restructuring the tax system proceeded.

Similarly, on the spending side, I believe a deficit reduction package to be enacted in the next session of Congress would have to consist of rather arbitrary across-the-board cuts, some of which might be of a temporary nature pending restructuring of major programs. For example, a moratorium on cost-of-living increases in all programs might be combined with a moratorium on medical fee increases in Medicare and Medicaid and a percentage cut in other appropriations (including defense), in which the size of the cut was related to the rapidity with which the program has been growing.

Such a program might seem draconian, but its size should not be exaggerated. According to CBO estimates, government spending will be close to a trillion dollars in 1986. Cutting $50 billion from this anticipated spending level would involve cutting somewhat less than 5% of government spending and would still leave spending at more than 22% of gross national product. Similarly, on the tax side, a tax increase of $50 billion in 1986 would increase revenues about 6% and would bring revenues as a percent of gross national product back up to 20% or still below the 21% reached in 1981.

Enactment of such a program would only be possible if there were a strong will in the Congress to show that the Congress can function effectively and responsibly to solve a serious problem. I believe that the risk of delaying action on the deficits is great enough to justify a maximum effort on the part of the Congress. I also believe that the conventional wisdom about the politics of the situation may be wrong. It is just possible that the voters would admire and reward a courageous demonstration of bipartisan determination to get the finances of the United States Government back on a sound footing.

The CHAIRMAN. Dr. Stein, we will hear from you.

STATEMENT OF DR. HERBERT STEIN, SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, D.C.

Dr. STEIN. Is my microphone on?

The CHAIRMAN. Those are not very good mikes. You have to have it very close.

Dr. STEIN. All right. Why don't I borrow this one.

Well, Mr. Chairman, I first want to congratulate the members of the committee on giving up part of their recess to work here on the extremely serious budgetary problem facing the country.

I have submitted to the committee an article that I wrote for the American Enterprise Institute called "Controlling the Budget Deficit: If Not Now, Why? If Not Us, Who?" And I would like to have that included in the record.

The CHAIRMAN. It will be made a part of the record.

[The article from Dr. Stein follows:]

the AEI economist

American Enterprise Institute for Public Policy Research December 1983

Controlling the Budget Deficit: If Not Now, When? If Not Us, Who?

Herbert Stein

Our present situation with respect to the budget deficit would be laughable if it were not serious. We now face the prospect of the largest deficit, relative to GNP, in peacetime history. That is happening under the most conservative administration of the past fifty years—one that had promised to bring the budget into balance by now and that a year ago was promoting a constitutional amendment requiring the budget to be balanced. No one has a good word to say for the deficit. But no one has much confidence that the deficit will soon be eliminated or even greatly reduced. Although people talk as if they believe the deficits do harm, there is much disagreement and vagueness about what and how much harm they do. The secretary of the treasury, traditional watchdog of the nation's credit, is in the forefront of those who belittle the adverse consequences of the deficit. Economists, including Keynesian economists, typically assailants of the conventional wisdom regarding deficits, are now among the strongest defenders of the conventional wisdom that deficits are bad.

It is true that for a long time we have run budget deficits while professing aversion to them. Also for a long time strong claims have been made about the effects of deficits, beneficial as well as harmful, that exceeded the firm knowledge of economists. But the gap between our pretensions and our performance is now greater than ever because the deficits are larger and because this administration originally had more pretensions about balancing the budget. Moreover, experience and analysis have shown how far the common statements about the effects of deficits are from anything we can assert with confidence.

Traditional Views of Deficits

To resolve disagreements and uncertainties about the deficit is exceedingly difficult—perhaps impossible—for several reasons. The long history of groundless claims about the deficit produces skepticism about anything that may now be said on the subject. For many people, realistic discussion of the deficit is unacceptable, or beside the point, because the deficit is only a convenient symbol for something else they care more about. That is, people say they are against deficits because they are really against the entitlement programs or against the defense program or against the Reagan tax cuts. In general, most of these people would oppose these programs without regard to the presence of the deficit, and they will not change their mind about deficits if that requires them to change their mind about the other things. Oddly, supporting or opposing deficits is now also a way of supporting or opposing Reagan, and people are more attached to their views of Reagan than they are to their views of the deficit.

"Moreover, economists, if they are candid, must recognize that they do not know with certainty what the effects of the deficit are and especially what the magnitudes of those effects are."

Moreover, economists if they are candid, must recognize that they do not know with certainty what the effects of the deficit are and especially what the magnitudes of those effects are. And even if these effects could be known with certainty, that information would not tell us unequivocally what policy should be. Some of the effects are positive, and some are negative; balancing them is a matter of political judgment, not economic analysis. To be more specific, in my opinion the important effect of a budget deficit—leaving aside the way in which it is created—is to reduce the long-range rate of economic growth. But I would be very uncertain about how much increase in the growth rate would result from cutting the deficit by, say, $50 billion a year. To cut the deficit, we would have to give up something—say, $50 billion of defense expenditures. Would the increase in the growth rate resulting from the deficit cut be worth the weakening of national security resulting from the defense cut—even assuming that the economic growth is not interrupted by Armageddon? Neither side of the equation can be measured at all precisely, and even if the measurements could be made, they could not be objectively compared.

"Concern that the deficit would abort the recovery has faded as the recovery has actually begun and seems to be following a fairly typical path."

That is the kind of question that is implicit in the budget issue. It is not a question of black-or-white. It is a question of degrees and priorities. Neither is it a question that can be answered definitively by economic analysis. But it should be possible to state the real issue more clearly than is now commonly done and to give a more balanced picture of what economists can contribute to such a discussion.

The argument about deficits has gone through a number of claims in the past. There used to be a simple appeal to common sense as voiced by Micawber, who said, "Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery."

But experience showed that Micawber was wrong. We ran federal deficits continuously after 1930, and we suffered no misery attributable to them. Some people appealed to the threat of national bankruptcy as a reason for not having budget deficits. But we discovered that this did not apply to a government that borrowed in its own currency, of which it could always create as much as it wanted.

The realistic meaning of national bankruptcy for a government that borrows in its own currency is depreciation of the currency. That is the equivalent of the way in which a private borrower unable to pay his debts gets the amount of the debt written down. The most important aspect of depreciation of the currency, for the United States at least, is inflation. The idea that deficits would cause national bankruptcy, then, was converted to the idea that deficits would cause inflation.

That, in fact, became the principal argument against deficits during the 1970s when we had continuous deficits and accelerating inflation. In his campaigning in 1980, for example, Ronald Reagan identified inflation as the chief evil consequence of deficits.

But despite the simultaneous existence of big deficits and inflation, the logical connection became harder and harder to establish. The 1970s were also a period in which monetarist explanations of aggregate economic behavior, especially of the behavior of the price level, were gaining ground. It thus became necessary to say that deficits were inflationary because the deficits led the Federal Reserve to generate an inflationary monetary expansion. But that was less an argument against deficits than an argument that the Federal Reserve, which is a government agency, should do its duty in discharging its first responsibility, which is to maintain a currency of stable value.

It was sometimes said that budget deficits made a noninflationary monetary policy difficult if not impossible because the combination of deficits and noninflationary monetary policy would result in interest rates that were too high in some sense. But this notion implied that the Federal Reserve had an option of avoiding those interest rates by following an inflationary policy. In fact, this is not true. Inflationary policy will not reduce real interest rates and will raise nominal interest rates. There is no good reason for the Federal Reserve to respond to a high budget deficit by inflationary monetary policy.

Since 1980 we have had a demonstration that budget deficits do not make inflation inevitable. The inflation rate has come down sharply, and monetary policy has been on the whole disinflationary, despite large and rising deficits. Although there is a possible connection between deficits and inflation, the connection is more uncertain, complicated, and remote than is commonly thought.

Will the Deficit Abort the Recovery?

Since 1981 the concern about the deficit has taken another turn. Then it began to be argued that the deficit would deepen the recession or at least abort the recovery, in the common cliché. This kind of reasoning had hardly been heard since the time of Herbert Hoover. Surprisingly, this claim about deficits was made by—among others—Keynesians who had once taken the lead in demonstrating that deficits stimulated the economy.

This time the argument has held that large deficits caused high interest rates that would repress private investment and that a satisfactory, sustainable recovery could not develop if private investment were repressed. I will leave for later the question of whether big deficits do in fact repress private investment. Here I am concerned with the second half of the proposition—namely, that there cannot be a satisfactory, sustainable recovery if private investment is repressed.

This proposition is incorrect or, more precisely, its validity depends on what is repressing private investment. The necessary condition for achieving and sustaining high employment is that private investment plus the government deficit (federal, state, and local combined) must equal the private saving that would occur with high employment. Thus, if gross private saving at high employment would be 15 percent of GNP, there can be high employment if private investment plus the government deficit equals 15 percent of GNP. If there is no government deficit, the necessary condition is that private investment should equal 15 percent of GNP. If the budget deficit equals 4 percent of GNP, the achievement of high employment requires only that private investment should equal 11 percent of GNP. Indeed, private investment could not exceed 11 percent of GNP unless the deficit were cut or private saving increased.

That is, there is no fixed amount or proportion of private investment required to achieve high employment. The ratio of private investment to GNP in years of high employment has been rather stable in the past because the saving rate has been rather stable and deficits have been small. But with large budget deficits the level of private investment required to achieve high employment will be smaller than in the past.

Concern that the deficit would abort the recovery has faded as the recovery has actually begun and seems to be following a fairly typical path. The most common forecasts call for the recovery to continue with typical durability and strength. That is, these forecasts imply that the recovery will continue despite the deficits. These forecasts are often accompanied by warnings that the recovery could be endangered by the large deficits. But this warning is not expressed in any discounting of the forecast itself, nor is there any specific explanation of the way in which the deficit will limit the recovery.

"It has been hypothesized that the present generation, seeing that the deficit is reducing the growth of the capital stock and therefore their future incomes, will save more to restore their expected future incomes."

What is commonly said is that the recovery will be "unbalanced" as a result of the deficits because there will be less investment than usual. But in fact, one could say more validly that the recovery will be in necessary balance with the priorities expressed in our fiscal policy. A decision has been made to increase the share of the GNP devoted to defense and, by cutting taxes, to increase the share of the GNP devoted to consumption. These decisions imply a decrease in the share of GNP going to investment.

Crowding Out Private Investment

In this analysis, the argument that the deficit will abort recovery is invalid. But the same analysis indicates a genuine source of worry. That is, we have here accepted the proposition that the deficit would hold down private investment and said that the recovery would nevertheless proceed. But repressing private investment has its costs even if it does not prevent the achievement and maintenance of high employment. It reduces the rate at which the stock of productive capital grows and thereby tends to reduce the rate at which productivity, per capita income, and total output grow.

This is the heart of the matter—now commonly known as the "crowding-out" problem. The argument is simple: As has already been suggested, total private investment plus the total budget deficit cannot exceed total private saving. (Private investment includes business domestic fixed investment, net inventory accumulation, residential construction, and net foreign investment.) If private saving is a given, an increase in the deficit will reduce—crowd out—private investment.

The outcome depends, therefore, on the condition that private saving is a given—that is, that an increase in the deficit does not raise private saving by as much as the increase in the deficit.

Several reasons have been advanced for denying this condition:

First, there was a common Keynesian argument. It was said, correctly, that the amount of saving would be higher, the higher the national income was. An enlarged deficit would raise the national income and so raise saving and would in fact raise saving enough to finance the enlarged deficit so that there would be no crowding out of private investment. In fact, raising the national income would stimulate private investment by improving demand. A higher level of private investment would further raise the national income, which would generate enough additional saving to finance the private investment, inducing the phenomenon known as crowding in—an increase rather than a decrease of private investment as a result of an increase in the budget deficit.

"In my opinion, the most probable and prudent assumption is that budget deficits crowd out private investment, not dollar for dollar, but by a very large proportion of the deficit."

This proposition depends on two conditions. The first is that the real national income is below its desired level so that there is room to raise the national income and to increase saving. The second condition is that the deficit is the only way to raise the national income. If, as is the general case, the desired level of national income can be achieved by monetary policy without the deficit, we then have to ask whether at the desired level of national income there will be more private investment with or without the deficit. The answer—at least so far as this argument goes—is without.

Second, there is an older reason for denying that deficits will increase saving by an equal amount and therefore not crowd out private investment. It has been hypothesized that the present generation, seeing that the deficit is reducing the growth of the capital stock and therefore their future incomes, will save more to restore their expected future incomes. Put another way, seeing that they will have higher future tax burdens, they will save more to increase the future incomes out of which to pay those taxes.

This seems a logical description of rational behavior. Probably one could find analogous situations in which such behavior could be observed. After an earthquake that has destroyed a community's capital structures, one could probably see a rise in the saving rate. But no one has observed such a response to deficits or to an increase in the government debt. And I have never encountered anyone who says that he has raised his own saving rate because of the budget deficit. Perhaps the budget deficits have been too small and their future effects on incomes and tax liabilities too uncertain to produce the hypothesized effects on saving. But even after the depression and World War II, when there had been about fifteen years of slow capital growth and enormous increase in the federal debt, no unusually high rate of private saving was visible.

Third, the two preceding points relate to the possible effect of deficits on saving regardless of the source of the deficit. Current discussion tends to emphasize the different effects of expenditures and taxes. Specifically, much attention has been paid to the possibility that reduction of tax rates would generate enough additional saving to offset the crowding-out effect of the resulting deficits. This response could occur through a combination of supply-side or incentive effects on the level of national income and supply-side or incentive effects on the proportion of their income that people save. The second effect depends on the increase in the after-tax return to saving that results from a reduction of income tax rates.

The expectation that private saving will be higher if tax rates are lower seems plausible. But no evidence indicates that the increase of saving would be nearly as large as the increase of the deficit that would result from a general cut of tax rates. In fact, the evidence that economists have about the size of the response of work effort, investment, saving, and innovation to the after-tax return suggests that the increase of saving would be much smaller than the revenue loss and deficit increase from a general tax cut.[1] The result would depend, of course, on the nature of the tax cut. The positive effect on saving would be greater, for example, if the corporate profits tax were cut than if the cigarette tax were cut. But still, if we are considering a general kind of tax cut that could cost tens of billions of dollars of revenue, it seems unlikely that a saving increase large enough to offset the deficit increase and so prevent a crowding out of private investment would occur.

As a bit of evidence on this subject, one may point to the experience of the past twenty-five years. In each of the three business cycles beginning in 1954, 1958, and 1960, the ratio of total taxes to GNP was around 26 percent and averaged 26.8 percent. In the two cycles beginning in 1970 and 1974, the tax rate was around 31 percent, or about 4 percentage points higher. Yet the net saving rate was almost exactly the same in both periods, 7.3 percent, and the gross savings rate actually rose a little. That is, the saving rate was not depressed by the higher tax rate.

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It is important to distinguish between the effect of the government budget on crowding out total private expenditures and the effect on crowding out a particular kind of private expenditure, namely private investment. Whether budget policy crowds out total private expenditure depends on the size and character of government spending. Whether it crowds out private *investment* depends on the character of the financing, including notably whether the financing is by taxation or by borrowing. If the expenditures are financed by borrowing, the taxpayers are left with more after-tax income and more assets (government securities) and would be expected to consume more than if the expenditures are financed by taxes.

"If the budget deficit is 4 percent of GNP, real GNP at the end of ten years would be about 11 percent lower than it would have been with a balanced budget."

One cannot absolutely rule out the possibility that increasing the deficit, whether by cutting taxes or raising expenditures, will generate an increase of saving sufficient to prevent the crowding out of private investment. There is nothing logically opposed to that idea. But there is no evidence for it, and such little evidence as we have is against it.

In my opinion, the most probable and prudent assumption is that budget deficits crowd out private investment, not dollar for dollar, but by a very large proportion of the deficit. Moreover, we must recognize that we face, with present programs and tax rates, very large deficits for years to come. Hope springs eternal that the growth of the economy will reduce the deficit substantially without need for further unpleasant action. This hope has been further nourished by the unexpectedly rapid increase of GNP in the second and third quarters of 1983. But the fact is that existing forecasts made by the administration and the Congressional Budget Office already assume substantial growth of the economy through 1986, 1987, and 1988. The rapid rise of the economy in the past two quarters does nothing to change the estimates of the level of the GNP or of the deficit in these later years. Although the growth of the economy will tend to reduce the deficit, other forces are at work—the rising trends of expenditures for defense, interest, and entitlements—pulling in the opposite direction so that the net effect is to keep the deficit very large despite the growth of the economy.

The Future of Economic Growth

We are probably looking at deficits that will run roughly around 4 percent of GNP for many years into the future, even with the administration's expenditure program, if there is no tax increase. A recent estimate by

"We may be in the process of losing all inhibitions about deficits, especially since the most conservative administration of the past fifty years is engaged in defending the largest deficits in history."

the CBO, incorporating the effect of tax legislation now being considered in the Congress, leaves the deficit equal to 4.7 percent of GNP in FY 1986. This may be compared to the net saving available to private investment running around 6 percent of GNP in the previous two decades. If, as seems likely to me, no major increase occurs in the saving rate, the 4 percent deficit will reduce the saving available for private investment by two-thirds.

How much will this affect the future rate of economic growth? The answer depends in part on how the cut in investment is distributed. At present a considerable part of the impact of the deficit on private investment has been borne by net foreign investment. That is, the United States has been importing capital, which has relieved us of the need to repress investment in the United States more than has happened. This foreign capital has helped to sustain the growth of income in the United States, but it also means that more of the income produced here belongs to foreigners. Housing will bear part of the impact of the deficit on investment, and this probably reduces the growth of output less than a reduction of business investment. Also, it is possible that the tax reduction, which contributes to the deficit, will improve the quality of the investment—making it more productive—by encouraging more risky enterprise.

Aside from these uncertainties, economists disagree a great deal about the possible size of the effect on growth from a reduction of net private investment. Many factors other than net private investment contribute to economic growth—the rise of the labor force, the improvement of its capabilities through education and training, research and development, and the embodiment of new technology in the replacement of the existing capital stock. How much weight to assign to net investment as compared to other factors is not known with any confidence.

I estimate the range of the growth effect as follows: Probably the lowest estimate is that reducing annual net investment by 1 percent of GNP would reduce the annual average growth of total GNP by one-tenth of a percentage point. Thus, if the growth rate would have been 4.0 percent per annum, it would be reduced to 3.9 percent. At the other extreme, if all growth except that due to increase in the size of the labor force is attributed to net private investment, reducing net private investment by 1 percent of GNP would reduce the growth rate by about one-half of 1 percent—say, from 4 percent to 3.5 percent. This extreme does, however, seem quite improbable because education and research and development surely contribute something to economic growth.

Probably the order of magnitude involved would be indicated by saying that a budget deficit of 1 percent of GNP, if continued for a long time, would reduce the growth rate by three-tenths of 1 percent, midway between the extremes. Thus, if the growth rate would have been 4 percent with a balanced budget, it would be 3.7 percent with a deficit equal to 1 percent of GNP. At the end of ten years, GNP would be about 3 percent lower than it would have been with a balanced budget. If the budget deficit is 4 percent of GNP, real GNP at the end of ten years would be about 11 percent lower than it would have been with a balanced budget.

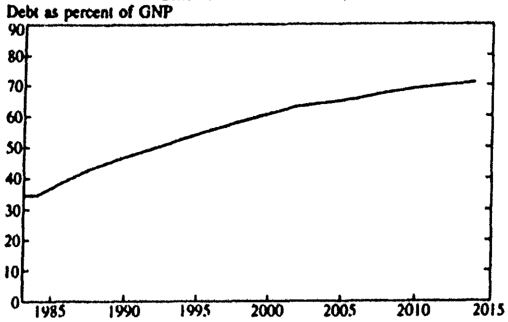
These estimates are subject to many qualifications and surrounded by uncertainties, but they indicate the ballpark we are operating in. If we face the prospect of deficits continuing at a stable rate of, for example, 4 percent of GNP, we would have to ask ourselves whether it is worth paying higher taxes or cutting expenditures, or both, to avoid some of the growth loss implied in such deficits.

Risks of a Debt Explosion

The situation confronting us is, however, more serious. The deficit adds to the debt, and that in turn tends

FIGURE 1: THE PROJECTED EXPLOSION OF THE NATIONAL DEBT, 1983–2013

(Illustrating how the ratio of federal debt to GNP will rise if the ratio of deficit to GNP is constant[a])



a. Assumes deficit equal to 4 percent of GNP; 5 percent annual rise of GNP.
SOURCE: Author's calculations.

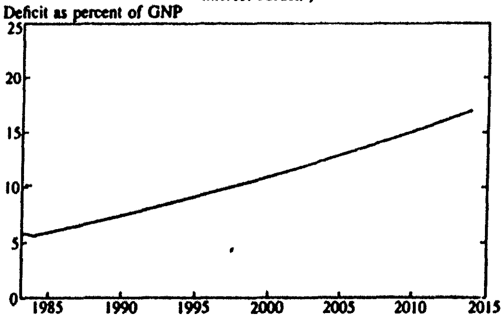
to increase the interest burden, which is part of the budget, and that additional burden can make it difficult to stabilize the deficit as a fraction of GNP. The net federal debt is now about 38 percent of GNP. If the deficit exceeds 38 percent of the increase of GNP, the ratio of debt to GNP will rise. If, for example, GNP rises by 10 percent a year, the debt will rise relative to GNP if the deficit exceeds 3.8 percent a year. If interest rates are stable, the interest burden will rise relative to GNP. And if expenditures other than interest are stable as a fraction of GNP, higher taxes will be required just to keep the deficit from rising relative to GNP. And if the deficit is not kept from rising relative to GNP, then the debt and the interest burden will rise even faster, and the deficit will rise still faster. The whole process feeds on itself. (This process is illustrated in figures 1 and 2.) And even if one is not alarmed by what I have described as the possible consequences of deficits equal to 4 percent of GNP, one cannot be calm about the prospect of deficits rising to 8 percent or 12 percent of GNP, exceeding net private saving and almost equaling gross private saving. That would be a prescription for eating into our capital stock. It would also create a very strong temptation to escape the debt burden by inflation, which would reduce the real value of the debt. That is, I think, the ultimate inflationary danger in the deficit.

The average annual rate of growth of nominal GNP that is consistent with reasonable price stability is around 5 or 6 percent. To keep the federal debt around its present ratio to GNP, therefore, would require keeping the deficit to about 2 percent of GNP—about half what is now in prospect unless new measures are taken.

Another danger looms ahead, which reinforces the tendency for deficits to feed upon themselves mathematically: that is, the political tendency for deficits to feed upon themselves. The federal government has been running budget deficits for a long time. But there has always been a certain amount of shame and guilt about that, which limited the size of the deficits. The size of the deficit at which shame and guilt become operative increases with experience. We become used to larger and larger deficits. We moved from the $10-billion level to the $20-billion level during the Vietnam War and to the $50-billion level during the late 1970s. We passed through the $100-billion barrier very quickly and are now adapting to $200 billion. There is no reason to think that we have reached the limit to political tolerance of deficits. We may be in the process of losing all inhibitions about deficits, especially since the most conservative administration of the past fifty years is engaged in defending the largest deficits in history.

FIGURE 2: THE PROJECTED EXPLOSION OF THE FEDERAL DEFICIT, 1983–2013

(Illustrating how, if the ratio of revenues to GNP and the ratio of noninterest expenditures to GNP are constant at 1983 levels, the deficit rises with the interest burden[a])



a. Assumes 5 percent annual rise of GNP; 7 percent interest rate on debt; revenues equal to 18.5 percent of GNP; expenditures other than interest equal to 21.8 percent of GNP.
SOURCE: Author's calculations.

We are left without any overall rule of fiscal policy—any rule that would represent the long-run national interest against the short-run political interest in cutting taxes and raising expenditures.

In summary, our present deficit prospects and trends present us with three dangers:

- First, even the currently foreseeable deficits will have a significant negative effect on future growth rates and income levels. Whether raising taxes or cutting expenditures would be desirable to avoid that effect is a political question, but it is not being seriously weighed.
- Second, deficits of the present size relative to GNP threaten to escalate through their effects on the size of the debt and the interest burden.
- Third, our present practice and rhetoric about deficits are undermining all respect for budgetary rules that would give weight to the income levels and tax burdens of future generations.

In my opinion these are serious dangers. They are worth paying a cost to avoid or reduce. I would include an increase in taxes in the costs worth paying.

A common argument against reducing the deficit by raising the revenue is that fear of deficits, by Congress and the citizens, restrains expenditures and that providing more revenue will weaken that fear and encourage more spending. That is an anomalous position when held by people who do not share that fear and who demonstrate their unconcern about deficits by refusing to consider any tax increase. In any case, the country has run large and increasing deficits for many years, and that has not frightened politicians from raising expenditures to the level that is now the subject of complaint. It may be true that the deficits have kept expenditures from being larger than they are although the size of that effect is quite uncertain. But large deficits have not frightened the country into balancing the budget and have almost certainly inured the country to still larger deficits. The best way to keep down both expenditures and deficits would be for leaders of government and of public opinion to defend the proposition that beyond some identifiable point additional expenditures have to be paid for in taxes.

The basic political difficulty is that the adverse consequences of large deficits will come only after many years, but the pain of correcting the deficits comes now. What is tested is our ability to give the future the weight it deserves in today's decisions. We have to ask ourselves, "If not now, when, and if not us, who?" If we do not curb the deficits now, when will they be curbed, and if the citizens of this generation and their political leaders do not do it, who will?

1. This evidence was reviewed in "Taxes and Saving" by Herbert Stein and Murray Foss, *AEI Economist*, July 1981.

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Dr. STEIN. I have no other prepared statement. I've spent so much time in the last 3 weeks writing and talking about this subject that I've been unable to prepare something for you.

And one of the reasons I hope you will solve this problem quickly is that it would permit economists to go onto something more interesting.

But I will just state briefly and flatly what I think the situation is and what I think should be done about it.

The CHAIRMAN. Hold that mike up just a bit closer, Herb. We don't have very good sound here.

Dr. STEIN. The deficits we are now running and have in prospect will slow down the rate of economic growth, the growth of real per capita income in the United States, to a degree that is undesirable and that the American people would not choose if given a clear choice. I do not subscribe to the belief that the deficits will abort the recovery or may abort the recovery, and that is one of the few points on which I disagree with what Dr. Rivlin has said here. I think the evil consequences of the deficit will show up gradually but cumulatively over a very long period. And that is one of the reasons, I think, why we find it so difficult to deal with this problem. That's because it does not portend an imminent crisis, but really tests our ability to look ahead and deal with a longer run, very serious, but not imminent, problem.

The deficits we are now running are increasing the Federal debt at a rapid rate, and so raising the interest burden. That will make future budget deficits even larger than those projected for the next few years, and will make the drag on economic growth greater and greater unless steps are taken to check the deficit. And in the article I have submitted, I include two charts which show on not unrealistic assumptions about budget policy what the explosion of the debt and the interest burden could be if one looks ahead for 10 or 20 years.

Failure of the Government to limit the deficit that almost all Government leaders bemoan has serious political and psychological effects. It dilutes public expectations of what a responsible fiscal policy is. And it generates tolerance for wilder and wilder deficits. It breeds cynicism about a political process that looks blatantly hypocritical and self-serving.

We arrived at this situation by budget decisions made in 1981 without recognition or admission of what the consequences for the deficit would be. We made a large tax cut and embarked upon a large increase of defense expenditures as part of an overall budget program that promised to balance the budget in fiscal year 1984, the year we are now in. Neither the President nor the Congress made a decision to have a $200 billion deficit in this year. Or if they did make such a decision, they didn't tell the American people they were doing so.

The idea that the budget could be balanced in 1984 with the big tax cut and defense increase was based on two beliefs, both of which were false. One was that the big tax cut would accelerate the growth of the economy enough to prevent much or any loss of revenue. The second was that even though the administration was unable at the time, in 1981, to specify enough cuts of nondefense expenditures to bring the budget into balance by 1984, it would be able to specify such cuts later, or that the mere reduction of the revenues would force the reduction of expenditures.

Neither of these things has happened, and neither was plausible.

Carrying out the defense buildup proposed by the administration is necessary in my opinion to protect the country against the most serious threat facing it; namely, the inadequacy of its military forces relative to those of its adversary. This is a greater threat even than the deficit. Therefore, delaying the defense buildup is not a sensible way to deal with the deficit problem, although some economies may be possible in the execution of the program.

Reducing the deficit to a sustainable level will require both tax increases and expenditure reductions. This is not only a judgment of political necessities and realities; it is also a judgment about national priorities. To reduce the deficit to $100 billion a year only by cutting expenditures, even if it could be done, would involve sacrificing national purposes of greater value than would be sacrificed by giving up some private consumption. And it's an indication of the length to which we have come that we now all talk about a $100 billion deficit as if it were zero, as if that were par for the course. I think of a $100 billion deficit as a kind of target because it seems to me one thing we should be aiming at is to prevent a rise in the ratio of the Federal debt to the GNP.

In the long run we cannot expect, if we have a noninflationary economy, to have the GNP rising by more than about 5 percent per annum, in which case a deficit equal to about 2 percent of GNP would keep the Federal debt constant as a share of the GNP. The Federal debt is now about 40 percent of the GNP. And that seems to me a reasonable short run target.

The basic national problem that is reflected in the deficit is that in this country too little of the national output goes to defense, to investment for future growth, and to the care of very poor people. And that means by subtraction that too much goes to the consumption of the average middle-income American. And that includes almost all of us.

The deficit reducing measures should be designed to reduce the consumption of the average middle-income American. This can be done by reducing some of the transfer payments that go to such people and by increasing taxes. It will be fairest and most acceptable if it is done by some of each.

On the subject of expenditure reductions, we do have a tendency to be obsessed with the social security and medicare programs, which obviously do account for the largest part of the manageable nondefense budget. But we should not, in the process, overlook a lot of things that are still of significant size and not included in that category, among which are the agricultural support program, which has risen to unconscionable levels, and such things as subsidies for the Export-Import Bank.

I would prefer a tax increase that bore on consumption rather than investment. I fear, however, that such a change of Federal taxation would require a long time to argue out and implement. And it may be necessary to do something less radical in the interim. I think the basic thing to say about the character of the tax increase we need in the near future is that we cannot afford to be too fussy about it. If each of us is adamantly insistent on a tax increase only of the kind that he would most prefer, we will not get anywhere, as we will not get anywhere with this whole program with any solution to the deficit problem.

I will say, however, while I have the opportunity to express my preferences, the thing that I would least like to change about the present tax system is the indexing feature of it, which was adopted in 1981. I think that was the best aspect of what was done in 1981 because it removes from the Government the possibility of appearing to solve its budget problem by regenerating inflation.

I think an important thing to say is that the evil effects of the deficit are being felt now, and the deficit should be curbed now, not after the election or after recovery is complete. The increase of the debt that is occurring this year because of this year's deficit will be part of the Federal debt forever. It will not go away on the day after the election. It is a permanent addition to the financial problem with which the country will have to wrestle, and we should start avoiding it right now.

Furthermore, I think that the psychological effect and the political effect of this country of a demonstration of the ability of the Government to move the deficit problem from its present status of being a hostage to the timing of the election, a demonstration of ability to rise above such short run political calculus, would be greatly inspiring to the country in all kinds of ways. And it's the kind of demonstration of national purpose—one might also say patriotism—that we are looking for.

As I have already suggested, a solution to the problem is going to require compromise. If each of us digs in his heels and says this is the only way in which he will agree to a proposal for reducing the deficit, then it won't happen. I don't think there are any sacred numbers in the package that need to come out. I don't think there is anything holy about dollar for dollar on the expenditure and revenue side. I think what is basically needed is that the persons who are in responsible positions should sit down together open-mindedly, stating their preferences but recognizing that they are all going to have to give up something to achieve this very seriously needed result.

Now I would like to comment on two common arguments that I encounter when I talk about this problem with other people. One is the statement that after all there is really no difference between taxing and borrowing; that taxing and borrowing are both ways of taking money away from people; and there is no difference in their economic consequences; that they both are ways of crowding out private expenditure. Well, I think there is a very big difference between taxing and borrowing. And the difference shows up in what is crowded out. The difference between taxing and borrowing is that if the Government borrows the money, it leaves the citizens in the possession of a large additional asset that they would not have otherwise had; namely, they will hold additional amounts of Federal debt. On the other hand, if the Federal Government taxes the money, the taxpayer is left only with a canceled check. And I think people respond differently to owning $200 billion worth of Federal securities than to owning $200 billion worth of canceled checks. I think if they own the $200 billion worth of securities they have less tendency to save in other forms. In fact, probably the closest estimate one could make of the consequence is that if they hold $200 billion worth of Federal debt, they will invest $200 billion less in other things, which means mainly in productivity generating capital investment.

Of course the argument that there is no difference between taxing and borrowing raises the question of what taxes are for at all. Why do we have any of them? We could simply abolish this committee and all the unpleasant consequences that it has provided for us over the course of the years, if there was no difference between taxing and borrowing. But there are very few people who are prepared to say, at least in groups of more than two, that we don't need any taxes. And that, of course, raises the question of how much we need. I think the answer to that question is that we need enough taxes so that given the expenditures we make we leave enough of the national saving available for investment to produce the rate of economic growth that we would like to see.

Now the second argument and the one that is very common is that if "we" raise the taxes, "they" will spend the money. That is, we are the people in the white hats, the right thinking, prudent fiscal managers, and they being the irresponsible spenders, usually meaning in the first place, Members of Congress.

This is, of course, an odd claim for people to make who are in positions of responsibility. It's an odd claim for the people who are not only we, but also they, the ones who not only propose the taxes, but also control the expenditures. And I think it's an odd claim to make when we have a President and a Senate who are all true believers in economy and government.

This argument is sometimes stated in the form of an analogy that the way to keep your teenage child from spending too much money is to cut his allowance. But there is a fallacy in that analogy, because while cutting the taxes may be an analogy to cutting the allowance, the fact is that we are, at the same time, giving this teenage child our credit card. And that is not going to induce him to reduce his expenditures, especially if we tell him, as many people with responsibility seem to do, that running up bills on a credit card does no damage.

Furthermore, the claim that if we give them the money they will spend it is not true if by that is meant that they will spend dollar for dollar what we give them in the form of a tax revenue. The fact is that expenditures over the course of the last 20 or 30 years shows no very close limitation by the amount of taxation. In fact, if it was closely limited by the amount of taxation, we wouldn't be facing the $200 billion deficit. So, obviously, something else is going on here.

I think that we should take the position that as a government, as an administration, as a Congress, as a citizenry, we are sufficiently responsible to decide two things, and to decide them simultaneously and don't have to be treated like teenage children. We can make a responsible decision to reduce expenditures, and we can make a decision to pay taxes for more of what we spend.

And I think we now have a great opportunity to demonstrate the responsibility of the political process which will have benefits far beyond the immediate effects on the size of the budget deficit.

Thank you very much.

The CHAIRMAN. Thank you very much.

I guess it's fair to say that both of you agree that the sooner we act the better it will be for the economy. There's no disagreement that if we can do it by April 1 or May 1 of next year, it's better than waiting—you say mid-1985. That's optimistic. I think we are really looking at maybe late 1985, and then there is always a lag from the time we act until it has any impact. It may be even 1986 before there is much impact.

Dr. STEIN. I think the sooner you can do it the better. I think I would have preferred to see it go into effect on January 1, 1984. I do not think we should regard this problem as a problem of business cycle management. It's a problem of getting ourselves into a stronger long run position. And you should not think you are going to fine tune the budget decision to the course of the business cycle, and I hope not to the course of the election calendar.

Dr. RIVLIN. I agree with that. I also agree that it would have been better to have acted last year. But I think the sooner the better.

The CHAIRMAN. And, of course, both of you understand the problem. One of the problems is that you have different views. You have Speaker O'Neill who is a very powerful force who has one view of how we might reduce the deficit. And the President, another very powerful force, who has a different view. And that's why I think you both suggest no one can have their own way. I think somewhere in that difference, that we ought to be able to put together some kind of a temporary package. I think suggestions made by both witnesses suggest that we maybe need to look at more of a consumption tax, a more radical change. But on a temporary basis it would seem to me we ought to do what we need to do to try to put together some package that will pass; not something that will have more hearings and more witnesses and not go anywhere.

And on this committee, even though we are dealing with billions, the magic number is 11. I mean there are only 20 of us. If you don't have 11, I don't care how many good ideas you have, if you don't have 11 votes, it's not going to happen.

There are some on my right who will not vote for anything that has any taxes on it. There are some, maybe on my left, who won't vote for anything that has any spending restraint in it. But, hopefully, there are enough in the middle who might vote for a package.

It makes it difficult when we are told that we have to cut spending, but then we are told that defense is off limits, entitlements for the most part are off limits, and, of course, interest on the debt is off limits. That covers about 70 some percent of where we ought to be looking for spending restraints. Do you think it's possible to put together a deficit reduction package without looking at defense or maybe entitlements? We're only looking at COLA's and social security. Can we still get that $100 billion you focused on, Dr. Rivlin?

Dr. RIVLIN. I think it would be extremely difficult. I think that a spending reduction package has to include cuts in the main items of Federal spending, and especially the main items of Federal spending increase. And those are defense and entitlement programs. The other item which has been increasing is interest payments, but there is nothing you can do about interest except to get the deficit itself down; that makes a lot of difference.

The CHAIRMAN. And I agree with Dr. Stein. I think agriculture—it has gone from $3½ billion to $22½ billion in 30 months, plus the $12 billion PIK program. Much of that is loans that are repaid, but you still have to have the money to make the outlays. There should be a sharp reduction in the cost of farm programs and other nondefense.

Dr. STEIN. I think what I am saying, and Mrs. Rivlin also, is that we think this objective of reducing the deficit and getting the budget on a path of declining deficits is of sufficiently overriding importance. That we are entitled to call upon people to submerge some of their preferences and interests which are from the standpoint of the national goals secondary. And I don't think that is too much to ask. We would do it when we recognize a real serious national crisis. The problem is that the deficit has not yet been sufficiently recognized for the crisis it is.

And I will say for myself I have only become terribly alarmed about this as I see the deficit rising to a level that promises to be explosive, rising to a level that, in turn, generates rates of increase for the debt, and rates of increase for the interest, that will make the whole thing cumulate and explode.

I have gone through my life arguing against the conventional wisdom about deficits, which usually was nonsensical in saying that deficits caused depressions, deficits caused inflation, deficits caused boom. Deficits don't do all those things, but deficits of this size and continued for the duration now in prospect—they are really frightening.

The CHAIRMAN. Well, there are a lot of things being advocated that we probably should do in the Congress whether it's a line-item veto or whether it is statutory, constitutional amendment, a balanced budget amendment. I support those things. But these are long range and are not going to happen soon. Let's face it. There is no way you are going to have a line-item veto approved, I don't believe, by the House or whether you will have a constitutional amendment approved.

So I think our charge by this committee, as I have indicated earlier, in a vote to the last day we met, is to come back by February 15 with something that the membership could vote to either approve or reject. In the interim we hope that there is more interest in the deficits expressed by the administration, and by leaders of the House. I find in discussions with the House leadership, the ones that I know, there is a high level of interest in deficit reduction.

Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

I think many Americans still think of the deficit only as an intellectual abstraction especially since interest rates have fallen and since unemployment and inflation are not as severe as they were, say, 1 year ago.

Given this, I wonder if you could describe in more graphic terms then you have so far, what's going to happen if we do nothing about these deficits.

Dr. STEIN. We are riding on the up phase of the cyclical wave in the economy and everybody is very happy about the present state, or most people are very happy about the present state of the economy. What we are talking about in my view is what the American economy will look like 10 years from now or 20 years from now.

We are already facing a budgetary situation in which the deficit is absorbing more than half, probably more than two-thirds, of our national saving. That is going to be a considerable drag on the rate of economic growth. And that means that in 1993 that our real incomes per capita will be, say, 4 or 5 percent lower than they would otherwise have been. Well, we will feel that in 1993.

But the thing that is really worse than that, as I have just said, is that if we don't do something about this, we will find that the deficit has risen to a point which absorbs not only all the net savings, but is absorbing most of the growth saving, where we are eating into our capital and becoming poorer. We are a country that is not used to becoming poorer. And I don't think that the American people would approve of such a policy if they were aware of what it would do.

Senator BAUCUS. So, if we don't act this year, we are going to create a situation in which these results are either inevitable or very difficult to prevent?

Dr. STEIN. Yeah. Well, one way to look at it, which just occurred to me, is that these deficits are the most extreme form of antienvironmentalism you can imagine in this country, because the most outstanding characteristic of the American environment is that we have this enormous stock of capital which makes us all so rich, and the deficit is a program for destroying that environment, for making us poor. And it's really irresponsible.

Our preceding generation has built up this stock of capital for us. We have some responsibility to the future to continue this process and not to abort it, not to undermine it.

Senator BAUCUS. Do you also subscribe to the theory that these deficits weaken our exports?

Dr. STEIN. I think that's quite clear. The deficits make interest rates high. High interest rates attract capital from abroad. The capital inflow from abroad makes the dollar high, and a high dollar reduces our ability to export and increases our imports. It is a clear diversion of production, of economic activity, from those industries which are highly involved in international competition.

Senator BAUCUS. Thank you.

Dr. RIVLIN. And that's not just a future abstraction. That's a very present reality. If you work in an industry that is dependent on exports or in one that competes with imports from abroad, you are very aware of this now. The high value of the dollar is cutting our exports. It is increasing our imports. And it is eliminating U.S. jobs.

Senator BAUCUS. That's a good point. In fact, take an agricultural product that is important to my State of Montana and to the chairman of the committee's state—wheat. This year, American farmers are gettting about the same price for wheat that they got in 1980. But, simply because of distorted exchange rates, Australian farmers are getting an extra dollar for their wheat.

Dr. RIVLIN. That's right. It's true of computers, and it's true of cars, and it's true of steel. It's true all across the economy.

Senator BAUCUS. In your judgment, what's the best mix of taxing and spending policies, not from a political viewpoint, but only from an economic viewpoint, to get these deficits down?

Dr. RIVLIN. I'm not sure there is an answer to that question in strict economic terms. It really is a value question—a question of how much you value what the Government does. If you value it very highly and feel that we should not cut any expenditures, then we should have higher taxes. Alternatively, if you think Government spending is increasing at too rapid a rate, then cutting expenditures and putting less emphasis on tax increases is a better mix.

I do not have an economic answer to that. I think it is a value judgment. And in a situation like this, some of each—a compromise—is the right answer.

Senator BAUCUS. Dr. Stein.

Dr. STEIN. Well, I agree with that. I don't think we should enter these negotiations that need to go on with some fixed idea that the answer has to come out dollar for dollar or three for one. People who are making these decisions have to look at the specifics of the expenditure programs and tax possibilities that there are, and see what they can agree on. I think I perhaps have more willingness to accept a tax increase than many others. And, therefore probably have more willingness to accept a package which included more tax increase than expenditure reduction because I am greatly impressed by the affluence of the average American taxpayer that is something, I suppose, that no member of Congress can say, but I can say.

However, I think the basic point is that you have to sit down in a room together and work this out, and see what you can agree on.

Senator BAUCUS. You say you tend to favor a tax increase. What advice would you give the President if you were to sit in the Oval Office with him privately? That is, if you could sit down and say, Mr. President, I'm sure there has to be some spending cuts, but perhaps there also has to be some revenue raised. What's the main point you would make to try to persuade him to agree that there has to be some revenue raised?

Dr. STEIN. My impression is that he has now agreed to that, and he has agreed to it from time to time. He seems to disagree also from time to time. But at the moment—when he is preparing the budget, he seems to agree.

The main thing I would say is what I said in my testimony. The object of the exercise, as I see it, is to reduce the level of consumption of the great mass of Americans; not the very poor, that he was committed to protect—and I think we should protect—not to reduce the military strength of the country, and not to reduce the growth of investment, and, therefore, we are left with reducing the consumption level of the average American. There are two ways we can deal with that. We can reduce the transfer payment that we give to the great mass of middle income Americans who are the recipients of most of the transfer payments, or we can impose taxes on them.

We have about $500 billion of transfer payments in this country and about $2,000 billion of earned income after tax. I would redistribute the burden with some recognition for the relative size of those numbers, although not necessarily in exact proportion to them.

The main thing I would say to the President is that the evils of tax increases have been enormously over-exaggerated in much of the political discussion that has gone on here in the last 5 or 6 years. People have come to have a phobia about taxation, and think that every percentage increase in the marginal rate of taxation is going to eliminate huge amounts of savings, it's going to discourage vast numbers of people from working. There is no basis in any economic research for such a conclusion. We have to think about that in a much more realistic way, that in recognizing if the country has for various reasons made commitments, some of which are quite realistic, to provide government programs, we can pay for them.

My only point would be that we should not start out with a kind of fixed idea or allergy about taxes, but try to look realistically at what they do, and who pays them, and how much revenue income there is out there to be taxed.

Senator BAUCUS. Dr. Rivlin.

Dr. RIVLIN. Yes. If I were in that position, I would try to convince the President of the dangers of the deficits. If you sit down with the numbers, having agreed that something has to be done, then I think it follows that some of what has to be done has to come on the tax side because taking all of the necessary deficit reduction out of the spending side is too difficult given the values that everybody holds.

I would urge a slowing of the defense increase in a way that Herb would not. But I think even with modest cuts in defense and some substantial cuts in domestic programs, some of the difference has to come out of taxes because there isn't enough on the spending side to close that gap as rapidly as it should be closed.

Senator BAUCUS. Again, putting politics aside—I know that's difficult; particularly here in this body—but putting politics aside for a moment, looking only at the spending side, from an economic point of view is there some kind of mix of spending cuts which tends to make more sense than some other mix? For example, take domestic programs, entitlements, and defense spending. Does it make much difference what the mix of spending cuts is, strictly from an economic point of view?

Dr. STEIN. Well, as Mrs. Rivlin said in answer to your question earlier, that is not a kind of question that an economist can answer, which is not to say that it is a political question in a narrow and pejorative sense of the term political, but it is a question of the national values and priorities, and what you think is more important.

Senator BAUCUS. So what you are saying is it doesn't make that much difference.

Dr. STEIN. I don't think you should get involved in the argument about whether defense expenditures produce more jobs or more inflation than other things. Those arguments are fruitless. The differences are invisible.

I think there are some kinds of expenditure reductions that have a particular economic justification in that they are interference with the operation of the markets. I think a lot of what we do on the agriculture side falls in that category. And I think, as I mentioned, the Export-Import Bank falls in that category, and probably some other things.

But, basically, what we are talking about are the big volumes of expenditures, expenditures for giving money to people. You have a question of deciding whether you want to give money to these people or take it away from those people? These people, by and large, tend to be old people. I hope you all have a great deal of sympathy for us old people.

But I think there is some argument for saying we over did it with respect to the old people. Of course, we made the mistake about the indexing, and we over-indexed it. Then we made kind of a quixotic increase in the social security program back in 1972 when a Member of Congress thought he was a Presidential candidate. So we have a number of things to correct there.

Senator Baucus Thank you.

The CHAIRMAN. Dr. Rivlin, you were talking about in 1986 maybe a $100 billion debt reduction. I just asked the staff to sort of break down the one we have been tinkering with or working on—in 1984, we would only get about a $5 billion reduction; in 1985, $28 billion; in 1986, about $46 million; and in 1987, about $67 billion. It would total about $150 billion, $148 billion. Is there any magic in how much has to fall on each year?

Dr. RIVLIN. No, there isn't. I just thought I would be ambitious.

The CHAIRMAN. We would like to be ambitious. In fact, there are some on the committee, I might add, who will—who knows why they will vote against things on the theory we don't do enough deficit reduction. You have got different players.

Then also I think the point should be made, if I am correct—I think Mr. Penner told us yesterday that he projects a $280 billion deficit by 1989. He's assuming that we have sort of a recovery at a 4 percent rate of GNP growth. If it does—Dr. Stein says it won't abort the recovery—but if there is some weakening, then I would assume the deficit would be higher. Is that correct?

Dr. RIVLIN. That's right. And if you have a 4 percent gross rate from now to 1989, you would have the longest expansion—perhaps the second longest in history.

The CHAIRMAN. What's the average recovery length? Thirty months or less?

Dr. RIVLIN. Recently, they have been quite short.

Dr. STEIN. I think the average post-war recovery has been 36 months. In a recent survey of Economic Forecasters, they predicted that this one would be 38 months in length, starting from November 1982, which brings it out to about the end of 1985.

The CHAIRMAN. End of 1985?

Dr. STEIN. Right.

The CHAIRMAN. That would have an impact on 1986.

Dr. STEIN. Yeah. But you shouldn't take that too seriously. Nobody really knows.

The CHAIRMAN. Unless you are running in 1986. [Laughter]

Senator Mitchell.

Senator MITCHELL. I would like to ask about a specific proposal in the package now before this committee. I apologize for not having heard your testimonies, but I have read Dr. Stein's previous written statement on this. And, Dr. Rivlin, I will read yours.

We agree that some tax increase as part of a package is necessary. I got here just as you were discussing, Dr. Stein, the importance of dealing with consumption. But I would like to ask for you to evaluate the proposed energy tax in the package as opposed to what I believe to be a more simple and equitable—the third year of the tax cut or something similar to that. Modifying the indexing, say, by CPI minus three or something like that.

Among the criteria that have traditionally been used to evaluate the taxes, the distributional impact, that is, the fairness issue, the ease of administration, and the economic impact of the tax—what effect they might have on inflation. I wonder if I could ask you first, Dr. Rivlin, and then Dr. Stein to evaluate those two proposals in that context.

Dr. RIVLIN. I think they are rather different. The straight rate change, which could be in the form of taking back the third year cut or in the form of a surtax basically doesn't change the income tax. It just raises the rates or raises them back to higher levels.

The argument for an energy tax, I think, is of a different kind. To be in favor of an energy tax—and I generally am—is to have other considerations in mind, such as conservation over the long run. We should be pricing energy to ourselves higher than we are so as to conserve it over the long run. I think there are some arguments for that.

So I think it's a different set of arguments. I, for one, would suggest you explore some of each.

Senator MITCHELL. I didn't hear you. What?

Dr. RIVLIN. That you explore some of each. We are going to need substantial revenues over the next several years. Doing part of this through an increase in the energy tax, and part of it in other ways would be sensible.

Senator MITCHELL. Well, of course, on the conservation point, all historical experience demonstrates that the effect of increased energy costs upon patterns of consumption so as to reduce conservation have a substantial time lag.

Dr. RIVLIN. That's right.

Senator MITCHELL. And here you have a proposal for a temporary 3-year tax. So unless you have some intention of making it permanent, there is no historic experience to support that it will induce the conservation consequences that you suggest.

Dr. RIVLIN. Over the longer run, though, the conservation effects seem to be quite substantial. We have achieved a lot in conservation as a result of the higher price of energy over the last few years.

Senator MITCHELL. That would be true if this were a permanent tax.

Dr. RIVLIN. Right.

Senator MITCHELL. Dr. Stein.

Dr. STEIN. Well, I have changed my mind about the energy tax. I used to be a great enthusiast for energy taxation—particularly, for an oil import duty mainly as a way of doing something about the OPEC cartel and forcing the world price down. That doesn't seem to me as necessary or important as it used to. And I am concerned about the interindustry distortions that would result from a tax on energy.

One industry with which I am familiar, which is the aluminum industry, would be rather severely hurt by it. And all those people with the six-packs of beer in aluminum cans would be hurt and so on. But I just don't see any reason at this point to single out the energy industry. I think we are making an adjustment in that industry. And so I would prefer, as I do in general, a more broadly based kind of tax—a tax more general in its impact. I would prefer to do something like an addition to the individual income tax. I would prefer not to go back to the corporate tax. I think it was a great step forward to reduce the effective burden of corporate taxation as we did. And I don't want to undo that. I think part of what we are interested in is promoting investment in economic growth, and its counterproductive to do it by the corporate tax route.

Of course, as I said at the beginning, I think perhaps when you were not here, I don't think you can afford to be too fussy about this or dig in your heels and say that under no circumstances will I take this or that compromise. You have to deal with the beliefs and interest and erroneous ideas that are out there in the country. But if I had my preference, I would confine the increase to the individual income tax. And I would not undo indexing. I think indexing was a great step forward, and in the long run will have a very salutary effect on the political process.

Senator MITCHELL. I would like also to simply express a concern and ask you to comment if you care to. I've read several recent reports which indicate that the effect of tax policy at all levels of government over the past 3 years has been a significant shift in the burden of taxation; generally, the Federal income tax has been reduced by a substantial degree, and that's the major revenue collected as related to income ability to pay. At the same time, Federal payroll taxes have increased, some excise taxes. Many States raised their taxes, and that is generally a sales tax. And many communities raised the property tax. And the effect has been to shift the burden of taxation increasingly on the middle class.

And my concern, frankly, about the energy tax is that it represents a further step in that direction, which would not occur were we to deal with the tax increase in the context of the income tax. And I ask whether, if you care to comment on that—if you care to comment, I would appreciate that. Do you feel that is a valid concern? Whether the assumptions contained in the statement are correct or incorrect, or any other comments you care to add.

Dr. RIVLIN. Well, over the period you are talking about we certainly shifted the burden of taxation from the corporate tax, which has gone down very substantially, as Dr. Stein noticed, onto the payroll tax, which has been a rising fraction of revenues, and which is paid by everybody who works, but is not a progressive tax.

I think in the ranges we are talking about right now, shifting the effect would be fairly marginal, whether you put part of it on energy, which essentially is a consumption tax—it's passed on to all of the consumers of energy, whether they are poor or middle or upper income.

Dr. STEIN. I think there has been some such shift and I think its commendable. The tax system that developed as a result of the inflation was burdensome on savings and investment to a degree that was harmful to the welfare of the national economy, and that was somewhat redressed in the 1981 action.

My complaint about the 1981 action was that it went far beyond that in reducing the tax burden on the middle class, which we have to rely on to pay the cost of government if we are not going to impair the long run health of the economy. So I think these shifts have been commendable. I don't want to undo them.

As I said, I guess before you came, I think the main object now is a budget policy which will somewhat restrain the consumption of the great mass of the American people, because that's where most of the income is; that's where most of the output goes; and that's where we have to look in order to find the income to pay for these other important functions of government, such as defense, caring for the poor, paying our interest, and reducing the deficit enough to permit the economy to go forward. So I do not rise in alarm at this thought of posing some additional taxes on the American middle class, even though I recognize that is most of us. That is all of us practically.

The CHAIRMAN. Do you think the contingency tax—are you satisfied that would work? And there are a lot of people very suspicious that even if we arrive at some formula and we have CBO working on it, it would trigger in the tax changes; that it will never happen. We will end up again with spending cuts and no tax changes.

Do you have any comments on the concept of the contingency tax? Is that sound tax policy?

Dr. STEIN. I really find it hard to understand. I think the conditions which call for the tax increase are here, and we should have the tax increase. And we don't need to wait to see something else happen before the tax increase goes into effect. It has already happened. The bell went off. We should have the tax increase. I think probably you are going to need a package, which is a different thing from a contingency. I think we need a package which will provide for the tax increase to go into effect at a date certain and specified and as soon as possible, and for certain changes in the appropriations or spending legislation. We've had such packages before. We had a package like that in 1968. And I am sure there have been others, which you would know better than I do.

But these are not things that need to wait for some statistic to appear which has not yet appeared. All the statistics are here.

The CHAIRMAN. Dr. Rivlin.

Dr. RIVLIN. I think you should put together a package and enact it. It should have a future date. But part of what you are trying to achieve is to show that there is a plan written into law to bring the deficit down. You want to show that to the financial markets and to the rest of the world. You want to show it to the American public in general. And I think the way to do that is to enact a law.

The CHAIRMAN. That's the part that concerns some of us. If, in fact, it triggers, whatever; but if it is just a gimmick to say, well, we will get through something, whatever it is, this will take the pressure off those who say not to do anything on the tax; we will make it contingent on something happening.

I'm not certain how the financial markets are going to respond. I mean if it is something that is never going to happen, I assume somebody will discover that. There are pretty shrewd people out there in the business world. And I think what they would like to see is to know in advance that something will happen.

As Dr. Stein said, the bell has gone off, the alarm has sounded. And I think we need to act.

Dr. STEIN. I agree with that.

Dr. RIVLIN. I agree.

The CHAIRMAN. Well, thank you very much. We appreciate your coming, and we appreciate your statements and testimony.

I would like now, if there is no objection, to call Dr. Stuart Butler, director of domestic policy studies, the Heritage Foundation; John Palmer, Ph. D. Senior Fellow, the Urban Institute, Washington, D.C.

I would also like to call the next panel because Dr. Bergsten has a plane to catch. So if Dr. Bergsten and Carol Cox could also come up. And if there is no objection to hearing Dr. Bergsten first, it would accommodate him. Does anybody have any problem with that?

[No response.]

The CHAIRMAN. And, again, if your plane is out there already, you can summarize your statement. That would even get you there sooner.

Dr. BERGSTEN. It sounds like we have a common interest, Mr. Chairman.

The CHAIRMAN. We want to be thorough, but I don't want you to miss your airplane.

STATEMENT OF DR. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, D.C.

Dr. BERGSTEN. Right. Thank you very much, and also for changing the order.

I was asked to lay out some of the international implications of the budget problem that the country now faces. It is a pleasure to do that because I believe very strongly that international considerations not only add substantially to the need for prompt and decisive action on the budget, but that the several adverse effects of currently projected budget deficits on the international position of the United States and on the world economy as a whole—and back onto our own situation—may be among the most compelling reasons to launch a major and decisive effort to deal with the budget problem now.

As a prefatory note, before turning to those specific effects, I think everyone now recognizes the deep structural involvement of the United States in the world economy: the fact that almost a quarter of our industrial output is now exported; the fact that over 40 percent of our agricultural output is exported; the fact that almost one out of every $3 of U.S. corporate profits derive from the international activities of American firms, both their exports and their investment.

But what I think is not recognized is that the changes in the external position of the United States have actually dominated the overall course of our economy over most of the last 5 to 6 years.

When you look back to the last modest recovery that we had, from 1978 to 1980, fully three-quarters of the expansion of our economy derived from the improvement in our trade balance. U.S. exports were then growing at twice the rate of world trade, we resumed a share of world markets for manufactured goods we had not seen since the late sixties, our current account balance improved by over $50 billion in just 2 years excluding the impact of the second oil price shock. So in the last positive period for the U.S. economy, the external side was, in fact, dominant.

By contrast, during the recent recession, from the first quarter of 1981 to the fourth quarter of 1982, the decline in our net export position equaled three-quarters of the total decline in our real GNP. The decline in our trade balance, not the housing slump, not the auto slump, was by far the single biggest factor in the recession. Indeed, if it hadn't been for that deterioration in the trade balance, we might not have even talked about a recession because we wouldn't have noticed much decline in the GNP.

It is thus extremely perilous to ignore the international impact of what we usually think of as domestic policies, as I would argue has been done for the past several years.

The international problems now arise and have arisen over the last couple of years, of course, because the prospect of huge and unending budget deficits, when combined with a responsible monetary policy, produced extremely high U.S. interest rates. In turn, those high interest rates attract massive inflows of capital to the United States from abroad and produce a severe overvaluation of the dollar in the exchange markets compared with the underlying competitive relationship between the United States and other major countries. And as if to give further urgency to your hearings, Mr. Chairman, the dollar yesterday hit its highest trade weighted average level since 1970—offsetting all of the depreciation of the seventies, the competitive gains and correction that occurred during that period; it has all been given back and we are now in an extremely perilous international position.

My institute published a study just 2 months ago to try to calculate how much the dollar is out of line. We concluded that it was overvalued, compared to trade competitiveness, by something on the order of 20 to 25 percent. And that, of course, has the same effect as placing a tax of 25 percent on everything we sell to the rest of the world and paying a subsidy of 25 percent on all goods coming into the United States.

The combination, therefore, of high interest rates and dollar overvaluation produces major international consequences with extremely negative effects on the United States itself.

What I would like to do quickly—it's elaborated in my statement—is tick off the six major effects that I think derive from the international implications of the budget deficit and high interest rates, and how those adversely affect the U.S. economy.

First, the trade deficit itself. I suggested over 2 years ago that what was happening was going to take the U.S. trade deficit to $100 billion. It is now conventional wisdom that the merchandise balance will hit $100 billion next year. My own guess is that it will be more like $120 billion. That will take the current account deficit, even cranking in our big surplus on services, to somewhere on the order of $80 to $100 billion, five or six times as great as it ever was prior to 1983.

This further deterioration in our external position will in the first instance take something like 1 to 1½ percentage points off the economic recovery next year. It will take unemployment, directly traceable to trade, to over 2 million jobs by the middle or end of next year. Most of those losses come to the manufacturing sector, encompassing both basic industries and high tech industries, which both export and import.

Of course, the major cause of the trade decline is the overvaluation of the dollar. Every percentage point of price competitiveness that we lose costs our trade deficit about $3 billion annually. And the sorry story is that if the situation is not rectified, the trade deficits will continue to run at least at the $100 billion level for the indefinite future. There are even some estimates, including by DRI, that see the trade deficit getting close to $200 billion later in this decade unless we correct the underlying problem of budget deficit, interest rates, and overall dollar overvaluation.

In fact, there is an even more stunning fact. Over the last 60 to 70 years, the Unites States, of course, has been a net foreign investor. Our firms and our individuals have been investing heavily abroad, and building up a net creditor position for the United States in the world economy. If we run trade and current account deficits at this level for the next 2 to 3 years, the entirety of our net creditor position abroad will be eliminated. And the United States again would become a net debtor country, as it was in the 19th century.

In short, Mr. Chairman, there is a foreign borrowing counterpart stemming from the trade deficit to your borrowing counterpart in domestic terms from the budget deficit. A lot of our budget deficit is being financed abroad. That is quickly turning the United States back into an international debtor rather than creditor, which would be a fundamental structural change for a country of our type.

So the first huge problem is the trade deficit and what it means for jobs, production, and our overall position.

Second, and maybe even more worrisome in a longer run sense I'm afraid that the trade deficits and dollar overvaluation are now posing a growing threat to the future of U.S. investment in plant and equipment. We have to keep in mind that a very large segment of U.S. industry—it's now estimated at 60 to 75 percent—must compete with firms abroad, either internationally or in our domestic markets. Many of those firms now see the competitive price disadvantage, the 25 percent overvaluation of the dollar, as badly undermining their ability to compete out of the United States. Some American firms are, therefore, beginning to question the basic wisdom of future investment in the United States. Most of them have subsidiaries and affiliates abroad. What we could get is a new wave of foreign investment by American firms, just as we had in the late sixties and early seventies—the last time that the dollar became so overvalued relative to other currencies and undermined the competitive position of our economy.

That, of course, would cost still more jobs and, indeed, in my mind is the major single threat that sometimes goes under the term "deindustrialization." In short, if our manufacturing and high-tech industries see themselves perennially disadvantaged by a dollar which is the equivalent of taxing all their exports 25 percent and subsidizing their import competition by 25 percent, they may not invest here.

The CHAIRMAN. Could you speed up?

Dr. BERGSTEN. I will do it very quickly.

The third effect, and it has already been mentioned, is protectionism. The history of U.S. trade policy shows that the major sources of protectionist pressure to insulate our economy come from dollar overvaluation, the competitive disadvantage I mentioned. That is occurring again. You see it here in the committee and the Congress every day. As long as the dollar overvaluation continues, it will continue.

Four, the debt bomb. The only prospect for the developing countries to resume earning foreign exchange enough to service their external debt on anything like a stable basis is for them to resume exporting to the rest of the world. That requires an avoidance of protectionism, and a pickup in economic growth, which is jeopardized by the current situation.

So the deficit problem here relates directly to the deficit problems of those debtor countries around the world, and could cause the explosion of that debt crisis, which so far has been managed quite skillfully, but certainly is going to be with us for the foreseeable future until and unless the underlying economic situation is corrected.

Finally, economic growth abroad. High U.S. interest rates which feed out to the rest of the world through the dollar mean that other countries have to keep their interest rates high as well, and cannot use monetary policy to stimulate their economy. The result is that the U.S. recovery is not spreading very rapidly to the rest of the world. Japan is growing more slowly than we for the first time in 30 years. Europe remains pretty much dead in the water.

The bottom line for us is that it is very hard to imagine the U.S. recovery continuing very strong for very long if the rest of the world remains stagnant. We tried that in 1977 and 1978. The result was the U.S. economy fell back into the stagnation of the rest of the world rather than our being able to pull up those other countries.

So, again, unless we are cognizant of the world effects of our own policy and get our own house in order, the feedback onto us is going to badly undermine our own situation.

The bottom line, Mr. Chairman, is that there are five or six major international effects of what is going on now in our policy here at home. Unless we quickly recognize those and take the kind of steps that you are promoting to deal with them decisively, the impact on both ourselves and the world economy could be disastrous.

The CHAIRMAN. Thank you very much.

[The prepared statement of Dr. Bergsten follows:]

THE US BUDGET DEFICIT

AND THE WORLD ECONOMY

Statement by

C. Fred Bergsten

Director

Institute for International Economics[1]

Before the

Senate Finance Committee

December 13, 1983

Introduction

International considerations add substantially to the need for prompt and decisive action, by the Administration and the Congress, to implement major and lasting reductions in the US budget deficit. Indeed, the several adverse effects of currently projected budget deficits on the international position of the United States and on the world economy as a whole may be the most compelling reasons to launch such an effort.

In addressing this issue, it is essential to recognize that changes in the external position of the United States have dominated the overall course of our economy during five of the last six years. From 1978 to 1980, three-quarters of the total

1. Assistant Secretary of the Treasury for International Affairs, 1977-January 1981; Assistant for International Economic Affairs to the National Security Council, 1969-May 1971.

growth in real US gross national product was accounted for by the sharp improvement in our net export position.[2] From the first quarter of 1981 through the fourth quarter of 1982, the decline in net exports equalled three-quarters of the total decline in real GNP--and was by far the largest single factor in the recession. Hence it is extremely perilous to ignore the international impact of US "domestic" policies, as has been done for the past three years.[3]

The international problems arise, of course, because the prospect of huge and unending budget deficits, when combined with responsible monetary policy, produces extremely high US interest rates. In turn, these high interest rates attract massive inflows of capital and produce severe overvaluation of the dollar in the exchange markets, compared with the underlying competitive relationship between the United States and other major countries.

2. During that period, US exports grew twice as fast as world trade. By early 1981, the United States had regained a share of world markets for manufactured goods which it had last experienced in the late 1960s. The current account improved by $15 billion despite a further rise of $40 billion in oil import costs due to the second oil shock--implying a gain of $55 billion on everything else in just two years. Assertions that the United States faces some fundamental problem in competing in the world economy are thus totally disproven by the facts.

3. During President Reagan's recent visit to Tokyo, the Administration finally admitted that the strength of the dollar (particulary vis-a-vis the yen) was a major problem which requires policy response. Unfortunately, the responses announced (regarding further liberalization of the Japanese capital market and inter-nationalization of the yen) are unlikely to improve the situation, and may even worsen it. Since the Tokyo meeting, the dollar has strengthened further (including against the yen).

A study published by the Institute for International Economics in September demonstrats that the dollar is overvalued by 20-25 percent.[4] This has the same economic effect as placing a tax of 20-25 percent on all US exports and paying a subsidy of 20-25 percent on all imports into this country. The combination of high interest rates and dollar overvaluation, both of which derive in large part from the current and prospective budget deficits, produces major international consequences which have extremely negative effects on the United States itself--four of which operate directly on our economy and two of which feed back into the United States through their impact, in the first instance, on the rest of the world.

The Trade Deficit

As I predicted over two years ago,[5] the US trade deficit will soar to at least $100 billion in 1984. Indeed, that rate has been approached during the last few months, and I now fear that the trade deficit may hit $120 billion next year. This in turn implies a current account deficit of $80-100 billion, five to six times as great as the pre-1983 record.

Such further deterioration in our external position would take 1 to 1 1/2 percentage points off the recovery next year,

4. John Williamson, The Exchange Rate System, Washington: Institute for International Economics, September 1983.

5. In "The Costs of Reaganomics," Foreign Policy, Fall 1981, pp. 28-29. See also my "The International Implications of Reaganomics," Kieler Vorträge, no. 96, February 18, 1982. Both are reprinted in the The United States in the World Economy: Selected Papers of C. Fred Bergsten 1981-1982, Lexington, Mass.: D.C. Heath and Co., 1983.

after taking off about a full percentage point this year. By late 1984, over two million jobs will have been lost as a result of the deterioration in the trade balance. Most of these losses come in the manufacturing sector, encompassing both key basic industries which compete against imports (such as steel and autos) or rely heavily on export markets (such as farm machinery) and high-tech industries which do both.

The overwhelming cause of the trade decline, to date, is the overvaluation of the dollar. Traditionally, every percentage point loss of international price competitiveness costs our merchandise trade balance about $3 billion. Thus the overvaluation of 20-25 percent, first reached in mid-1981, would be expected to generate annual losses of $60-75 billion--which, from the starting point of a $25-30 billion deficit in 1979-81 (more than offset in those years by our structural surplus on services)--takes the deficit to about $100 billion.[6] Further substantial losses, pushing the deficit even higher, are now resulting from the much faster pace of economic recovery in the United States than in the rest of the world and will continue to do so as long as this "growth gap" persists (see below)--although there may be some offset from a modest restoration of imports by Mexico and other large debtor countries as their stabilization programs permit.

6. This is a highly conservative estimate, because the appreciation of the dollar--from its low point in 1978 to its recent and current highs--averaged about 40 percent, implying a possible trade loss as high as $120 billion from the currency change alone. This would take the merchandise deficit to about $150 billion.

If the dollar overvaluation is not soon corrected, the deficits will continue to run around $100 billion annually; some estimates (such as those by DRI) suggest that the merchandise imbalance could approach $200 billion later in the decade. The associated job losses would exceed four million. By 1986, the United States could again become a net debtor country--reversing in four years the entire net buildup of foreign assets of the past seven decades and returning to our status of the nineteenth century.

Deindustrialization?

Beyond the trade deficits, dollar overvaluation poses a growing threat to future investment in US plant and equipment. A large segment of American industry, running as high as 60-75 percent on some estimates, must now compete actively with firms based abroad either in world markets or here at home. Yet many of these firms are increasingly aware that the huge (20-25 percent) price disadvantage caused by dollar overvaluation may persist well into the future, if no action is taken to deal with the underlying cause of the problem--the budget deficit.

Some firms are therefore beginning to question the wisdom of future investment in the United States. Continued sizable dollar overvaluation is likely to force them to invest abroad instead, not from any "runaway plant" mentality but simply for self-preservation, particularly because their foreign competitors are enjoying such huge profits and may be reaping irreversible competitive gains. Indeed, massive foreign direct investment was one result of the last prolonged period of dollar overvaluation in the late 1960s and early 1970s.[7] Such a shift would of course further reduce job opportunitites in the United States. In addition to jeopardizing the sustainability of the present recovery, this phenomenon is probably the greatest present cause for concern over any future "deindustrialization" of our economy.

Protectionism

The history of US trade policy throughout the postwar period reveals that dollar overvaluation, even more than aggregate unemployment, is the most reliable "leading indicator" of protectionist trade pressure in this country.[8] The reason is clear: dollar overvaluation badly jeopardizes the competitive position of even our healthy import-competing industries, as well as those which are traditionally vulnerable. Hence the coalition which seeks import relief is broadened substantially. The latest evidence is the adoption by the current Administration, despite its devotion to open markets and free trade, of major protectionist steps in at least a half dozen industries to date (autos, textiles/apparel, steel, sugar, motorcycles, and specialty steel).

7. There were of course other major reasons for the expansion of foreign direct investment by US-based firms during that period. However, the buildup correlates almost precisely with the growing dollar overvaluation and, given the inherent lags in corporate planning, so did its slowdown from the mid-1970s (after the dollar devaluations of 1971-73). Likewise, investment in the United States by foreign-based firms was miniscule prior to those currency corrections but has expanded rapidly since then.

8. C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy," in William R. Cline, editor, Trade Policy in the 1980s, Washington: Institute for International Economics, November 1983.

These pressures could become particularly intense in 1984. As noted, the trade deficit will soar to (or beyond) $100 billion. Unemployment, though down sharply, will still be high--and a great deal of it will be directly traceable to trade. The election campaign will generate intense pressures to support additional import relief. Continued dollar overvaluation would undermine the traditional case for open trade, in part because its benefits would be skewed heavily against the United States. I believe that a widespread resort to protectionism would be a tragic error, by using trade instruments to respond to a monetary and macroeconomic problem, but would not be surprised to see it happen--even perhaps through an across-the-board import surcharge, à la Richard Nixon and John Connally in 1971 in similar, but much less severe, circumstances.

Any widespread US adoption of protectionist devices could, in turn, topple the open trading system which has been so crucial to postwar prosperity. Europe, with its much higher level of unemployment and structural economic woes, would reply in kind (or worse). The developing countries, seeing the evaporation of their only hope to earn their way out of the debt crisis (see below), would have to tighten their own trade controls further. The encouraging progress toward liberalization in Japan would abort. The damage would be all too reminiscent of the 1930s, and could take years (or decades) to repair.

A "Stabilization Crisis"?

One other possibility, recently outlined by my colleague Stephen Marris, is that the trade deficit itself will eventually produce such a precipitous fall in the exchange rate of the dollar as to have major adverse consequences for our economy.[9] Such a fall would come from a sharp reversal in capital flows, stemming from a collapse of international confidence in the sustainability of the American situation, which would then push US interest rates up both directly and--because the Federal Reserve would have to tighten money to stem the run on the dollar--indirectly.

Moreover, a sharp decline in the dollar would add significantly to inflationary pressures in the economy: a fall of 20 percent in the exchange rate would add about three percentage points to the CPI.[10] As a result, the United States would for a while get the worst of all worlds from its external accounts: a continued huge trade deficit, because of previous dollar overvaluation, and then higher interest rates and new inflationary pressures as well from a rapid fall of the currency. Again, urgent action is required--to begin the adjustment process soon enough to foster the needed currency correction in a relatively smooth manner, without a "free fall" à la 1978 and the enhanced risk of overshooting to an excessively weak (and inflationary) dollar once again.

9. Stephen Marris, "Crisis Ahead for the Dollar," Fortune, December 26, 1983.

10. The correction in the exchange rate of the dollar which is needed, as noted above, would of course also produce such an effect--but in a more orderly way over a longer period of time. Indeed, the inevitable upward push in the CPI from dollar depreciation--which, it should be noted, does not affect the "core" or "underlying" inflation rate--is better taken now than later, given the continuing low level of recorded inflation, thus adding to the urgency of restoring dollar equilibrium.

The Debt Crisis

The current nexus of high US interest rates and an excessively strong dollar adds substantially to the risks that the debt bomb will explode.

Every percentage point on the interest rate adds $3-4 billion to the annual servicing costs of the debtor countries. Their total interest payments now far exceed their new capital inflows, making them substantial net transferers of resources to the richer industrial countries. Hence their "default calculus" turns increasingly positive. Lower interest rates are urgently needed to reduce the risk of severe disruption to the world economy and financial systems.

The overvalued dollar also intensifies the debt crisis. Since most of the debt itself is denominated in dollars, the strong dollar sharply increases its real value--and the real costs of servicing it. Since most of the large debtor countries peg their currencies to the dollar, its strength drags their exchange rates up and impairs their competitiveness in third markets. Since most of their commodity exports (including oil) are denominated in dollars, the strong dollar weakens demand for their products and cuts their dollar earnings. The protectionist pressures cited above, if successful, would also reduce the hard-currency earnings of the debtors--whereas renewed export growth is the *only* way they can resume normal debt servicing and restore market creditworthiness.

The debt crisis can be surmounted if the debtor countries stick to effective adjustment policies and *if* several key conditions are met by the world economy: real growth in the OECD as a whole of at least 3 percent annually through 1986, LIBOR at 8-9 percent, the avoidance of new trade protectionism, a restoration of exchange-rate equilibrium between the dollar and other major currencies, stability of oil prices and continued inflows of capital at adequate levels.[11] The huge and continuing US budget deficits make it harder to fulfill every one of these criteria. Despite encouraging recent progress in several of the major debtor countries, the longer run situation remains uncertain and urgent action is needed to assure its continued manageability.

Economic Growth Abroad

The strong dollar, with its devastating effect on the US trade balance, is now enabling Japan and Europe to improve their competitive positions sharply and to experience rising trade surpluses. Hence the current US policy mix provides one positive impulse for the other industrial countries.

On the other hand, and even leaving aside the moral implications of the richest nation in the world financing its budget deficits from other countries' savings, the high US interest rates (which cause most of the dollar strength) continue to depress economic activity abroad. This is partly because the

11. William R. Cline, International Debt and the Stability of the World Economy, Washington: Institute for International Economics, September 1983. See also the thoughtful recent speech by Deputy Treasury Secretary R. T. McNamar, "The International Debt Problem: Working Out a Solution," presented to the Fifth International Monetary and Trade Conference, Philadelphia, December 5, 1983.

international flow of capital to the United States is depriving other countries of investment resources. Even more importantly, most other major countries feel that they must maintain interest rates high enough to keep their exchange rates from weakening further, in light of the inflationary pressures--notably including higher prices for dollar-denominated oil and other commodities--which would result. Hence they are unable to use monetary policy to stimulate more rapid expansion of their economies; indeed, several of them are now maintaining interest rates far higher than called for by domestic conditions, and are thus retarding their own economies.

At the same time, the most important of these countries--Japan, Germany, and the United Kingdom--are, in direct contrast to the United States, steadily reducing their budget deficits. Indeed, there is extensive political consensus in those countries for doing so, in the interest of long-run fiscal prudence. Hence neither monetary nor fiscal policy is available to promote their recoveries (though the immediate cyclical situation would seem to call for fiscal expansion instead). Partly as a result, the US recovery has not yet spread; for example, US growth will exceed Japanese growth in both 1983 and 1984, a rare juxtaposition since the postwar reconstruction of Japan.

Thus the United States may wind up seeking to maintain its recovery in a largely stagnant world economy. The last time it tried to do so, in 1977-78, the result was a snuffing out of the US recovery--via a "stabilization crisis" of the type described

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above--rather than a generalization of US growth to the others. In light of the further integration of the United States into the world economy over the past five years, as described at the outset, it is doubtful that the United States can grow very fast for very long if the other major countries are not doing so, at least to some extent, as well. So the impact of US policy on the rest of the world, which on balance is negative for most countries, will feed back adversely onto the prospects for sustainability of our own recovery--and, by slowing world growth, add to the risks surrounding the debt crisis as well. The situation would be worse if the United States is hit by a "stabilization crisis," as outlined above, because other countries would then probably face both a slackening of the American economy and a decline over time in their competitive positions as the dollar fell.

Conclusions

The international effects of the present US policy mix are thus extremely costly for our own economy, both directly via its impact on the US competitive position and indirectly via its effects on the other industrial countries and the developing countries. Substantial numbers of US jobs and investments are being lost, and severe systemic risks--a collapse of the open trade regime and renewed eruption of the debt crisis--are threatened.

It is thus imperative to attack the root of the problem: the prospect for huge and interminable budget deficits, which is the most important cause of both high interest rates and dollar overvaluation. In the absence of such an attack, any or all of the problems cited here could become acute and even unmanageable. At a minimum, alternative steps of a decidedly inferior nature might have to be taken to head off major international disturbances: direct manipulation of capital flows and massive intervention in the exchange markets, to correct the currency imbalances, and huge new infusions of capital to cope with the debt bomb.

It will ultimately be essential to bring our public finances into order; our national self-interest in the global economic situation counsels that we do so promptly and decisively. Indeed, urgency is required particularly because of some of these international phenomena. A renewed flight of US investment abroad, once begun, would not be easy to reverse. A breakdown of the open trading system, which would surely follow promptly any major US reversion to protectionism, could take decades to overcome. Explosion of the debt bomb could leave an even longer trail of disaster. The international dimension of the US fiscal crisis thus adds substantially, perhaps decisively, to the case for immediate action to begin the corrective process.

The CHAIRMAN. Senator Mitchell, do you have any questions for Dr. Bergsten? If not, then he could probably be excused.

Senator MITCHELL. No, I do not.

The CHAIRMAN. It's an excellent statement, and we may have some questions, if it's all right with you, to submit in writing as we go through the testimony of different witnesses.

Dr. BERGSTEN. Thank you, Mr. Chairman.

The CHAIRMAN. Now we will go back to our regular order. And we appreciate the other members waiting because he does have a plane to catch.

Dr. Butler, we will hear from you. Let me say from the outset that your entire statements will be made a part of the record. And if you can summarize or highlight your statements, it will be appreciated.

STATEMENT OF DR. STUART BUTLER, DIRECTOR OF DOMESTIC POLICY STUDIES, THE HERITAGE FOUNDATION, WASHINGTON, D.C.

Dr. BUTLER. I will just highlight five major points that I tried to make in the testimony.

The first is that we recognize our ability to forecast the deficit is primitive, to put it mildly. In 1979, for example, the OMB forecasted the next year's deficit and it was exactly double the actual turnout. In 1982, it was one-quarter of the actual situation. In fact, only three times between 1971 and 1982 have official estimates of the deficit come within 75 percent of the actual totals.

If we are looking forward several years, and if we recognize the possible combination of such errors, we begin to realize, I think, that we are really groping in the dark when we try to get some idea of what the deficit is going to be in the future.

Senator MITCHELL. Excuse me. May I interject with a question?

The CHAIRMAN. Sure.

Senator MITCHELL. In the cases that you refer to, where they missed by over 75 percent, were they both over and under it or always underestimated?

Dr. BUTLER. Both sides. I think that one could argue that if you are looking at out years, you are talking almost about random numbers when it comes to estimating the deficit. I'm not trying to suggest that it's one way or the other.

The second point to bear in mind is that if we are really talking about the deficit as having an impact on borrowing and on the bond markets in the country, we must look at the total deficit, or the total impact of Government borrowing. That means we must look at State and local borrowing. It means we must look at the so-called off budget items. And there are other types of Government borrowing that are not shown in the official deficit.

We should bear in mind, for example, that at the State and local government level we have been seeing steadily increasing surpluses over the last couple of years. So if the Federal Government provides a State with, say, revenue sharing or UDAG grants, that appears in the deficit. But it appears in the surplus as far as the State is concerned. So we see the deficit growing, in some respects, due merely to accounting changes, if you like, between various levels of Government.

I recommended in my statement that we should adopt at least one thing that we have managed to do correctly, I think, in Britain. And that is to consolidate all of this borrowing into a so-called public sector borrowing requirement, which includes all elements of government borrowing, including borrowing by government corporations, such as nationalized industries in the British case.

The third point I would like to emphasize is that although it may seem commonsense that the deficit will have an impact on interest rates, and therefore on the economy, the evidence to support this position is by no means clear. Many studies have been done looking at the correlations between deficits and interest rates, and show a very, very poor correlation. I think that we ought to bear that in mind before we rush blindly into passing tax increases to deal with this alleged problem.

The fourth point I would like to make is that on the other hand the impact of tax increases on the economy is pretty well documented. Indeed, the reduction in tax rates was the heart of the Reagan program to stimulate the economy. And I don't think there are many people—I have yet to find any, in fact—that argue that increasing taxes will be stimulative or improve productivity in the economy.

The fifth point I would like to make really summarizes the broad direction I think we should take. And that is to recognize that most of the evidence tends to suggest that it is the size of Government activity that is much more important in determining the course of the economy, and even interest rates, than the size of the deficit.

If we pass tax increases to supposedly close the deficit—as I point out we did in 1982—it seems to me that the evidence suggests that this will merely take the pressure off moves to reduce spending. When we increased taxes under TEFRA, we did not see the kinds of reductions in spending that were promised. And I don't think there is much evidence to suggest that if we——

Senator MITCHELL. Promised by who?

Dr. BUTLER. By those supporting the measure—the three for one reduction in spending.

Senator MITCHELL. I've attended meetings with the Secretary of Treasury where he was questioned about that, and persons present in the meeting said there was never any such promise; there was never any such commitment. That was a point that was raised by a White House staffer. And that was the extent of it.

Dr. BUTLER. Well, it would seem to me that the American people had been led to believe that we were seeing budget reductions.

Senator MITCHELL. I think it's very important, when you talk about the need for correlation between the past and present and proven things—I was not present at the meetings, but——

Dr. BUTLER. My point still stands, however, that tax increases have not tended to coincide with either reduction in deficits or reduction in Government spending.

Senator MITCHELL. I don't disagree with that at all.

Dr. BUTLER. Fine.

However, what I would argue is that what we should be doing instead is to look at different methods, different strategies of reaching the objectives of Government. I think Dr. Stein pointed out that if we merely go in and reduce spending we are going to have to eliminate some of the objectives of Government spending. But I argued in a paper I have presented to the committee that we should look very closely at a strategy—which has been called privatization—that would look at nongovernment methods of providing the same types of services, and the objectives of Government spending, by looking systematically at methods of reducing the level of Government activity by shifting functions out of the Government area. I think there are many areas of major Government spending that we could examine in that way, social security being, I think, one of the most important ones. We could do this by building on the IRA system that we now have set in motion.

I think it would be harder to have private defense, of course, but I think the method by which defense contracting is established ought to be looked at very carefully. We don't really have a functioning market, if you like, in defense contracting. Those alternative methods of achieving the objective of government should be looked at, rather than just some crude front-end attack on spending levels or increasing taxes, which I don't believe will reduce the deficit.

I think those are the major points I would like to make.

The CHAIRMAN. Thank you very much, Dr. Butler.

[The prepared statement of Dr. Butler follows:]

Testimony to the Senate Finance Committee

December 13, 1983

Stuart M. Butler
Director of Domestic Policy Studies
The Heritage Foundation
Washington, D.C.

Introduction

My name is Stuart Butler and I am Director of Domestic Policy Studies at The Heritage Foundation, Washington, D.C. The views expressed herein are my own.

Few would dispute the claim that deficits do matter. There is far from being any concensus, however, regarding how they matter, or even how big the deficits really are. Congress seems determined to push through a package of major tax increases to reduce the projected federal deficit. Yet we know that tax increases are damaging to savings, growth and job creation. It would seem only sensible, then for Congress to consider carefully and fully just what deficits do to the American economy before it tries to solve one problem which may damage the economy by adopting one policy option which will certainly hurt it. These hearings are a welcome opportunity for the Senate to ponder the evidence.

In addressing these issues, I will first survey some of the problems associated with forecasting the deficit, noting that the degree of possible error in such forecasts is enormous. Secondly, I will consider the likely effects of federal deficits, noting that the pace of recovery belies the argument that deficits necessarily destroy capital formation, and that the total size of the government sector sppears more threatening to a healthy economy. Thirdly, I will look at one option for reducing deficits, tax increases; and finally I will explore a new strategy, privatization, that holds considerable promise as a successful strategy for reducing the federal budget.

Estimating the Deficit

While a great deal of consideration has been given to strategies of cutting the deficit, one thing that has usually been overlooked is that our ability to forecast the deficit -- even for the next fiscal year -- is extremely poor. As studies by the U.S. Chamber of Commerce have shown, government projections of the deficit released just 9 months in advance of the fiscal year have missed the mark by a wide margin. In the years 1979 to 1982, the Chamber shows, the error in OMB forecasts for the coming year has ranged from a low of 45 percent of actual to an overestimate of nearly 400 percent.

Year	Original Deficit Estimates	Actual	Difference
1979	-60.5 billion	-27.7 billion	+32.8 billion
1980	-29.0	-59.6	-30.6
1981	-15.7	-57.9	-42.2
1982	-27.5	-110.6	-83.1

In these projections, there were many mistakes in both revenue and expenditure estimates.

The Cato Institute, analyzing the years 1971 to 1982, has discovered an average error of 529 percent in official estimates of the change in the federal deficit for the next fiscal year. And only three times during the period did the estimate of the deficit come within 75 percent of the actual level.[1]

Given the enormous level of error in even these short range estimates, we can have little or no faith in the longer term deficit projection for

[1] Forecasting the Economy: Do Presidents Get It Right?, (Cato Institute, Washington, D.C., 1983).

the late 1980s -- projections that are being used by some in Congress to justify major tax increases. It would be the utmost folly for Congress to enact damaging tax increases on the basis of such flimsy projections.

It should not be forgotten, moreover, that the principal concern regarding deficits is that government borrowing will put pressure on the credit market and force up interest rates. Even if this line of argument is correct, the key variable must be the total level of all government borrowing, not merely that of the federal government. On the negative side of the ledger, therefore, all "off-budget" deficits, unfunded pension liabilities, and other government-sponsored borrowing should be included in the picture. On the positive side, however, the increasing surpluses of state and local government ease pressure on the markets -- black ink due mainly to excess receipts in pension and insurance funds (a large segment of which, no doubt, is invested in Treasury bills issued to cover the federal deficit). The Bureau of Economic Analysis shows that the state and local surplus swelled from under $7 billion in 1975, to $30 billion in 1979, and to an estimated $55 billion for 1983.

An important reform, which would enable lawmakers to take account of this borrowing by different governments and government institutions, would be to draw up an annual "Public Sector Borrowing Requirement," as the British government does. The PSBR measures total net borrowing by all levels of government, and all government-sponsored enterprises (primarily nationalized industries in Britain). It is a far more accurate measure of the impact of government on the bond market than the far more limited federal deficit used in this country.

The Impact of Deficits

The effect of deficits on the American economy is by no means certain. We do know, thanks to extensive work by Milton Friedman and others, that if the deficit is monetized, and if this leads to an increase in money supply that is not commensurate with output, inflation will surely follow. What is not clear, however, is the consequences of covering a deficit with increased borrowing. A number of studies, including the recent analysis by the Treasury, suggest that there is a very poor correlation between federal deficits and interest rates. The Treasury analysis lends support to the view of several economists that the level of government spending is a more important factor in the performance of the economy, and that the correlation is negative.

Even if there was a strong positive correlation between federal deficits and interest rates, higher than normal interest rates would only be a danger signal if they impeded capital formation and economic growth. That was the assumption behind the tax increases last year and a number of tax proposals this year: the deficit must be closed, the country was told, or high interest rates will abort the recovery. This has not happened. Indeed, capital spending during this recovery has occurred earlier than normal, and the rate of such spending is approximately double that of the average for the last five recoveries. If high interest rates, allegedly caused by deficits, coincide with an unusually rapid recovery and a surge in capital spending, one may ask, "Why all the panic about deficits?"

The Folly of Tax Increases

If we could be sure that the estimates for future deficits are correct (and we cannot), and if there was a clear correlation between high deficits and high interest rates (which there is not), and if high interest rates were now damaging the recovery (which they are not), reducing the deficit with tax increases would still be a major mistake. Taxes are not neutral in their effect. Reductions in taxes improve the incentives to take risks, work harder and save that are essential to capital formation and economic growth, and we know that tax increases reduce these incentives. Supporters of tax increases to reduce deficits must therefore demonstrate not only that there is a strong and damaging relationship between deficits and economic performance, but that the damage done by deficits is greater that that wrought by tax hikes to cover those deficits. So far they have failed to do this.

As stated earlier, the evidence is stronger that it is the size of the government sector, not the size of the government deficit, that is the principal threat to long-term economic health for this and other nations.

Cutting Federal Spending -- Privatization

If the scale of government spending is the true villain of the piece, it follows that raising taxes does nothing to solve the problem. Indeed, the records of this and previous administrations suggest that increasing federal revenues through new taxes only leads to increased federal outlays, not smaller deficits. It is perhaps no surprise that those who have favored increased federal spending in the past are all of a sudden today's "born again" budget balancers.

To whose aim is truly smaller deficits, not raising new revenues for the federal government to spend, tax increases may seem to be the only possible option available, since the federal budget appears to be resistant to all attempts to control it. Even under the Reagan Administration spending has surged ahead.

Appended to this testimony is a study I completed for The Heritage Foundation on the so-called "privatization" strategy. In the paper I discuss the political dynamics of government spending, noting that public choice analysis shows why programs grow and are so difficult to cut. The argument is advanced that only by changing these political dynamics do we stand any chance of reducing federal spending.

The privatization approach recognizes that "conventional" budget cutting focuses solely on the <u>supply</u> of government services, and largely ignores the political coalitions which constitute the <u>demand</u> for such services. Privatization consists of establishing incentives, and removing regulatory barriers, to create similar coalitions favoring the delivery of services from the private sector. In so doing, privatization attempts to cut the budget by first altering the demand for government services, thereby reducing the resistance to cuts.

<u>Conclusion</u>

In summary, it is evident that not only is it unclear what levels of federal deficits we face in this and future years, but the relationship between deficits and economic performance is also uncertain. On the other hand, capital formation and economic growth appear to be sensitive to tax rates.

Instead of exploring new taxes to offset anticipated deficits, therefore, Congress should look instead at more effective measures of reducing total spending, since it is the scale of government, not federal deficits, which seems to be the principal threat to America's economic well-being.

The Heritage Foundation Backgrounder

310 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

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PRIVATIZATION: A STRATEGY FOR CUTTING FEDERAL SPENDING

SUMMARY

Despite Ronald Reagan's image as a determined enemy of federal programs, spending has expanded rapidly under his presidency--in real terms and as a proportion of national output. Federal spending has risen from 22.4 percent of GNP in 1980 to an estimated 25.2 percent for 1983. The President's congressional supporters appear to have all but conceded that the federal budget cannot be cut, arguing that the focus should be changed to raising taxes.

The Administration's failure to reduce federal spending stems from a failure to understand the political dynamics of budget growth. Programs expand because the narrow interest groups affected make every effort to defeat reductions, while the savings are thinly spread over all taxpayers. The absence of any linkage between budget reductions and significant benefits to the taxpayer gives the momentum to those who wish to preserve and expand federal spending.

Rather than concentrating exclusively on the supply of government programs, the Administration should address the demand for such services. Instead of engaging in a war of attrition, it should provide incentives for beneficiaries of federal spending to choose non-governmental alternatives, and it should reduce barriers to private suppliers. Rather than merely chipping away at programs, in other words, it should attempt to move these functions out of the federal domain, by fostering private sector options that are more attractive to beneficiaries.

By pursuing this "privatization" strategy the Administration would seize the initiative and change the political dynamics of

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

budget-cutting. Privatization would offer Americans the option of a superior private service. In so doing, it would reduce the intensity of opposition to program cuts. The current strategy merely tries to force beneficiaries to accept a reduced public service. Privatization, on the other hand, would create a "mirror-image" of the existing political dynamics and lead to a diminishing federal role. Coalitions forming behind each private sector program could be expected to resist fiercely any attempt to eliminate it, and the coalition would press for an expansion of the private role.

The Administration should turn the privatization strategy into a coherent plan to reduce federal spending. The President should appoint a commission to identify programs that could be privatized. The Vice President's Task Force on Regulatory Reform should be resuscitated and restructured to focus on regulatory impediments to alternative service providers. And Treasury and the Office of Management and Budget should examine alternative tax incentives which would foster privatization.

WHY GOVERNMENT PROGRAMS GROW AND CANNOT BE CUT

Federally funded programs generally grow according to a pattern. The first step is usually the creation of a small program to provide for a perceived public need or distressed group--or powerful interest group. Some programs do command significant resources at the outset (such as social security or Medicare), but normally the budget allocation is small enough for the taxpayer to feel a need has been met at no identifiable extra cost to himself or herself.

Once the initial program is established, however, a coalition develops with incentives to press for increased spending. The coalition consists of three elements:

1) Beneficiaries and "Near" Beneficiaries: The initial program is rarely sufficient to deal with all desires of the beneficiaries. So organizations emerge to represent beneficiaries and to mobilize political support for increased funding. Moreover, there are those who fall just outside the rules for inclusion, yet feel they are just as needy as some who fall just within the orbit of the program. The original beneficiaries are likely to support near beneficiaries by pressing for an expansion of the program.

2) Service Providers: Public and private providers of federal services have compelling incentives to lobby for the program's expansion.
Housing contractors have much to gain from increased funding for public housing, for example, while social workers press for more welfare spending.

Every profession, moreover, tries to shut out competition and thereby increase its income. This can be achieved through regulatory barriers to entry. Federal service providers find it politically easy to obtain such restrictions by appealing to the need for "standards." Teachers and child care providers, for instance, have won government credentialling restrictions which make it difficult for those outside the narrowly defined profession to be licensed (and hence receive government funds).

These barriers to entry reduce the supply of providers, allowing them to command higher incomes. This raises the cost of the federal program. But restrictions often have another effect. Normally the same professional credentials and standards are applied to all providers, even if they are volunteers receiving no federal funding. The result: service gaps appear, because effective voluntary groups cannot afford to meet the onerous requirements, and so the demand increases for expanded federal programs. This "crowding out" effect is a significant cause of the growth of federal human service expenditures.

3) Administrators: More resources mean more jobs and promotions for the federal staff administering programs. And just as private sector executives always look for new opportunities, federal workers tackling one problem try to identify new problems--real or perceived--to be treated.

The Federal Ratchet

The coalition supporting each program provides the momentum to expand federal spending. The taxpayer may complain about taxes and spending in total, but any particular program imposes no discernable additional burden on him.

The momentum only operates in one direction, however. The coalition works to frustrate the budget cutters. One need only recollect the media attention given proposed welfare cuts--and even the possibility of social security cuts--to recognize just how effective the coalition is.

It is effective for two reasons. First, it can mobilize those affected by cuts, to give credence to the argument that the program is essential. Secondly, it can exploit the fact that there is no link between cutting a program and any significant tax benefit to each elector. Traditional budget cutting tactics fail, in other words, because the taxpayer may oppose levels of total spending, but finds it difficult to see how cutting a particular program will reduce his tax burden significantly.

THE LOGIC OF PRIVATIZATION

The privatization strategy acknowledges the federal ratchet and seeks to replace it with a private ratchet, by creating a mirror image of the pressures that expand federal spending. It envisions government as the "facilitator," rather than the provider, of services for society. The government would require private spending in some cases (such as mandatory health insurance and pension payments), provide incentives in others, and remove barriers to private service providers, rather than taxing and spending to provide these services directly. The strategy would reduce the budget by diverting demand into the non-governmental sector.

Political Dynamics of Privatization

A close examination of the political dynamics of the approach suggests that it could reduce federal spending significantly.

Deflecting Demand: Privatization alters the demand for federal spending by offering a preferred non-government alternative. Instead of cutting federal spending by forcing people to find some alternative, privatization establishes the alternative first, encourages people to use it, and then reduces spending in line with reduced demand.

Social security is a good example of this process already underway. Congress attached a provision to the 1981 tax act allowing Americans to open tax-deductible Individual Retirement Accounts (IRAs). By establishing this tax incentive, Congress planted the seeds of a private social security alternative. IRAs, indeed, are a classic example of privatization. To many Americans, the IRA option is a preferred vehicle to achieve the goals of financial security for their retirement years. With the IRA alternative in place, the demand for the federal social security system is partially deflected, and opposition to controlling spending reduced.

Constructing a Private Coalition: In addition to deflecting the demand for federal spending, the privatization strategy involves the conscious creation of coalitions of beneficiaries, providers and administrators to press for an expanded private role, just as the public sector coalitions press for increased federal spending. These private sector coalitions are the key to privatization. They supply the political pressure for the expansion of private alternatives.

The political dynamics of privatization are a mirror image of those leading to the federal ratchet. By giving a benefit (such as a tax incentive) only to people choosing the private option, it is possible to concentrate benefits on a relatively small group at a "cost" which is spread thinly and widely.[1] The beneficiaries, and the "near" beneficiaries who just fail to qualify for the incentive, can be expected to campaign for an expansion of the private option. Privatization also encourages providers and administrators of the private sector service to press for increased private provision, just as they do when a federal spending program is established.

Privatization thus stands the conventional political dynamics on their head. Each element of the coalition has much to gain from the growth of the private sector option, and will press for more incentives and wider jurisdiction. Each success the coalition receives only strengthens it, adding to its political capacity to achieve further concessions.

Again, IRAs are a perfect example of this process. Even before the new law went into effect, banks and financial institutions were engaged in a massive campaign to persuade Americans to open IRAs. Soon the coalition began to press for a wider deduction, to bring homemakers and other "near" beneficiaries under the incentive umbrella.

ADVANTAGES OF PRIVATIZATION

Choice: Privatization gives consumers of federal services an alternative. The IRA law, for instance, has led to an explosion of retirement options. An easing of the tight credentialling rules governing social service providers would have a similar effect.

Efficiency: Choice and competition also reduce the cost to society of providing services. The federal monopoly breeds inefficiencies, and barriers to entry force up costs. Reducing licensing barriers would also encourage lower cost competition providing human services.

Tax savings: The taxpayer also gains. Where non-governmental suppliers are encouraged through purely regulatory changes, private alternatives would have no impact on federal revenues. But even if a tax incentive were used to stimulate private provision, the taxpayer would come out ahead, whether or not he can utilize the incentive himself. If the tax incentive to the provider or beneficiary of the private service were less than 100 percent of the federal cost, more than one dollar's service would be provided for each dollar in revenue "lost." So the revenue needed by government to facilitate a specific level of privatized services would be less than if those services came directly from government--enabling taxes to be cut.

VARIETIES OF PRIVATIZATION

Privatization as discussed so far implies shifting both the service and funding functions out of the government's domain. Often this complete form of privatization is called "load-shedding." Many writers interpret the term privatization

A brief overview of these versions is useful, both as a guide to limited forms of the concept, and also as a warning against some of the dangers resulting from incomplete privatization.

User Fees: User fees and taxes are sometimes referred to as privatization. Yet they are only a stimulus to privatization, in that they encourage the search for private sector alternatives by assigning the real cost of a government service to its users. Examples include the airline ticket tax and road tolls. But even if these fees are based on cost--and often they are not--one may ask why the federal middleman has to be there at all.

Contracting-Out: This is the most common form of incomplete privatization. It is also open to abuse. Just as user fees represent the private funding of a government-supplied service, so contracting-out represents the private provision of a government- funded service. If there is real competition, contracting-out can lead to significant savings to the taxpayer. The budget pressures on cities in recent years, for instance, have encouraged contracting-out of many urban services, such as garbage collection, with considerable savings. But private contractors sometimes manage to persuade government agencies to restrict competition, leading to monopolies and bloated costs. Uncompetitive defense contracts and tight professional requirements sought by professional human service providers are examples of successful efforts to shut out competition. Moreover, private contractors have every incentive to join the campaign for higher government spending--the antithesis of privatization.

Vouchers: Vouchers constitute a method whereby functions can be moved completely into the private sector while ensuring that low income people, or those with unusual needs, can purchase the service in the private market. Combined with incentives for charitable deductions and the removal of constraints on voluntary organization, vouchers offer a funding instrument to enable "hard-to-privatize" functions, such as education, low-income housing, urban mass transit, and training assistance, to be moved to the private sector.

Vouchers enable poor people to become active participants in the coalition for privatization. By giving low income people the financial power to choose among the available alternatives, vouchers turn dependent clients into powerful consumers, and make it harder for government agencies to monopolize a service.

THE PRIVATIZATION AGENDA

The Reagan Administration should review the federal budget to identify programs to be privatized. The survey best could be accomplished by a presidential commission, with its own staff and the authority to work closely with federal agencies and private sector organizations. The commission should be required to report to the President within one year.

The work of the President's Commission on Privatization should be supplemented by two other groups. The Vice-President's Task Force on Regulation, recently disbanded, should be reconstituted to examine regulatory impediments to privatization, and to recommend administrative and legislative changes that would facilitate the options suggested by the commission. A joint task force of officials from the Treasury and OMB could also explore tax incentives and other financial aspects of privatization.

While a full agenda must await this full survey, existing studies and experience already suggest a number of possible candidates.

Social Security

Social security now accounts for more than a quarter of the federal budget. Analysis by Peter Ferrara and Peter Germanis has demonstrated that it is an ideal candidate for partial privatization.[3] By widening the IRA tax deduction to form a "super IRA," providing hospital, disability and other forms of coverage, a private social security alternative could be constructed.

Public Housing

Britain has privatized 500,000 public units by selling them to tenants at discounts of up to 50 percent. The Department of Housing and Urban Development should explore an American version of this asset transfer--possibly a shared-equity cooperative housing program.

Education

Various forms of privatization should be considered. Education vouchers would give low income parents real power to determine the way in which their children are educated. Improved tax deductions for companies providing financial and teaching assistance would also lead to a greater private sector role in the provision of education. Education credentialling requirements should be examined closely by the regulatory task force.

Welfare Services

Robert Woodson, of the Washington-based National Center for Neighborhood Enterprise, has shown that restrictive licensing, and expensive federal social programs designed in Washington and "parachuted" into neighborhoods, have led to poor results while preventing neighborhood organizations from delivering basic services to the community. The result, Woodson argues, is often programs that replace local self-help groups and foster dependence on welfare.[4] If the restrictive rules were lifted and vouchers replaced many federal delivery systems, Woodson maintains, privatization would lead to greater efficiency and community self-reliance.

Economic Development

Vouchers and tax incentives could be used to privatize many economic development programs. Training vouchers would open many creative private training programs to the poor. And technical assistance vouchers would allow neighborhood groups to turn to competitive private organizations for economic development advice, rather than relying solely on federal grants.

Mass Transit

Vouchers for low income people, combined with cost-based user fees, would stimulate a wide array of private sector mass transit systems. Reason magazine, World Bank scholar Gabriel Roth and others have pointed out that subsidies and underpricing discourages more efficient private mass transit, and that there are many examples around the world of highly successful private systems.[5] Electronic metering systems are now available that would allow many roads and bridges, now heavily financed by the federal government, to be transferred to private operators.

Conrail and Amtrak

The Administration is currently developing plans to privatize Conrail, as required by Congress. John Semmens has shown that Amtrak has been a financial disaster[6] It chould be privatized in a similar way.

Air Traffic Control

Robert Poole has developed a model for privatizing the air traffic control system, based on private systems in other countries.[7] He shows that many of the deficiencies of the current system would be eliminated with the incentives implicit in private ownership. He suggests also that many federally owned and operated airports be transferred to private operators.

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FDIC

Catherine England and John Palffy have shown that federal deposit insurance discourages proper risk assessment in banking, and this has been a cause of several failures. They recommend moving the entire insurance function to the private sector.[8]

Energy Research

Milton Copulos argues that many federally supported energy projects should either not be undertaken at all or should be financed privately. He suggests that by increasing the tax credits available for research, and amending the anti-trust laws, private consortia could be encouraged to take over long-term research now funded by Washington.[9]

Postal Service

Although private electronic mail systems, overnight carriers and other innovations do constitute partial privatization of the Postal Service, the Private Express statutes prevent significant private competition. Some experts have pressed for the repeal of the statutes.[10] Others, such as Postal Rate Commissioner John Crutcher, point out that the current legal framework would allow many large segments of the service, such as rural delivery, to be contracted out to private companies.[11]

Wastewater Treatment

The federal government spends more than $2 billion in grants for wastewater treatment projects. But as economist Steve Hanke points out, government-operated plants typically cost 20 to 50 percent more than equivalent private plants.[12] He shows that ownership and operation of these projects could be shifted to the private sector. Paul Langerman has noted that similar inefficiencies arise from federal rules governing solid waste disposal, and that tax and regulatory changes would spur highly efficient private alternatives.[13]

Federal Lands

The Administration has taken some steps toward privatizing certain federal lands. President Reagan issued an executive order in 1982, establishing a Property Review Board, with the goal of selling $9 billion worth of properties by 1986. Steve Hanke, one of the architects of the program, notes that privatization would improve productivity and efficient use of land, and depoliticize land-use decisions.[14]

CONCLUSION

When Margaret Thatcher and Ronald Reagan were elected in 1979 and 1980 respectively, two experiments in conservatism began. Both leaders were committed to reducing the size of the state. But while Ronald Reagan scored some stunning early legislative successes, his Administration has never experimented with new techniques of cutting federal spending. And once proponents of increased federal spending caught their breath and regrouped, the underlying momentum returned.

The Thatcher government, in contrast, re-examined the whole process of government spending, once it became clear just how difficult it is to cut the budget. Eventually, the Tories stumbled onto privatization, recognizing that the strategy altered the political dynamics of the budget battle. The British are now selling many segments of the economy that have been owned by the government. They are contracting out many urban services and parts of the national health service, and have accelerated the pace of public housing sales to tenants. Unlike her counterparts in the United States, Thatcher has set government spending in reverse as a proportion of GNP.

The Reagan Administration should learn from this. The White House has far less control over spending, than the Prime Minister has in Britain. All the more reason, therefore, that Ronald Reagan look not simply at places to cut the budget, but at new strategies to gain the initiative. Privatization is a technique ideally suited to his needs.

Stuart M. Butler, Ph.D.
Director of Domestic
Policy Studies

The CHAIRMAN. Dr. Palmer.

STATEMENT OF DR. JOHN PALMER, SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, D.C.

Dr. PALMER. Thank you, Mr. Chairman. I appreciate the opportunity to testify here this morning. With the time alloted, I will very briefly answer four questions.

First, how large is the problem? Under current economic projections in Federal policies, I expect that Federal deficits will continue to grow throughout the decade to levels of between $250 and $300 billion. If the recovery does not proceed much longer than prior experience would suggest, they could even exceed $300 billion.

More importantly, stronger than expected economic growth cannot substantially alleviate the problem. It's primarily structural in nature, reflecting a rapidly growing disequilibrium between Federal tax and spending policies, which will persist even in a full employment economy.

For this reason, the fundamental problem is much worse than the conventional projections indicate. I submitted two tables for the record that are from a recently published study we did called the "Deficit Dilemma," which illustrate this. The first table shows that, whereas the structural component of the deficit is currently less than half, or about 3 percent of GNP, by 1988 it's projected to grow to about 90 percent of the total deficit, or about 5 percent of GNP.

Second, what are the likely consequences if Congress and the administration do nothing to address the deficit problem? Here I agree with Dr. Stein. The danger of the deficits is not that they will abruptly abort the current recovery, since they represent an extremely stimulative fiscal policy. Rather, it's that they will severely undermine the longer run growth of the economy. The inevitable response of the Federal Reserve to such stimulative fiscal policy, in order to prevent a serious rekindling of inflation, will raise interest rates, reduce private investment, and further exacerbate our continuing vulnerability to foreign competition.

Even if currently depressed savings rates eventually increase in response to the supply side tax cuts, the amount of savings in relationship to the size of the economy that will be left to finance private investment will be less than half that of the 1960's and 1970's.

The second table which I have provided shows that over the past two decades about 6 percent of the gross national product was available for private investment. Under current deficit projections, we will be fortunate if half that much is available the remainder of this decade. This is a sure recipe for major reductions in our standards of living over the long run.

Third, do we need to act in early 1984 or can we afford to wait to address the deficits until 1985 or thereafter?

I think the answer to this question is self-evident. I strongly urge action in early 1984 to address the problem. The longer we wait, the deeper is the hole which we are digging for ourselves. Inaction exacerbates the problem by allowing the underlying imbalance between taxing and spending policies to grow, and by cumulating mounting debt and the necessary interest payments to finance it.

A prudent policy course would begin phasing in substantial deficit reduction measures with the fiscal year 1985 budget. Such measures should increase in magnitude each year to achieve an annual level in excess of $150 billion by fiscal 1988. This is more or less consistent with the $100 billion Dr. Rivlin suggested by fiscal 1986.

This would require a total deficit reduction package probably in excess of $300 billion cumulated over the 4 year period of fiscal 1985 through fiscal 1988.

Finally, what specific legislation would I recommend the Congress enact to reduce the deficit?

Given the magnitude of the problem, it's clear that major actions will have to be taken on all three fronts—scaling back the defense buildup, continued restraint on domestic spending, and tax increases.

The proposed Senate Finance Committee deficit reduction package, which balances spending cuts and tax increases, is an admirable step in the right direction. However, considerably more deficit reduction measures should eventually be enacted to reach a desired target for deficits in the late 1980's.

Let me just sketch very quickly what the broad outlines of such a package might be, on the assumption that one would look for about equal reductions in taxes and spending. Here I also agree with Dr. Stein. One shouldn't be locked into any precise proposals or numbers.

First, if you assume explicit deficit reduction measures totalling $160 billion annually by fiscal 1988, that would mean accomplishing $80 billion on the spending side, and $80 billion on the tax side. You would get another $20 to $25 billion in interest saving. This would bring the total deficit down under 2 percent of GNP, and the structural component to about 1 percent. I think that's quite livable, and an ambitious target for a 4 or 5 year program.

Furthermore, assume that the $80 billion in spending is split evenly between defense and nondefense. A defense reduction of $40 billion relative to the administration's request could be achieved by scaling back the increase in budget authority over the fiscal year 1985 through fiscal year 1988 period to about 3 percent real growth.

In combination with 40 percent increase that has occurred already since fiscal 1981, this would result in an annual real growth rate of nearly 7 percent for defense budget authority over the 1980's.

On the nondefense side, $40 billion could be saved through the following broad measures: A freeze in discretionary programs would yield on the order of $15 to $20 billion. The remainder would come by targeting primarily on three areas—agriculture supports, the medicare program, which has its own deficit problem that is going to need to be addressed, and COLA reductions in the major entitlement programs.

On the tax side, I would favor some sort of major reform that would combine base broadening with rate reduction to raise the $80 billion. I recognize this may not be practical in the short run for reasons that were discussed earlier. In light of that, then I would suggest provisions such as the Senate Finance proposal combined with some selected base broadening measures. However, these are not likely to be sufficient to reach an $80 billion target. This would lead me reluctantly to consider a delay of indexing, which in principle I favor, until such broader reforms would be possible. Once the tax base is broadened considerably then phasing indexing back in would be highly desirable.

Let me just conclude by saying I applaud your efforts to try to spur action in early 1984 on the deficit. I think it's the most serious problem facing the country right now, and it will require considerable political courage and leadership to address it.

The CHAIRMAN. Thank you.

[The tables furnished by Dr. Palmer follow:]

From The Deficit Dilemma: Budget Policy in the Reagan Era, by Gregory B. Mills and John L. Palmer, The Urban Institute Press, c. 1983.

TABLE 11

THE STRUCTURAL COMPONENT OF PAST AND PROJECTED FEDERAL DEFICITS (FY 1961–FY 1988)

	Actual: Average, FY 1961–FY 1970	Actual: Average, FY 1971–FY 1980	Actual: FY 1981	Actual: FY 1982	Projected[a]: FY 1983	Projected[a]: FY 1984	Projected[a]: FY 1986	Projected[a]: FY 1988
	Percentage of GNP[b]							
Total deficit	0.9	2.4	2.7	4.2	7.0	6.0	5.6	5.8
Structural deficit	0.9	1.9	1.2	1.4	2.9	3.2	4.1	5.0
	Billions of Dollars							
Total deficit	—	—	79	128	225	213	236	280
Structural deficit	—	—	37	46	104	123	179	247
(Percentage of total)	—	—	(47)	(36)	(46)	(58)	(76)	(88)

SOURCES: Congressional Budget Office, unpublished CBO tabulations; Office of Management and Budget, "Federal Government Finances," February 1983, pp. 5 and 7; and authors' calculations.

NOTE: All estimates include off-budget outlays, which are assumed not to be cyclically sensitive. Structural deficit projections are standardized at a 6 percent unemployment rate.

a. Estimated under the economic forecast adopted by Congress in passing its *First Concurrent Resolution on the Budget for Fiscal Year 1984*. Assumes adoption of the administration's defense request for FY 1984 and subsequent years, plus the continuation of all tax and spending policies enacted through August 1983 (including the emergency jobs legislation, Social Security amendments, and repeal of tax withholding on interest and dividend income).

b. "Total deficit" estimates are expressed as a percentage of historical or predicted levels of *observed* GNP. "Structural deficit" estimates are expressed as a percentage of *potential* GNP. The reader is cautioned against any interpretation of the difference between the estimated percentages for any given year, due to their differing denominators.

TABLE 12

FEDERAL DEFICITS AND NET SAVING
(FY 1961–FY 1988)

	Actual				*Projected*[a]			
	Average							
	FY 1961–FY 1970	*FY 1971–FY 1980*	*FY 1981*	*FY 1982*	*FY 1983*	*FY 1984*	*FY 1986*	*FY 1988*
	Billions of Dollars							
Total net domestic saving	56	133	200	206	209	251	352	422
Total deficit	6	42	79	128	225	213	236	280
Remaining amount available for other investment[b]	50	92	121	78	−16	38	116	142
	Percentage of GNP							
Total net domestic saving	7.8	8.0	6.9	6.7	6.5	7.1	8.4	8.7
Total deficit	0.9	2.4	2.7	4.2	7.0	6.0	5.6	5.8
Remaining amount available for other investment[b]	6.9	5.6	4.2	2.5	−0.5	1.1	2.8	2.9
	Percentage of Total Net Domestic Saving							
Total net domestic saving	100	100	100	100	100	100	100	100
Total deficit	11	31	41	60	108	85	67	66
Remaining amount available for other investment[b]	89	69	59	40	−8	15	33	34

SOURCES: Committee on the Budget, House of Representatives, *First Concurrent Resolution on The Budget—Fiscal Year 1984* (Washington, D.C.: GPO, 1983), p. 33, and unpublished tabulations; authors' calculations.

NOTE: All "total deficit" estimates include off-budget outlays. "Total net domestic saving" is the sum of personal saving, undistributed corporate profits (with inventory valuation and capital consumption adjustments), and state and local government surpluses.

a. Estimated under the economic forecast adopted by the Congress in passing its *First Concurrent Resolution on the Budget for Fiscal Year 1984*. Assumes adoption of the administration's defense request for FY 1984 and subsequent years, plus the continuation of all tax and spending policies enacted through August 1983 (including the emergency jobs legislation, Social Security amendments, and repeal of tax withholding on interest and dividend income).

b. The total amount of credit available for other investment also includes net inflows of foreign credit.

From The Deficit Dilemma: Budget Policy in the Reagan Era, by Gregory B. Mills and John L. Palmer, The Urban Institute Press, Washington, D.C., c. 1983.

The CHAIRMAN. Carol.

STATEMENT OF CAROL COX, PRESIDENT, CHIEF EXECUTIVE OFFICER AND DIRECTOR, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET, WASHINGTON, D.C.

Ms. Cox. Mr. Chairman, Senator Mitchell, let me——

The CHAIRMAN. If you would tell us a little about your organization. I think it might be helpful to indicate the bipartisan efforts being made by the Committee for a Responsible Budget.

Ms. Cox. Thank you, Senator.

I am president of the Committee for a Responsible Federal Budget, which is cochaired by Bob Giaimo, the former chairman of the House Budget Committee, a Democrat from Connecticut; and John Rhodes, the former minority leader of the House of Representatives. Our board includes Brock Adams, Dick Bolling, Jim McIntyre, Howard Moskof, Ed Muskie, Bob Strauss, Al Ullman, Roy Ash, Henry Bellmon, Caldwell Butler, Delwin Clawson, Alan Greenspan, Jim Lynn, Pete Peterson, myself, John Filer, the chairman of Dietna; John Gardner, Cliff Garvin, the chairman of Exxon; Arthur Levitt, the chairman of the American Stock Exchange; Lee Prussia, the chairman of Bank of America, Alice Rivlin and Elmer Staats.

We formed originally out of concern for Federal budget process and more recently we began a public education campaign this year on the seriousness of the deficit. We published a booklet in January of this year, of which I have provided the committee copies, along with our testimony. We, obviously, believe given the title of the booklet—The Deficit Crisis: Hard Facts and Hard Choices—that you are facing a problem of crisis proportions.

Mr. Chairman, we are very encouraged that your committee is holding these hearings now, and that you continue to focus public attention on the deficit and to search for ways to deal with what we obviously think is a critically important issue.

It is true the economy is in recovery, and some political leaders fervently hope that recovery will permit them to avoid wrestling with the deficit until after the election. But as Drs. Stein and Rivlin said earlier, this is not a cyclical phenomenon, and dealing with the deficit really should not await some point on the economic cycle, nor should it await an election.

The deficit is rapidly approaching crisis proportions. Current spending and tax laws can never result in a budget that is in balance. A high consumption, low investment policy probably will not abort the recovery, but it will not lead to prosperity. And that is not a semantic argument, Mr. Chairman. There is a difference between recovery which is of statistical phenomena and prosperity should be our goal.

We are particularly pleased that you are holding these hearings now as we are convinced that acting now is important. In our testimony we say simply "sooner is better than later." Delay makes the problem worse. With every day that passes, the choices available to you become more difficult. And even now there are no easy ways to reduce the deficit.

There may be some who say all you need to do is wave a magic wand; do away with waste, fraud and abuse in Government, for instance, and the problem will go away. We do not believe that you and your colleagues in Congress and the President of the United States are so contrary that if there were an easy option, you wouldn't have balanced the budget long ago. There are only three areas in the budget large enough to make a difference in deficits the size we face. They are: defense, entitlements and revenues.

Interest is large enough, but you can't cut interest by fiat. Defense spending is not in your committee's jurisdiction, I don't need to tell you. But a decision on the rate of growth for defense will almost certainly be part of the solution of the deficit problem.

Dr. Stein is right when he says you have to examine agricultural subsidies, and for that matter, all other areas of Federal spending. But slowing the rate of growth and entitlement spending will mean some hard choices on social security and medicare. And even if you constrain the rate of growth in defense and entitlements a lot, it is virtually certain that you will need as well to raise revenues in order to move the budget toward balance at any time in the foreseeable future.

We do not advocate specific solutions or specific legislation, but we must say to you—don't dismiss out of hand changes in indexing; reduction and indexing on both sides of the budget could yield large deficits savings in the short-term. Those savings would come approximately equally from the spending side of the budget, slowing the rate of growth in entitlement programs, and from reduced tax relief.

While this might prove a stop-gap measure, it or something like it may be necessary to give you time to consider more complicated changes in basic spending and tax law. Dr. Stein, for instance, alluded to his preference for a consumption tax. He also said he was concerned it might take too long to decide on major changes in our system of taxation, and that we don't have that kind of time in dealing with this immediate problem.

You may have to do some things short-term that yield short-term deficit reduction to buy yourself time for the longer term.

Let me repeat myself for just a moment. There are no easy choices available to you. Dick Bolling, the former chairman of the House Rules Committee, has said that western democracy will stand or fall on the question of whether we can manage our Nation's fiscal affairs in a responsible fashion, that not only this Nation, but all our western allies are facing the same challenge. That may sound like hyperbole, but if you believe it—and we do—if you believe that our very future is at stake, then no amount of work is too much and no sacrifice is too great. We must get on with the task as soon as we can.

And so, again, Mr. Chairman, we are very glad that you are holding these hearings. And we will do whatever we can to assist you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Ms. Cox follows:]

TESTIMONY

to be delivered by

CAROL G. COX, PRESIDENT

on behalf of

COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

before

THE COMMITTEE ON FINANCE, U.S. SENATE

on

December 13, 1983

EXECUTIVE SUMMARY

The Deficit is Rapidly Approaching Crisis Proportions.

The deficit matters. Current spending and tax laws can never result in a budget that is in balance. The deficit probably won't abort the recovery, but it causes distortion. A high consumption, low investment recovery keeps interest rates high, slows productivity growth, hurts export industries. It does not lead to prosperity.

Sooner is Better than Later.

Acting now is important. Delay makes the problem worse. And the actions necessary to solve the problem become more difficult as time passes. Compound deficits -- the most visible cost of those deficits being compound interest -- are closing like a noose around our policy options.

There are no Easy Choices.

The only categories in the budget large enough to make a dent in deficits the size we face are defense, entitlements and revenues. (Interest is large enough, but you can't cut interest costs by fiat.) Politics, and a need for perceived fairness, will probably dictate that a solution draw from all three.

- -- Defense is not in the Finance Committee's jurisdiction. But a decision on the rate of growth for defense spending will almost certainly be part of the solution.
- -- Slowing the growth in entitlements means hard decisions on Social Security and Medicare.
- -- Even if you constrain significantly the growth in defense and entitlement spending, you will surely need to raise revenues as well to move the budget toward balance in the foreseeable future.

We do not -- indeed we cannot -- push a specific legislative program for deficit relief.

But we would counsel: don't dismiss out o hand changes in indexing. Reductions in indexing on both sides of the budget could yield very large deficit savings short term. Those savings would come approximately equally from slower growth in entitlements and reduced tax relief. While this might prove to be a stop-gap measure, it or something like it may be necessary to give you time to consider more complicated changes in our basic spending and tax laws.

TESTIMONY

The Deficit is Rapidly Approaching Crisis Proportions.

Today's deficits are different than any we have experienced in the past in two ways: first they are larger; and second they are structural in nature.

For the first time in our history we face a large and apparently growing deficit regardless of economic circumstances. Current spending and tax laws can never result in a budget that is in balance. There is a very real possibility -- indeed without changes in laws and policy a certainty -- that the federal deficit will be about 5% of GNP for the rest of the rest of the decade. And that assumes no oil crisis, no farm crisis, no recession. It leaves no margin to face a war or other national emergency.

The deficit looms over our future. It forces the Federal Reserve to walk an incredible tightrope -- trying to finance a recovery and at the same time trying to guard against a rekindling of inflation. The resultant mix of loose fiscal policy and tight monetary policy is the wrong prescription for future economic health. It is not a mix that will stimulate investment, nor productivity growth, nor a healthy export sector in our economy.

The Committee For A Responsible Federal Budget is a bipartisan private nonprofit organization formed to support and strengthen the Federal Budget Process.

The Committee is Co-Chaired by Robert N. Giaimo and John J. Rhodes. Brock Adams, Roy Ash, Henry Bellmon, Richard Bolling, M. Caldwell Butler, Delwin M. Clawson, Carol G. Cox, John H. Filer, John W. Gardner, Clifton C. Garvin, Jr., Alan Greenspan, Arthur Levitt Jr., James Lynn, James T. McIntyre, Jr., Howard R. Moskof, Edmund S. Muskie, Peter G. Peterson, Leland S. Prussia, Alice M. Rivlin, Elmer Staats, Robert Strauss and Al Ullman are on the Board of Directors.

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We are a strong nation. We are blessed with a strong and dynamic economy. This very strength, however, could in the short term foster an illusion. That illusion -- the perception that these historically high deficits are not harming the incipient recovery -- could in turn provide the excuse for inaction.

The Secretary of Treasury is right when he points out there is no historical correlation between high deficits and high interest rates. What the Secretary's analysis does not mention is that except in wartime, there is no historical correlation between high deficits and economic recovery. Of course there is no historical data where there is no historical precedent.

We can if we choose take comfort from the lack of a clear historic example. We can kid ourselves that we are embarked on some grand experiment. But are we willing to gamble the health of our entire economy on some untried and untested scheme -- and a scheme that belies common sense at that?

The tragedy may prove to be that there is no catastrophe. If we faced calamity, we all know our government would respond. We would do what had to be done to avoid imminent disaster. But will we find the courage to respond to the threat of insidious distortions which can sap our economic vitality? Can we face the fact that we are likely consuming our very future? How long will it be before we realize that spending every dime we can raise in taxes, plus every dollar we can borrow, means we do not have the resources to meet new needs and priorities as they emerge?

The damage may be insidious, but it is nonetheless real. Failure to take action to reduce the deficit will keep real interest rates high, reducing investment. Indeed, it may be that all the changes in tax laws you have enacted in this Administration to encourage saving and investment can at best offset the drag on investment resulting from these very high real interest rates -- that there may prove to be no real net gain. Wouldn't that be a waste and a shame?

The absence of real gains in investment leads to slower growth in productivity. We are seeing real gains in productivity for the first time in years. But those gains result mainly from adjustments in staffing patterns and in wage and price levels. And those adjustments are primarily the result of the "wringing out" which occurred in the last recession. Wouldn't it be a tragedy if we wasted those results by refusing to do what is necessary to continue this productivity growth as the recovery matures? Productivity growth has always been the engine driving an ever improving standard of living for all Americans. It may be a long time before we can accurately measure the full effect of government dissaving on an unprecedented scale. But we believe time will prove it is a terrible price we pay for every day we delay in making the hard decisions which simply must be made.

High interest rates will also sap investment by state and local governments in transportation and other capital improvements. Higher interest rates directly harm housing and auto manufacturers. And since high interest rates help keep the dollar high, failure to deal with the deficit hurts our export industries.

Continuing high real interest rates, which we believe result from expectations of continuing high deficits as well as from competition for the capital remaining after government satisfies its needs for borrowed money, have the effect of a tax. But it is a tax levied unconsciously, and a tax which falls very unevenly on different sectors of the economy. The recovery may continue in the face of high deficits and high interest and the displacement they cause, but it will be a consumption-driven recovery contributing little or nothing to our long term prosperity.

And that is the bottom line. There is a difference between recovery and prosperity. And the price of real prosperity is almost certainly going to involve significant deficit reduction. And significant deficit reduction will require some very hard choices.

Sooner is Better than Later.

If you agree with us that deficit reduction -- moving the federal budget toward balance on a believable set of economic assumptions sometime in the foreseeable future -- is or should be a major national priority, then the sooner you act the better.

Delay has its own price. As you delay the problem gets larger. We have all been taught the wonders of compound interest as that phenomenon applies to our savings accounts. Compound interest is killing us, as it subsumes ever increasing amounts of our resources.

Interest is the one truly uncontrollable category of federal spending. It is also the category of spending which buys us nothing we really want. As interest cost grows, we have less money for defense, for social security, for education, for anything we really want from government. And as interest consumes ever increasing proportions of total federal spending, we are left with ever declining amounts from which we can make cuts to move the budget toward balance.

And as you delay, the base level of federal spending gets larger. Today the debate centers on reductions in growth in defense and entitlement spending -- and on how much you will have to raise taxes, once you have cut spending as much as you can. As time passes, as current levels of spending increase, you will be left with the choice: either make cuts which are proportionately greater than would be required today; or raise taxes even more than would be necessary if you act now.

And there is another risk. Deficits tend not to be static. If you are not working to reduce the deficit next year, in an election year we fearlessly predict there will be incredible pressure to add to specific programs -- to spend even more. And, we need hardly add, that will make the task of deficit reduction even more difficult when you finally turn to that important work.

There are No Easy Choices.

Make no mistake about it, reducing the deficit will demand some sacrifice from all of us. There are no easy options left. Congress and this Administration have cut significantly non-defense discretionary spending. Those programs have shrunk to 14% of federal spending in the '84 budget. If you entirely eliminated non-defense discretionary spending, the budget still would not be in balance. And that would mean eliminating what most of us think of as the basic functions of government: salaries for Congress and its employees, for the State and Treasury Departments, and for most other Federal agencies. There may be some who would abolish one or another of these agencies -- or the programs they administer -- but we don't think anyone is willing to wipe out basic government.

I don't think I have to tell members of the Finance Committee: the only areas of spending that are growing are interest, entitlements, and defense. We cannot cut interest by fiat. Interest will come down when the deficit comes down, and not before.

Today we are spending about 24% of GNP and collecting about 18% - 19% in taxes. That 5% to 6% gap is the deficit. It is true that in the early 1960's we financed government from a revenue base about equal to what we have today in terms of share of GNP. But since the early 1960's we have all come to demand more from government.

After the Viet Nam War, there was a general abhorance of all things military in this country. That abhorance extended to spending on the military. Reduced military spending freed up vast resources. And with those resources we invented a whole new array of federal programs, by far the largest of which was Medicare. We turned over to government the responsibility for the elderly in this country to a far greater extent than had been the case historically. And unless you believe we will repeal Medicare (and all the other programs and services generally referred to under the umbrella of "The Great Society,") and assuming you subscribe to the general proposition that we must do more in the area of defense outlays than we did in the late 1960's and early 1970's, then we have bought into a more costly government.

Having said all that, it must be clear that we believe some revenue increases will be necessary to put us back on track toward fiscal sanity. But you can't do it all with tax increases. It may be arithmetically possible to balance the budget just by raising taxes, but we believe the American people will demand more spending restraint just as we believe they will countenance higher taxes to pay for what they want from government.

If you want to balance the budget, you must go where the money is: defense, entitlements, and taxes.

Just as we believe the gap cannot be closed solely by raising taxes, neither do we believe you can deal with the deficit simply by cutting one or another category of spending. Think of the solution as a three legged stool. The three legs are defense, entitlements, and revenues. Try to balance the budget on one or two legs and the stool becomes unstable.

In the case of the budget debate, the stability of the stool is a metaphor for the political consensus necessary to enact the changes in law that will be needed. The political consensus will require a perception of fairness. And the perception of fairness means everyone must appear to give up something.

Congress has already moved to slow the President's proposed growth in the defense budget. You may wish to slow that growth further. But defense spending is not in the jurisdiction of the Finance Committee. And I am not a defense expert. So let me speak to the two legs of the stool over which you do have control, saying only that there may be a need to couple whatever you undertake to do with some determination on the question: how fast shall defense spending continue to grow? For simultaneity may be required to bring your efforts to fruition.

Simultaneity, i.e., action on all three legs of the deficit reduction stool, all at one time, all in one package, may be necessary because fairness has taken on a very specific meaning in the context of today's budget debate. "Fairness" in this debate has none of the qualitative connotations ascribed to it by Webster. In this debate, "fairness" means: "If I give up something, so must everyone else." And it may be the only way everyone will believe that is the case is if you act simultaneously on a consolidated package which includes defense, entitlements, and taxes.

Simultaneity is a strategy, a method for forging and enacting a package -- it does not dictate the contents of that package.

As a nonprofit educational corporation we do not -- indeed cannot -- offer you specific legislative proposals for reducing the deficit. However we can make some observations on the menu you face. You all know better than I the nature of your revenue options. You can increase rates -- either directly or in the form of a surtax; you can broaden the base -- by closing specific "loopholes," and/or imposing a corporate minimum tax; you can impose an oil import fee; or you can levy some other form of energy tax; and/or you can try a major overhaul of the tax system. As I said, we cannot offer specific suggestions. I might observe that an overhaul is likely to take time and so you will in all likelihood have to pick another short term option in addition -- even if just as a bridge.

The third leg of the three legged stool is entitlements. And that really means Social Security and Medicare, both of which are in your jurisdiction. As I said, we cannot make specific legislative proposals. However, we have previously commented upon the only specific proposal before you to tackle both taxes and entitlements: S. 1627, the Danforth/Boren bill to reduce indexing (and H.R.3790, its House counterpart.) Without necessarily endorsing that proposal let me share with you our observations on it. It has a number of positive aspects.

First. Deficit reduction comes roughly half from reduced outlays half from increased revenues. This balance is, we believe, important

Second. The sacrifice demanded to reduce the deficit is spread. There is a kind of elemental evenhandedness in saying to the taxpayer: you will not be protected from some rise in the tax burden resulting from inflation; while saying to the retiree: you will not be wholly protected from inflation for this same period. Both the beneficiary and the payer give up something.

Third. These proposals would take away future benefits, not current payments to current recipients. This does not make the cuts less real, but it does make them easier to swallow. Most individuals do not budget on a "current services" basis. They measure increases and decreases in income and expenditures in nominal dollar terms. And we believe they will understand government's providing somewhat less more -- in both tax relief and benefit increases -- in the face of the kind of deficits we now face.

Fourth. Both proposals exempt needs-tested entitlements. This is an important consideration for those who care about the qualitative aspects of the "fairness" debate. It is one thing to say we must all sacrifice. It is absolutely consistent with our general philosophy of government to say: but we will make an exception for those among us who have little or nothing to give up.

Fifth. These proposals have a kind of appealing simplicity. Once you decide how you will reduce the deficit, you must explain that decision. Simplicity would forward significantly that process of explanation.

Sixth. It is a given that to control the deficit we will have to slow the growth in entitlements and raise revenues. Danforth/ Boren suggests a proxy (in reductions in indexing) for the plethora of structural changes which would be required to achieve similar deficit reduction on both sides of the budget. Like most proxies, this one may not be perfect. But something like it may be the only hope you have for reaching agreement in a few weeks, or months, or (heaven help us) even in a few years.

Reductions in indexing are probably only stop-gap remedies. They were not proposed as permanent changes. Even if you thought you could -- and wanted to -- make them permanent they still would not deal with the underlying structural issues which must be addressed in the name of good public policy.

Clearly, these proposals do nothing to constrain the growth in the cost of medical programs, nor in farm price supports. They do not address the question: are we basically happy with our tax system? Do we want only to adjust rates to raise the revenue we will surely need even after we have cut spending as much as we can -- or as much as is politically possible, which is really the same thing? Or do we want to think about alternative tax systems, such as flat rate taxes, or consumption-based tax.

By definition, any modification in indexing touches only those elements of government which are explicitly indexed. Senators Danforth and Boren have never claimed their proposal would do more than that.

But we think it is important to be explicit about this feature. Hard as it might be to make the decision to change indexing formulae, Congress could not pass a law to effect this change then rest easy believing it had solved the deficit dilemma.

Why waste time in our testimony on something the Chairman has said is politically impossible -- and which we suggest may be (in addition) a stop-gap remedy at best?

You cannot control the deficit without dealing with the question: how fast shall non-needs tested entitlements continue to grow? And you cannot ignore Social Security and at the same time answer that question in fashion consistent with major deficit reduction.

Reducing indexing in entitlements may seem politically impossible (particularly as applied to Social Security, and most particularly so soon on the heals of the Social Security package passed earlier this year). But you may need to include modifications in indexing in the menu of choices you consider.

There are other ways to save money. There are even other ways to save money in Social Security. You could, for example, tax Social Security benefits over and above the amounts each individual has contributed to the system -- and over and above interest on those amounts -- i.e., you could treat Social Security like you treat private contributory retirement benefits, or tax purposes. (I, for one, think that makes a lot of sense from a policy perspective.) But you must ask yourselves if any alternative will politically popular than changes in indexing. Is there any proposal which stands a chance of garnering broad enough support to put it in place in the near term future? You must make an unpleasant selection.

The debate cannot center on how we shall avoid pain. If there were a painless solution, we would not be facing $200 billion deficits for as far as the eye can see. You and the President would have grabbed at a painless solution -- if such a thing existed -- ages ago. Unlike the decade of the 60's, you are not in a position to spread largess. There is no largess to share. You legislate in an era of scarcity. Some of that scarcity was created by earlier Congresses, when they passed laws which locked in spending increases and tax reductions. But scarcity is what we face, and it is up to you to find a way of apportioning the short-term pain that can help lay the groundwork for a more prosperous future.

We are not here to offer a specific prescription for apportionment or sacrifice. We belief you know what are the options. We understand that you must choose from the limited options available those you feel are most defensible. We understand you want to be reelected.

Unlike some, however, who rail at our system of government because they believe it produces politicians paralyzed by any decision they feel threatens their chances of reelection we have confidence that you put the country's well-being above your own personal futures.

We sympathize with the difficulties presented you. We would say that because only one-third of the Senate is up for reelection

next year (as opposed to one hundred percent of both the House and the Administration) it is
task will not be delayed any longer than is absolutely necessary.

Dick Bolling, the former Chairman of the House Rules Committee, has said that Western Democracy will stand or fall on the question of whether we can manage our nation's fiscal affairs in a responsible fashion -- that not only this nation, but all our Western allies, are facing this same challenge. It may sound like hyperbole. But if you believe, and we do, that our very future is at stake, then no amount of work is too much, no sacrifice too great. We must get on with the task as soon as we can.

Thank you.

THE DEFICIT CRISIS:

HARD FACTS AND HARD CHOICES

The United States today is facing a crisis so urgent and so severe that it threatens to tear apart the very fabric of our economic and political life. It is the prospect of continuous large Federal deficits. These future deficits cannot be "fixed" by the elimination of Government inefficiency, by a moratorium on new programs, or even by further cuts in existing discretionary programs. And continued high deficits will strangle a recovery.

Unless all of us understand and address these facts; unless the country can reach an equitable solution, we face unending political debate and a sputtering economy.

Sliding toward disaster

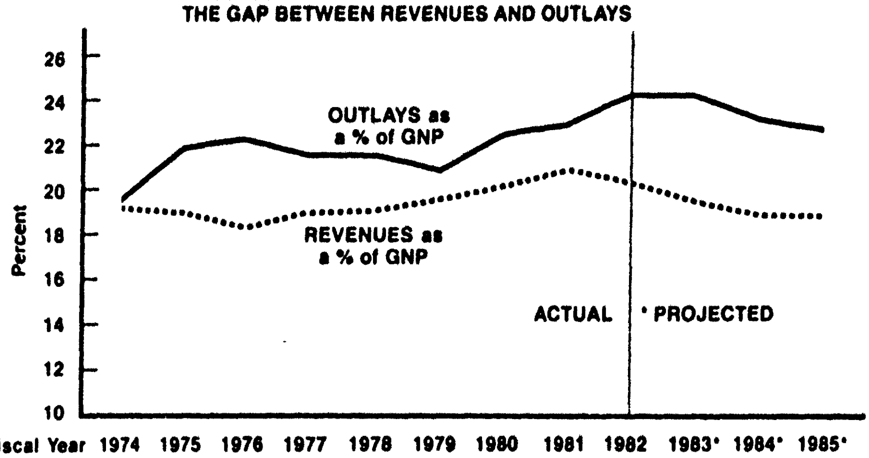
The crisis is not rooted in the immense size of this year's budget deficit, bad as it may be. In a time of recession, an economy as vast as ours can hope to sustain even a large deficit—so long as the deficit is temporary.

But our Government's deficit is not temporary. As a result of taxing and spending decisions made in recent years, the deficit is built into our budget this year and for the forseeable future[2] And it will undermine the prospects for a real, lasting economic recovery.

The U.S. Government will spend at least $150 billion more this year than it will take in taxes—if the economy shows recovery. If recovery is weak or abortive, that $150 billion could surge alarmingly.

$150 billion. The scale of such a deficit is staggering. It represents a Federal deficit that has *tripled* in only two years and most importantly, it is a deficit that cannot be corrected by economic recovery. Next year and the year after, the deficit will be at least as large[3]

THE FEDERAL BUDGET DEFICIT AS A PERCENT OF GNP:
THE GAP BETWEEN REVENUES AND OUTLAYS



SOURCE: 1974-1982, *Budget of the United States Government* Fiscal Year, 1983; 1983-85 Congressional Budget Office, *The Economic and Budget Outlook: An Update*, September 1982

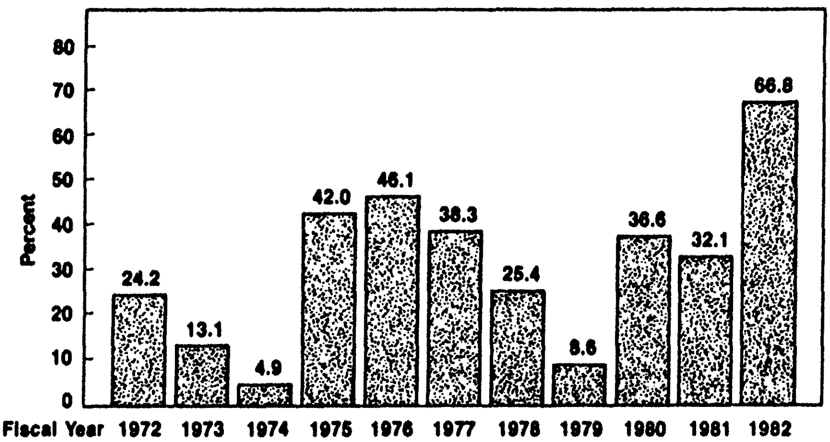
*1983-1985 projected figures are based on current services

Deficits are financed by borrowing. Washington is, in fact, the most gargantuan borrower in the country. To finance the current deficit, the Government will have to borrow 60 percent of all private savings—money available for lending and investment in the United States.

At the bottom of a recession Federal borrowing may not seriously affect the cost of funds available to people and businesses. But as the economy recovers Uncle Sam should get out of credit markets. Money for lending and investment should go to business and industry for new plants, equipment and jobs, to consumers for houses or automobiles.

If that doesn't happen, if Government continues to require more than half of all the credit available—even during economic recovery—interest rates will rise. Rising interest rates will ultimately choke off the recovery[4] And we will be back on the downward path to economic stagnation.

FEDERAL DEFICIT AS A PERCENT OF NET PRIVATE SAVINGS



SOURCE: DEPARTMENT OF COMMERCE, 11/82

The need for public understanding

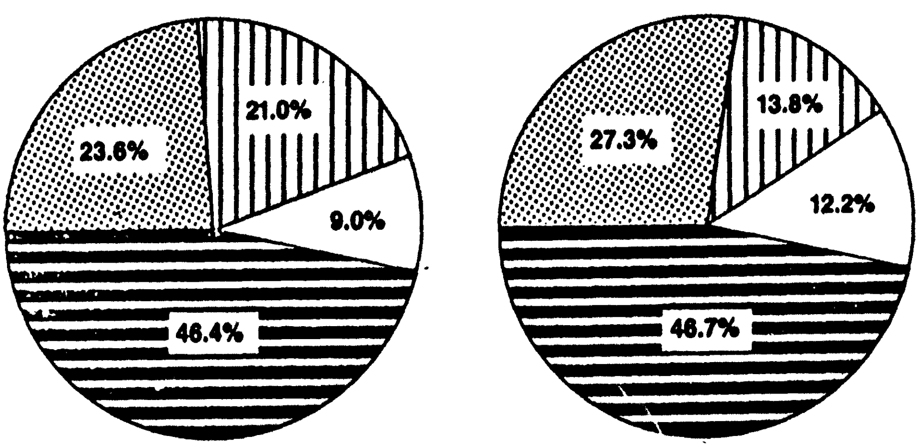
You can make a case that the public understands the problem. But, if you ask most people how we got into our present mess, chances are they'll tell you it's because the Federal Government—our Government—is inefficient.

It's a nice, simple answer. It has the appeal of describing a situation that ought to be easy to fix. But it's the wrong answer. Eliminating Government inefficiency is important, but it alone will not solve the deficit problem.[5]

A budget, after all, is a plan for raising and spending money. When expenditures exceed revenues, there's a deficit.

To reduce a deficit, we have only three choices: cut spending, raise taxes, or do both.

COMPOSITION OF FEDERAL SPENDING



1980
Actual

1983
Projected

SOURCE: Congressional Budget Office September 1982, adapted

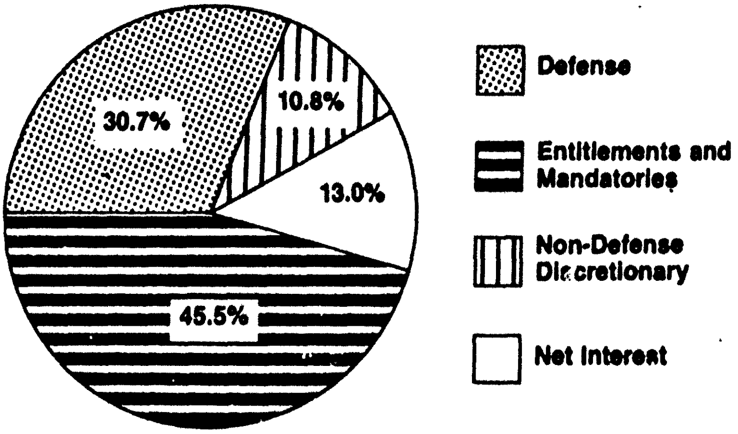
There are four general categories of spending in the Federal budget:

- non-defense discretionary spending (the catch-all which includes operating the Government);
- interest on the Federal debt;
- defense;
- entitlement programs.

Non-defense discretionary spending has borne the brunt of recent budget cuts. Although these programs must still be scrutinized, further cutbacks in them will not solve the crisis. They account for only 14 percent of spending.

Interest on the Federal debt costs another 12 percent, and there's no way to cut that directly.

If we are honestly committed to confronting and solving the deficit crisis, we have to go where the real money is.



1985
Projected

Where the real money is

There is real money on both the revenue side and the spending side. On the spending side the real money—about 74 percent of the entire Federal budget—is in two places: defense spending and entitlement programs.

Defense is now the fastest growing function in the Federal budget. Entitlement programs—the programs that provide billions in payments and benefits to millions of Americans every year—account for almost half of our Federal budget.

The American people have said they want a strong defense and a humane society. These expenditures are expressions of those goals.

To meet the nation's goals, the Government will spend 24 percent of our Gross National Product in the coming year.

But under current tax laws, it will collect only 19 percent of our Gross National Product in tax revenues.

In that gap lies the crisis in deficit spending that threatens all of us. That 5 percent gap amounts to \$150 billion in 1983.

And even if we get the recovery most economists are predicting, by 1986 Government spending required by law for defense, entitlements and interest alone will exceed total Federal revenues.

Closing the gap with balance and fairness

There is only one way to solve the deficit crisis and revive and maintain the strength of America's economy. And that is to start closing the gap between Government spending and Government income with balance and fairness.

And there are only three elements that, together, can be brought to bear on the deficit crisis. Moderating the rate of growth in defense spending. Moderating the growth in entitlement programs. Raising revenues. There is simply not enough flexibility anywhere else.

Defense spending must be subjected to a new and demanding scrutiny. No matter what our positions on defense, it must be examined. On the other hand, no one wants to sacrifice our national security.

And because so much of defense spending is set in advance through massive long-term commitments of money for systems that take years to develop, future results require decisions now.

A strong defense ultimately rests on a strong economy. To support one at the expense of the other is a fool's paradise.

Entitlement programs—those benefits that we the people give ourselves—must undergo the same intense scrutiny. This need not mean cutting benefits now going to people dependent on these programs. No one wants to sacrifice our humane society.

Like defense, much of entitlement spending is determined by decisions made far in advance. Therefore, action must be taken now—before these programs are bankrupt.

The issue in both defense and entitlement programs is: how fast shall these programs continue to grow?

Today we are demanding more from our Government than we are paying for. One way to cut the deficit would be to raise taxes enough to support today's spending levels. But what would be the economic consequences in terms of investment and growth? No one wants to solve today's crisis at the cost of long-term economic stagnation.[6]

We will have to decide what we want from our Government, and recognize we may have to pay for these decisions through higher taxes. But these decisions won't be easy—and they will only be reached if the debate focuses on balance and fairness.

If we are to succeed, all three areas—defense, entitlements and taxes—will have to be reviewed. The course we set must be fair and equitable to all Americans; it must assure an adequate defense and a humane society; it must be economically sound; and it must be politically realistic and workable.

It means sharing a vision of a future in which we pass on to the next generation an America as rich in opportunity as the one we ourselves were given.

It means sharing a determination to win out in this crisis, as we have in so many others throughout our past.

If decisions are not made this year, the momentum of these deficits will be so great we may lose our chance and further narrow our choices.

If you would like to know more about this issue, write or call us at:

Committee For A Responsible Federal Budget
220 1/2 E Street, N.E.
Washington, DC 20002
(202) 547-4484

The CHAIRMAN. I was handed a little note here earlier today from Jim Wetzler of the Joint Tax Committee. It's a quote from Louis XIV's finance minister. "The art of taxation consists of so plucking the goose as to obtain the greatest amount of feathers with the least amount of hissing." That's the lesson for the day, as he passed it onto me.

And whether or not we are going to be able to do anything may depend on what kind of a package we can put together. I think you are correct. If there had been any easy answers—we are all looking for easy answers. I don't know of anyone here who wants to make a difficult choice if there is an easy one to make. And we think we are capable of that. But we need the support of groups like those who have been here, and those who are here now.

I'm not certain there is any magic. As I understand the Heritage Foundation, you are not really worried about the deficit. You don't think we should do anything about it. Is that correct?

Dr. BUTLER. We see it more as an indicator of our inability to control spending rather than a problem in itself.

The CHAIRMAN. What would you do about it assuming that—I think there are some good points in your privatization program, but I don't know how many votes there are. I mean we have to live in the real world where things have to happen. We don't put out newsletters, and we have to say, OK, how do we get a package that reduces the deficit. How many votes do you have for your program, and how much would it raise?

Dr. BUTLER. The analysis I did on privatization specifically addresses the political aspects of budgets and controlling budgets. I think, for example, a particular area of privatization that we have been looking at in some detail, social security, shows that one can, in fact, create a constituency around an alternative; namely, the IRA system. So I think that the privatization strategy is, in many ways, a more realistic approach to controlling spending than arguing for a freeze on COLA's.

The CHAIRMAN. I think you are right. I think there are a lot of areas there that I think I have an interest in. But what would you do in the meantime?

Dr. BUTLER. Well, our argument is this. One school of thought is that we need to have tax increases right now to give us the breathing space necessary in order to embark on major structural changes.

The CHAIRMAN. I don't know if we're talking just of tax increases. We are talking about a combination of things.

Dr. BUTLER. Yes, but if our position is correct—that the deficit is, first of all, difficult to forecast, and second, that the relationship between the deficit and interest rates is uncertain—then perhaps we are in that breathing space now, and we have the opportunity to embark on longer range strategy, rather than just looking for another quick fix to get us over another election.

The CHAIRMAN. Do you have any concrete proposals about the deficit? I read your previous newsletter. Did you help Margaret Thatcher with her plan?

Dr. BUTLER. Not personally, I must admit. It is interesting to note, however, that the British case shows that within a year or so of deciding on the strategy of systematically moving functions out of government that program can be strongly on its way. So I think the privatization strategy is by no means a very long-term strategy. It's something that can be moved into action very quickly.

I would also mention to you, Mr. Chairman, that we are going to publish in January an analysis of the budget which looks at detailed programs, looking not just for privatization, but for other reductions. So we are, indeed, looking at down-to-earth examples, if you like, of spending reductions.

The CHAIRMAN. Well, what about closing tax loopholes? Do you object to that? I mean do you think if we are going to reduce spending we ought to permit some big loophole in the Tax Code?

Dr. BUTLER. I have no problem with eliminating loopholes. It's the total level of taxation and revenue that I think is important. We have advocated, for example, putting a cap on the deductions available for health care plans, and so forth, and balancing that with other reductions in taxes. So we certainly are not friends of loophole seekers or tax accountants.

The CHAIRMAN. Or tax compliance. You don't have any quarrel with better tax compliance?

Dr. BUTLER. Not at all. None whatsoever.

The CHAIRMAN. Where we can recover some of the underground economy out there.

Dr. BUTLER. None whatsoever, although I suspect that probably one of the best ways of getting money from the underground economy is to reduce tax levels.

The CHAIRMAN. Well, that's what we were told. And it may work. Maybe we are not low enough. But if it gets to the point where you don't have to pay taxes, then there's not much reason to conceal it.

Dr. BUTLER. But the point I would just emphasize is that, yes, of course, we agree in equity in taxes. And we have a lot of sympathy with the idea of a flat rate tax and so forth. But we still think that the total level of taxation is an extremely important factor in the growth of Government. And moves to increase the total level of taxation do more than just have an affect on the deficit. They tend also to reduce the pressure to control spending.

The CHAIRMAN. We are not advocating taxes. We would just as soon not have to advocate any change in revenues except for equity and reform. But there seems to be an overwhelming case being made—and it's going to be stronger and stronger in the next 3 or 4 months—I mean deficits are not going to be forgotten. I mean when ABC devotes 2 minutes at each segment last week on deficits, and NBC last night, different publications—and I assume even some running for office may talk about deficits, and the damage they do or the damage they don't do, depending on their point of view. So it's going to be, I think, critical that we do something. And we need the responsible Budget Committee, bipartisan as it is, and the Urban Institute and others, and the Heritage Foundation trying to push us in the right direction.

I think Herb Stein also indicated that he might have a perfect package, but he can't expect that to be the one we might accept. So I would hope that we can have your support. And we are looking at two or three areas of privatization that we think interesting.

Senator Mitchell.

Senator MITCHELL. I just wanted to clarify something. Dr. Butler, you agree that the deficit is not desirable.

Dr. BUTLER. I certainly do. And I certainly think that when the deficit is monetized that is a catastrophe.

Senator MITCHELL. You used a phrase in your statement: "The alleged problem." You agree that it is a problem?

Dr. BUTLER. Yes. But I don't necessarily agree what the problem is. What I tried to point out in the testimony is that the argument goes: deficits are growing and important; this leads to high interest rates, which lead to—well, last year it was going to be an abortion of the recovery. Now that has not taken place. So by alleged problem I'm talking about the specific line of argument used, which seems inevitably to end up with increases in taxation.

Senator MITCHELL. And even accepting your point regarding the difficulty in forecasting deficits, which really is a more narrow application of human ability to predict anything.

Dr. BUTLER. I agree totally.

Senator MITCHELL. Even accepting that fact, do you agree that they are going to be large?

Dr. BUTLER. Yes, but we have no idea how large.

Senator MITCHELL. That's right. And you agree, as you already have, that large deficits are in and of themselves a problem. There is some disagreement on what consequences are.

Dr. BUTLER. And also the consequences of closing those deficits. There is also disagreement about that.

Senator MITCHELL. In other words, your position really is that you don't like deficits, but you don't want the deficits used as an excuse to raise taxes.

Dr. BUTLER. Exactly.

Senator MITCHELL. That's really what you are most concerned about. And you see a greater danger arising, a more concrete danger, more easily or more readily predictable from raising taxes than you do from closing the——

Dr. BUTLER. That's correct. And I also think that the evidence that an increase in taxes will reduce the deficit is by no means overwhelming, to put it mildly.

Senator MITCHELL. Is it fair to say, Ms. Cox and Mr. Palmer, based upon your testimony that you disagree with what Dr. Butler is saying?

Ms. COX. Absolutely. I would like very much to constrain Federal spending. I am no different than anybody else. I don't really want to pay any higher taxes. But we have concluded as an organization that represents people from, virtually all points on the political spectrum that the deficits we face now are a real and present, not predicted, danger to our economy. And that the danger they create is so substantial as to really run the risk of undermining things that we hold so dear that we are willing to listen to any reasonable set of proposals to reduce those deficits. We stand willing and we hope able to help you put in place some package to reduce those deficits. We are convinced it will have to be balanced. We are convinced nobody will like it, but we think it's that important.

Dr. PALMER. I also disagree. I think, first of all, that the projections are a reasonably good indication of the magnitude of the problem. While they obviously won't be precisely borne out, as an order of magnitude, they are very indicative. And while no one can be absolutely precise about tracing very direct relationships among these things, it's quite clear that the overwhelming economic evidence is that if these deficits are allowed to come about they will have very detrimental effects on the longrun growth of the economy for the reasons that we have talked about.

Senator MITCHELL. The other point I wanted to make, Dr. Butler, is that there was a remarkable lack of intensity on the question of the defense budget. There was considerable intensity in your words and presentation on taxes and privatization, but when I asked you about the defense budget, there wasn't much there. That appears to be a substantial area of growth. This is a document that Ms. Cox's organization brought that I think is very good because it explains in clear and precise terms. It indicates that the composition of Federal spending between 1980 and 1985 be divided into four areas. Two will decline. Those are entitlements and mandatories as a percentage of the composition of Federal spending, and nondefense discretionary. And two will increase—interest and defense. This publication makes the statement that you have to deal with all of them to get at some reduction.

And it seems to me that if you are serious about reducing it, you have to deal with the area that is growing the fastest. And that's defense in terms of its percentage of the composition of the Federal spending over that period of time.

Dr. BUTLER. I wouldn't agree that that follows logically. I think if you have a situation where one element is growing, because of insufficient spending in previous years, there could be a very strong argument for allowing that increase to occur. With regard to defense, I don't think anybody that supports strong defense is particularly in favor of throwing dollars at battleships and so forth. But the bottom line, the obligation, I think, of any government is the defense of its people. And the question is what level of spending is necessary to provide the hardware and the manpower to provide adequate defense. Now there can be a strong debate over that, but if you get that debate wrong you might as well give up talking about everything else— because it won't matter.

Senator MITCHELL. Well, of course, there is no disagreement on that principle. But there is very substantial disagreement on what level of spending is necessary to achieve that objective.

Dr. BUTLER. I agree.

Senator MITCHELL. And there are many of us that feel—and you don't agree with me—that there is a very real difference between a strong defense and a wasteful and unnecessary defense budget.

Dr. BUTLER. I don't disagree with that position at all.

The CHAIRMAN. In fact, I think the Heritage Foundation issued a rather strong study last year, several months ago, where they made a number of recommendations in the Defense Department—waste duplication, overlapping.

Dr. BUTLER. We got in very hot water. But the bottom line there was it is the final product that matters; not the amount of money you spend on it. And we have very fundamental criticisms of the way in which defense spending is allocated; particularly, the method of contracting.

Senator MITCHELL. Well, not to get into a broad, philosophical session because time is up—I've got to go and I know the chairman does too—but there's a lot more national defense than how much you spend on airplanes, missiles, and bombs. Ultimately, national defense rests upon the national health and welfare and the economic strength of the Nation, and the spirit of the people. And I think you can make a very effective argument that when you purchase some of these weapon systems that are of dubious value, indeed, reduce our security, divert the funds from other, more productive uses, that you reduce national defense although you may be increasing the amount of money that goes into what is called the defense budget.

Dr. BUTLER. I agree totally with that.

The CHAIRMAN. Carol, last year, you know, we spent most of the year worrying about the budget process instead of the budget. Now if we are going to start that whole mix over again in January, we will be around here until June or July worrying about, well, we are going to get a budget; what's the budget going to be. It would seem to me that the best course to follow would be if we can reach some agreement in this committee. Maybe we can. And if the House will pass their last year's resolution, we could properly amend that on the Senate side. You are the expert on the budget.

Ms. COX. I understand that. I don't see what you face as a mechanical difficulty. I see it as a political difficulty, and I am confident if you can reach a politically acceptable conclusion that people who do what I used to do can work out the mechanics of how you get from here to there for you.

Clearly, you can proceed as you are proceeding now. And if the House will send you what they passed last year, you have available to you a vehicle on which to resolve some of the major issues which are part of the package. That will not deal with yours and Herb Stein's agricultural price support problem. It will not deal with the defense issue, and how fast shall defense continue to grow. There are other pieces that wouldn't wind up in that package because of jurisdictional issues.

However, I hope you will also have, a budget again this year—the country should have a budget. And there is nothing to keep you from using that as a packaging device to put into place whatever other pieces there are to the package. It is certainly not written in law any place that everything has to be done at the same time in one place. But as we comment in our testimony, it may be that the distrust level is so high that simultaneity will become the next buzz word in budgeting. You may have to put everything all in one bill so that everybody is confident that everybody is giving up their fair share at the same time.

The CHAIRMAN. Well, I could see a problem if you had a $75 billion tax package and only $32 billion in spending reductions of getting that passed because someone says, well, when do we get the other $40. I mean if the President——

Ms. COX. Senator, we can package it. I say "we." Institutionally, there are all kinds of ways for putting the package together.

The CHAIRMAN. I think once there is the will in the Senate, bipartisan, we are going to do something. It always happens. I mean there is a way of things happening around here that I have never fully understood. And when they are happening to you, you really don't appreciate them. But I do hope we don't go through the whole year—we are going to be out of here for all practical purposes in July, except for a few weeks in September, I guess, so if we don't have it finished by June 1, the whole package. I would guess we are under some——

Ms. Cox. Senator, look at the bright side. If you have, in this committee, covered the tremendous portion of the issues that have to be settled by mid-February, and if you are working on a budget as you ought to be in the Senate in March, and have completed Senate action on it in April, there is no reason that that budget cannot also include the other components of the package. And that the two can't move along either sequentially or in tandom.

As I said, I don't think it's a mechanical problem.

The Chairman. If you could put together a couple of those scenarios, I would really appreciate it personally.

Ms. Cox. I would be delighted.

The Chairman. We don't want to get bogged down.

[The information from Ms. Cox follows:]

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COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET
220 1/2 "E" STREET, N.E.
WASHINGTON, D.C. 20002

(202) 547-4484

December 19, 1983

Senator Robert Dole,
Chairman
Senate Finance Committee
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter responds to your request when I testified before the Finance Committee on December 13. The attachment outlines the procedural options for moving a major deficit reduction package through the legislative labyrinth.

(As I note in the attachment, the Senate can do anything by unanimous consent. But without unanimous consent the procedural options available to the Senate are somewhat less expansive than the options available to the House. The House Rules Committee can recommend, and the House can adopt, a rule making in order almost any procedure the mind of man can conceive. Bearing that in mind, I think it is appropriate to focus on your unique institutional concerns at this point in your deliberations.)

I have spoken with your staff, the Budget Committee staff, and the Parliamentarian, and I think they will agree you could move a package in any of the ways described in the attachment to this letter. There may also be additional options, which occurred to none of us, depending on what it is exactly the Senate ultimately decides.

As I said at the hearing, I believe your problems are political not mechanical. If the Senate can agree on what it wants to do, it can find a way to do it. And I am certain you will find the Chairman and the Ranking Member of the Budget Committee -- and their staffs -- as well as the Leadership and the Leadership staff most anxious to be helpful, if indeed you can agree on legislation to reduce the deficit significantly.

If there is anything further I can do, or that the Committee For A Responsible Federal Budget can do, to help you in this important work, please let us know. We truly do believe what you are doing is necessary and urgent. We will assist in any way we can.

Have a happy holiday season.

Best regards,

Carol G. Cox

I. Sequential Action

A. The Finance Committee could proceed as suggested by the Chairman at the hearing.

-- Report an original bill from the Finance Committee (The Chairman suggested this might occur as early as mid-February.)

-- Schedule Senate Action on that bill as soon as possible.

-- Hope the House passes the reconciliation legislation they had before them when Congress adjourned. [The House had passed one spending reduction bill; and the rule the House defeated -- for consideration of the Ways and Means bill. The House could pass the Ways and Means part of the package, and in a similar manner could send all the deficit reductions pursuant to the FY 1984 budget resolution to the Senate in one piece of legislation.]

-- Conference the new Senate (Finance) and the House-passed bills.

-- This procedure would give you neither the protections of reconciliation, nor assurance that any additional deficit reduction legislation would be enacted.

B. Possible safeguards to ensure legislation on which you proceeded in this fashion would become law only if additional deficit reduction legislation was also enacted could include the following:

-- Delayed enrollment. The Budget Act provides for delayed enrollment of specific kinds of legislation. The procedure suggested here borrows from that concept -- but would not be delayed enrollment as described in the Budget Act. It would, therefore require unanimous consent in the Senate to delay enrollment of the [original] bill(s) in question.

But Congress could instruct the Clerk of the House or the Secretary of the Senate, as the case may be, to delay hold at the desk the bill(s) -- and to send it (them) to the President for signature or veto only when action is completed on other specific legislation.

The President, of course, would have before him to sign or veto at least two bills. It is possible he would sign one and veto the other. You would have to rely on informal, i.e., non-legislation, agreement that the President would treat the two bills as one -- either sign or veto both.

-- Language in the bill, enacting the changes in law contained therein only when other specific conditions have been met, e.g., "effective on the enactment of __________ (You fill in the blank) __________.

I assume any safeguard you felt you needed would be included in your bill(s), since I suspect the fear would be the President might veto tax increases and sign into law the spending reductions in other legislation.

C. If you decide on safeguards such as the ones described above, you should also spell out very clearly who would determine when the safeguard conditions had been met and how.

-- If, for instance, the safeguard conditions required Congressional passage of X additional dollars in spending reduction, there should be an agreement as to whether the cuts must come in entitlement programs, whether lower appropriations would satisfy the conditions, and against what baseline the cuts would be measured.

-- Definitions can get tricky, as you decide these issues. For instance, there are programs in which you can reduce the deficit by increasing user fees, or by cutting spending. If you follow a course that depends on some future determination as to whether specified conditions have been met, you should decide in advance what will be counted. (And that decision should take into account, as nearly as it can, all the possible alternative ways of reducing the deficit.)

D. -- One final observation on sequential action: There is no prohibition in the Budget Act against early action on cuts in entitlement programs. But the Budget Act does create a point of order against a bill to increase or decrease taxes -- first effective in the next fiscal year -- before Congress adopts the budget resolution.

-- If your bill increases taxes, therefore, those tax increases would have to become effective first in FY 1984 or FY 1986.

-- If the tax increases become effective first in FY 1985, it would require a waiver under the Budget Act for the Senate to consider the bill before the first budget resolution for FY 1985 is adopted.

II. <u>A combination of sequential action and inclusion of your bill(s) in an omnibus reconciliation bill (pursuant to reconciliation instructions contained in the first budget resolution for FY 1985.)</u>.

A. You could move forward as soon as Congress reconvenes on a Finance/House reconciliation package as described in "I A" above.

B. The FY 1985 budget resolution could include the deficit reduction achieved by that package and instructions to the Finance Committee directing you to report legislation to achieve the savings and tax increases contained in your original bill.

-- The budget resolution would have to contain instructions to the Finance Committee (even if everyone knew you had already reported -- and even if the Senate had already passed -- the legislation to be included in an omnibus reconciliation bill pursuant to those instructions). The Parliamentarian has already ruled Committees can't volunteer for reconciliation.

-- In order to comply with your reconciliation instructions, The Finance Committee would submit to the Budget Committee the legislation on which you had already settled.

-- That legislation would then be incorporated into an omnibus reconciliation bill. (You would have no real work to do to comply with your reconciliation instructions.)

C. Your parts of the total package would then go to the President as part of one bill -- a bill which also contained whatever other savings were required in programs in other Committees' jurisdictions.

-- If Congress chose this approach it would be realistic to include in the budget resolution a very short deadline for other Committees to report their parts of the package -- as each individual Committee would have much less to do than the Finance Committee would have accomplished already.

-- If you were able to agree on the Finance component by the middle of February, and on the total package by mid-March (when the various Committees are required to submit their views to the Budget Committees), there is no reason that the budget resolution could not be passed before the Easter Recess and the reconciliation bill enacted before late May or early June.

-- These are big "if's", but IF the Senate could agree on a package, more or less within the time frame described above, that agreement should help expedite both Budget Committee action on the resolution, and subsequent Senate floor action (as well as making possible quick action by all Senate Committees on their parts of the reconciliation bill).

D. Another way to accomplish essentially the same thing would be to pass your bill, hold it at the desk in the Senate, and agree that it would be considered as an amendment (to which it would be considered the Senate had agreed) when the reconciliation bill is before the Senate.

This would require unanimous consent; but it is consistent with the way in which we packaged the tax and spending parts of an earlier reconciliation.

III. Revise H. Con. Res. 91 (The FY 1984 Budget Resolution) to include new reconciliation instructions -- and for no other purpose.

A. The Budget Act provides that Congress may revise the budget resolution, whenever you feel that is necessary.

B. The Parliamentarian has already ruled that the budget resolution may be revised -- only to include new or revised reconciliation instructions and for no other purpose. (That is, you do not have to revise new budget numbers.

C. This would allow early action on a resolution to instruct all Committees involved in whatever deficit reduction package on which you agreed.

-- In some ways, this is the most attractive of the available options, as it would allow each of the instructed Committees to offer (Committee) amendments if necessary -- thus leaving each Committee maximum time and flexibility in meeting their reconciliation instructions.

-- From the point of view of someone who cares about preserving the reconciliation process for future use, it also has the advantage of erasing the precedent of Congress' having ignored the reconciliation instructions in the most recently adopted budget resolution.

D. This also ensures the protections of the reconciliation process for all the parts of the package reported pursuant to the instructions contained in the revised budget resolution -- but separates consideration of that package completely from consideration of the FY 1985 budget.

IV. <u>An Omnibus bill outside the budget and reconciliation process.</u>

A. If you reach agreement on a deficit reduction package, the Senate could of course agree to package legislation in several Committees' jurisdictions in one bill.

-- You could even agree to time limits for debate, and germaneness requirements, governing floor consideration of such a bill.

-- As the Senate has no regular process for joint referral, however, you would have also to work out ground rules.

-- Time and germaneness limits, and ground rules for joint or sequential referral would require unanimous consent.

B. We considered this option before recommending reconciliation as a vehicle for the 1981 budget package, but rejected it because of our feeling that it would be easier to use a process the Senate had used before, i.e., reconciliation, than it would be to try out a whole new procedure.

V. <u>Summary</u>

A. You could pass the Finance Committee part of a deficit reduction package all by itself -- with or without legislative language designed to ensure it became law only if other spending reduction legislation also passed and was signed.

B. You could pass a part of the package early, and by unanimous consent the Senate could agree that it would be added to the reconciliation bill as an amendment.

C. You could pass your part of the package early, and also include that package in an omnibus reconciliation bill -- your part of the package being submitted to the Budget Committee pursuant to instructions contained in the budget must contain instructions to the Finance Committee, as the Parliamentarian has ruled that Committees cannot volunteer for reconciliation.

D. You could revise H.Con. Res. 91 (The FY 1984 Budget Resolution) to include new (revised) reconciliation instructions, and for no other purpose. You could then move a reconciliation bill(s) pursuant to those instructions, early in the year, separate from consideration of the FY 1985 budget resolution.

E. The Senate could agree to package all deficit reduciton legislation in one bill -- but not to use the budget/ reconciliation procedure for considering that bill.

F. And, of course, the Senate could agree by unanimous consent to do anything including an agreement to pass original legislation which had not been (formally) referred to or reported from any Committee.

However, I suspect you will have enough difficulty inventing a package without also trying to invent a whole new procedure. And inventing a new procedure should not be ncessary since I expect the Budget Committee and the Leadership will be most sympathetic to your desires and willing to accomodate you in any way they can -- particularly if your Committee can contribute amounts similar to those you are contemplating to a package to reduce the deficit as much as $100 billion to $150 billion.

The CHAIRMAN. We like the Budget Committee as long as they don't take us over. And we don't want to be a subcommittee of the Budget Committee. I have said that to Senator Domenici and Senator Chiles. We are willing to be a partner.

So that would be another problem. But if we can put it all together in one package, it seems to me that there would be some chance of maybe passing it, at least get it started.

Are there any magic numbers? You know, we have talked about $150 billion, $125 billion, 3 years, 4 years. And does anybody have a number that we really ought to focus on and say, well, this is what you have to have; it has to be this large?

Dr. PALMER. I don't think there is such a number, Senator. What is critical is simply that action that is substantial and that begins to phase in soon be taken. It's always possible to come back in subsequent years and add more on if it appears the initial step isn't sufficient. But I think making it clear that there is a commitment to deal with the problem and taking some major first step is what is essential.

The CHAIRMAN. That's what we are told by the experts.

Ms. COX. As we say in our testimony, and for that matter in our executive summary, current laws and policy can never lead to a budget that is in balance. Somehow, the obverse of that is what is necessary. A set of policies that on some believable set of economic assumptions will move the budget toward balance in the foreseeable future seems, to us, to be terribly, terribly important. It's not the only thing that we need to do to make everything well with the world. But it certainly would be a tremendous contributing factor.

The CHAIRMAN. Well, we appreciate very much your testimony. We hope that we can keep in contact with each of you. As I have said before, the purpose of these hearings is to demonstrate that there is a lot of concern out there. We need a lot of public support.

I was handed the preliminary survey being taken by realtors and others, and there's a lot of recognition of the deficit, but then it sort of falls off on the impact it might have and what's to be done about it. And it was compared with withholding so I know how intense that became and how it finally just disappeared.

So if we could turn those same people loose on the budget deficit, we might be able to put it together.

This afternoon we will have two panels—Dr. Jack Carlson, Dr. John Albertine, Dr. Jasinowski; and then Dr. Rahn of the chamber and Harry Pryde of the National Association of Home Builders; and Dr. Mark Reidy, Mortgage Bankers.

We appreciate very much your testimony. We will stand in recess until 2.

[Whereupon, at 12:04 p.m., the hearing was recessed.]

AFTERNOON SESSION

The CHAIRMAN. We will continue our hearings. We have another list of outstanding witnesses, consisting of two panels. The first panel is Dr. Jack Carlson, executive vice president and chief economist, National Association of Realtors; Dr. John M. Albertine, President of the American Business Conference; Jerry Jasinowski, executive vice president and chief economist, National Association of Manufacturers.

Again, let me welcome you to the hearings. We think we've had some good solid testimony yesterday afternoon and this morning. Your entire statements will be made a part of the record, and if you can summarize your statement to give us some time for questions.

Jack, we will start with you.

STATEMENT OF DR. JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, D.C.

Dr. CARLSON. Yes, sir. Mr. Chairman, may I refer you to the testimony. I do have some tables and charts.

The CHAIRMAN. Sure.

Dr. CARLSON. We've attempted to answer the questions you have phrased. And let me start off in answer to your first question—what are the economic consequences if the administration and Congress do nothing to address the deficit problem?

The CHAIRMAN. Right.

Dr. CARLSON. Huge deficits have and continue to cause over one-half of the current long-term interest rates, and we have the best empirical analysis, I believe. And in a debate in the Joint Economics Committee, I think that it has stood up under fire. So you see over 50 percent is coming from the deficit.

On the next page you will see what the real interest rate is. It has gone up at least in terms of mortgage interest rates. In 1979, 2.7 percent; 7.37 percent in 1981; and in the third quarter of this year, we estimated 9.2 percent. The real level is going up. And by the way, this has not occurred since President Hoover's administration in 1932, that you can see on page 4. That gives you idea of real corporate interest rates over a long period of time.

And if you look on page 5, you see the relationship of ourselves with other industrialized countries. Our Government is borrowing a larger percent of net private domestic savings than any other country, and consequently our real interest rates are much higher than they are.

Now this hurts in a number of areas. It cripples the interest-sensitive sectors of the economy. Exports and investment and education, training, housing, commercial structures and plant and equipment are particularly hurt. The 1981–82 tax cut has been more than offset by the increase in real interest rates, so we could expect slow growth even in those areas that have had the incentive, let alone those areas that have not had the incentive.

Education, training and homes owned by occupants did not receive any incentives for greater investment in 1981–82 and so they are doubly affected and relatively worse off because of the tax laws. And, in addition, the higher real interest rates are causing problems.

In the case of home ownership, you can see on page 6 that home ownership is declining and is estimated by the Census Bureau to decline through the remainder of this particular century.

I skip over to page 10 to show that that fact has some significance on overall savings. If you notice in the table there that people who own their own home have the discipline of providing for their homes, and they save 263 percent of those than renters save. Also after you exclude the residents themselves, they save 155 percent of renters. So home ownership appears to be a discipline for saving and investing in industry; not just in housing alone. That has implications with the decline in home ownership as we see it through the remainder of this century.

High interest rates cause foreigners to invest in the United States which temporarily provides funds to finance the deficits, but at a high cost. Greater supply of loanable funds has increased the exchange value of the U.S. dollar by 25 to 35 percent, which now acts like a tax on U.S. exports, which is to reduce sales jobs and expansion of the most progressive and competitive industries. Also the deficit caused over-valuation of the dollar and acts as a 25 to 35 percent subsidy for imports and reduces sales jobs, and growth of other progressive and competitive industries which provide goods and services that are substitute for imports.

And, of course, as others have testified before you, the deficit causes high interest rates, drive up the interest costs of the Federal debt, and a faster pace in growth or revenues expected in future years.

In answer to your second question—when should we act—we should act as soon as possible so that we do not have the slowing up of investment, the crippling of these particular industries, and the lack of balance in the economy. Frankly speaking from a political standpoint, about the best time that you can make the changes you need is during the time of fast growth of jobs and incomes and that is occurring now and will slow down through 1984 and 1985.

In terms of criteria for selecting the solution, they are outlined on page 13. And, frankly speaking, even though you have cautioned against that, I don't see where you can get away from CPI minus 3 or minus 2 or something like that to solve the problem, let alone some restraint on defense and other programs. You can get a near balance of the structural deficit by 1989; and you will see the different programs, including your own, as measured on figure 11 on page 14 as to how it brings down the deficit.

Then on page 15 you can see the reduction in real interest rate that occurs because of each of those additional programs. In this case, particularly the CPI minus 3, and then the economic consequences are shown in figure 13.

In fact, you can look at figure 13 as the opposite. If you do nothing, that's the loss in the economy you are going to have as opposed to doing something to brino down the deficit.

Obviously, in the longer run we would all like to reform the tax code and movements in that direction to broaden the tax base would be wise as opposed to having rate increases. However, I think it's important to recognize that that should be done while encouraging savings and investment. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Does your statement also include the——

Dr. CARLSON. Yes, sir.

The CHAIRMAN. I think that would be helpful. It's a wide-ranging group.

Dr. CARLSON. Yes, sir.

The CHAIRMAN. I will have everybody give their statements, and then we will have some questions.

[The prepared statement of Dr. Carlson follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
DEFICIT REDUCTION LEGISLATION
to the
SENATE FINANCE COMMITTEE
by
DR. JACK CARLSON
December 13, 1983

I am Jack Carlson, Executive Officer of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the 600,000 members of the National Association, we greatly appreciate the opportunity to testify before the Senate Finance Committee on a topic of reducing the federal budget deficit so that real long-term interest rates can decline to normal and economic growth can be balanced and sustainable.

Our industry is very concerned with the current record federal budget deficit projected for 1984 and future years. We are greatly disappointed with the inability of Congress and the President to limit the size of the federal deficit. With rapid growth of defense and entitlement spending and automatic personal income tax cuts the federal deficit will continue at record levels for the foreseeable future.

We therefore commend Chairman Robert Dole and this Committee for leading the legislative effort to reduce the deficits throughout 1983 and particularly during the closing days of the last session of Congress. We also commend you for your decision to develop specific legislative proposals for consideration and to conduct these hearings rather than to accept the widespread idea that nothing can be done to attack deficits in 1984.

RECOMMENDATIONS

QUESTION #1:

WHAT ARE THE ECONOMIC CONSEQUENCES IF THE ADMINISTRATION AND CONGRESS DO NOTHING TO ADDRESS THE DEFICIT PROBLEM?

ANSWER #1:

Huge federal deficits have and continue to cause over one-half of current long-term interest rates (see Figure 1).

FIGURE 1

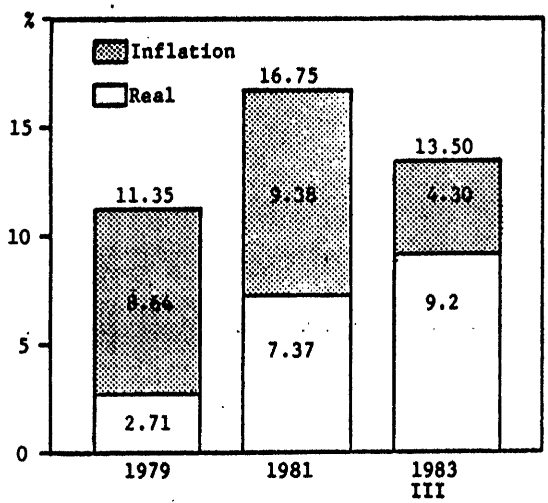
CURRENT CAUSE OF HIGH MORTGAGE INTEREST RATES
(Third Quarter 1983)

	Percentage Points		Percent of Total	
Fiscal Policy - Deficit		7.8		57
Current Crowding Out	1.1		8	
Inflation fears -- Future Crowding Out	6.7		49	
Monetary Policy Money Growth		5.9		43
ACTUAL INTEREST RATE		13.7		100

Source: Testimony of Jack Carlson debating the Treasury Department on "The Relationship Between Federal Deficits and Interest Rates", October 21, 1983. The estimates are based on an extension and update of previous studies reported and additional empirical analysis by Martin S. Feldstein and Otto Eckstein, "The Fundamental Determinants of the Interest Rate", The Review of Economics and Statistics, November 1970, pp. 363-375.

Real long-term interest rates, market interest rates minus inflation rates, are at a record level of over 9% this year, compared to about 7% in 1981 and 3% in 1979 (see Figure 2).

FIGURE 2
MORTGAGE INTEREST RATES

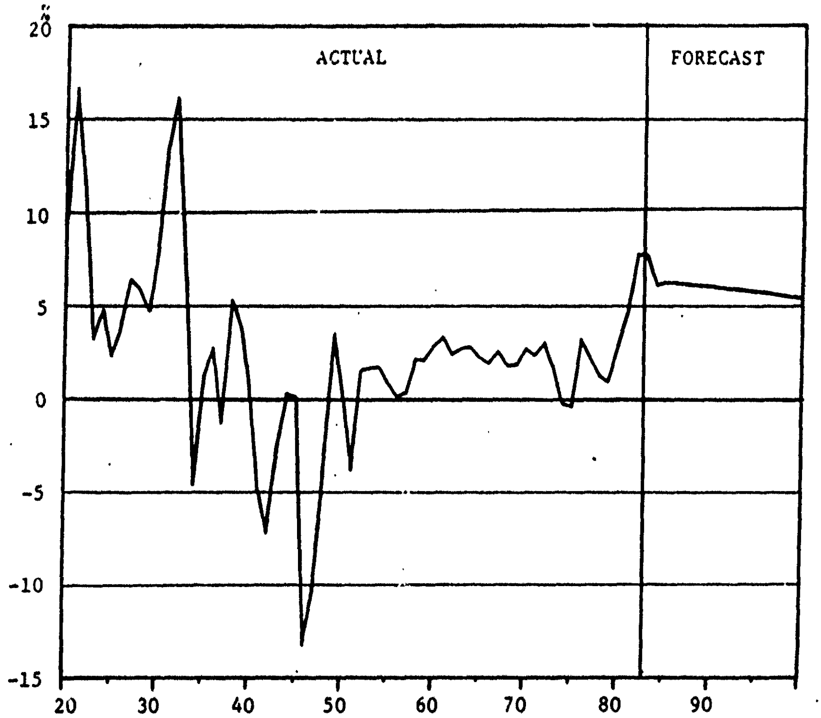


Note: Real interest rates were calculated by subtracting the percentage change in the GNP deflator from the mortgage commitment rate published by the Federal Home Loan Bank Board.

Source: NATIONAL ASSOCIATION OF REALTORS®.

This level has not occurred since the term of President Hoover in 1932. Without a major reduction in deficits, real interest rates are not likely to decline to a normal 3% during our lifetime (see Figure 3).

FIGURE 3
REAL INTEREST RATES 1/



1/ AAA Corporate bond rate, adjusted for inflation by the Consumer Price Index (1919-29), and by the GNP price deflator (1930-2000).

Sources: Actual data from the Bureau of the Census, Historical Statistics: Colonial Times to 1970, and Moody's Investors Service. Forecast from the NATIONAL ASSOCIATION OF REALTORS® based on a simulation of the Data Resources Inc. long-term annual model of the U.S. economy.

Last year, the deficit was taking 77% of net private domestic savings, much larger than other major industrial countries and consequently we experienced the highest real long-term interest rates (see Figure 4).

FIGURE 4

RELATIONSHIP BETWEEN CENTRAL GOVERNMENT DEMAND FOR LOANABLE FUNDS AND REAL INTEREST RATES IN MAJOR INDUSTRIAL COUNTRIES: 1982

	Central Government Deficit as a Percent of GNP 1/	Central Government Borrowing as a Percent of Net Private Domestic Savings 2/	Real Long-term Interest Rates 3/
United States	4.3	77	5.3
United Kingdom	2.8	58	4.6
Japan	5.8	41	3.9
France	2.8	40	3.8
Germany	2.6	29	3.4

1/ Source: International Monetary Fund.
2/ Source: International Monetary Fund. Net private savings is defined as household saving plus gross savings of business enterprises, subtracting depreciation charges and other capital consumption allowances.
3/ Computed assuming the rate of growth of money supply is equal in all countries.

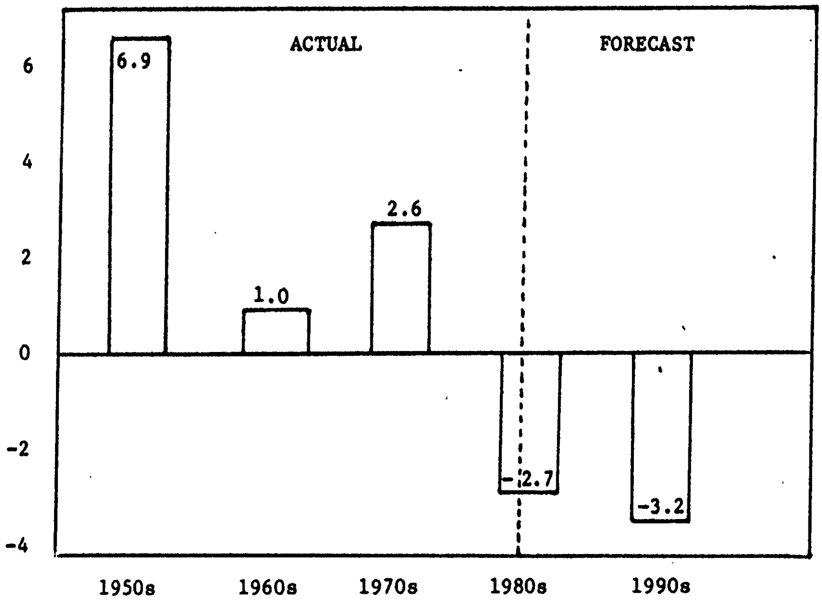
The Federal Reserve Board is acting appropriately to contain the excessive stimulation of high federal deficits now and in the future (structural deficit). If the deficits were reduced, monetary policy could and should be easier (see column 2, Figure 12 on page 15).

Deficit-caused high real interest rates cripple the interest-sensitive sectors of the U.S. economy -- exports and investment in education and training, housing, commercial structures and plant and equipment. The 1981-82 tax cuts reduced the costs of commercial and industrial structures and equipment, but three to six percentage points higher real long-term interest rates have more than offset the tax change. Therefore, investment can be expected to grow more slowly.

Because education, training and homes owned-by-occupants did not receive any incentives for greater investment in the 1981-82 tax law changes, investments in these areas are doubly disadvantaged by being less competitive with commercial investments and by high real interest rates.

This is already occurring. According to the Census Bureau, since 1980 home ownership has declined and is forecast to continue to decline during the remainder of the decade of the 1980s and 1990s (see Figure 5).

FIGURE 5
CHANGE IN THE HOME OWNERSHIP RATE
(Percentage points by decade)

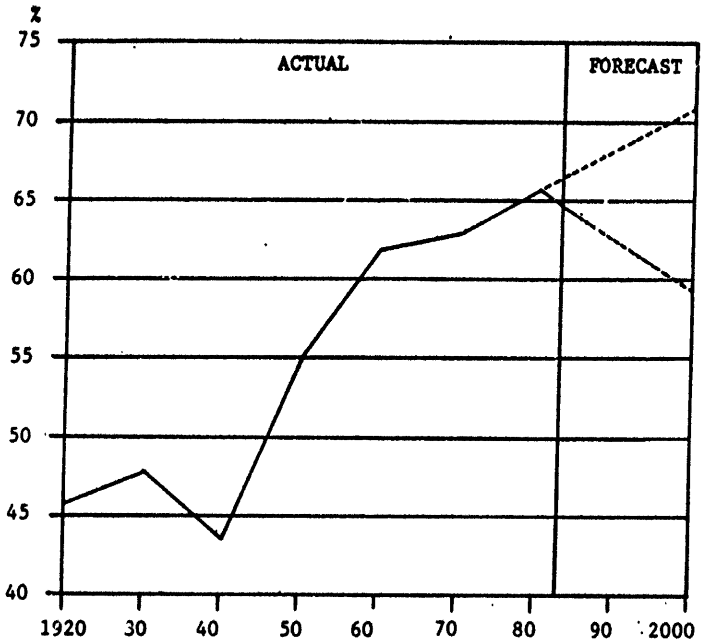


a/ Forecast based on 1980-83 trend and other factors considered relevant by the Bureau of the Census.
Source: United States Bureau of the Census.

This could lower the home ownership rate from 66% in 1980 or from the trend rate of above 70% expected in 2000 A.D. down to below 60% (see Figure 6).

FIGURE 6

THE HOME OWNERSHIP RATE



Source: U.S. Bureau of the Census.

This trend is understandable because when real mortgage interest rates are increased by three percentage points, the payments on the median-priced home increase $140 per month, $1,680 per year, equal to 6.5% of the median-income household's income. Because home values tend to act like bond values, the value of all homes was driven down by the deficit-caused increase in real interest rates. Three percentage points increase in real interest rates if allowed to continue, may cause median-priced home owners to lose $13,000 or 16% in home value or a total of $700 billion (see Figure 7).

FIGURE 7

IMPACT OF 3 PERCENTAGE POINTS INCREASE IN REAL INTEREST RATES FOR THE TYPICAL HOME OWNER

Monthly Payment	$140
Yearly Payments	$1,680
Percent of Median Family Income	6.5%
Potential Loss in Home Value	-$13,000
Percent of Typical Home Value	-16%
All Homes	-$700 billion

Source: NATIONAL ASSOCIATION OF REALTORS®.

When the typical home owner realizes what the Congress and President have potentially done to them, the political consequences could and should be significant (see Figure 8).

FIGURE 8

THE IMPACT ON HOME OWNERS FROM A 3 PERCENTAGE POINTS HIGHER REAL INTEREST RATE CAUSED BY FEDERAL DEFICITS
(1983 Dollars)

STATES	MEDIAN PRICED HOME	LOSS ON MEDIAN HOME	LOSS ON ALL HOMES
ALL STATES	$75,500	$13,000	$[illegible]00,000,000,000
Alabama	43,130	6,901	7,572,295,000
Alaska	111,304	17,809	2,409,039,000
Arizona	61,565	9,850	3,303,240,000
Arkansas	45,217	7,235	6,786,036,000
California	90,783	14,525	100,919,200,000
Colorado	68,087	10,894	10,237,190,000
Connecticut	91,043	14,567	12,504,410,000
Delaware	61,391	9,823	1,759,868,000
Dist. of Columbia	103,217	16,515	3,267,830,000
Florida	58,435	9,350	33,132,300,000
Georgia	63,217	10,115	15,756,810,000
Hawaii	121,652	19,464	5,041,923,000
Idaho	46,348	7,416	2,118,331,000
Illinois	73,565	11,770	36,909,110,000
Indiana	53,478	8,557	13,156,960,000
Iowa	52,870	8,459	6,975,322,000
Kansas	51,217	8,195	5,808,012,000
Kentucky	51,826	8,292	8,460,548,000
Louisiana	60,174	9,628	11,354,320,000
Maine	50,435	8,070	3,054,146,000
Maryland	73,130	11,701	13,681,240,000
Massachusetts	78,261	12,522	20,416,360,000
Michigan	61,478	9,837	25,876,270,000
Minnesota	62,609	10,017	12,123,680,000
Mississippi	46,609	7,457	5,065,389,000
Missouri	49,217	7,875	11,440,070,000
Montana	38,261	6,122	1,506,450,000
Nebraska	48,435	7,750	3,546,405,000
Nevada	71,391	11,423	3,106,783,000
New Hampshire	65,565	10,490	3,132,532,000
New Jersey	82,957	13,273	27,171,070,000
New Mexico	44,957	7,193	2,862,145,000
New York	72,696	11,631	57,964,860,000
North Carolina	50,957	8,153	14,343,410,000
North Dakota	52,087	8,334	1,601,084,000
Ohio	65,391	10,463	31,437,960,000
Oklahoma	61,217	9,795	9,387,563,000
Oregon	54,435	8,710	7,119,159,000
Pennsylvania	45,304	7,249	24,602,520,000
Rhode Island	66,957	10,713	2,960,043,000
South Carolina	60,174	9,628	8,555,572,000
South Dakota	41,826	6,692	1,367,538,000
Tennessee	54,522	8,723	11,499,240,000
Texas	69,304	11,089	49,228,830,000
Utah	64,087	10,254	3,851,359,000
Vermont	51,391	8,223	1,467,287,000
Virginia	70,435	11,270	17,247,590,000
Washington	65,043	10,407	13,351,470,000
West Virginia	44,435	7,110	4,020,865,000
Wisconsin	66,522	10,643	14,719,430,000
Wyoming	51,043	8,167	1,222,299,000

Source: NATIONAL ASSOCIATION OF REALTORS.

Loss of home ownership means less incentive and discipline to work harder and save and invest. For example, from the latest data, middle income earners who owned their own homes saved 263% of the savings of renters. They saved 155% of the savings of renters, even after subtracting the cost of their own residence (see Figure 9).

FIGURE 9
SAVINGS AND INVESTMENT BY HOUSEHOLD INCOME 1/
(1977 dollars)

	RENTER	HOME OWNER			
		Including Residence		Excluding Residence	
		$	% of renters	$	% of renters
All	$16,000	$42,000	263%	$24,000	150%
Low Income	$ 5,000	$23,000	460%	$12,000	240%
Middle Income	$11,000	$29,000	263%	$17,000	155%
High Income	$36,000	$71,000	197%	$42,000	117%

1/ Includes the amount of money in savings and checking accounts, certificates of deposit, the market value of common and preferred stocks, government and corporate bonds, and equity in real estate.

Source: Calculations by the NATIONAL ASSOCIATION OF REALTORS®, based on survey data from the University of Michigan, Survey Research Center, Study of Consumer Credit, 1977.

The Census Bureau's projections and recognition that home ownership is a significant cause of greater work effort and savings and investment, indicate that the nation's total savings could be lower by $50 to $100 billion by the year 2000 A.D. with loss of investment in shelter by $45 to $100 billion, investment in industry by $55 to $100 billion, loss of 2 to 4 million jobs and $1,000 to $2,000 lower household income and $135 to $300 billion higher federal government deficits (see Figure 10).

FIGURE 10

IMPACT OF 10 PERCENTAGE POINTS LOWER
HOME OWNERSHIP RATE BY THE YEAR 2000 A.D. 1/
(Annual Result in 1983 dollars)

	Low Estimate	High Estimate
Savings	- $50 billion	- $100 billion
Investment in Shelter	- $45 billion	- $100 billion
Housing Units	- 550,000	- 1,000,000
Investment in Industry	- $55 billion	- $100 billion
Employment	- 2,000,000	- 4,000,000
Household Income	- $1,000	- $2,000
Automobile Sales	- 900,000	- 2,000,000
Federal Deficit	$135 billion	$300 billion
Inflation (percentage points)	0.8	1.5

1/ The lower home ownership rate is associated with slower growth of employment and lower work effort. A slower employment growth lowers income growth which decreases personal savings and consumption. Researchers have found that the addition of a second earner in a household is associated with the household's desires for home ownership. Also, home ownership is strongly associated with greater work effort. Polls show home owners are 30% more likely to believe if one works hard one will get ahead. Other research shows that if people are unable to achieve home ownership, they no longer feel they can get ahead by working hard, and therefore work effort is reduced.

Source: NATIONAL ASSOCIATION OF REALTORS®, based on a simulation of the Data Resources Inc. macroeconomic annual model of the U.S. economy. See also Dowell Myers, "The Impact of Rising Home Ownership Costs on Family Change," a paper prepared for the Population Association of America, April 1983; and Myers, "Growing Tensions Within the American Dream: The Home Ownership Crisis and Social Change," a paper prepared for the Association of Collegiate Schools of Planning, October, 1982.

High interest rates cause foreigners to invest in the United States which temporarily provides additional funds to finance the deficits, but at a high cost. Greater supply of loanable funds has increased the exchange value of the U.S. dollar by 25% to 35%, which now acts like a tax on U.S. exports, which has reduced sales, jobs, and expansion of the most progressive and competitive industries. Also, the deficit-caused over valuation of the dollar acts as a 25% to 35% subsidy for imports and reduces the sales, jobs and growth of other progressive and competitive industries which provides goods and services that are substitutes for imports.

Deficit-caused high interest rates drive up the interest cost of the federal debt, and at a faster pace than growth of revenues expected after 1984.

QUESTION #2:

DO WE NEED TO ACT IN EARLY 1984 OR CAN WE AFFORD TO WAIT TO ADDRESS THE DEFICITS UNTIL 1985 OR THEREAFTER?

ANSWER #2:

We need to act as soon as possible, certainly as early in 1984 as possible, realizing policy changes during 1984 mean implementation and impact during 1985.

The burden of policies to reduce the deficit on Americans is actually and perceptually less during good times, times of fastest growth in income and jobs, which argues for action as soon as possible. Growth is forecast to slow down throughout 1984 and 1985.

QUESTION #3:

WHAT SPECIFIC LEGISLATION SHOULD CONGRESS ENACT TO REDUCE THE BUDGET DEFICITS?

ANSWER #3:

We recommend that any legislation enacted by Congress to reduce the budget deficits be designed to:

- continue the economic recovery;
- reduce spending as much as increase taxes and in one inseparable policy action (no waiting for spending cuts after tax increases);
- require a small sacrifice for most Americans;
- reward most Americans above the initial sacrifice;
- encourage savings and investment in residential and nonresidential capital and in education and training;
- reduce uncertainty (without discretionary triggers); and
- continue for many years.

In order to achieve these objectives, we recommend:

- CPI-3 for entitlement and personal income tax[1/];
- slower growth of real defense expenditure (less than 5%); and
- slower growth of other programs (less than inflation).

Such a program could lower deficits to near balance by 1989 (see Figure 11).

1/ We hasten to add we do not want to be or appear unresponsive to the Committee instruction against COLA proposals but we see no potentially feasible legislative proposals to attack deficits that do not include them.

FIGURE 11

REDUCTION IN THE FEDERAL DEFICIT FROM INDEXING ENTITLEMENTS AND PERSONAL INCOME TAX BRACKETS AND A COMBINATION PROGRAM PROPOSED BY SENATOR DOLE
(NIA Basis, Billions of Dollars)

	1985				1987				1989			
	CPI Minus 3	CPI Minus 2	CPI Minus 1	Sen. Dole 11/29	CPI Minus 3	CPI Minus 2	CPI Minus 1	Sen. Dole 11/29	CPI Minus 3	CPI Minus 2	CPI Minus 1	Sen. Dole 11/29
Expected Deficit	$-220	$-220	$-220	$-220	$-230	$-230	$-230	-$230	$-220	$-220	$-220	$-220
Impact on:												
Revenues	12	7	2	10	45	25	11	15	85	50	23	25
Direct	1	1	0	12	15	10	5	22	40	27	13	35
Induced	11	6	2	-2	30	15	6	-7	45	23	10	-10
Expenditures	-19	-11	-5	-14	-45	-24	-10	-34	-100	-56	-23	-45
Transfer Payments	-10	-7	-3	-4	-14	-9	-4	-9	-37	-24	-11	-18
Direct	-9	-6	-3	-5	-12	-8	-4	-11	-26	-18	-9	-22
Induced	-1	-1	0	1	-2	-1	0	2	-11	-6	-2	4
Net Interest	-9	-5	-2	-7	-31	-15	-6	-19	-63	-32	-12	-27
Deficit	-31	-18	-7	-24	-90	-49	-22	-49	-185	-106	-46	-70
Resulting Deficit	-189	-202	-213	-196	-140	-181	-208	-181	-35	-114	-174	-150

Source: NATIONAL ASSOCIATION OF REALTORS®.

FIGURE 12

RESULT OF GRADUAL REDUCTION IN FEDERAL DEFICIT (THREE-FOR-ALL PROPOSAL) ON LONG-TERM INTEREST RATES (CORPORATE BOND Aaa)

After Passage and Implementation	Monetary Policy		Federal Debt (Current Crowding Out)		Inflation Expectations (Future Crowding Out)		Total Decrease in Interest Rates
	% Point Decline	% of Total Interest Rate Decline	% Point Decline	% of Total Interest Rate Decline	% Point Decline	% of Total Interest Rate Decline	
1st Quarter	0.08	7	0.01	1	0.97	87	-1.11
1st Year	0.24	17	0.06	4	1.11	79	-1.41
2nd Year	0.43	22	0.20	10	1.28	66	-1.93
3rd Year	0.61	25	0.35	14	1.50	60	-2.48
4th Year	0.69	23	0.62	21	1.68	56	-3.01
5th Year	0.77	21	0.98	27	1.83	51	-3.59

Source: NATIONAL ASSOCIATION OF REALTORS®.

The economy could grow longer and steadier and create a higher standard of living for all Americans (see Figure 13).

FIGURE 13

MACROECONOMIC IMPACTS OF ALTERNATIVE PROPOSALS FOR INDEXING OF ENTITLEMENTS AND PERSONAL INCOME TAX BRACKETS

	1985			1987			1989		
	CPI Minus 3	CPI Minus 2	CPI Minus 1	CPI Minus 3	CPI Minus 2	CPI Minus 1	CPI Minus 3	CPI Minus 2	CPI Minus 1
GNP ($84 billion)	13.5	6.8	2.7	113.9	57.0	22.8	178.3	89.2	35.7
Percent (%)	0.4	0.2	0.1	3.1	1.6	0.6	4.5	2.3	0.9
Residential Investment ($84 billion)	6.5	3.3	1.3	38.6	19.3	7.7	82.4	41.2	16.5
Percent (%)	4.4	2.2	0.9	24.6	12.3	4.9	46.7	23.4	9.3
Nonresidential Investment ($84 billion)	0.8	0.4	0.2	14.7	7.4	2.9	46.9	23.5	9.4
Percent (%)	0.2	0.1	0.0	3.7	1.9	0.7	10.8	5.4	2.2
Structures ($84 billion)	0.5	0.3	0.1	8.0	4.0	1.6	24.1	12.1	4.8
Percent (%)	0.4	0.2	0.1	5.2	2.6	1.0	14.0	7.0	2.8
Equipment ($84 billion)	0.3	0.2	0.1	6.8	3.4	1.4	22.8	11.4	4.6
Percent (%)	0.1	0.1	0.0	2.8	1.4	0.6	8.7	4.4	1.7
Income per Household ($84)	100	50	20	860	430	172	1800	900	500
Percent (%)	0.3	0.2	0.1	1.7	0.9	0.3	3.0	1.5	0.6
Total Private Savings ($84 billion)	12.0	6.0	2.4	25.4	12.7	5.1	25.8	12.9	5.2
Percent (%)	1.9	0.9	0.4	3.8	1.9	0.8	4.3	2.2	0.9
Employment (millions of jobs)	0.30	0.15	0.06	1.4	0.7	0.3	2.2	1.1	0.4
Long-term Interest Rates (e.g. Mortgage Interest Rates) (Percentage Points)	-1.3	-0.7	-0.3	-2.3	-1.2	-0.5	-3.3	-1.7	-0.7
New Home Starts (thousands of units)	195	98	39	500	250	100	650	325	130
Existing Home Sales (thousands of units)	350	175	70	1000	500	200	1200	600	240
Domestic Car Sales (thousands of units)	260	130	52	800	400	160	1500	750	300

Source: NATIONAL ASSOCIATION OF REALTORS®.

Senator Dole has proposed a combination of tax provisions that encourages savings and investment such as "rounding down of indexing" and "energy tax", and discourages savings and investment such as "high income individual surcharge", "2 percent tax on corporate economic income and tax increase on shelter." His proposal could reduce the deficit by $70 billion by 1989. This would fall short of a balanced budget at high employment by $150 billion (Figure 11, column 4). Nonetheless, his proposal would lower interest rates and improve investment and thus make the proposal better than no policy change at all (Figure 14). However, CPI minus 3, 2 or 1 would be better for the entire economy (see Figure 14).

FIGURE 14

MACROECONOMIC IMPACT OF DOLE COMBINATION PROPOSAL FOR INDEXING OF ENTITLEMENTS AND PERSONAL INCOME TAX BRACKETS

	1985	1987	1989
GNP ($84 billion)	0.0	-11.4	-4.0
Percent (%)	0.0	-0.3	-0.1
Residential Investment ($84 billion)	10.4	15.1	17.6
Percent (%)	6.8	8.9	10.0
Nonresidential Investment ($84 billion)	2.2	2.9	4.3
Percent (%)	0.6	0.7	1.0
Structures ($84 billion)	1.5	2.3	3.4
Percent (%)	1.2	1.5	2.0
Equipment ($84 billion)	2.1	0.7	0.8
Percent (%)	0.7	0.3	0.3
Income per Household ($84)	0.0	-85	-60
Percent (%)	0.0	-0.2	-0.1
Total Private Savings ($84 billion)	0.0	-26.5	-12.0
Percent (%)	0.0	-4.6	-2.0
Employment (Millions of Jobs)	0	-0.2	-0.1
Long-term Interest Rates (e.g. Mortgage Interest Rates) (percentage points)	-0.7	-1.2	-1.5
New Home Starts (units)	200	120	100
Existing Home Sales (thousands of units)	390	240	195
Domestic Car Sales (units)	-200	-200	-150

Source: NATIONAL ASSOCIATION OF REALTORS®.

In the longer run, reform to broaden the taxable base instead of continuing to increase tax rates is desirable, but only if the reforms encourage savings and investment and home ownership.

STATEMENT OF DR. JOHN M. ALBERTINE, PRESIDENT, AMERICAN BUSINESS CONFERENCE, WASHINGTON, D.C.

Dr. ALBERTINE. Thank you, Mr. Chairman.

On behalf of the chairman of the American Business Conference and myself, Mr. Chairman, that we congratulate you for your consistency and your tenacity in looking at the command over economic resources exercised by the Federal Government. You are one of the few Members of the Congress that has been extremely tenacious on that subject, and I think the country owes you a great debt.

With respect to the issue of deficits, Mr. Chairman, it is clear to every chief executive officer of the American Business Conference—and I think every business person in America—that deficits effect the economy in adverse ways. Precisely how deficits affect the economy is a complex question. There are, in my judgment, very complex connections, but there is no question that most business people believe that deficits matter a great deal.

Let me just make three points about the deficits. First, I agree with the Secretary of the Treasury—and I know you have said this yourself, Mr. Chairman, on a number of occasions—that these deficits are symptoms of another problem. That is the Federal Government's growing command over resources in this economy through spending, through the credit allocation system, and through the regulatory system, and it has had the effect of slowing economic growth in the last 40 years. Second, there is no question that deficits do have an effect on real rates of interest. And, obviously, that directly affects the cost of capital in the United States. But it also affects the cost of capital in an indirect fashion, which is, frankly, more important. High real rates of interest have had the effect of depressing equity prices in the equity markets of America.

Mr. Chairman, I would like to submit for the record, if I could, a study which the American Business Conference produced recently by Dr. George Hatsopoulos on the cost of capital in the United States.

The CHAIRMAN. Let me just say it will be accepted for the record, but not be printed in the record.

Dr. ALBERTINE. The study, Mr. Chairman, shows that the cost of capital in the United States is about three times as high as the cost of capital in Japan. The main reason for that, Mr. Chairman, is that the debt/equity ratios in the United States are about the inverse of what they are in Japan, and equity is much more expensive than debt. Debt/equity ratios for 2,000 corporations that we looked at are about 1 to 3. In Japan, they are about 3 to 1.

The cost of equity is significantly higher than the cost of debt for two reasons. One is that equity holders bear a greater risk than debt holders so they require a higher rate of return. The second is the asymmetry in the tax code as it applies to equity versus debt. Interest payments are deductible to a corporation; dividend payments are not.

The importance of this, Mr. Chairman, is that our figures show—and we have no members who are a part of the steel industry of America or the automobile industry, as our companies are significantly smaller—that the basic industries in the United States, given these differentials, have been unable to compete effectively since 1965. In fact, if you were to criticize the management of the steel industry since 1965, rationally, you would have to fault them for not having liquidated the steel industry faster. We think it's terribly important that the cost of capital be reduced.

As far as the high tech sector is concerned, our numbers show that a Japanese corporation undertaking the exact same R&D activity as an American corporation can invest about five times as much as the American corporation. So our view is that the high tech sector is going to experience the same sort of thing that the basic industry sector has experienced since 1965.

That's one major reason we have to get these deficits under control. Mr. Chairman, with respect to how we would do it, we obviously share your view. I think we are very close to your position—we ought to look at the spending side first. We have some recommendations for specific spending reductions. One of my favorite is—and all three of us on this panel happen to be economists; we also happen to be economists who once worked for the Federal Government. There are 5,523 economists who work for the Federal Government, most of whom are in the business of generating econometric predictions which aren't worth a damn. Therefore, we think it might be useful, for example, for this Congress to take a look at that situation, and perhaps reduce some of those economists in the Federal Government.

We have a whole range of specific recommendations in our testimony.

Let me say, Mr. Chairman, finally, with respect to taxes, if tax increases become inevitable, as you have indicated, and I think the Secretary of the Treasury has indicated, we obviously would like to see a broad approach to a restructuring of the tax code and move toward a consumption based system.

Thank you, Mr. Chairman.

The CHAIRMAN. Go ahead if you have anything else that you wanted to add.

Dr. ALBERTINE. That's all, sir.

The CHAIRMAN. All right.

[The prepared statement of Dr. Albertine follows:]

TESTIMONY
OF
DR. JOHN M. ALBERTINE
PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE
BEFORE THE
SENATE FINANCE COMMITTEE
DECEMBER 13, 1983

GOOD AFTERNOON!

MY NAME IS JACK ALBERTINE, AND I AM THE PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE. THE ABC IS A COALITION OF 100 SUCCESSFUL ENTREPRENEURS. EACH OF OUR MEMBERS RUNS A COMPANY WHICH HAS DOUBLED IN SIZE OVER THE LAST FIVE YEARS. THEIR FIRMS ARE MID-SIZED -- EACH HAS ANNUAL REVENUES BETWEEN $25 MILLION AND $1 BILLION.

ALTHOUGH THERE ARE MANY REASONS FOR THE SUCCESS OF THE ABC FIRMS, I THINK THAT THE BIGGEST REASON IS THAT OUR CEO'S ARE CAN-DO PEOPLE. THEY BELIEVE THAT ANYTHING CAN BE DONE, THAT NOTHING IS IMPOSSIBLE, AND NO PROBLEM IS INSURMOUNTABLE. I'D LIKE TO APPLY THEIR ATTITUDE TO THE BUDGET CRISIS LOOMING EVER SO NEAR IN OUR COUNTRY'S FUTURE.

I KNOW I DON'T HAVE TO TELL YOU, MR. CHAIRMAN, THAT WE HAVE VERY LITTLE TIME LEFT TO DEFUSE THE DEFICITS. ACTION MUST BE TAKEN IN THE NEXT FEW MONTHS IN ORDER TO HAVE A SERIOUS IMPACT ON THE DEFICITS IN 1985 AND 1985. THE NEXT SIX MONTHS WILL BE CRITICAL TO OUR NATION'S ECONOMIC FUTURE. CLEARLY, WE CAN'T WAIT TO SEE WHAT WILL HAPPEN. IF REVENUES AND EXPENDITURES CONTINUE TO INCREASE AT THE SAME RATES AT WHICH THEY HAVE GROWN FOR THE LAST 18 YEARS, BY 1990, A MERE SIX YEARS AWAY, THE DEFICIT WILL EXCEED $500 BILLION. BY THE YEAR 2000, THE DEFICIT WILL EXCEED TWO TRILLION DOLLARS.

I DON'T SUBSCRIBE TO THE PHILOSOPHY THAT DEFICITS DON'T MATTER, MOST PEOPLE WHO AGREE THAT DEFICITS MATTER CONCENTRATE ON THE "CROWDING OUT" ARGUMENT. THEY MAINTAIN THAT, IN THE ABSENCE OF A RAPIDLY EXPANDING MONEY SUPPLY, THE MORE THE GOVERNMENT BORROWS TO FINANCE DEFICITS, THE LESS IS AVAILABLE FOR PRIVATE BORROWING AND INVESTING. AS A RESULT, THEY BELIEVE INTEREST RATES WILL RISE, AND ECONOMIC GROWTH WILL BE SLOWER THAN

IT WOULD BE IN THE ABSENCE OF EXTENSIVE GOVERNMENT BORROWING. THIS MAKES A LOT OF SENSE INTUITIVELY, BUT I CAN'T PROVE IT, AND I'VE YET TO SEE ANOTHER ECONOMIST WHO CAN.

IN THE LAST YEAR, THE DEFICIT HAS DOUBLED. YET, WE HAVE WITNESSED THE STRONGEST RECOVERY OF THE POSTWAR ERA. SOME SAY THIS PROVES THAT DEFICITS DON'T MATTER. I THINK THAT DEFICITS AFFECT THE ECONOMY IN A COMPLEX WAY WITH A COMPLEX LAG STRUCTURE.

I WOULD LIKE TO PUT ASIDE THE "CROWDING OUT" THEORY AND REFUTE THE "INNOCUOUS DEFICITS" ARGUMENT IN ANOTHER WAY. DEFICITS ARE AN INTER-GENERATIONAL TRANSFER OF INCOME FROM OUR CHILDREN TO US. THESE DEFICITS WILL PUT A TREMENDOUS BURDEN ON OUR CHILDREN AND OUR GRANDCHILDREN.

I AM NOT IMPLYING THAT OUR CHILDREN WILL HAVE TO PAY BACK THE NATIONAL DEBT. YET, AN EVER INCREASING PROPORTION OF THE FEDERAL BUDGET WILL HAVE TO BE ALLOCATED TO FINANCING THE DEBT THAT WE ARE SO WANTONLY INCURRING TODAY. THE NEXT GENERATION WILL FACE HIGHER TAXES AND DIMINISHED FEDERAL SERVICES JUST TO

PAY THE INTEREST CHARGES ON THE DEFICITS WE ARE RUNNING RIGHT NOW. FOR THE FIRST TIME IN AMERICAN HISTORY, OUR CHILDREN COULD HAVE LESS THAN THEIR PARENTS. I DON'T THINK HUGE FINANCE CHARGES OR AN ENORMOUS NATIONAL DEBT ARE THE LEGACY AMERICANS WANT TO LEAVE FOR FUTURE GENERATIONS.

THERE IS ANOTHER REASON WHY DEFICITS ARE IMPORTANT. THEY REFLECT THE PERCENTAGE OF GNP THAT GOES TO THE GOVERNMENT SECTOR. HIGH DEFICITS ARE THE RESULT OF HIGH FEDERAL SPENDING. ECONOMIC GROWTH COMES FROM THE PRIVATE SECTOR, NOT THE GOVERNMENT. WHEN THE GOVERNMENT COMMANDS MORE AND MORE OF THIS NATION'S GNP, THERE ARE FEWER OPPORTUNITIES FOR ECONOMIC GROWTH. OVER THE LAST DECADE, THROUGH TAXES, REGULATION, AND SPENDING, THE FEDERAL GOVERNMENT HAS EXERCISED GREATER CONTROL OVER THE PRIVATE ECONOMY. BY 1981, PRODUCTIVITY AND ECONOMIC GROWTH WERE AT A SNAIL'S PACE. I THINK THAT MANY OF THOSE SPENDING DECISIONS SHOULD BE MADE BY THE PRIVATE SECTOR, NOT THE FEDERAL GOVERNMENT.

I think the time has come for the Congress to take a serious look at government spending. The federal budget has more sacred cows than all of India. It's time for some of these holy heifers to bite the dust.

The private sector has been so concerned about the deficits that it has contributed more than $75 million to finance a study of ways that the federal government could cut spending by applying business-like management techniques. The President's Private Sector Survey on Cost Control -- the Grace Commission -- proposed more than $300 billion in spending reductions and revenue enhancers for the next three years. About 60% of these proposals would require Congressional action. About 40% are administrative in nature. I understand that the White House is already acting to implement many of the administrative proposals.

THE GRACE COMMISSION'S PROPOSALS ARE MORE THAN SUGGESTIONS TO CUT WASTE AND INCREASE EFFICIENCY IN GOVERNMENT. THEY ARE FUNDAMENTAL REFORMS OF SOME OF THE IRRATIONAL WAYS OUR GOVERNMENT DOES BUSINESS. THEY PROPOSE THAT INSTEAD OF WRITING OFF ITS BAD DEBTS, THE GOVERNMENT TRY TO COLLECT THEM OR CONTRACT THEM OUT TO COLLECTION AGENCIES JUST AS OTHER BUSINESSES DO.

THEY SUGGEST THAT THE COAST GUARD SHOULD CHARGE FOR OR CONTRACT OUT NON-EMERGENCY SHIP TOWING. IF MY CAR BREAKS DOWN, THE GOVERNMENT WON'T TOW IT FOR FREE, SO WHY SHOULD THEY TOW MY BOAT FOR FREE? IF MY CAR BREAKS DOWN IN THE MIDDLE OF CONSTITUTION AVENUE, THE DISTRICT OF COLUMBIA WOULD PROBABLY TOW IT AWAY, BUT I'D HAVE TO PAY TO GET IT BACK. THE GRACE COMMISSION IS RIGHT--THERE IS NO REASON WHY THE COAST GUARD SHOULD SUBSIDIZE BOAT OWNERS. I UNDERSTAND THAT YOU HAVE GOOD CONNECTIONS AT THE COAST GUARD, MR. CHAIRMAN, AS IT IS UNDER THE JURISDICTION OF THE SECRETARY OF TRANSPORTATION.

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I'M SURE THAT, GIVEN THE LIMITATIONS OF TIME AND MONEY WHICH CONSTRAINED THOSE WORKING ON THE SURVEY, A HANDFUL OF THEIR MANY PROPOSALS MAY BE INAPPROPRIATE AND INAPPLICABLE. YET, SOME HAVE USED A FEW EXAMPLES AS REASONS TO IGNORE THE ENTIRE REPORT. I HOPE, MR. CHAIRMAN, THAT YOU WILL OVERLOOK ITS FEW DEFICIENCIES AND COMMEND IT TO YOUR COLLEAGUES AS THE STARTING POINT FOR INSTILLING FURTHER EFFICIENCY IN OUR GOVERNMENT. THE GRACE COMMISION REPORT GIVES THE CONGRESS A BLUEPRINT FOR DEFICIT REDUCTION.

ONE OF THE AREAS WHICH I FEEL IS MOST IN NEED OF REFORM IS THE FEDERAL CIVIL SERVICE SYSTEM. AS YOU KNOW, I'M AN ECONOMIST. THE FEDERAL GOVERNMENT HAS 5,521 ECONOMISTS ON ITS PAYROLL. SOME PREPARE ECONOMIC STATISTICS AT THE BLS AND THE BEA. SOME PREPARE BUDGET NUMBERS AT OMB. MANY PROVIDE INACCURATE ECONOMIC FORECASTS. I'M NOT SURE WHAT ALL OF THESE PEOPLE DO, BUT I AM SURE THAT THERE ARE TOO MANY OF THEM.

WHY IS THERE AN ASSISTANT SECRETARY FOR ECONOMIC POLICY IN EACH OF THE DEPARTMENTS? FOR ONE MAIN REASON: TO FIGHT OMB. THE COMMERCE DEPARTMENT HAS ENOUGH CHIEF ECONOMISTS TO HOLD TRIBAL CONVENTIONS. I SAY, LET OMB AND THE COUNCIL OF ECONOMIC ADVISERS BE IN CHARGE OF ECONOMICS AND FIRE HALF THE ECONOMISTS ON THE FEDERAL PAYROLL. THIS WOULD SAVE ABOUT $100 MILLION PER YEAR.

I HOPE THE LAWYERS ON THIS PANEL WILL WISH THE SAME FOR THEIR BARRISTER BRETHREN IN THE FEDERAL GOVERNMENT--ALL 17,118 OF THEM. IF YOU FIRED HALF THE LAWYERS IN THE GOVERNMENT, YOU WOULD SAVE OVER $350 MILLION PER YEAR.

ON A RELATED TOPIC, I HAVE RARELY SEEN THE FRUIT OF ANY OF THE BILLIONS OF DOLLARS OF ECONOMIC RESEARCH FUNDED BY THIS GOVERNMENT. BY THE TIME AN ECONOMIC PROBLEM IS DELINEATED, AN RFP ISSUED, A CONTRACTOR SELECTED, AND THE REPORT FINISHED, EITHER THE ORIGINAL ISSUE NO LONGER MATTERS, OR THE ADMINISTRATION HAS CHANGED AND NO ONE CARES ABOUT THE PROBLEM AT

ALL. MOST OF THIS ECONOMIC RESEARCH MONEY IS DISTRIBUTED LIKE MANNA TO FRIENDS, TO FORMER EMPLOYERS AND TO FUTURE EMPLOYERS OF MID AND SENIOR LEVEL ECONOMISTS IN THE EXECUTIVE BRANCH. I DON'T MEAN TO IMPUGN THE QUALITY OF THIS RESEARCH, BECAUSE THAT IS NOT THE ISSUE. THE PROBLEM IS THAT THE CONCLUSIONS OF THESE STUDIES ARE ALMOST NEVER IMPLEMENTED. I DON'T SEE WHY WE SHOULD CONTINUE TO PAY FOR STUDIES THAT ARE NEVER USED.

THE LABOR DEPARTMENT, FOR EXAMPLE, SPENT IN THE MID-SIX FIGURES TO STUDY INDUSTRIAL POLICY IN THE LAST FEW MONTHS OF THE CARTER ADMINISTRATION. THE STUDY WAS SOLE-SOURCED, BUT LABOR DEPARTMENT OFFICIALS HAD SO LITTLE FAITH IN THE CONTRACTOR THEY HAD CHOSEN THAT THEY HAD THEIR STAFF DRAFT THE MAJOR REPORTS AND SEND THEM TO THE CONTRACTOR. TAXPAYERS GOT TWO OPPORTUNITIES TO PAY FOR A STUDY THAT WAS NEVER IMPLEMENTED.

YOU WON'T SAVE A TRILLION DOLLARS BY AXING ECONOMISTS AND ELIMINATING SPENDING FOR OUTSIDE ECONOMIC RESEARCH. BUT, I THINK FEDERAL SPENDING WILL HAVE TO BE CUT THROUGH HUNDREDS OR THOUSANDS OF SMALL REDUCTIONS AS WELL AS A HANDFUL OF LARGE ONES.

ONE LARGE SACRED COW THAT I WOULD LIKE TO SEE SKEWERED IS THE CIVIL SERVICE RETIREMENT SYSTEM. TO PARAPHRASE CHURCHILL, NEVER IN THE COURSE OF HUMAN EVENTS HAVE SO FEW GOTTEN SO MUCH FOR SO LITTLE. THROW THOSE GOVERNMENT EMPLOYEES' LOBBYISTS OUT OF YOUR OFFICES. NO ONE IN THE PRIVATE SECTOR HAS SUCH A GENEROUS RETIREMENT PROGRAM. TALK ABOUT GOLDEN PARACHUTES . . .

I DON'T THINK IT'S ENOUGH THAT ALL NEW GOVERNMENT EMPLOYEES GO DIRECTLY INTO THE SOCIAL SECURITY SYSTEM. FOR CURRENT EMPLOYEES WITH LESS THAN FIFTEEN YEARS OF SERVICE, SUBTRACT THE CONTRIBUTIONS THEY WOULD HAVE MADE TO SOCIAL SECURITY FROM THEIR RETIREMENT CONTRIBUTIONS, ISSUE THEM A CHECK FOR THE DIFFERENCE

AND RETROACTIVELY PUT THEM UNDER SOCIAL SECURITY. ALTHOUGH IT PAINS ME, I THINK THAT THOSE WITH FIFTEEN YEARS OF SERVICE SHOULD BE ALLOWED TO GET THEIR CIVIL SERVICE RETIREMENT. I MAY BE SOFT-HEARTED, BUT WHEN YOU'VE EXPECTED SOMETHING FOR FIFTEEN YEARS IT MAY BE DIFFICULT TO RE-ADJUST.

I THINK THAT DOUBLE AND TRIPLE DIPPERS SHOULD BE ALLOWED TO AVOID TAX ON THEIR ADDITIONAL RETIREMENT CHECKS ONLY IF THEY SAVE THEM. WE SHOULD SET UP TADDSA'S--TRIPLE AND DOUBLE DIPPER SAVINGS ACCOUNTS--ALONG THE SAME LINES AS IRA'S. YOU WOULD BE ALLOWED ONE FEDERAL PENSION CHECK TAX FREE. ANY ADDITIONAL CHECKS WOULD BE TAXED UNLESS THEY WERE SAVED. INCOME WITHDRAWN FROM TADDSA'S WOULD BE SUBJECT TO INCOME TAX. THE EXTRA SAVINGS INDUCED BY TADDSA'S WOULD HELP COMPENSATE FOR THE ADDITIONAL FEDERAL SPENDING OUTFLOW AND STRENGTHEN THE ECONOMY.

IF IT IS NOT POSSIBLE TO CUT GOVERNMENT SPENDING THROUGH THE AGGREGATION OF MANY SMALL SPENDING CUTS, THEN I WOULD SUPPORT A 10% TAX ON GOVERNMENT. YOU HAVE SUPPORTED A SURTAX ON BUSINESS. WELL, BUSINESS, WHICH SEES SPENDING CUTS A LOT LESS OFTEN THAN IT SEES TAX INCREASES, WANTS TO PUT A TAX ON THE GOVERNMENT. IF SPENDING CUTS LIKE THOSE CONTAINED IN THE GRACE REPORT RUN INTO THE PROVERBIAL CONGRESSIONAL STONEWALL, I THINK WE SHOULD JUST FORCE THE APPROPRIATIONS COMMITTEES TO RETURN 10% OF THEIR FUNDS TO THE TREASURY. THIS MAY SOUND DRACONIAN, BUT IF CERTAIN MEMBERS OF CONGRESS INSIST ON BLOCKING ALL EFFORTS TO CUT SPENDING, I DON'T KNOW WHAT ELSE YOU CAN DO. THE CONGRESS CAN'T SPEND ALL ITS TIME ON BUDGET ISSUES ALONE.

I ALSO ENDORSE THE CONCEPT OF A LINE ITEM VETO OR GIVING ADDITIONAL IMPOUNDMENT AUTHORITY TO THE PRESIDENT. I REALIZE THAT THIS WOULD MEAN THAT THE CONGRESS WOULD HAVE TO CEDE SOME POWER TO THE EXECUTIVE BRANCH. HOWEVER, AT THIS JUNCTURE I THINK

THIS IS THE ONLY WAY TO RESPOND TO SOME OF THE IRRESPONSIBLE, PORK BARREL SPENDING PROGRAMS SUPPORTED BY A HANDFUL OF SHORT-SIGHTED LEGISLATORS. PERHAPS, IT WOULD BE ENOUGH TO GIVE THE PRESIDENT ADDITIONAL IMPOUNDMENT AUTHORITY FOR JUST A FEW YEARS.

TODAY, I HAVE SPOKEN PRIMARILY ABOUT SPENDING CUTS. LAST YEAR, AS YOU KNOW, I LED THE COALITION OF BUSINESS GROUPS THAT SUPPORTED THE PASSAGE OF TEFRA. WE WERE PROMISED $3 IN SPENDING CUTS FOR EVERY $1 OF TAX INCREASE. INSTEAD, WE GOT A DOLLAR OF SPENDING INCREASE FOR EVERY DOLLAR OF TAX INCREASE, AND, ON NET, THE BUDGET DEFICIT DID NOT BUDGE.

THIS YEAR, I WANT TO SEE SOME SIGNIFICANT SPENDING CUTS BEFORE I TALK TAXES. I THINK YOUR PHILOSOPHY ON THIS SUBJECT IS SIMILAR TO MINE -- NO TAX INCREASES AT ALL WITHOUT IRREVOCABLE BUDGET CUTS. IF TAX INCREASES ARE INEVITABLE, ONCE THE SPENDING

CUTS HAVE BEEN SECURED, THE CONGRESS SHOULD ONLY CONSIDER TAX INCREASES WHICH WILL STIMULATE SAVINGS AND INVESTMENT. A LOW CONSUMPTION TAX, WHICH WOULD BE PARTIALLY REBATED THROUGH EXPANDED IRA'S, PERSONAL AND CORPORATE RATE REDUCTIONS, AND INCENTIVES FOR SAVINGS AND INVESTMENT, WOULD BE IN THE BALLPARK, PROVIDED, OF COURSE, THAT THE SPENDING CUTS ARE IN HAND AND NOT IN THE BUSH.

MR. CHAIRMAN, I'M EXTREMELY PLEASED THAT YOU HAVE CALLED THIS HEARING. IT'S GOOD TO SEE THAT THERE IS AT LEAST ONE MAN IN THE CONGRESS WHO REALIZES THAT THE TIME HAS COME TO GET TOUGH ON THE DEFICITS.

THANK YOU.

The CHAIRMAN. Jerry.

STATEMENT OF JERRY JASINOWSKI, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, D.C.

Mr. JASINOWSKI. Thank you very much, Mr. Chairman.

The CHAIRMAN. We didn't list Jerry as an economist. No, I guess we did.

Mr. JASINOWSKI. Thank you very much, Mr. Chairman. The National Association of Manufacturers is delighted to be a part of these important hearings. I join with Jack Albertine and the members of our association in commending you for the consistent focus that you have put on this issue.

I have a long statement, which I would like to summarize. Dealing with the deficit is a little bit like the challenge that faced Sisyphus. Sisyphus, as you may recall, was not a fieldgoal kicker for the Green Bay Packers. He was a Greek king who was condemned in hell to constantly push a large stone up a hill, only to see that stone continually roll back.

I was struck this morning, as I am sure you were, and many others, that that's a bit like what the deficit problem is. As I looked at the CBO numbers that were released yesterday, they showed that we face potentially a $280 billion deficit in fiscal 1989, that the national debt may double in 6 years, and that the interest payments on the debt will grow faster than the rate of growth of the gross national product. If the cost of financing the national debt grows faster than the economy, it will increase the size of future deficits and call into question our very ability to pay for those deficits.

There is for the first time, it seems to me, the potential for these deficits to become self-perpetuating. The major cause for the deficit, as we have argued before, is spending increases that have exceeded our revenue base. Receipts today are 20 percent of GNP, which is what they were more or less in 1970. Over the same period, our outlays have jumped 5 percentage points in relation to GNP, from 20 to 25 percent because of the massive increase in transfer payments in the seventies, and more recently because of defense and interest rate payments.

The adverse effects of these large deficits in addition to the possibility they may become self-perpetuating are outlined in our testimony in detail, and include lower levels of capital formation and productivity growth, the potential for increased inflation, higher interest rates, continued over-valuation of the dollar and lost trade competitiveness, and increased future business cycle instability.

Clearly we must act to reduce these huge deficits and define a way to keep these deficits under control in the future. It seems to me that the projected deficits need to be reduced by about $100 billion in order to bring the full employment budget deficits into some balance over the business cycle.

At the minimum, at the minimum, neither the national debt nor the debt service thereon should be permitted to increase faster than the growth in the economy in a recovery period. If they do, we risk losing control of the deficit situation completely.

To deal with this, Mr. Chairman, we don't have answers that are definitive. Still, I would submit the following five items to guide this committee.

We continue to believe quite strongly that the primary strategy for lowering Federal deficits must consist of across-the-board reductions in the growth of Federal spending, including social security, medicare and defense spending.

Second, no new entitlement programs should be created and all existing index entitlement programs, including social security, should be indexed to something less than 100 percent of the CPI, which overstates the rate of inflation.

Third, the budget process should be strengthened through spending limitations either in terms of across-the-board percentage cuts or by holding spending to a specified percentage of GNP. A limit should be placed on Federal credit activity.

Fourth, we urge that any future deficit reduction package be structured so that, as you have indicated yourself, on a year-by-year basis no planned tax increase will go into effect until there has been an objective, clear, certifiable indication that spending cuts have been made and are at least greater than any tax increases.

Finally, it may be that the deficit reduction efforts being made necessitate a package which combines expenditure reductions with revenue increases. If so, Congress and the administration should carefully investigate, making major structural revisions of our tax laws, such as a consumption tax.

That completes my testimony, Mr. Chairman.

The CHAIRMAN. Well, thank you very much.

[The prepared statement of Mr. Jasinowski follows:]

STATEMENT OF

JERRY J. JASINOWSKI

EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST

OF THE

NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SENATE FINANCE COMMITTEE

ON THE FEDERAL DEFICIT AND THE ECONOMY

DECEMBER 13, 1983

I am Jerry Jasinowski, Executive Vice President and Chief Economist of the National Association of Manufacturers (NAM).

The National Association of Manufacturers is a voluntary business association of over 13,000 corporations, large and small, located in every state. Eighty percent of the firms are considered to be small businesses. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council. On behalf of our members, we are pleased to have this opportunity to present our views on the federal deficit and to discuss what would be an appropriate posture for fiscal policy in the stabilization of the macroeconomy.

This statement sets forth (1) an overview of the current and projected magnitudes of federal deficits; (2) a description of the longer term causes of the rise in federal deficits and the trends that have affected fiscal policy in general; (3) a discussion of the economic significance of the deficits; and (4) an analysis of various policy options for dealing with the deficit issue.

MAGNITUDE OF THE DEFICITS

According to recent preliminary projections by the Congressional Budget Office (CBO), the federal deficit will amount to $194 billion in FY 1984 and, after several years at the same level, will begin to rise again for the balance of the decade. The deficit is projected at $192 billion in FY 1985, $197 billion in FY 1986, $227 billion in FY 1987, $249 billion in FY 1988, and $280 billion in FY 1989. This translates into a brief decline and then an upsurge in the ratio of the deficit to gross national product (GNP), which is projected at 5.5% in FY 1984, 4.9% in FY 1985, 4.7% in FY 1986, 5.0% in FY 1987, 5.1% in FY 1988 and 5.3% in FY 1989. Thus, throughout the balance of the decade--and despite reasonably good economic growth assumptions--the real magnitude of the deficits as expressed as a ratio to GNP will continuously surpass all postwar precedents.

Table 1 provides the preliminary CBO deficit projections and other related figures in columnar form. Among other things, this Table indicates that the standardized full employment deficit will rise continuously throughout the remainder of the 1980's until it has increased by more than half, beginning at 3.0% of GNP in FY 1984 and ending at 4.6% of GNP in FY 1989. This tends to indicate that, even as we move towards full employment, we will still be putting excessive stimulus into the economic system through large deficits.

It must be recognized, of course, that projecting deficits is a somewhat inexact science. Nevertheless, in recent years it appears the tendency has been to underestimate them, so that we are well advised to treat these figures quite seriously in examining our policy options.

In this regard the most troubling projection, in my judgment, relates to the national debt. As shown in Table 1, the national debt will increase in size from 37.5% of GNP in FY 1984 to 47.8% of GNP in FY 1989. This means a doubling in the size of the national debt in six years.

As a direct result of this extraordinary growth in the national debt, annual debt service requirements on the national debt will be 71% higher in FY 1989 ($178 billion) than in FY 1984 ($104 billion). However, GNP in FY 1989 ($5.33 trillion) will only be 49% higher than in FY 1984 ($3.56 trillion). This spread in growth rates (71% vs. 49%) should be viewed with considerable alarm. For debt service on the national debt to increase at a much faster rate than the economy in general calls into question our ability to meet such debt service requirements through politically acceptable tax and spending policies. It also means that we are moving towards placing an insupportable burden on future generations.

ORIGINS OF THE PRESENT SITUATION

Over the past two decades, there has been a trend toward an increase in the share of national income accounted for by the federal government. The cyclically adjusted trend for real federal expenditures has been upward, from less than 18% of GNP in the late 1950s to 21.5% in 1968 at the height of the Vietnam War, to an average of over 22% in 1975-78 and finally to over 24% in 1983. Along with the tendency toward a rise in the ratio of federal outlays to GNP, there has been a corresponding tendency toward increases in the ratio of the deficit to GNP. (These and related figures are set forth in Table 2.)

The causes of this expansion of the federal sector have been manifold. During the late 1960s, fiscal policy developments were dominated by the Vietnam War, and by the reluctance (until 1969) of the Johnson administration to finance the war through a tax increase, or to compromise on its social programs sufficiently to keep the budget in equilibrium. Interestingly, the social programs of the Great Society era were in themselves relatively modest compared to what came later.

It was primarily in the 1970s that transfer payments and other social program costs began to place significant upward pressure on overall federal outlays, driving them from 20% to 24% of GNP. During this period, transfer payments rose from 27% to 47% of federal outlays while defense spending slipped from 44% to 26% of federal outlays (see Table 3).

One of the major causes of budgetary uncontrollability has been indexation which, interestingly enough, was initially adopted in order to depoliticize the issue of cost-of-living adjustments in federal entitlement programs. Since the index used for cost-of-living adjustments was the consumer price index (CPI), which is widely recognized as having overstated the inflation rate during the late 1970s, transfer payments expanded far more rapidly than the cost of living would have warranted. A longer run obstacle to the effective control of transfer payments has had to do with demographic factors, in particular the increase in the ratio of recipients to contributors in such programs as Social Security. As a result, outlays for pensions and Social Security are projected to double by the next decade, despite the fact that the inflation rate is expected to be lower than it was during the 1970s. This combination of factors--demographic pressure on social programs in conjunction with indexation--has caused transfer payments to rise to about 48% of federal outlays in FY 1983, and has resulted in an increasing share of the budget being classified as uncontrollable.

When indexed transfer payments are added to debt service and prior year obligations, the share of the federal budget classified as uncontrollable rises from about two-thirds in FY 1969 to four-fifths in FY 1975. Thereafter, although some progress has been made, the share of the budget classed as uncontrollable is still higher on average than during the late 1960s. In FY 1983, about three-quarters of all federal outlays were still classified as uncontrollable.

While transfer payments in our view continue to be unacceptably high, their growth pattern seems to have leveled off and may undergo a modest decline over the next several fiscal years (see Table 3). Unfortunately, this decline is matched almost exactly by offsetting increases in both defense spending and interest costs. From FY 1983 to FY 1986, defense is projected as rising from 26% to 30% of federal outlays, with interest costs rising from 11% to nearly 13% of federal outlays during the same period. The net result is that federal outlays will continue to be a relatively constant 24% to 25% of GNP.

Government revenues, on the other hand, have for the past decade been fairly consistently in the range of 19% to 20% of GNP and will continue at approximately that level. The "tax cuts" enacted in 1981, viewed in the proper perspective, did not really reduce levels of taxation but instead have resulted primarily in maintaining federal revenues at a relatively constant percentage of GNP over the past decade. Government outlays, however, now account for an additional 5% of GNP compared to ten years ago. This latter increase is the real source of our deficit problem.

ECONOMIC IMPLICATIONS OF LARGE DEFICITS

The emergence of extremely large deficits during the past few years and the longer-term tendency toward an increase in the ratio of federal spending to GNP have brought into sharp relief the question of the wider economic implications of such deficits.

Deficits and Inflation

When deficits are financed through additional money creation (i.e., if the Federal Reserve creates new bank reserves through purchases of government debt), the resulting increases in the money supply will yield increases in aggregate demand that ultimately lead to inflation. This was clearly in evidence during the late 1960s when the Vietnam War deficits were financed through excess money creation rather than by raising taxes.

It also seems to me that large deficits will inevitably give rise to political pressure for excessive money creation, since the resulting increases in the national debt have to be financed somehow. This would seem to be particularly true in the case of extremely large deficits (e.g., those in the annual range of 200+ billion) occurring during a period of economic recovery. There is then an understandable reluctance to raise taxes and/or cut spending in the amounts necessary to meet numbers of such magnitude, which tends to leave only the monetary option.

Deficits and Interest Rates

In recent years, high interest rates appear to have been caused in part by expectations that large federal deficits will cause major problems in the future, e.g., inflation, "crowding out," etc. During 1980-81 in particular, there were widespread fears in the financial markets that the anticipated deficits would be accommodated monetarily, leading to expectations of higher inflation and causing financial decision-makers to raise the inflation premium on loans. Then, when it became apparent that the Federal Reserve would offset rather than accommodate the deficits, expectations of future interest rates were raised since financial decision-makers generally understood that large deficits would continue to "crowd out" the private sector and keep real interest rates abnormally high.

In situations where private sector demand for credit is high or savings are small relative to private and public sector demand for credit, large deficits, to the extent they are not financed through money creation, will tend to "crowd out" the private sector in credit markets, leading to higher interest rates. This problem has the potential to become acute in the coming years. The federal participation rate in capital markets in FY 1980-81 increased to just under 34% of all funds raised (see Table 2). In FY 1982, it reached 48.9%. In FY 1983 it is estimated at about 68%, and for FY 1984 it is projected at 62%. Assuming no changes in the savings rate, the federal participation rate in capital markets is likely to average 50% to 60% over the next few fiscal years.

The implications of this for interest rates are particularly serious inasmuch as it will coincide with an expanding economy. As the borrowing requirement of the federal government increasingly comes into conflict with the credit needs of the private sector, this will further raise interest rates and will keep interest rates during the upcoming business cycle at levels that are unprecedented for a postwar recovery.

Misalignment of Exchange Rates

The current mix of relatively tight monetary policy and extremely loose fiscal policy is the single most important factor responsible for the overvaluation of the dollar since 1981. The rise in U.S. interest rates and the resulting differential in real rates of return vis-a-vis other countries have led to increased world demand for dollars to purchase dollar-denominated financial assets. A related factor has been the increased volume of U.S. government debt instruments issued in global financial markets. In FY 1983, approximately 16% of total issuances of Treasury debt were held by foreign sources. To the extent that the large deficits projected for the balance of the decade cannot be financed by domestic borrowing, they will be financed through continued reserve inflows, thereby keeping the dollar overvalued.

This overvaluation has had a series of adverse effects on both the domestic and global economies. In a purely domestic sense, the misalignment in exchange rates has led to a deterioration in our trade competitiveness, yielding a substantial drop in export volume and aggregate economic activity. At the same time, the fall in the relative price of imports associated with the appreciation of the dollar has led to an increase in the ratio of imports to total consumption, further reducing U.S. employment. At a global level, the appreciated dollar has forced the other industrial countries to apply restrictive policies to prevent further depreciation in their exchange rates, support the balance of payments and mitigate reserve outflows. This was substantially responsible for the prolongation of the world recession in 1981-82, and for the sluggish pace of worldwide recovery in 1983. It is difficult to overstate the adverse international repercussions that stem from the monstrously large current and projected federal deficits.

Business Cycle Instability

In normal macro-policymaking, the full employment budget is used as a cyclically neutral measure of the impact of fiscal policy on aggregate demand. A budget deficit at full employment implies that fiscal policy is excessively expansionist, confronting policy-makers with an unfavorable choice of alternatives. Accommodating the full employment deficit through looser money leads to overheating of the economy followed by accelerating inflation, while offsetting the deficit through monetary restriction results in "crowding out" and higher interest rates. Since this can result in severe fluctuations in interest rates, a deficit at high employment can result in destabilization of financial markets and the macroeconomy whether or not it is accommodated.

Historically, the impact of fiscal policy on the business cycle has tended to be destabilizing more often than not. During the early 1960s when the full employment budget was in balance, the economy converged to its equilibrium growth trajectory with a stable non-accelerating inflation rate in the 1% range. However, beginning with the Vietnam War escalation of the late 1960s and continuing through the following decade and a half, the full employment budget exhibited chronic disequilibrium. During relatively late stages in the business cycle when fiscal policy should have become restrictive in order to prevent the economy from overheating, the stance of fiscal policy remained consistently over-expansionist. The large full employment deficits recorded in 1968, 1972 and 1977-78 confirm this point. The net outcome was the overheating of the economy during the booms of the late 1960s and the early and late 1970s.

Essentially the same outcome can be expected over the next several years, except that the Federal Reserve is expected to offset the stance of fiscal policy, with the result that the main impact of the expansionary fiscal posture will be to keep real interest rates high. This in turn will tend to produce unbalanced growth. Several key sectors of the American economy--housing, durable goods and capital equipment--are critically sensitive to the cost and availability of long-term debt, so that continued high interest rates will impair the ability of these industries to participate fully in the current recovery.

Continued high interest rates in the 1980's, when combined with the large deficits currently being projected (and which could be enlarged in another recession), also could create a self-perpetuating situation where an ever-increasing portion of each annual deficit is attributable to rising debt service requirements. This could lead to almost complete loss of control over the national debt.

Deterioration in Productivity Growth and Other Adverse Effects

An increase in the ratio of the deficit to GNP can be associated with lower levels of capital formation and productivity growth. This takes place through several channels. The negative effect of deficits on investment spending occurs mainly through the increase in the user cost of capital--the rise in interest rates associated with higher government borrowing prevents business from borrowing to finance new investment. The diminution of credit flows to the private sector resulting from heavy government borrowing also results directly in a fall in funds available for plant and equipment spending, which typically requires recourse to long-term borrowing. Because productivity growth is highly correlated with the capital-labor ratio, decreases in capital formation are in turn normally associated with slower productivity gains.

In addition to changes in the user cost of capital and the "crowding out" process, a secondary effect takes place through changes in the output mix. Increases in the share of GNP accounted for by the public sector engender a shift in the sectoral composition of output from manufacturing to services. Since services are less capital intensive and exhibit lower productivity growth than manufacturing, the change in the output mix produced by fiscal expansion also works against gains in investment and the ratio of output to labor.

Another implication of large deficits has to do with intergenerational wealth transfers. As a result of the current deficits, both the real national debt and the debt service ratio (the share of GNP comprised by net interest payments) will increase substantially during the late 1980s. The result is that future generations will have to sacrifice an increased share of their consumption in order that the government may make payments on the national debt.

Given all of the foregoing, the most essential priority for Congress in the area of fiscal policy over the next few years is the development of a budgetary program more commensurate with macroeconomic stability. This should consist of a major reduction in deficits achieved primarily through phased cuts in outlays. Such a policy would have a series of beneficial effects on the economy.

First, reductions in outlays will mitigate the current over-expansionary stance of fiscal policy and lower the risk of destabilizing the business cycle. By lowering the amount of fiscal stimulus provided by the budget, it will be possible to bring the economy closer to its long-term equilibrium growth trajectory. In essence, a less stimulative fiscal posture will eliminate the current adverse range of choice between allowing the economy to overheat as it has during prior recoveries, or forcing interest rates to rise by non-accommodation of the fiscal stimulus.

Second, reductions in spending will facilitate a more permanent reduction in interest rates. This will take place through two channels. The reduction in aggregate demand resulting from spending cuts will lead to slower credit demand, and at the same time, lower federal credit needs will mitigate the "crowding out" problem in capital markets. In this respect, a lower federal participation rate in credit markets will result in increased capital flows to the private sector and greater credit availability for purchases of housing, durable goods and capital equipment. Therefore, in the long run, lower federal spending should create the basis for sustainable growth in those manufacturing and other industries which are highly sensitive to interest rates.

Third, reductions in both interest rates and the volume of Treasury securities issued in global financial markets will help to achieve a more realistic exchange rate for the dollar. This will generate an improvement in trade competitiveness, leading ultimately to higher employment. At the same time it will alleviate the balance of payments constraint on demand management in the other industrial countries, enabling them to pursue more expansionary policies, stimulating faster worldwide economic growth.

ALTERNATIVES FOR CONTROLLING DEFICITS

Controlling deficits will require that we move ahead on several fronts including: adhering to proper fiscal policy rules; implementing procedural improvements in the Congressional budgeting process; and reducing the growth of federal spending across-the-board. Increased taxes are not the appropriate economic means for reducing the deficits. Moreover, any examination of tax increase alternatives should, if we are to increase productivity growth and our ability to compete in international markets, avoid options that place increased burdens on savings and investment.

Suggestions for Fiscal Policy Rules

Clearly, we must act to reduce large deficits and to find a way to keep deficits under control in the future. A necessary step towards this end is the development of a workable rule (or set of rules) by which to measure government fiscal policy. One possible rule which suggests itself is that Congress should bring the full employment budget into surplus over the next business cycle, and hold it in surplus permanently thereafter. By maintaining the full employment budget in surplus, the asymmetry between fiscal and monetary policy would be substantially reduced. Further, reduction of the deficit to a level commensurate with a permanent surplus at full employment would leave the stance of fiscal policy more compatible with stable economic growth. With the full employment budget in surplus, the actual budget would be in approximate equilibrium over the business cycles: surpluses would occur during periods of high growth, and would effectively offset deficits incurred during recessions.

In order to bring the full employment budget into surplus, the deficit would have to be reduced by approximately $100 billion (in current dollars). Rather than attempt to achieve this in a single year, however, it would be more desirable to achieve the full employment budget surplus more gradually, for instance, over a period of three years or so.

A more practical deficit control rule that seems to have merit--and that should be considered as a minimum--is that neither the national debt nor the debt service thereon should be permitted to increase faster than the growth of the economy in a recovery period. As mentioned previously, one of the truly alarming aspects of the economic projections for the balance of the 1980s is that both the national debt and the related debt service requirements will outstrip GNP growth by considerable margins, so that by 1989 the national debt will equal almost half of annual GNP (up from a little over a third today). Optimally, increases in debt and debt service should be held as low as possible and if possible eliminated. At the least, however, they should not grow faster than GNP. If they do, we risk losing control of the deficit situation completely.

<u>Deficit Reduction Techniques</u>

We continue to believe quite strongly that the primary strategy for lowering federal deficits must be across-the-board reductions in the growth rate of federal spending. It is also our view that such reductions should be spread as evenly as practicable over all portions of the federal budget, including Social Security, Medicare and defense spending. To do otherwise and hold certain segments immune from reductions will simply not get the job done.

Set forth below are a number of specific spending reduction techniques which we think deserve consideration.

<u>Curtailment of Entitlement Spending</u>. As noted previously, the enormous growth of indexed entitlement programs has been a major factor in the growth of government spending to its present level of about 24% of GNP. We can never hope to control deficits without reducing the growth of entitlement spending. Our recommendations in this regard are twofold. First, no new entitlement

programs should be created. Second, all existing indexed entitlement programs, including Social Security, should be indexed to something less than 100% of CPI increases. In this regard, there seem to be two major options: reducing the indexing formula by a specified number of percentage points (e.g., CPI increase minus 3%) or holding the index to a percentage of CPI increase (e.g., 60% of CPI). Both approaches would produce major savings.

Freeze Proposals; Spending Limitations. We have in the past supported the concept of freezing federal spending at current levels (or at current levels plus a modest growth increment) and continue to do so. An enforceable overall freeze may be one of the few techniques for imposing the across-the-board sacrifices for which the Congress otherwise seems to lack the willpower. A possibly more viable variation of this technique would be a statutory spending limitation which limits aggregate federal outlays to a specified percentage of GNP. Such a limitation might be even more effective if combined with a requirement that there be a greater-than-majority (e.g., 60%) vote in the Congress to permit taxes to be increased faster than the rate of GNP growth.

Limits on Federal Credit Activity. We believe that binding limits should be established for all federal credit activity. Such limits should be enforced through the authorizations and appropriations process, primarily through dollar limitations. Funds for credit activities should also be subject to the same impoundment and reconciliation procedures that are mandated in the Congressional Budget Act for other types of activity. In other words, an equivalent degree of control should be exercised over both direct spending and credit programs.

Procedural Improvements. We believe the Congressional budgeting process needs to be strengthened further in order achieve the fiscal discipline needed to reduce deficits. In this regard, we have made a number of specific suggestions to the Budget Committees of both Houses. These are set forth in our attached letter to Senator Domenici dated October 13, 1983, which is offered for inclusion in the record of this hearing. One important addition to the recommendations therein relates to deficit reduction packages which purport to combine spending reductions with tax increases. The past experience in this regard tends to indicate that while the tax increases are permanently codified, the spending cuts prove much more elusive and ephemeral. We therefore urge that any future deficit reduction package must be structured so that, on a year by year basis, no planned tax increase will go into effect until there has been an objective certification (perhaps by the CBO) that planned spending cuts of a greater magnitude than the tax increases have actually occurred.

Changes in Taxation

It eventually may be that the deficit reductions needed will necessitate a package which combines expenditure reduction with revenue increases. Here, extreme caution must be exercised. Because tax increases tend to exert an immediate contractionary effect on economic activity, the timing of tax increases over the business cycle is of critical importance to their effects on the economy. If taxes are raised during a period of recession or slow growth, they will tend to produce greater economic slack and perpetuate higher unemployment. In the event that taxes were to be raised this year but the increases were not to take effect until future years, this would require acutely accurate foresight on the part of Congress as to the probable condition of the economy at the time the increases are scheduled to go into effect. Raising taxes at the wrong stage in the business cycle, in the final analysis, is likely to lead to a slowdown or contraction in the growth rate and for this reason does not guarantee a reduction in the deficit. For this reason, extreme caution should be applied with respect to any bill which would raise taxes at some future time, since it is not always possible to gauge the condition of the economy at the time when the higher taxes take effect. Under the circumstances, Congress should defer consideration of any major revenue bills until such time as it is appears the economy can sustain such an increase.

Investment in particular would be likely to suffer as a result of a major tax increase. Throughout the 1970s, businesses were excessively taxed as a result of two factors: the understatement of depreciation costs due to the inadequacies of the depreciation system then in effect, and the overstatement of inventory profits due to inflation. While the Economic Recovery Tax Act of 1981 (ERTA) attempted to provide a more realistic system of capital recovery allowances, the tax increases enacted in 1982 cut back substantially on these important business investment incentives, which should not further be eroded.

A further argument against enacting tax increases now is that this would represent only a temporary expedient, rather than a systematic reform of the tax system. In the event that Congress enacts legislation substantially altering the tax laws, such a bill should address deficiencies in the current tax laws on a systematic basis, and should produce a more efficient tax structure that is more commensurate with stable economic growth. Rather than rushing into piecemeal and ill-considered tax increases now, it may be more profitable for the Congress to take the time necessary to consider major reform or redirection of the tax system as part of any effort to achieve lower deficits.

In this respect, a major long run problem with the American tax code has been its tendency to penalize savings and investment while subsidizing or otherwise rewarding consumption. The treatment of savings versus consumption in the American tax system is highly atypical of tax codes throughout the industrial countries. Most of the major industrial countries derive a substantial share of their revenue from consumption taxes, most commonly through value-added taxes levied at the successive stages of production. The result is that although the ratio of tax revenues to national income is lower in the United States than in all of the major industrial countries except Japan, the share of revenue derived from direct income taxes (as opposed to indirect consumption-based taxes) in the United States is one of the highest in the industrial world.

The experience of the other industrial countries suggests that there are certain advantages to be gained by taxing consumption rather than income. Because the tax codes of other countries do not penalize investment to the same degree as the United States, these countries generally exhibit a higher level of personal savings and a higher ratio of capital formation to GNP. Increasing personal savings is important because it raises overall liquidity and permits the financing of government deficits without extensive upward pressure on interest rates. A higher level of capital formation, in turn, is necessary for higher productivity growth and improved international competitiveness. Indirect taxation of consumption rather than direct taxation of income may provide less of an incentive for individuals to seek access to tax shelters.

Examples of consumption-based taxes which might be applicable in the United States include either a value-added tax comparable to similar taxes in

Western Europe, or a national sales tax. Another alternative is to convert the present income tax system into a consumed income tax by excluding from income taxation the net amount put into savings or investment. NAM does not at this time endorse or recommend any particular type of consumption tax, but we do think that Congress should carefully investigate the possibility of making major structural revisions in our tax laws which would shift the incidence of taxation away from savings and investment, in lieu of making further patchwork revisions to an already unwieldy income tax system.

Mr. Chairman, the primary causes of the deficit problem are spending programs that have been and continue to be out of control. Reducing spending is where Congress and the Administration, along with all other interested parties, should direct their energies. NAM cannot and will not support any additional tax increases until genuine and substantial progress has been made on the spending front.

TABLE 1

THE IMPACT OF FISCAL POLICY

1983-89

	1983	1984	1985	1986	1987	1988	1989
	(fiscal years in billions of dollars)						
Federal Outlays							
Current Dollars	$795	$859	$925	$993	$1,084	$1,177	$1,989
Percent of GNP	24.6%	24.1%	23.8%	23.5%	23.8%	23.9%	24.0%
Federal Receipts							
Current Dollars	$600	$665	$733	$796	$857	$928	$998
Percent of GNP	18.6%	18.7%	18.8%	18.9%	18.8%	18.8%	18.7%
Federal Deficit							
Current Dollars	$195	$194	$192	$197	$227	$249	$280
Percent of GNP	6.0%	5.5%	4.9%	4.7%	5.0%	5.1%	5.3%
Standardized Full Employment Deficit:							
Current Dollars	$109	$112	$127	$141	$180	$210	$251
Percent of GNP	3.1%	3.0%	3.1%	3.2%	3.8%	4.2%	4.6%
National Debt (end of year)							
Current Dollars	$1,142	$1,335	$1,540	$1,750	$1,990	$2,252	$2,545
Percent of GNP	35.3%	37.5%	39.6%	41.4%	43.6%	45.7%	47.8%
Federal Debt Service							
Current Dollars	$87	$104	$116	$128	$144	$160	$178
Percent of GNP	2.7%	2.9%	3.0%	3.0%	3.2%	3.2%	3.3%

Source: Congressional Budget Office

TABLE 2

RECEIPTS, OUTLAYS, DEFICIT, NATIONAL DEBT
AS PERCENT OF GNP AND
FEDERAL PARTICIPATION IN CREDIT MARKETS

1970-82

Fiscal Year	Outlays % of GNP	Receipts % of GNP	Deficit % of GNP	National Debt % of GNP	Federal Participation Rate in Capital Markets*
1970	20.2	19.9	.3	39.5	18.1
1971	20.4	18.1	2.2	39.7	26.8
1972	20.4	18.4	2.1	38.7	25.6
1973	19.6	18.4	1.2	37.4	23.5
1974	19.5	19.1	.4	35.3	12.9
1975	22.5	18.9	3.6	36.8	36.4
1976	22.7	18.2	4.5	38.5	40.4
1977	22.0	19.1	2.9	38.1	25.6
1978	21.9	19.1	2.8	37.3	24.5
1979	21.4	19.7	1.7	35.4	18.9
1980	23.0	20.1	2.9	35.5	33.7
1981	23.6	20.9	2.8	35.0	33.3
1982	24.6	20.4	4.2	37.8	48.9

Source: U.S. Treasury

* Federal borrowing as a percent of total funds raised in credit markets, excluding equities.

TABLE 3

COMPOSITION OF FEDERAL OUTLAYS
(PERCENT OF TOTAL)

Fiscal Year	Defense	Transfer Payments	Net Interest	Other
1964	43.4	26.6	6.9	23.0
1968	44.2	27.3	6.2	22.2
1971	36.1	37.4	7.0	19.5
1973	30.3	41.6	7.0	21.1
1978	23.5	46.1	7.9	22.5
1982	25.7	47.9	11.6	14.8
1983	26.5	48.2	11.0	14.3
1984	28.4	44.8	11.6	15.2
1985	29.0	44.1	12.2	14.7
1986	30.0	43.9	12.8	13.3

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National Association
of Manufacturers

ALEXANDER B. TROWBRIDGE
President

October 13, 1983

Senator Pete V. Domenici
United States Senate
Washington, DC 20510

Dear Senator Domenici:

The National Association of Manufacturers' (NAM) Fiscal and Monetary Policy Committee welcomes this opportunity to present our views on specific budget policy and procedural reform. In response to your letter of September 24, 1982, we created five task forces to examine some of the specific subjects you highlighted.

Specifically, small working groups met to evaluate progress in the areas of multi-year budgeting, impoundment procedures, entitlements, federal credit activity, and the reconciliation process. Knowledgeable representatives from Congress and the Office of Management and Budget were invited by several of the task forces to present their views on the current situation and to offer their recommendations for reform. As is evident by the following recommendations, many hours of consideration were devoted by our members to this project.

Prior to a discussion of the five specific areas of concern, it is necessary to reiterate an important point emphasized in past testimony. The NAM continues to believe that all federal spending and revenues should be included in the unified budget totals. Past and current projections of budget deficits have fallen short of stating the true amount of federal indebtedness because a portion of federal spending, commonly referred to as off-budget outlays, is never included in budget total estimates. We contend that all off-budget spending should be tranferred on-budget all at once.

With this measure of budgetary control as a base, we present the following broader recommendations:

A. <u>Federal Credit Activity</u>

The National Association of Manufacturers has long recognized the importance and impact of federal credit activity on the national economy. The growth of these programs has contributed to the significant increase in government

1776 F Street, N.W.
Washington, D.C. 20006
(202) 626-3800

absorption of available credit. This in turn has made it more difficult for private industry to service its own borrowing requirements, which has resulted in slower rates of capital investment and job creation.

The magnitude of federal credit has been largely overlooked due to a lack of uniform accounting procedures among borrowers and lenders. Comprehensive statistics are essential to determine the full extent of federal credit liability. If the growth of these programs is to be effectively managed, we must begin to address the issue now. The National Association of Manufacturers' Fiscal and Monetary Policy Committee therefore recommends the following:

1. Congress, the Office of Management and Budget (OMB), the Congressional Budget Office (CBO) and the General Accounting Office (GAO) should agree on the definitions for all credit terminology. Currently, major differences exist in the interpretation of these terms. A unified effort would produce the reliable data necessary to assess and establish responsible levels of federal credit activity.

2. Binding limits should be established in the budget resolutions for all federal credit activities. These limits should then be enforced through the congressional authorizations and appropriations processes, primarily through dollar appropriation limitations on credit activity. In order to unify federal spending and credit activities, an equivalent degree of control should be exercised over credit and direct spending programs.

   The language necessary to implement these changes has been developed and was included in the First Concurrent Resolution on the Budget for FY 1983. Similar language should become a standard part of the FY 1984 and subsequent budget resolutions and a part of the Congressional Budget and Impoundment Control Act of 1974.

3. The federal government's total credit liability should be included in both the President's budget and in the reports accompanying all budget resolutions emanating from Congress to highlight the extent of federal involvement in credit markets. In addition, default rates for individual programs should be included in the President's budget to assist in program management and congressional oversight activities.

4. Funds for credit activities should be subject to the same impoundment and reconciliation procedures that are included in the Budget Act for other types of federal funds.

5. As part of its oversight responsibilities, Congress should review all credit programs. Priority for federal funds should be established based on need, program efficiency and cost-effectiveness.

6. Comprehensive statistics on all federal lending activities should be compiled and a periodic analysis of all federal credit programs should be prepared. Development of a credit budget, studies requested by congressional committees, and computer scorekeeping capabilities developed by the Congressional Budget Office have all been helpful in providing the necessary information, but more is needed to establish an accurate assessment of our government's credit obligations.

Many of these recommendations stem from the realization that budgetary treatment of credit practices has been less than that for taxes or direct spending. Credit programs must be subject to the same scrutiny that is afforded by Congress for all federal spending.

B. Multi-Year Budgeting

The NAM supports the purpose and objectives of the Congressional Budget and Impoundment Control Act of 1974. However, the ability of Congress to adhere to the timetable of the Budget Act has declined markedly since the process was initiated, substantially curtailing the ability of Congress to review other legislative issues.

Our Fiscal Policy Committee endorses the concept and benefits of multi-year budgeting. Specifically, the Committee recommends a biennial budget process. The cycle should begin in the first session of each Congress. A budget resolution and all authorization and appropriations bills should be passed in the first year of the cycle, leaving the second year open for oversight and other legislation. In addition, the Fiscal Policy Committee believes that a number of issues related to the budget process need to be addressed and therefore recommends that:

1. A single set of economic assumptions should be agreed upon for all budget proposals by the Congress and the Administration.

2. The first concurrent budget resolution shall be made binding and the mandatory second concurrent budget resolution shall be eliminated.

3. Congress shall have the option to attach reconciliation instructions to concurrent budget resolutions.

4. Any modification of a budget resolution to increase spending shall require a super-majority vote.

C. Impoundment Procedures

We further believe that the impoundment procedures contained in the Congressional Budget and Impoundment Control Act of 1974 are adequate for providing congressional control over the impoundment of funds by the executive branch.

While this executive authority to impound funds may be useful to prevent unnecessary expenditures, it should not be used as a primary tool to reduce federal spending and deficit levels. Policy and program revisions to control the growth of federal spending should be accomplished through the authorization and appropriations processes.

NAM's Fiscal Policy Committee believes that the President should retain the authority to rescind and defer federal expenditures. Therefore, before any changes are made in the Budget Act regarding impoundment procedures, Congress should consider the following recommendations:

1. Line item veto authority should not be granted.

2. The provision of Title X, Section 1001(4) of the Budget Act, known as the "Fourth Disclaimer"[1], should be clarified. This provision attempts to define which federal appropriations are subject to impoundment by the President. The Congress, the Office of Management and Budget (OMB), and the General Accounting Office (GAO) differ in their interpretation of the duration and scope of this provision. We believe that:
    - The Fourth Disclaimer was intended to be a permanent, rather than a temporary, provision of law.

- Only entitlements[2], as narrowly defined by Title IV Section 401(c)(2)(C) of the Budget Act, should not be subject to presidential impoundment.

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[1]Fourth Disclaimer, as defined in the Congressional Budget and Impoundment Control Act, PL 93-344, 31 USC 1401:

Title X -
Section 1001. Nothing contained in the Act, or in any amendments made by this Act, shall be construed as -
(4) superseding any provision of law which requires the obligation of budget authority or the making of outlays thereunder.

[2]Entitlements, as defined in the Budget Act, PL 93-344 USC 1351:

Title IV -
Section 401.
(c) Definitions. -
(2) For purposes of paragraph (1), the term "spending authority" means authority (whether temporary or permanent) -
(C) to make payments (including loans and grants), the budget authority for which is not provided for in advance by appropriations Acts, to any person or government if, under the provisions of the law containing such authority, the United States is obligated to make such payments to persons or governments who meet the requirements established by such law.
Such term does not include authority to insure or guarantee the repayment of indebtedness incurred by another person or government.

D. Entitlement Reform

The NAM has long been concerned with the growth in entitlement programs and their impact on the economy. The "uncontrollable" nature of these programs has hindered numerous efforts aimed at bringing federal spending more in line with revenues.

Our Fiscal Policy Committee believes that entitlement reform should be undertaken to ensure that necessary programs accomplish their objectives in an efficient and cost-effective manner. This entitlement reform can be achieved through existing congressional oversight procedures. However, the procedures must be strengthened to ensure greater congressional accountability.

The business community has its own responsibility in these efforts. Recommendation and implementation of constructive alternatives will assist in reforming entitlement programs. Successful entitlement reform initiatives will lead to the achievement of the common goal of economic stability. Therefore, we recommend the following:

1. The congressional authorization committees should study all entitlement programs within their jurisdiction to determine which programs, if any, should remain as entitlements and which can be reconstituted as regularly authorized and appropriated programs. Pursuant to this task, Congress should determine if the original purpose of the program is still valid; if the eligibility criteria are too broad; and whether benefits are excessive.

2. Congress should not create any new entitlement programs. This would not preclude Congress from creating new programs. Rather, it would ensure congressional control of spending levels that would otherwise be relinquished if the benefits were established as entitlements.

3. Automatic cost-of-living adjustments for entitlement programs should be eliminated. Any periodic adjustments that Congress deems necessary should require a recorded vote.

4. A congressional study should be initiated to evaluate the feasibility of the private sector administration and/or management of federal entitlement programs.

5. Uniform scorekeeping measures should be adopted by both Houses of Congress. The current methods used by the House and Senate differ in the way they assess spending levels, thereby producing misleading comparisons.

E. <u>Reconciliation</u>

NAM's Fiscal and Monetary Policy Committee believes that in order to maintain the integrity of the congressional budget process, enforcement mechanisms, such as reconciliation, are necessary. However, as Congress has expanded its use of reconciliation in the past few years, it has become apparent the process needs to be strengthened and defined in order to help achieve fiscal discipline. Therefore, we recommend the following:

1. The first concurrent budget resolution should be made binding and the mandatory second concurrent budget resolution shall be eliminated. In addition, Congress shall have the option to attach reconciliation instructions to concurrent budget resolutions.

2. The current statutory ten day limit for Congress to complete action on a reconciliation bill or resolution, included in Title III, Section 310(d) of the Congressional Budget and Impoundment Control Act of 1974, is insufficient. The time restraints included in the Budget Act were associated with the need for Congress to adopt a second concurrent budget resolution and reconciliation, if mandated, prior to the beginning of a new fiscal year, October 1. With our recommendation to require only one concurrent budget resolution, these time constraints are mitigated. We look forward to working with Congress to determine a more appropriate timetable for committees to make their recommendations to fulfill reconciliation instructions and for final congressional action on a reconciliation bill or resolution.

3. The Budget Committees and Congress should codify the option to include provisions for reducing spending for both discretionary programs and entitlements in reconciliation instructions.

4. The amount of savings achieved in reconciliation bills shall be measured on the same basis used by the budget resolution which required them.

In conclusion, we would again like to thank you for this opportunity to present our proposals for budget reform. Our members gained a great deal of knowledge and a better understanding of the process while developing these recommendations. This insight will serve as an excellent basis for our future consideration of budgeting procedures.

Sincerely,

AB Trowbridge

The CHAIRMAN. I want to commend all of the witnesses. I'm not certain what we need to do precisely, but I think we need to do something, and I think we need to do it very quickly. And we can differ on the details, but if we all agree on the objective, in my view, it ought to be done. I mean I think there are enough of us in both parties around here who are willing to take a little heat.

Could I ask each of you to indicate—there has been some question about whether the contingency tax really makes all that much sense or whether we just ought to go ahead and enact a tax package and a spending reduction package; not wait for something to happen. I guess that's for a couple of reasons.

First, it becomes sort of a gimmick, and you are never going to trigger in the taxes. It doesn't have any impact in the financial markets, the things you are talking about.

Second, I guess if it is going to trigger in, why not just do it. I mean if you are certain you have the spending legislation reduction in place, why do you need a contingency tax. And maybe we can devise one. We've had the Congressional Budget Office working with our staff and the Joint Committee staff trying to come up with some mechanism which would trigger in or trigger off, or whatever.

Anybody have any views on the contingency tax generally?

Dr. CARLSON. I think that as you are indicating, the contingency tax would be viewed as not a credible tax that would be imposed. It would have judgment left. And whoever was to pull the trigger would be exercising that judgment. Or the Congress could change its mind after the election is over at some other time in the future.

So I think that the problem is big enough that you should go ahead with the tax increases as well as the spending reductions, and not have the uncertainty of a trigger mechanism.

Mr. JASINOWSKI. Two points, Mr. Chairman. First, I think that the uncertainty associated with a contingency tax, both in terms of the reliance it places on economic projections, and the adverse impact on business investment planning, argue against this option. Second, I think that we really are facing difficult issues here of choosing among national priorities. The sooner we make the judgment about what our national priorities will be and how to pay for it, the better off we will be. I think that the contingency tax, although we have not taken a firm position against it, tends to have the flavor of avoiding those difficult choices.

Dr. ALBERTINE. On the contingency tax, a point, something that is terribly important to us—the formulation of the tax, as I understand it, from what the Assistant Secretary for Treasury for Tax Policy said last year, would indicate that the tax would have been a flat surtax on corporate taxable income. That, to us, Mr. Chairman, is not the appropriate way to formulate the tax. It has the affect of raising the effective tax rates of those firms that have the highest effective rates. I happen to be chairman of a the "Coalition to Reduce the High Effective Rates," which is made up of not just mid-size companies, but some very large corporations in America that have very high effective rates. We have members of the ABC, for example, with effective rates above 40 percent. So we don't like that surtax formulation.

With respect to the concept, I agree with my colleagues on the panel. I would much prefer to see the Congress follow your leadership and go after spending reductions across the board. Once those spending reductions were in place, it would be time to take a look at the figures, see where the economy is, and then make a judgment with respect to taxes.

The CHAIRMAN. It may be that we will have to do it all in one package. And if what I read is accurate, though obviously there won't be any White House decision until next month some time on the budget—but it's reported, at least, that they may include a contingency tax as they did last year. Now, obviously, that has the political advantage of saying, well, I'm really not for more taxes, and I'm going to make certain we don't have taxes unless we have spending reduction.

It would seem to me if we could be assured of each, we just ought to go ahead and do it. I don't disagree with the thought that if we are going to wriggle out of the spending cuts we ought to get stuck with tax increases. Again, I'm not certain it can be drafted in a way that somebody doesn't exercise discretion later on. Maybe we could figure out some way to do it.

And I would say we have experts working on it. Is it also correct that when we are looking at the CBO number of, what, $280 billion by 1989, that's based on a fairly steady recovery? Isn't it?

Mr. JASINOWSKI. Yes, sir. That's based on, I think——

The CHAIRMAN. About a 5-year recovery.

Mr. JASINOWSKI. That is based on a normal recovery in 1984-85, followed by average growth rates over the business cycle of 3.4 percent for the remainder of the decade. The estimates for 1984-85 would be commensurate with prior recoveries, but the assumptions for the late 1980's are probably too optimistic.

The CHAIRMAN. Have we had any recoveries that have lasted 7 years lately?

Dr. ALBERTINE. Four percent in real terms is above the historic average for that point in time. The scenario it is based on is optimistic in terms of growth of the economy.

The CHAIRMAN. Right. I mean I wondered if that deficit could be much higher than $280 billion.

Dr. ALBERTINE. I think it's fair to say that that growth estimate is optimistic by historical standards.

The CHAIRMAN. And you have all been making efforts through your own associations of focusing attention on the deficit so it can be clearly understood by not only realtors but people buying homes, buying a car, farmers, whatever. I mean how do we put the deficit in terms where it can be easily understood, comprehended and applied to each household where somebody can understand that even though we are in a fairly strong recovery—obviously, things are much better than they were—how do we convince people that in sort of these good times we ought to do a little bit more to sustain the recovery, whether it is on the spending side or the revenue side? I've used the example of the homeowner which I see is in your statement. I think I gave the wrong figures though. If yours are right, I gave the wrong one.

Dr. ALBERTINE. Mr. Chairman, I recently thought about taking the total figure and dividing it by the population in suggesting that the resulting figure was the amount that each American home——

The CHAIRMAN. We did that yesterday.

Dr. ALBERTINE. And, Mr. Chairman, I went back and read a speech that a Presidential candidate from your State, Mr. Landon, made in 1936 where he did that, just exactly that, and he didn't fare too well in that election.

The CHAIRMAN. Do you remember what the figure was?

Dr. ALBERTINE. No, I don't.

The CHAIRMAN. It's only about $10.

Dr. ALBERTINE. A low figure.

Mr. JASINOWSKI. Mr. Chairman, historically economists have tended to not pay much attention to the national debt. And in the past that sometimes has been appropriate because it did not have the characteristics of becoming self-perpetuating. It seems to me that some further refinement of the concept of what is happening to the cost of debt service, which has exhibited exponential increases and the fact that it expands more rapidly than the ability of the economy to pay for it, put in simple arithmetic, is something that everybody can understand.

The CHAIRMAN. When will the interest payments reach $250 billion? By the end of the decade or a little beyond that?

Mr. JASINOWSKI. They don't reach $250 billion—by the end of the decade, I think it's about $178 in 1989. It's in the testimony that I presented.

The CHAIRMAN. That's as much as the cost of the social security program.

Mr. JASINOWSKI. It's $178 in 1989, under some fairly favorable interest rate assumptions. It's conceivable that it could reach $200 billion by the end of the decade, if the interest rate assumptions are more adverse.

The CHAIRMAN. Those are net figures, right?

Mr. JASINOWSKI. Yes, sir.

The CHAIRMAN. As I understand the actual funding for interest payments, it's about $250, and you get some back.

Mr. JASINOWSKI. That's a net interest payment that I was giving you.

The CHAIRMAN. How many jobs is that going to create? And how many farm programs? How many homes will it build? It seems to me we can ask all these questions. When does it reach a point where even those who never want to do anything, even close loopholes around this town, suggest that we ought to do something about interest payments? What was the total budget in 1972?

Dr. ALBERTINE. Lyndon Johnson had the first $100 billion budget. Fiscal 1966, as I recall.

The CHAIRMAN. You guys are better with numbers, but you can look back just a decade and say now we are paying more in interest, or almost. I don't know when people begin to understand that interest payments don't do much for the economy.

How do you react to the fact that for all practical purposes we are told that because we fixed social security earlier this year that that is off limits? Defense is off limits. And, of course, interest on the debt is off limits. That doesn't leave us very much room for cutting. Do you see any way of putting together a package with those three items—they are off limit.

Dr. CARLSON. No, sir. I don't see how you can solve this deficit problem and put those off limits. You are going to have to have a slowing of growth in each of those areas to be able to do the job.

By the way, Mr. Chairman, I do think you are finding out among homeowners a 3-percentage point increase in real interest rates takes away $13,000 average value of your home in this country because of the black effect that it has upon housing. And the homeowners are just now starting to realize this. And I think this is a big sleeper in the election of next year. Are people not addressing the fact that they have taken $700 billion away of value because the Congress and the President have allowed these interest rates to go up and to sustain themselves.

The CHAIRMAN. What do you figure the real difference in interest rates? Three points?

Dr. CARLSON. Historically in the postwar period, for mortgages it has been 3 and 3¾. And for corporate triple A's it has been roughly around 3. The third quarter of this year for mortgages is around 9. And for corporate triple A's, it's about 8, but that's an unusual low inflation rate. It's 6 to 7 percent. It's more than double what the historic average has been. We've never had it so high since 1932.

The CHAIRMAN. Do you agree that you may have your own better way to put it together, but if we can, in fact, reach a bipartisan consensus—maybe not unanimous—but a consensus on this committee that it might be something worth supporting? Now I know you haven't made any final judgments.

Mr. JASINOWSKI. As I have said to you before, Mr. Chairman, the NAM would always be prepared to look at any package that you put together, or others, that had genuine bipartisan support, and would put the first emphasis on reducing spending even if that meant possible tax increases. We would continue to do that.

I must say that our greatest concern is—going back to your question on defense and social security and medicare—is that it is very difficult for us to see how in an election year you or anyone else is going to be able to get the spending reductions that will have to be contingently related to the tax increases. Even if groups like ours support such spending reductions, the issue, obviously, is much more difficult because of the election.

But if such a package can be put together, we would always be prepared to take another look at it and see if we could support it.

Dr. CARLSON. Mr. Chairman, I do think that that is the advantage of going after the indexing because you can't put in one package both the tax part of it and the spending part of it and have a chance for it to carry, as opposed to different committees handling the different kinds of spending and the tax side.

Also, I do think it's important—and this may be one of the points of criticism of the package that is now before the committee—that it tends to penalize savings and investment too much for other objective reasons. But nonetheless we are an investment and savings short economy, and we should put the load on consumption and protect savings and investment.

Dr. ALBERTINE. Mr. Chairman, the conventional wisdom that entitlements can't be touched in an election year, the truth of the matter is, in my judgment, that when people like you and others in the Congress focus in on this issue and bring it to the public's attention and do the sorts of things you are talking about with respect to the problem of the deficit, a conventional wisdom can change rapidly. The terms of the public policy debate need to be shifted. And I think that you are doing an excellent job in that direction.

Obviously, there has to be some package across the board. We supported you last year, as you know, with respect to the tax increase even though we didn't agree with all of the components of the package. But I think you find most business people in this country willing to support you and others if it can be demonstrated—and I think it can be—that these entitlement programs can be—the growth of the entitlement programs can be marginally reduced.

The CHAIRMAN. I haven't figured out quite how to do it yet, and I'm certain maybe you have and maybe you think about the same thing. But it has got to be presented in a positive way, whether we are taking something away from someone. That's why I say we can't argue—if that's the basis for the argument, we lose. We've got to shift the argument to what happens if we do something to the same people who might give up a little. I mean what happens in the long run if it's CPI minus 2 or minus 3. We are even trying to round down the COLA's, and that's being objected to by people in the social security area. If you are entitled to 3.6, we say we will give you 3. And even that little adjustment picks up about $6 billion. And you do the same on taxing. That's $12 billion. I mean it's a very substantial amount of money, and very little sacrifice. But even that, we are told, is too hot a button at the White House and at the Speaker's office.

And I don't fault them because I was a member of the Social Security Commission. But there is also a feeling that somehow the senior citizens are going to turn against everyone if we ask them to just give up a little of the COLA. And we would even take it and put it into the HI trust fund, which is about to go bellyup. That's medicare, which to me is the most important thing that we can do for senior citizens. And we should keep that fund solvent. So we'd transfer from the social security fund to the HI trust fund any savings on the COLA's.

But it's just a very hot button politically. And I can understand why the President and others don't want to be posture to taking money away from senior citizens in 1984 or any other year. But I think it's also well to point out that we are not just dreaming up all these tax ideas. What we try to do is go back to the President's 1984 budget where he suggested a surtax on individual income and corporate income. But as you suggested, it was not fair because the only ones who paid the tax are those who are paying a high effective rate now. So we have tried to change that some. We have also changed the individual surcharge so that upper income individuals would pay more.

There is an energy tax, but it's not just on oil, which the President suggested. It's an all-energy. And we tried to offset the effects of that by increasing the zero bracket so that the low income would probably be neutral as far as cost.

On the spending side, we have taken nearly everything the President recommended in his 1984 budget on medicare and medicaid, and maybe did a little more in some areas, and have reached more savings than he recommended. So it seems difficult for me to understand why the White House can't find at least some ground in what we are trying to do. And hopefully they may do that in the next couple of months.

Mr. JASINOWSKI. Mr. Chairman, may I make a suggestion?

The CHAIRMAN. Sure.

Mr. JASINOWSKI. It is related to the line of discussion we have had so far, but is on a slightly different tack. It's my judgment that it will not be possible to put together a package of spending reductions and tax increases in 1984, both because of the strength of the recovery and the fact that it's an election year make it difficult to get appropriate spending reductions. I well understand your strategy of attempting to deal with the tax component of this as one in which you put together a lot of small tax provisions in order to spread the burden that way. It seems to me, although I acknowledge that it's a fundamental restructuring and a major reform, and, therefore, a long shot, it could well be that the deficit and taxes will not be addressed until 1985. And it seems to me that it would be quite useful to examine for the Congress in detail this whole question of a broader based consumption tax, which has far more economic merits than putting together a lot of small provisions, many of which would adversely affect savings and investment.

I recognize that that doesn't solve the political problem. It is just something which seems to me of moving along on more than one track, given the situation might be useful.

The CHAIRMAN. It's a good suggestion. In fact, I think I've commented on it earlier today with you. If, in fact—we should know by April or May if anything is going to happen. If not, then I don't think we just stop until after the election. We at least can explore some of the alternatives. I think everyone has said, the President, or Mondale, or Glenn, whoever, that we are going to have a real problem in 1985. So we will be exploring that.

We've also been told by some of the previous witnesses that the longer we wait, the more it is going to cost. I mean it is going to cost more to do what we could do in 1984, if we wait until 1985. Take a bigger tax bite, maybe.

Have you tried to predict how long the recovery is going to last?

Dr. ALBERTINE. Mr. Chairman, I'm pretty optimistic. I think you will have a good year in 1984. And I think the chances are for a reasonably good year in 1985. I think that when you get beyond that the predictions for subsequent years might not be worth anything to begin with.

But I'm pretty optimistic that this economy is moving quite nicely, and recovery is actually becoming a lot more balanced than it was. I notice, for example, a phenomenon which is very interesting. Early in the recovery, most chief executive officers that I talked to were extremely worried about the outyear deficits, and that had a negative effect on their desire to go to the capital markets and borrow for planned expansion. Yet, you face an interesting phenomenon when you are chief executive officer. You have customers that are requiring commodities, and the key thing you have to do is to protect your market share. So, I now notice people going to the capital markets. I now notice that the business fixed investment, in fact, is picking up, and that is balancing the recovery to a larger extent than I thought would be possible at this stage. So I'm optimistic. I think you will have a good 1984, and a reasonably good 1985.

The CHAIRMAN. Is that true for small businesses? Some of the analysts have indicated the recovery hasn't hit the small business sector yet.

Dr. ALBERTINE. That's a tough question for me. We don't represent small businesses. My impression is that the small business sector is doing fairly well. It depends on what sector of the economy. The service sector, for example, is very good. Retailing is very good. Certainly, in terms of our organization, across the board, except for energy, as you well know in your State, Senator, except for energy, which is still lagging, this recovery is very broad based.

Mr. JASINOWSKI. Mr. Chairman, I would just like to throw in my 2 cents. First of all, acknowledging that I don't think that the projections beyond 1 year out are very useful because things change too much, I agree with Jack Albertine that 1984 will be a good year. I would qualify the extent to which the economy is, in fact, moving into a normal expansionary phase. And not taking away anything from what he has said, we will see a slowdown in 1984 because international markets will not be strong because of the overevaluation of the dollar. I think capital spending, although more robust now than we expected, is not going to hold up as much as it should. Real interest rates are too high for consumer durables and housing. So there are some imbalances there which come from the deficit. They don't show up primarily in 1984, but by 1985, I think we could already be having some difficulties here.

I don't think you can project out for 2 or 3 years and say that we are going to have a reasonably good recovery.

The CHAIRMAN. Jack, do you have anything to add?

Dr. CARLSON. I do agree with Jerry's assessment. I do think 1985 is a reasonably good year, but imbalanced. And the export sector is taking it on the chin. You are losing some good industries that will have a hard time coming back in the future. Residential is already going down. This is the first time in a recovery that they have gone down this soon. And that other long-lifed assets will be unduly affected. It'll be a consumption oriented recovery. However, I would expect it would be normal. It could go 4 years. It's normal so far in terms of overall magnitude. But the composition looks bad for the longer run. And we will have less capacity, less capability of educated people and trained people as well as long-lifed physical assets for the longer run. Consequently, American standard of living over the longer run will be less because of this mix of policy causing the composition to be bad over the longer run.

The CHAIRMAN. As you know, the magic number here is 11. There are 20 on the committee, and while you may be talking about billions, without 11, nothing is going to happen in this committee. Eleven votes, that is. And I know there are some who don't want to cut spending, and some who don't want to raise taxes, and some who would be willing to vote for a combination.

And I think the feeling is fairly strong in this committee that spending reduction is the first priority. I think I can speak for nearly everyone on the committee. There are others who don't feel as strongly on the tax side. But I think the record should show, as I have indicated before, that what we are responding to in this committee is the budget resolution which passed the Congress. I didn't vote for it. It was $73 billion in taxes, and only $12 billion spending reductions over three years. In fact, 11 members of this committee voted against the budget resolution. And that will give you an indication of the attitude. You have got $6 in taxes for every dollar in spending reductions. In fact, some of the spending reduction was smoke. You probably didn't even get 6 to 1 or probably even worse.

So what we have tried to do is say, OK, if we are stuck with the $73 billion in taxes, how do we get $73 billion savings. That's simply all we are trying to do in this committee. And we believe it's a responsible effort to at least go from 6 to 1 to 1 to 1. Others would like to have it 3 to 1 spending. But I think if we can go from 6 to 1 to 1 to 1 it is a step in the right direction.

And, hopefully, the President and the Speaker will be cooperative. And I don't mean that critically. I think the big political hot button around here is social security, medicare, Congressman Pepper, chairman of the Rules Committee. I listened to him at a big rally in Madison Square Garden. He didn't think we ought to do anything on the spending side.

So there are some political realities. And I think the average person in my State, the voters and other taxpayers, maybe they don't like it, but it's a fact. I mean you have to deal with the facts. The facts are that a lot of us would be willing to vote for CPI minus 3. The beauty of that, as you said, Dr. Carlson, is that you get it all right here in this committee. You don't have to go outside of the committee. You can save plenty. And indexing is the best thing we did in the tax bill. It's an amendment I offered on the floor. The President has now adopted it as his own. And I'm pleased of that. And we don't want to lose it. But I think there is sort of an emergency here that we ought to address.

We will be working closely with your groups. As I understand there is an attitudinal survey in the works. Is that correct? It's by the realtors and homebuilders and others. And I guess the early returns are that there are a lot of people understanding the deficit, but I guess there is less understanding of what you do about it.

Dr. CARLSON. Yes, sir.

The CHAIRMAN. Do you think the deficit debate is going to disappear next year?

Dr. ALBERTINE. I don't, Senator. I think it will be with us until the Congress takes significant action to reduce them in the out years. There is no question that at some point these deficits are going to become extremely debilitating. I don't think there is any doubt about it. The $64,000 question is when. And I think as long as you have deficits that are running $200 billion-plus, I think—frankly, as long as you have deficits over $100 billion—the debate will continue.

The CHAIRMAN. We have got the tax cuts in place. And somebody gave me some figures, but I have lot them. We are giving some people an average of $600 or $700 worth of tax cuts, but their interest payments are $800. I mean we have kept interest up. Maybe there is no correlation between the two, but I think there ought to be some—there has got to be some way to demonstrate that we need to do something. I'm not suggesting more taxes, but I'm suggesting it is serious.

Dr. CARLSON. I think we have a situation where it's not apparent to the average citizen in this country that we are facing a problem because the problem is long-term in nature. And inherently, this kind of situation requires heavy leadership. Fortunately, you are providing that leadership, but not enough others are providing that leadership. We are trying to do it with our constituency, but I'm afraid that it is going to take an awful lot of adult education of the general body politic and some of us need to push a little harder in that regard.

The CHAIRMAN. Well, in Phillipsburg, Kans., cattle loans are still 14 percent. Mortgage interest loans, I think in Witchita—what are they, about 13? That's better than it was, but it could be better yet. And the farmers realize, I think, the best thing we can do for a program is not try to increase subsidies, but bring down the interest rates. The farm program is one of the worst examples of excessive Government spending. And we would like to reduce that.

Dr. ALBERTINE. Mr. Chairman, in the last year, one of the finest developments in this economy has been the booming equity markets, which have lowered the cost of capital by 3½ points according to our numbers. That's a terribly significant fact. If we could somehow convince the financial community that the Congress were serious about these long-term deficits, and could, in fact, get some action, it would reduce real rates of interest. More importantly, in terms of the long-term health of capital formation, it would, cause a boom in the equity markets.

Our numbers show that if we had a Dow-Jones of 3,000 the cost of capital in the United States would be the same as the cost of capital in Japan, despite all our handicaps. The steel industry would be able to invest $3 billion a year more than they invest today. Basic industries, in our judgment, would be able to be competitive, and our high tech sector, in fact, would remain ahead of the Japanese and others.

The CHAIRMAN. Well, thank you very much. We appreciate it.

Dr. CARLSON. Thank you, Mr. Chairman.

The CHAIRMAN. The next panel is Dr. Richard Rahn, chief economist, Chamber of Commerce of the United States; Harry Pryde, president of the National Association of Home Builders; Dr. Mark Reidy, executive vice president, Mortgage Bankers Association.

Now if anybody has any plane to catch, I think we can shift the order. But if not, Harry are you in good shape? Anybody need to leave before anybody else?

[No response.]

The CHAIRMAN. If not, we will start off with you, Dick. And I would say that your entire statements will be made a part of the record. And you can summarize, if you can.

STATEMENT OF DR. RICHARD RAHN, CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, D.C.

Dr. RAHN. Thank you very much, Mr. Chairman. I do appreciate you inviting us here today. I'm Richard Rahn, vice president and chief economist of the Chamber of Commerce of the United States.

Mr. Chairman, as you well know, the deficit is just a symptom of the real problem, which is the growth in Federal Government spending, which is the true measure of crowding out of the private sector of our economy. This past year reached an alltime record high of 24.7 percent of GNP.

Economists have long known that both taxing and borrowing crowd out, and both are harmful to economic growth. However, if you surveyed the economic literature, you will find far more documented evidence of the harmful effects of high taxation than the effects of deficits.

History continues to show that major tax increases are counterproductive. Thus, if the Congress is truly concerned about maintaining an increased standard of living for all Americans, it has only one choice—it must reduce the growth rate of Government spending.

Projected deficits are a very poor guide to public policy. For instance, from 1979 to 1983 the OMB in the beginning of the year forecast for the deficit for the next fiscal year missed the mark by a range of minus 46 percent to plus 400 percent. Just this past July 25, in its mid-year economic review, OMB made a projection of the deficit for fiscal 1983. They only had to project 2 months—August and September. Yet they missed by $14.4 billion or $216 million per day.

Treasury receipts are now running on an annualized basis of about $22 billion higher than those projected by CBO as recently as this past August. So I would discount over-reliance on projected deficits as a measure of policy guide.

Last month the Chamber of Commerce's Board of Directors again endorsed a spending reduction plan that does not gut any major Federal spending program, but is likely to give us a balanced budget by the end of this decade. It can be found on pages 12 and 13 of my testimony.

And, thus, Mr. Chairman, I urge you and your fellow members to put the emphasis on spending growth rate reduction. I realize that you would like for us to come up with solutions for spending that do not involve entitlements or defense.

The CHAIRMAN. It's all right with me if you do.

Dr. RAHN. We believe that's impossible. I have been serving for the last 15 minutes, months on the——

[Laughter.]

Dr. RAHN. Fifteen minutes—it seems like several years. That was on the Social Security Advisory Council dealing with medicare, a so-called medicare commission. We have just finished up our recommendations, which will hopefully cut about $200 billion off the $300 billion projected deficit in that program by 1995.

In addition, we have put in a suggestion for a long-term program. But, clearly, if we are going to bring deficits under control, we have to look at medicare; we have to look at social security; we have to look at the entitlement programs.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Rahn follows:]

STATEMENT
on
WAYS TO REDUCE THE DEFICIT
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Dr. Richard W. Rahn
December 13, 1983

I am Dr. Richard W. Rahn, Vice President and Chief Economist for the Chamber of Commerce of the United States. On behalf of the Chamber's more than 204,000 business, trade association and local and state chamber members, I welcome this opportunity to present our views on the trends in federal spending that have contributed to large deficits in the past, present and future and to share with you our recommendations for reducing these projected deficits by imposing firmer limits on the growth of government spending.

Summary

The chief causes of federal deficits in our view are rapid growth in government spending and below-average growth in our economy. Effective solutions to this problem are those that impose firm limits on the growth of government spending and preserve and encourage the economic recovery now underway. Anything short of this, and I include tax increases in this category, will be largely ineffective and will likely make the problem worse.

While we share your concern about the future course of projected deficits, we view these projections as a symptom of a larger and more severe problem.

The true measure of "crowding out" by the federal government is the share of our gross national product devoted to the funding of the vast array of federal spending programs. Last fiscal year, this crowding out amounted to 24.7 percent of our gross national product, the highest level ever achieved in peacetime and nearly 20 percent more than the level of intrusion in FY '79. Despite this substantial increase in the degree of crowding out, the policy debate on the budget has persistently focused on the symptom of this problem: the gap between outlays and receipts. Expressed as such, the debate has degenerated into endless quibbling as to the proper mix of borrowing and taxation to fund the spending that Congress imposes on the American people.

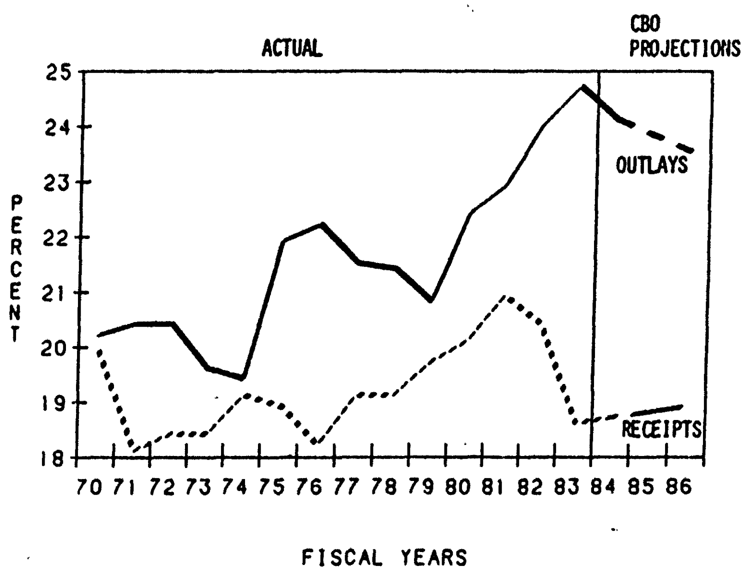
But whether Congress chooses to fund this spending by taxing or borrowing, someone, somewhere will be crowded out, and the private economy will suffer accordingly. As I survey the literature on the subject, it is clear that we have more documented evidence on the harmful effects of high taxes than we do on the effects of deficits. Clearly, deficits are a threat to our economy. However, the real threat of the deficit is derived more from the fearful reactions it induces in our policy makers and the actions they might take to resolve the problem than from whatever direct and measurable impact it might have on financial markets and economic activity.

Last year, in recognition that rapidly rising federal spending was imposing a severe burden on the U.S. economy, the Chamber developed its own budget proposal and submitted it to Congress for consideration. Consisting of six key principles of spending restraint and focusing on those areas of the budget that have grown the fastest, the Chamber's budget proposal would have led to substantial deficit reductions over this decade without relying on any major tax increases or imposing an undue burden upon those who rely on federal benefit programs. I have included a summary of the proposal in my testimony because many of the spending limits we suggested are the direct responsibility of this Committee.

The Problem: Deficit Spending

As the chart below clearly illustrates, the widening gap between revenues and outlays is largely a result of the explosive growth in outlays that began during the Carter Administration and continues through the present and into the future. Many in and out of Congress have tried to lay the blame on the Reagan tax reductions. However, as the chart demonstrates, these tax rate reductions have merely served to stabilize the tax burden at a level that characterized much of the 1970's. The persistent failure to stabilize the spending burden is the chief cause of the problem.

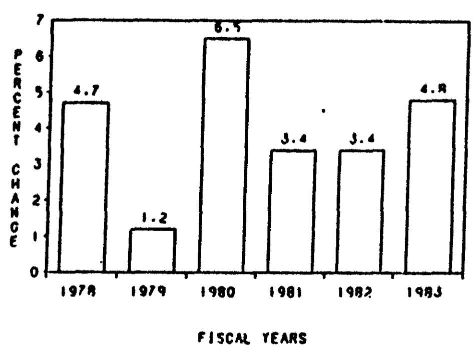
FEDERAL BUDGET OUTLAYS AND RECEIPTS
AS A PERCENT OF GNP



In spite of all evidence to the contrary, many in Congress have come to believe that spending has been restrained and that few opportunities remain for limiting it in the future. While Congress has indeed made a number of notable spending growth reductions in a few areas, these have been more than offset by excessive growth in many others. To cite just a few examples, during FY '83, spending on farm price supports, food stamps, Farmers Home Administration, energy programs, social security, health care, housing assistance and unemployment benefits all increased at a rate well in excess of GNP growth over the same period. In the case of farm price supports and unemployment benefits, the growth exceeded 60 percent. Recent legislative actions in these two areas indicate little Congressional willingness to make changes that would prevent such growth in the future.

Those making the claim that progress has been made in limiting spending growth frequently cite the fact that federal outlays are now growing at a slower pace than they were a few years ago. This "progress", however, is largely attributable to the Administration's success in the battle against inflation. After deflating the nominal outlay numbers and expressing them in real terms, we can see that FY '83 outlays grew at a rate in excess of real spending growth in 1981 and 1982. The chart below illustrates the recent trends in real federal spending growth.

REAL FEDERAL SPENDING GROWTH



As should be obvious from the above, a persistent pattern of growth in federal outlays is the chief cause of the large deficits we have experienced. Thus, any policy to reduce those deficits must first resolve the spending problem. Any deficit reduction package that relies largely or partially on tax increases amounts to the treatment of a symptom at the neglect of the cause. The crowding out problem would remain or worsen as the increase in taxes takes additional resources from the private sector, further diminishes the incentive for productive work, saving and investment and contributes to a lower rate of economic growth.

Tax Increases: Ineffective and Counterproductive

Despite evidence indicating that spending is the problem, many in Congress and the Administration continue to adhere to the belief that a substantial tax increase is the cornerstone of an effective deficit reduction package. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) is an example of this sort of thinking. It also serves to demonstrate that massive tax increases will not reduce the deficit and may even worsen it by diminishing economic growth and holding forth the false promise that deficit reductions can be accomplished without substantive spending restraint. When it was enacted, TEFRA, in conjunction with the modest spending decreases included in the reconciliation bill, promised a $103.9 billion deficit in FY '83 and an $83.9 billion deficit in 1984. These targets, of course, were never achieved. Revenues failed to rise and spending exceeded targets by a substantial margin: $26 billion in FY '83 and a projected $37 billion in FY '84.

TEFRA failed to achieve its objective. Not only did the deficit fail to decline; it more than doubled from what had been projected. Although it did not even come close to achieving its targets, it did leave a trail of damage that will be with us for some time. TEFRA was promoted as ~~a~~ "loophole closing" measure, but it had a severe impact on business. Nearly 60 percent of the revenue came from cutbacks on business, and these changes eliminated more than 70 percent of the reductions business received in the 1981 Act. Investment was especially hard hit through changes in the Accelerated Cost Recovery System (ACRS). Changes in the pension area through the "top-heavy" rules added to the cost of compliance and have induced small firms to terminate pension plans. The financial industry has wasted millions of dollars on unneeded withholding schemes. Worse than this, however, federal spending continued to expand, continued to crowd out the private economy, and remains, as a consequence of this neglect, a more difficult problem to resolve than it was two years ago.

TEFRA, regrettably, was not the only major tax increase inflicted on our nation over the past year or two. Despite the well-documented evidence that payroll taxes have a substantial negative effect on employment, economic growth and overall government revenues, an increase in payroll taxes was key to last year's Social Security legislation that was largely dependent upon tax increases as the solution to the solvency problem. As far back as 1978, the Congressional Budget Office (CBO) warned that a half a million lost jobs would result from the 1977 legislation that raised payroll taxes in an earlier failed effort to restore solvency to the Social Security system. In part, the record unemployment that occurred last year was attributable to this. In addition, as in the case with TEFRA, these payroll tax increases fell well short of restoring solvency to the system.

As part of the Social Security compromise, future payroll tax increases were enacted again in the 1983 Act, despite projections made by the leading economic forecasting firms that a payroll tax increase would substantially diminish employment and economic growth. Simulations by Data Resources Inc., Wharton Econometrics, the Congressional Research Service and the U.S. Chamber found that the employment loss during the remainder of this decade could range from a low of 300,000 jobs to 4.1 million jobs, depending on how much the tax was increased. The table on the next page details the findings of these simulations.

With this as a prologue, late last spring, in the midst of a fiscal year characterized by the largest deficit ever and a peacetime record level of spending, the congressional budget committees responded by proposing tax increases in excess of $250 billion over the next five years. Fortunately, Congress had the good sense to reject these proposals by settling on a somewhat less harmful tax increase of $73 billion over three years. And, consistent with recent trends on spending, the reconciliation instructions accompanying the budget resolution included a meager spending reduction of $12.3 billion over the next three years. Had it passed, this spending restraint would have reduced the projected deficit by 2.3 percent.

Projected Deficits: A Poor Guide to Public Policy

The projected baseline deficits, estimated by the CBO to average $223 billion per year between now and 1989, are the reason we have been asked to come before this Committee and offer our views and solutions on this issue of great public concern. As I noted earlier, while I find large deficits

Social Security Payroll Taxes
Different Acceleration Scenarios and the Cumulative Decline in Employment

Year	Currently Legislated	Chamber Sim A	Chamber Sim B	Chamber Sim C	Chamber Sim D*	Congressional Research Sim**	Wharton Sim***	Data Resources****
1983	6.70	6.70	6.70	7.15	6.70	7.12	6.70	6.70
1984	6.70	7.15	7.65	7.15	7.65	7.12	7.05	7.65
1985	7.05	7.15	7.65	7.40	7.65	7.55	7.15	7.65
1986	7.15	7.15	7.65	7.40	7.65	7.65	7.65	N.A.
1987	7.15	7.15	7.65	7.65	7.65	7.65	7.65	N.A.
1988	7.15	7.15	7.65	7.65	7.65	N.A.	7.65	N.A.
1989	7.15	7.15	7.65	7.65	7.65	N.A.	7.65	N.A.
1990	7.65	7.65	7.65	7.65	7.65	N.A.	7.65	N.A.
Cumulative Decline in Employment (millions)		0.3	2.2	2.0	1.1	1.8	4.1	0.5

* With offsetting tax credit for individuals.
** Forecast period is 1983 through 1987.
*** Also includes a three-month delay in the Social Security cost of living adjustment.
**** Forecast period is 1983 through 1985.

worrisome, the concern is not so great as to induce me to support a major tax increase as a solution because it would be counterproductive. Deficits are a symptom of federal spending and represent one way in which the government can acquire the funds to meet its multitude of spending promises. Nonetheless, the notion that the deficit is an evil in and of itself now characterizes all public policy debate to the exclusion of everything else. The reason for this is the belief that deficits will raise interest rates, prevent an economic recovery, slow economic growth, raise economic growth, cause inflation, overvalue the dollar, widen our trade deficit and so on.

Over the past several years, the economics profession has carefully inspected all these claims and has yet to find substantive evidence in support of any. Indeed, in early October, the Federal Reserve Bank of Boston held a conference on the subject and the learned participants were unable to come to any agreement on the deficits' likely impact, let alone whether it would even have one. And, I note with interest that some of the major forecasters continue to foresee declining interest rates. The CBO, for example, projects declining interest rates during each of the next chree years, despite its exceptionally large deficit projections.

Aside from whatever impact a high deficit has on the economy, these deficit projections, in and of themselves, should be a real source of concern to policy makers. It is these estimates, projected out to 1989, that have motivated many in Congress and the Administration to seek the swift enactment of a substantial tax increase. In effect, we are being asked to accept the certainty of a tax increase in an effort to resolve a projected problem derived from estimating procedures that have been notoriously incorrect.

In forecasting budget deficits over the past several years, OMB has missed the mark by a wide margin. In the five years from 1979 to 1983, actual deficits have ranged from a low of 46 percent of estimate to a high of four times as great of estimate, using estimates prepared nine months in advance of the fiscal year. Clearly, errors have been significant both in direction and magnitude.

In projecting deficits for fiscal years in progress, OMB's record improves but the errors are still large. Deficit projections made three months after the start of a fiscal year experienced errors that ranged from 35 percent below forecast to 50 percent above. Again, the errors are large both in direction and magnitude.

On July 25, 1983, OMB issued its "Midsession Review of the 1984 Budget". In that document, issued just 67 days before the end of FY '83, OMB estimated that the 1983 budget deficit would be $209.8 billion, based on projected outlays of $809.8 billion and receipts of $599.9 billion. In addition, it projected the unemployment rate falling to 9.6 percent by the fourth quarter of 1983.

None of this happened, of course. In the subsequent 67 days, the federal deficit fell short of the OMB projection by $14.4 billion, giving them a forecasting error of $215.6 million per day for an annualized error of $78.7 billion. And the unemployment rate fell to 8.4 percent in November. With an error rate of this magnitude only two months in advance of the end of the fiscal year, how seriously should we take their projections for next year, not to mention 1988?

In part, the more recent errors in deficit projections stem from a persistent underestimation of the strength of this recovery. In their most recent estimates of the economy, both the CBO and OMB have substantially overestimated the unemployment rate. The CBO projects the unemployment rate to average 8.4 percent in 1984 while the Administration estimates an unemployment rate of 9.1 percent for the same year. But as of November, 1983, the unemployment rate had fallen to 8.4 percent as more than 700,000 new jobs were created during the month by the booming recovery. These represent 700,000 new taxpayers, savers and consumers who will help propel the recovery forward.

In spite of these trends, CBO's most recent "Preliminary Baseline Budget Projections" assume that individual income tax receipts in FY '84 will rise by only 1.4 percent over last year's. However, the "Monthly Treasury Statement of Receipts and Outlays for the United States Government" for October, 1983, the first month of FY 1984, shows that individual income tax receipts are currently running 11.4 percent above last October's level. If this continues, and I believe it will, given the employment growth now under way, individual income tax receipts will be $22 billion higher in FY '84 than the CBO currently projects.

Limiting Federal Spending: What's to Be Done?

Although the rapidly recovering economy will narrow the deficit at a faster pace than most forecasters now project, severe crowding out will still persist as the federal government again absorbs more than 23 or 24 percent of the nation's output. The only way to resolve this problem is to limit federal spending growth by imposing firm restraints on those programs that are responsible for the rapid growth we have experienced over the past many years.

Last year, recognizing that neither Congress nor the Administration was inclined to propose a budget that placed firm limits on spending growth, the U.S. Chamber took the unprecedented step of developing its own budget for the Senate to consider. In its present form, our proposal incorporates seven key proposals for spending restraint.

1. Cost of Living Adjustments (COLAs) for all indexed entitlement and disability programs should be frozen for up to twelve months to correct for past overindexing due to flaws in the Consumer Price Index (CPI). After the freeze, indexing should be limited to 60% of the CPI change in each year. The 60% is the Chamber's "equity cap" COLA and is equal to the average private sector wage COLA.

2. The growth in medicare and medicaid should be limited to the percentage growth in the number of beneficiaries plus the change in the GNP deflator. This would leave real outlays per beneficiary frozen, unless changes in medical costs can be reduced below the level of the change in the deflator. Strict limits on federal medical care spending must be adopted now to avoid an explosive growth in outlays after 1990 as the aged population swells rapidly.

3. Federal pay should be frozen for one year. In subsequent years, the total federal payroll should be limited to a 3% increase per year. On average, an individual's pay can rise by a higher amount to the extent that productivity gains and program reductions permit attrition in the workforce.

4. Defense outlays other than retirement (covered under #1) and pay (covered under #3) are to grow no more than 7% each year in real terms, as the President requested in 1981. Real growth should be measured as deflated by the GNP deflator in order to provide cost containment incentives to the Defense Department.

5. Additional reductions should be sought in nondefense discretionary programs. The recommendations of the General Accounting Office, the Congressional Budget Office, the Grace Commission, and previous Administration budget proposals should be given serious consideration.

6. All government and nonprofit workers should be included in the Social Security system starting in 1985, rather than the far more limited number that will be included pursuant to the recently enacted Social Security legislation. This approach, combined with the COLA cap, will substantially improve the solvency of the system, without overburdening existing workers and employers, or breaking parity in their payments, and without tapping general revenues.

7. Efforts should be made to limit off-budget outlays, including federal loans and loan guarantees, to bring selected off-budget programs on the unified budget and to enact legislation that would subject the off-budget outlays and commitments to the controls and procedures of the existing budget process.

When we presented this proposal last year, we estimated that, under CBO high growth economic assumptions and OMB baseline projections, it would lead to a balanced budget by FY '89 without having to rely on any major tax increase. The absence of official baseline projections and economic assumptions prevent us from providing detailed outlay estimates for the proposal at this time. However, given the robust economic growth now underway, our preliminary estimates lead us to believe that the enactment of the proposals embodied in this budget would lead to a balanced budget within five fiscal years.

Conclusion

A little more than three years ago, the American electorate voted overwhelmingly for a Senate and a President that promised to reduce the size of government. Despite this mandate, our elected officials have instead enlarged the scope of government. Had we simply held the burden of spending at the share of output that characterized the budget during President Carter's last full fiscal year, spending today would be $62 billion lower, and the deficit would not be nearly the problem that most perceive.

The CHAIRMAN. Harry, I think you are next.

STATEMENT OF HARRY PRYDE, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C.

Mr. PRYDE. I am Harry Pryde, the president of the National Association of Home Builders. Well, Mr. Chairman, with all the bombs going off in the Middle East, we still feel—and, of course, it has been very difficult to focus on the ticking time bomb we have going off here some time in the future in this country. And we compliment you on your leadership in focusing national attention on the No. 1 priority in this country.

We feel housing is in the eye of the hurricane, and that action is needed now to enact a combination of spending reductions and tax increases to reduce the unprecedented Federal deficits that we have. Otherwise, the economy will not grow, the deficits will widen as the economy slows, and interest rates will turn upward.

As Mr. Greenspan has said recently, the spector of continued large deficits have increased current rates by as much as 4 percent. Should deficits remain high, the most likely scenario is a clash for funds between the private and public sector. In 1983, as we know, the Federal Government has taken in excess of 50 percent of the loanable funds of the country.

We feel a delay until 1985 could be fatal to the current economic recovery. Without action, the Federal deficits will certainly exceed over $200 billion through 1988, as we have heard earlier. And to push this program until 1985 means that as a practical matter no changes will really take place until 1986, which we feel could be too late.

The specific program for reducing the deficits should be a balance between spending reductions and tax increases. Broad based tax increases, which are neutral in terms of modifying investment incentives and behavior should be considered. Among the options are the administration's contingency tax plan, the Danforth-Boren indexing, freezing scheduled future tax reductions, and generally the Finance Committee's deficit reduction package. The proposal to broaden the tax base should, however, be viewed with skepticism. For rental housing, tax expenditures are a legitimate and necessary means of attracting needed capital. That's very important.

The changes that have been outlined could drastically reduce such capital formation.

And in conclusion, NAHB members feel so strongly about this issue that we have embarked on a national grass roots campaign last fall to develop a bipartisan consensus, as you know, for action. The campaign is the result of a growing awareness that the Federal deficits are a major deterrent, we feel, to sustained economic recovery so important in our country. And that our childrens' future is at stake, and is being stolen. And your leadership in confronting this issue now is greatly appreciated.

The CHAIRMAN. Thank you very much, Mr. Pryde.

[The prepared statement of Mr. Pryde follows:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before

THE SENATE FINANCE COMMITTEE

ON

DEFICIT REDUCTION LEGISLATION

on

December 13, 1983

Mr. Chairman and Members of the Committee:

My name is Harry Pryde and I am President of the NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB). I am testifying on behalf of more than 117,000 members of NAHB. NAHB is a trade association of the nation's homebuilding industry. Accompanying me today are Jim Schuyler, NAHB's Staff Vice President/Legislative Counsel, and Ed Beck, NAHB's Tax Counsel.

NAHB appreciates the opportunity to present its views on the need to enact major deficit reductions prior to 1985. NAHB applauds your leadership and the leadership which the Finance Committee has shown to develop a program for reducing ever increasing federal deficits. Action now to enact a combination of spending reductions and tax increases to reduce the unprecedented federal deficit should be the number one domestic priority of the Congress and this administration during 1984.

NAHB's members feel so strongly about this issue that NAHB have embarked on a national, grassroots campaign to develop a broad consensus for action. The campaign is the result of a growing awareness among NAHB's membership and leadership that federal budget deficits are a major deterrent to sustained economic growth and the continuing health of the American economy.

In the early part of 1983, interest rates were trending downward and an economic recovery was well under way. However, the prospects of an ever increasing deficit along with the political stalemate which has developed in the Congress and with the Administration have created mounting uncertainty about the ability of the economy to continue to grow beyond 1984 in a non-inflationary manner. The current economic situation demands bold and creative political leadership.

High interest rates will ultimately be a drag on the economy to the point where NAHB now sees a long-term sustained economic recovery in jeopardy.

To maintain the current economic recovery at a healthy, non-inflationary pace, NAHB supports a bipartisan compromise on the following issues:

- Domestic discretionary spending should be restricted.
- The growth in entitlement programs must be scaled back.
- Increase in defense spending must be curtailed.
- Appropriate tax increase that will not abort the recovery

should be instituted now.

- Federal Reserve monetary policy should provide for sufficient expansion of the money supply to accommodate economic growth.

NAHB has not only embarked on a nationwide educational and grassroots lobbying campaign to encourage action on the deficit immediately, it has also supported legislation in the Congress to achieve this result. Most recently, it actively worked in the House of Representatives for passage of the Ways and Means Committee tax proposal. This, unfortunately, was defeated.

In response to the specific items for consideration mentioned in the Press Release announcing this hearing, the consequences of failure to act are enormous. In terms just of government finance, mounting government deficits, piled each year on top of each other, have ballooned the federal debt and increased interest payments to such a degree that interest now constitutes the third highest expenditure in the federal government, after national defense and income security. Mounting deficits will continue to strain the capacity of the government merely to pay interest on its debt.

The more the debt grows, the higher the interest rates it has to pay to keep borrowing money; and servicing the debt eats up more and more of the funds needed for economic growth.

Large projected deficits and the uncertainty of any future action to reduce them raise inflationary expectations. Even at a time of historically low current rates of inflation, a large interest premium is placed on long term debt financing, especially home mortgages. This translates into higher housing costs for home buyers and a curtailment of needed investment in new rental housing.

Residential contruction has again, been in the forefront of the upturn. On the GNP basis, after still declining in the third quarter of last year, expenditures for residential construction jumped by 53.2 percent in the fourth quarter of 1982, then again 57.3 percent in the first quarter of 1983, 79.5 percent in the second quarter of 1983, and 37 percent in the third quarter of 1983.

Rising interest rates, soaring and uncontrollable federal deficits, and great uncertainty over the nation's monetary policy threaten to choke off this housing-led recovery. Since the spring of 1983, mortgage interest rates have risen by a full percentage point, pricing out of the market more than a million potential housing purchasers. Interest rate increases have slowed home sales, reduced subdivision traffic and left builders with a growing inventory of unsold units.

Developing a consensus on these issues will not be easy, but it is absolutely essential that Congress act now to reduce the federal deficit.

The need for action now is based upon a combination of factors. First and foremost, the economy may not be able to sustain the growth necessary to continue to finance the government. Deficits in FY 1984 through FY 1989 could exceed 200 billion dollars according to the latest CBO baseline projections. Despite the generally optimistic figures on housing starts and unemployment, the underlying health of the economy is showing signs of weakening. Signs of future growth such as the level of building permits, have started to trend downward. NAHB's housing affordability index, of which interest rates are a major factor, has shown a downward trend, evidence that potential home buyers are now being priced out of the housing market. A delay until 1985 postpones resolution of the problem until mid-1985 at the earliest. This would push collection of any new taxes and spending restraints into 1986. Such a delay could very well be too late and will continue to perpetuate uncertainty during the period of the delay. Hence, the theme of NAHB's campaign "the deficit time bomb."

We are now almost three months into FY 1984 and by mid-February, the fiscal year will already be half over. Fiscal year 1985, the crucial year, will begin in October, 1984. This timing necessitates action immediately if out-year deficits are to be brought on a downward trend.

As to the specifics needed to bring the deficit down, NAHB urges the Committee to adopt as an operating premise that both the spending and the tax increases should be as broad based as possible. They should be fair in the sense of equally affecting all income levels and sectors of the economy. On the revenue side, they should strive toward investment neutrality -- i.e., not shift the relative attractiveness of capital from one economic sector to another thereby not altering the present mix of investment options.

NAHB has endorsed the following revenue proposals:

- The Administration's contingency tax.
- The "tax freeze" concept of delaying scheduled future tax decreases, as advanced by Dan Rostenkowski, Chairman of the Ways and Means Committee.
- The Danforth-Boren, Jones-Campbell "de-indexing" proposals.

NAHB also endorses the broad elements of the Finance Committee deficit-reduction package which includes an energy consumption tax, a surtax on high income individuals, and a corporate surtax.

On the spending side, NAHB recognizes that many of the reforms may be outside of the jurisdiction of the Finance Committee. However, the idea of reducing non means-tested cost of living adjustments (COLAs) has a great deal of merit. Revisions, such as a delay of three to six months of COLA increase, should be considered. If the Committee deems that it is not politically possible to revise Social Security, it should turn to other entitlement programs, particularly Medicare. The spending cuts should be made concurrently with tax increases to prevent taxes from being increased without commensurate spending reductions.

A final area of spending which need to be examined is the overall domestic discretionary budget and defense budget. Obviously, most of these are outside the scope of this Committee but must be considered if the budget is to be brought under control.

A final comment should be made on the direction of tax increases. A great deal of discussion has been directed toward major restructuring of the tax code. Consumption taxes, a value-added tax, or alternatively, a major broadening of the income tax base, as proposed by Senator Bradley, have been looked upon as likely new sources of revenue. NAHB urges the Committee to delay consideration of major structural changes until 1985. What is needed at present is modification of the current law in as broad based a manner as possible to raise significant revenues to reduce the federal deficit. The implications of major restructuring are not clear and such changes should be the result of extensive debate and consideration.

In seeking to develop a tax package for 1984, NAHB urges the Committee to avoid changes which are designed to raise revenues through relatively minor changes affecting various sectors of the economy. This approach, which was employed in 1982, could instead of raising revenues merely jeopardize the incentives for economic growth which are a part of the tax code. Tax increases directly affecting real estate would increase the current investment bias established in 1981 against investment in housing as opposed to other investment and savings alternatives.

For individuals, proposals to cap the mortgage interest deduction or other tax benefits for housing would have a devestating effect on the housing market. On the business side, tax increases affecting real estate would accentuate current biases against business investment in real estate. One measure which has received attention is a lengthening to 20 years of the depreciation period on structures. Currently, structures have a depreciation period that is three times longer than equipment. To increase the disparity to four times would be highly detrimental -- pushing capital away from high risk investment in residential rental projects.

Finally, part of the Finance Committee deficit reduction measures are directed towards "tax shelters." These changes probably will not raise significant additional revenue and should be viewed with some skepticism. For real estate investment, tax shelters are a legitimate and necessary means of attracting needed capital. The changes that have been outlined could very drastically affect capital formation making it difficult to attract needed investment capital. NAHB shares concerns of the Department of Treasury and this Committee over tax evasion techniques. It would be willing to work with this Committee to develop proposals to close unintended "loopholes" while preserving legitimate approaches for encouraging capital formation. The following testimony will look at these comments in further detail.

I. THE DEFICIT PROBLEM.

The current debate over the federal deficit involves the extent to which the economy will generate sufficient growth to accommodate federal spending needs through tax revenues and a savings pool to finance the tax shortfall. The optimistic view is that there will be sufficient economic growth to accommodate deficits, without an inflationary expansion of the money supply.

A growing consensus seems to be developing, however, that this optimistic view is incorrect. The longer the deficit problem continues without treatment, the greater the possiblity that longer-term growth will be retarded.

Estimates by DRI of the effects from deficit reduction of 100 billion dollars a year show a quick 2 percentage point decline in long-term bond yields and a drop in short-term rated by 3 or 4 percentage points. Likewise, CBO estimated that for every 60 billion dollars of deficit reductions in 1984, there would be a corresponding decline of about 1 percentage point in interest rates.

Should budget deficits remain high into the indefinite future, and the available pool of savings not significantly increase, then there is a likelihood that a clash for funds will occur between the private and public sections. Through the first months of 1983, the federal government absorbed nearly 50 percent of all loanable funds. This is likely to remain the same or even increase should deficits remain at current levels.

The federal deficits perpetuate structurally high interest rates which in turn are dampening the recovery in housing. This is highly significant since more than half of the increase of GNP over the past year can be attributed to the housing rebound.

The current recovery, particularly the recovery in housing, is now in its early, formative stages.

Some important indicators are:

- Housing starts for October 1983 show a downward trend -- falling 15.5 percent to 1.608 million from nearly 1.9 million in August 1983.
- Interest rates for mortgages have started an upward spiral. FHA and VA rates are currently at 12.5 percent. Conventional rates now average 13.5 - 14 percent for 30 year fixed mortgages. This is an increase of 100 basis points for FHA and VA over the past two months and 100-150 basis points for conventional over the past two months.
- New unsold inventory is increasing. In October 1983, the inventory stood at 299,000 units or 5.5 months' supply at the current sales rate. The inventory is up 22 percent above one year ago.
- Construction unemployment stands at 15 percent in November 1983, representing 841,000 out of work. This, however, has dropped from a peak of 22.3 percent in October 1982.
- Housing affordability, as measured by the NAHB affordability index, decreased 3.2 percent in the third quarter of 1983 from the previous quarter. Thus, housing is more costly today than in the past.

Housing has been through a severe depression when compared with past economic housing cycles. (Appendix I) In 1982, the housing industry operated at its lowest level of production since 1946. Starts in 1982 ended up at 1.07 million about 46 percent below the peak of the previous cycle in 1978. New home sales were at their lowest level since the Census Bureau began its survey in 1963. Construction unemployment averaged 20 percent, the highest level since the Bureau of Labor Statistics began its monthly unemployment survey in the late 1940's.

The data indicates that a continued housing recovery needs a period of relative certainty with regard to interest rates, taxes and monetary policy. A steady monetary policy that accommodates the economic recovery is needed. The appropriate fiscal policy would be to reduce federal deficits through reductions in entitlement spending and defense growth and carefully formulated tax increases.

Failure to act in 1984 to reduce federal deficits will cause housing, as a dynamic component of the recovery, to suffer. Other basic industries will also lag.

The result will be a spiralling upward of the deficit, as revenues fail to meet projected levels. A vicious cycle of higher interest rates created by larger than anticipated deficits could develop.

This is not a remote scenario.

In the second quarter of 1983, the federal government was borrowing at an annual rate of 322.9 billion dollars. This is 50 percent of all the money raised in the capital markets. State and local governments had been borrowing at an annual rate of and local governments had been borrowing at an annual rate of 77.9 billion dollars. The combined total for borrowing reached 60 percent.

In 1950, the federal government took only 2.9 percent out of the capital markets. In 1960, this amount increased to 9.2 percent -- and it has been going up ever since.

Right now corporations are only borrowing at an annual rate of 40.7 billion dollars, or 6.4 percent of the total.

Corporations are able to use their own funds. But this will not continue. Mortgage borrowing is running at a 150 billion dollar rate and will need about the same amount of money next year.

It is almost inevitable, therefore, that private and public demand will collide and interest rates will go up.

Action now to reduce future federal deficits is imperative.

The important role which housing plays in the overall health of the economy should be considered. As in the past, the current recovery has relied to a large extent upon housing as the engine for recovery.

There is an enormous ripple effect associated with housing. A housing upturn has created jobs, improved consumer and investor confidence and stimulated activity throughout the economy. NAHB estimates that constructing 100,000 new single-family homes provides 176,000 work-years of employment and generates 14.7 billion dollars in total economic activity including the multiplier effect. When taking into account the financial, legal and other services involved in selling the units as well as the spinoff purchases of goods and services generated by the home sales, a substantial amount of additional employment and economic activity is created throughout the economy.

II. TIMING OF DEFICIT REDUCTION.

The debate over action to reduce the deficit is emerging, not as to whether action should be taken, but when action should be taken.

NAHB sees the need for action in 1984. Delay until 1985, after the election means that as a practical matter the changes enacted will not take effect until 1986. This delay could be fatal to the current economic recovery. All economic projections now look at the federal deficit at 200 billion dollars. Historically, economic projections are always optimistic. The escalating federal debt requires increasingly more federal expenditures for interest on the federal debt. Interest is compounded upon interest, meaning an increasingly difficult struggle for revenues to finance these interest payments and other government expenditures. To halt escalating demands of the federal debt for federal revenues, a reduction in the deficit is necessary.

A reduction in the deficit is also important as a signal that future deficits are beginning a downward trend. This will have an enormously positive effect on the economy. It will provide the framework for a decline in long-term interest rates, a crucial element in a sustained recovery for housing.

III. APPROACH TO REDUCING THE DEFICIT.

As the Committee develops proposals to reduce the federal deficit, certain general principles should be followed. First, the changes on both the spending and the revenue side should be as broad based as possible. Across the board spending cuts and tax increases which affect all taxpayers are the fairest way to reduce the deficit. On the revenue side, an approach which seeks to provide for neutrality with regard to investment decisions should be followed. Changes which skew investment towards one industry as opposed to another should be avoided. Instead, the current set of relationships between industries and incentives should be retained. Finally, the Committee should seek to balance both tax increases and spending reductions. In terms of economic impact, a reduction in spending is preferable to tax increases since a reduction in government spending would provide for more capital and savings in the private economy. However, to maintain the fairness and balance which is essential for action, an approach which the Committee has adopted of matching spending reductions and tax increases dollar for dollar has a great deal of appeal.

On the specifics of spending, the major area of spending reform is entitlement spending. Many entitlement programs are under this Committee's jurisdiction, most notably Medicare and Social Security.

The recent changes in Social Security, which NAHB supported, make it difficult to re-visit Social Security at this time. Therefore, the Committee may wish to look at other entitlement programs and seek revisions. COLA increases could be reduced to a certain percentage below the inflation rate. This could be a major revenue source. It should include programs such as Civil

Service Retirement which are not within the Committee's jurisdiction.

Domestic discretionary and defense spending, which also are generally outside the Finance Committee's jurisdiction, should also be examined. While National Defense is a top priority, the Congress should also consider the impact of the defense and military build-up upon the economy. It may discover that the economic cost of large scale defense increases, in excess of the increases in the Congressional budget, are not worth the price.

On the revenue side, a number of broad based approaches are available. These include the Administration's contingency tax, the "tax freeze" which would delay scheduled tax decreases, the "de-indexing" which has been suggested under the proposal of Senators Danforth and Boren, and the approach which the Finance Committee is reviewing which would impose an energy consumption tax, a high income individuals surtax, and a corporate income tax increase.

The idea of utilizing the current tax system as the base for generating additional revenues is appropriate because of the short time frame needed to develop a revenue increase proposal. In the long run, the Committee may want to look at major restructuring of the tax law, including a value added tax, a consumption tax, or a major broadening of the tax base coupled with a lowering of income tax rates. These changes, however, should not be done without thorough review and study. Many of these changes have social and political implications which far exceed their revenue and economic effects.

Housing, for example, has important social and political components. Home ownership promotes social stability and community involvement. Current tax incentives for home ownership, therefore, should not be undermined. For those who are unable or do not desire to own their own home, affordable housing is an important social and community concern. Provisions in the tax law which provide incentives to provide affordable rental housing should not be overturned without providing for alternative mechanisms to replace these incentives. A major restructuring of the tax law will require careful consideration of these and other national priorities, which should be delayed until after the 1984 Presidential election.

The immediate need is to utilize the existing tax structure to bring in needed revenues, to bring the deficit down and continue the economic recovery. In making these adjustments, the Committee should carefully consider the impact of its actions upon capital formation. Preservation of the current relationships with regard to tax incentives for investment decisions should be retained. It should be remembered that changes made in 1981 provided for a major reordering of investment incentives, shifting priorities towards savings and capital formation in the industrial sector of the economy. The changes, were a shift away from an investment in housing, both individual home ownership and investment in real estate and rental housing.

As the Economic Report of the President for 1982 noted:

> The sizable reductions in tax rates on capital income mean that real after tax returns on household savings will be substantially higher than they have been in the recent past. As a result, the

> implicit price of consumer durables has risen and a long run shift in demand away from housing, automobiles, and other consumer durables may result. (Page 126)

The movement in tax incentives away from housing is confirmed in a study dated October 25, 1982, by the Congressional Research Service. The study, Tax Subsidies to Housing, 1953-83 indicates that tax subsidies for housing, both owner-occupied and rental investment housing, have declined over time as compared to tax subsidies for other types of assets. The study notes "the spread between the return on business assets and the return on owner-occupied housing has diminished and in some cases disappeared. One can no longer argue unambiguously that owner-occupied housing receives a tax subsidy relative to business capital."

NAHB views the direction of tax changes towards more savings and investment as a healthy and necessary change. The point is not that the changes should have been made, but only that the changes reduce the tax incentive associated with a home purchase compared to other types of investments. Tax increases affecting housing would be counterproductive for the entire economy. Appendix II and III, for example, look at the effect of the mortgage interest deduction upon housing affordability and changes in new home prices over the past 10 years.

Regarding rental housing, changes in the current tax rules would severely disadvantage investment in rental housing as opposed to other types of investment alternatives. The history of recent tax legislation affecting residential structures has been a progressive diminution of investment attractiveness. The requirement that construction period interest and taxes (IRC

Section 189) be capitalized was introduced in 1976. No industry other than real estate construction is required to capitalize interest. Residential real estate also does not have the advantage of the investment tax credit, except for the rehabilitation of historic structures. In addition, the alternative minimum tax often make investments in other types of assets, particularly corporate equities or bonds, more attractive than real estate investment.

With this as background, NAHB is disturbed to note that there is a continuing interest in reducing tax incentives associated with housing. Often these changes surface as "technical revisions." The Finance Committee package, for example, contains an entire series of Treasury recommended changes in the partnership area. The Committee should realize the partnership mechanism is a major means of raising investment capital for real estate ventures, including rental housing. The partnership allocation rules provide a mechanism for attracting capital, through tax benefits, to socially desirable housing rehabilitation and construction. Without these tax incentives, many projects would never be built. These points are discussed in greater detail in appendix IV of this testimony.

If the Committee feels it necessary to revise partnership and other capital formation rules affecting real estate, NAHB urges it to consult with the industry as well as the Department of Treasury to arrive at an approach that will provide needed incentive while eliminating areas of tax abuse. Otherwise, if not well thought out, changes which may generate little revenue and be counterproductive with regard to continuing the economic recovery.

The important role of housing to the overall economy and its other positive social and political contributions should be considered as the Committee seeks to make adjustments in the revenue base. Existing incentives which have worked to provide affordable housing should be retained. The failure of the Congress to act in extending mortgage revenue bonds eliminates an important and flexible means of providing medium priced housing for the American home buyer. Renewal of mortgage revenue bonds should be an immediate top priority in January.

New approaches for reducing the cost of housing should also be considered. The TIMs proposal which Senators Tower and Garn have introduced is a revenue neutral way of broadening mortgage sources of finance by removing technical tax impediments to investment in mortgages and should receive serious consideration. Unfortunately, the Treasury is looking at this proposal as a means of adding additional restrictions upon builder bonds, an innovative technique of mortgage financing, which makes support for TIMs difficult.

Finally, if the Committee choses to eliminate other savings incentives such as the net interest exclusion, it should consider alternative approaches to encourage savings and home purchases. The Individual Housing Account concept should be explored. Senator Wallop and Chairman Dole and other members of the Committee have made a major step forward by introducing S.1435, establishing HOME ACCOUNTS to provide a carefully targetted savings incentive at a modest revenue cost.

IV. CONCLUSION

NAHB applauds the Senate Finance Committee for taking seriously the need to reduce the federal deficit. High federal deficits threaten economic growth and are causing a continuation of high interest rates at a time when inflation has subsided. Investor inflationary expectations continue to be high because of the federal deficits.

Action now to reduce federal deficits will help to continue the economic recovery which otherwise soon may falter. Delay will only increase the prospects for either a return to high inflation or economic recession.

The specific program for reducing the deficit should be a balanced approach utilizing spending reductions and tax increases. Broad based tax increases which are neutral in terms of modifying investment incentives and behavior should be considered. Among the options are the Administrations contingency tax, the Danforth-Boren "de-indexing", scheduled future tax reductions, and the Finance Committee deficit reduction package.

APPENDIX I

BACKGROUND: CURRENT HOUSING PRODUCTION AND PAST CYCLES

A comparison with past housing cycles shows that the current downturn was much more severe than past recessions. The latest housing recession was the longest running and the most devastating of the seven the industry has suffered since World War II. Total housing starts for 1981 were 1,100,300 -- the lowest annual production since 1946. Starts in 1982 finished slightly below the 1981 level.

1983 is forecast as a recovery year. The housing recovery will be strongest in the Sunbelt and less convincing in other areas of the Northeast and Midwest, whose main-line industries have been especially hard hit by the recession.

The recovery will be significantly slower than those that preceded it because: 1) it will take time for suppliers of building materials to shift back to higher levels of production; 2) the general economy will not gain as quickly as housing, most likely leaving unemployment above 10 percent until mid-year; and 3) mortgage interest rates, while significantly lower than they were during the recession, will, because of structural changes in the savings industry, remain relatively high by historical standards.

Seven Housing Cycles Since World War II

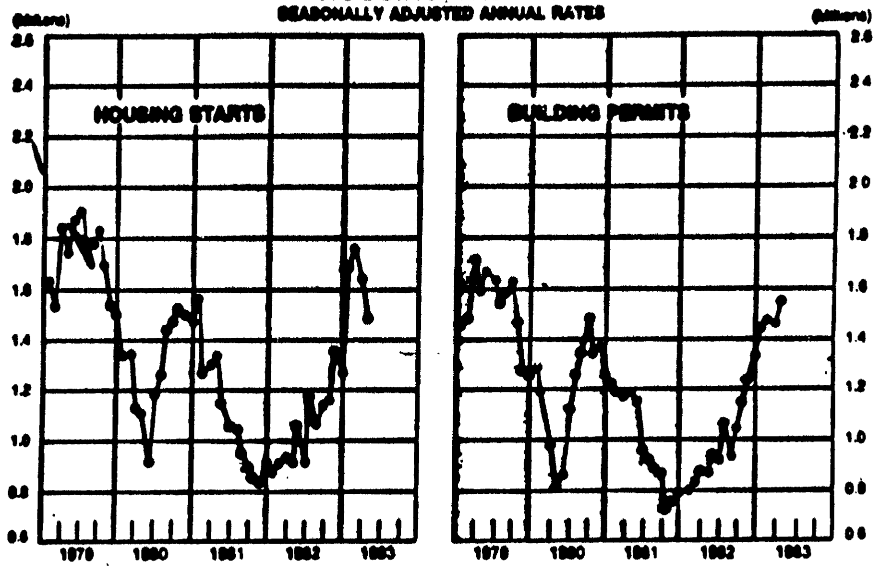
Period	No. of Months Between High and Low	Number of Housing Starts (in thousands) High	Low	Difference	Percent Change
8/50 - 7/51	11	1,889	1,154	735	-38.9%
12/54 - 3/57	27	1,703	1,068	635	-37.3%
12/58 - 12/60	24	1,604	1,041	563	-35.1%
12/65 - 10/66	10	1,656	843	813	-49.1%
1/69 - 1/70	12	1,769	1,108	661	-37.4%
1/73 - 2/75	25	2,481	904	1,577	-63.6%
11/78 - 10/81	36	2,107	854	1,253	-59.5%

On a ten-year basis, between 1971 and 1981, total private and public housing starts ranged from a high of almost 2.4 million units in 1972 to a low of just over 1.1 million units in 1981. A new annual low for the period was set in 1982 -- 1.07 million units.

Year	Price	Year	Price
1971	2,084,500	1977	2,001,700
1972	2,378,500	1978	2,036,100
1973	2,057,500	1979	1,760,000
1974	1,352,500	1980	1,312,600
1975	1,171,300	1981	1,100,300
1976	1,547,600	1982	1,072,000

APPENDIX I Con't

HOUSING TRENDS
SEASONALLY ADJUSTED ANNUAL RATES



SOURCE: Bureau of the Census, U.S. Department of Commerce, NAHB Economics Division

APPENDIX II

Mortgage Interest Deduction and Housing Affordability

Assume: Married couple filing joint return. $3,400 in deductions other than mortgage interest. Adjusted gross family income of $35,000 per year. Tax rates effective July 1, 1983.

Mortgage Interest Deduction	
Term	30 Years
Interest Rate	12 Percent
Price	$70,000
Downpayment	$7,000
Mortgage Amount	$63,000
P & I/Month	$648.00
P & I/Year	$7,776
Interest/Month	$629.00
Interest/Year	$7,548
Income -- Tax Savings	$1,922
Effective Annual P & I Payment	$5,854
Effective Monthly P & I Payment	$488.00
Effective Int. Rate	8.58 Percent

Real Estate Tax Deduction	
Property Taxes/Year	$1,260
Income Tax Savings	$277.00
Effective Property Tax/Year	$983.00

Total Tax Savings from Interest and Property Taxes/Year - $2,199

If one assumes principal, interest and property taxes, both deductions equal 30 percent of adjusted gross income, an income of $30,120 would be needed to qualify in the example above. Lenders calculate the interest and property tax savings into their 30 percent criterion. Hence, a family is paying only 22.7 percent of their income for principal, interest and property taxes. If there were no deduction and lenders used a 22.7 percent criterion, the family could afford a house costing only $53,000.

APPENDIX III

NEW HOME PRICES: 1972 to 1982

From 1972 to 1982, prices rose about 151 percent, from $27,600 to $69,300.

Year	Price	Year	Price
1972	27,600	1978	55,700
1973	32,500	1979	62,900
1974	35,900	1980	64,500
1975	39,300	1981	68,900
1976	44,200	1982	69,300
1977	48,800		

APPENDIX IV

The ACRS recovery allowance for structures, adopted in 1981, should not be revised to reduce current depreciation allowances.

From an investment point of view, rental housing has often not been attractive. Intensive management is necessary to both maintain rental housing and to assure a steady income stream. Cost of maintenance of rental property have increased considerably in recent years. In addition, income generated from rental property is lower than for other types of property.

Residential rentals do not generally carry CPI inflation increases, and the income of residents can only support a certain level of rent. Therefore, market rents generally do not create an income stream which is competitive with other types of investments. In addition, rent control in many jurisdictions has kept rents at below market levels.

As a result, residential housing needs to retain current depreciation allowances to be competitive with other types of investments. A reduction in present depreciation allowances would only drive capital away from residential housing at a time when more, not less, capital is needed.

NAHB supported the 1981 ACRS depreciation changes because of their certainty and simplicity. It is, however, a misconception to believe that the changes, in terms of new residential construction, significantly increased depreciation write-offs. In fact, component depreciation plus the ability to use 200 percent declining balance often created a more advantageous depreciation situation for new housing than the situation after ACRS. The tax savings as well as interest on the tax savings amounted to a substantial sum.

Possible changes in the current tax rules associated with depreciation allowances for structures would bring uncertainty into the market place again, thereby diminishing the potential for future economic growth in this important sector of the economy.

The ACRS changes benefitted other types of assets, particularly equipment, much more than real estate. The effective tax on structures, was relatively unchanged both before and after 1981. This result is confirmed in several places. First, the economic report of the President, 1982, comments:

> ...ACRS does not treat all types of business investments equally. Although favorable to all new investment, ACRS is relatively more favorable to investment in equipment. As a consequence, industries for which short-lived equipment represent a large fraction of their total capital will face lower effective tax rates than industries with a low equipment-intensive capital structure. (Page 124)

The relative bias of current tax rules toward equipment as opposed to apartment buildings is underscored in a Library of Congress study in 1981 entitled Effects of the Accelerated Cost Recovery System by Asset Type. The study notes:

> ...there may well be a shift in the composition of capital towards business equipment and away from structures particularly away from residential structures. The relative (and perhaps absolute) size of the housing stock could fall, not only because of the effects on rental housing but also because high interest rates will make owner-occupied housing less attractive and because there are no offsetting tax benefits.

Therefore, as the Committee looks at base broadening approaches, the relatively heavy tax burden on rental housing should be considered. Rather than increasing the tax burden by changing ACRS, the Committee should look at other avenues for broadening the tax base.

Another aspect of the ACRS that has generated criticism is that used property is treated the same as new property; both are equally eligible for the 15-year ACRS write-off. However, the ACRS is available for used property only if the persons acquiring the property did not own it prior to 1981, the year the ACRS rules became effective. Thus, while sales of existing residential property are possible, these involve a new set of purchasers and free up the capital of the former owners that has been locked up in such property. This freeing up of capital is a positive rather than negative result since the capital can be channeled into new investment. Moreover, the Treasury benefits from the capital gains tax that must be paid as a result of the resyndication.

Concern has also been expressed that the ACRS may be used for property received in a tax-deferred exchange qualifying under IRC §1031. This situation, however, is covered by the comprehensive rules against "churning" provided in IRC §168(e)(4). These rules deny ACRS depreciation for property received in exchange for pre-1981 property in a tax-deferred exchange unless additional debt or cash is made part of the transaction. Even then, ACRS is available only to the extent of the new debt or cash.

2/14/84

N A H B EXAMPLE
SIX YEAR COMPARISON
COMPONENT DEPRECIATION VS. A C R S

	COST	ESTIMATED LIFE	FIRST YEAR	SECOND YEAR	THIRD YEAR	FOUTH YEAR	FIFTH YEAR	SIXTH YEAR	TOTAL
	COMPONENT METHOD PRIOR TO 1981 TAX LAW								
BASIC STRUCTURE	$672,836	$40	$33,604	$31,924	$30,327	$28,811	$27,371	$26,002	$178,838
----INTERNAL CONSTRUCTION----									
CEILINGS	108,012	30	7,204	6,724	6,275	5,857	5,466	5,102	36,628
WALLS	192,022	30	12,808	11,954	11,156	10,412	9,718	9,069	65,117
DOORS	72,008	10	14,402	11,521	9,217	7,374	5,897	4,719	53,130
FLOORS	108,012	30	7,204	6,724	6,275	5,857	5,466	5,102	36,628
----ELECTRICAL----									
WIRING	84,010	15	11,199	9,706	8,412	7,291	6,319	5,476	48,403
LAMPS & FIXTURES	72,008	8	18,002	13,502	10,126	7,595	5,696	5,696	60,617
----PLUMBING----									
BASIC	96,011	15	12,798	11,092	9,614	8,332	7,221	6,259	55,316
FIXTURES	108,012	15	14,398	12,479	10,815	9,376	8,124	7,041	62,231
EQUIPMENT	60,007	8	15,002	11,251	8,439	6,329	4,747	4,747	50,515
ROOF	60,007	10	12,001	9,600	7,680	6,145	4,916	3,933	44,277
AIR CONDITIONING	144,016	10	28,803	23,043	18,434	14,747	11,798	9,438	106,263
APPLIANCES	96,011	3	64,008	21,333	10,670				96,011
FLOOR COVERING	156,018	3	104,013	34,667	17,338				156,018
DRAPES & DECORATING	120,014	3	80,010	26,667	13,337				120,014
CABINETS	72,008	15	9,599	8,308	7,196	6,230	5,409	4,6[illegible]	41,413
POOL	72,008	8	18,002	13,502	10,126	7,595	5,696	5,696	60,617
OUTSIDE FENCE	24,003	5	9,601	5,761	3,456	2,593	2,592		24,003
LAND IMPROVEMENTS	84,010	10	16,802	13,442	10,753	8,603	6,882	5,506	61,988
TOTAL	$2,400,273		$480,460	$283,193	$209,647	$143,154	$123,318	$108,476	$1,357,248
	A C R S METHOD ATER 1980 TAX LAW								
A C R S RATE (CCH TABLE 11650)			12.00%	10.00%	9.00%	8.00%	7.00%	6.00%	
A C R S DEPRECIATION	$2,400,273	$15	$288,033	$240,027	$216,025	$192,022	$168,019	$144,016	$1,248,142
	COMPARISION								
DIFFERENCE BETWEEN COMPONENT & A C R S			$201,427	$43,166	$-6,378	$-48,868	$44,701	$-35,540	$109,106
ACCUMULATED NET DIFFERENCE			$201,427	$244,593	$238,215	$189,347	$144,646	$109,106	$109,106
TAX SAVINGS (50% TAX RATE)			$100,714	$21,583	$-3,189	$-24,434	$-22,351	$-17,770	$54,553
INTEREST ON TAX SAVINGS			$20,143	$19,568	$14,293	$11,361	$8,679	$6,546	$80,590

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The CHAIRMAN. Dr. Riedy.

STATEMENT OF DR. MARK J. RIEDY, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION, WASHINGTON, D.C.

Dr. RIEDY. Thank you, Mr. Chairman. I'm Mark Riedy. I appreciate the opportunity to be here today. In response to one of your questions, we think the attack on budget deficits needs to begin immediately rather than after the 1984 elections.

This Nation really has been living on borrowed time with respect to the impact of present and prospective deficits on the economy. By that I mean that real and nominal interest rates would be higher than they already are, if it weren't for large corporate profits and cash flows, and relatively moderate long-term capital investment activities which have generated only modest business demands for credit during the current recovery.

We've been lucky thus far, but business credit demands are expected to rise, perhaps substantially in 1984. The results will be upward pressure on interest rates that will slow growth in interest sensitive industries, add to the borrowing cost of the Treasury, and, on balance, worsen the problems of the Federal deficit in the next few years.

The Mortgage Bankers Association of America has been keenly aware of the problems caused by excessively large Federal deficits because of their severe impact on mortgage interest rates and the affordability of home ownership.

In our formal statement we have provided an analysis of this impact on America's potential homeowners that illustrates clearly the long-term damage being done by the effects of the deficit. It is not merely a temporary problem, or a problem of shifting the timing of housing construction and home purchases by short periods, but a lasting shortfall of new construction and an on-going frustration by great numbers of families who are unable to afford to purchase suitable shelter.

Total private housing starts each of the first 4 years of this decade, for example, have fallen far short of the activity levels commonly accepted as necessary to satisfy even a moderate projection of new housing demand.

MBA's board of governors has consistently expressed its great distress regarding the mismanagement of fiscal policy. Initially, the board argued that the top priority had to be extensive cuts in Federal spending, including defense and entitlement programs. Only if spending cuts could not be deep enough to reduce projected deficits substantially should tax increases or cutbacks in future tax reductions be considered. The basic reasons for MBA's initial policy stance favoring spending cuts strongly over tax increases, was that Government spending crowds out private spending in an economy with limited resources; that entitlement program growth was out of control; that revenues from increased taxes can be abused through additional Government spending rather than being used to reduce the Federal debt, and that increased income or added taxes discourage and/or reduce the pool of private sector savings, which are already in short supply and extremely costly vis-a-vis the demands of the private sector for using these savings.

Over the past year, the possibility of congressional approval of meaningful spending cuts has gotten dimmer by the hour, much to our frustration. Reluctantly, therefore, MBA's board shifted its policy position to supporting spending cuts and broad-based tax increases on a roughly equal and simultaneous nature. MBA further believes that the approach most palatable politically, and the one that would make more sense for a majority of Americans, involves a broad approach to spending cuts and tax increases that spreads the burden over a wide range of industries and income groups, with the exception of lower-income families.

Therefore, MBA continues to support sizable cuts in the growth of defense spending and entitlement programs, including social security. On the revenue side, MBA recommends that the tax cuts scheduled for 1984 be postponed or eliminated altogether. Further, while we strongly approve of the indexing of personal tax brackets to a full change in the CPI scheduled to begin in fiscal 1985, we will support a reduction of the full indexing along the lines of S. 1627, known as the CPI minus 3 percent bill. That bill also cuts the indexing of entitlement programs, and we strongly support those cuts.

Finally, Congress should also look toward a consumption-based tax whether based on value added or simply a national sales tax. MBA's expertise is housing and housing financing. And in this area, we would note that Federal assistance to housing has been reduced substantially in recent years. Government spending on housing and community development programs fell from about $35 billion in fiscal 1980 to a proposed $15.6 billion in fiscal 1984. Moreover, through a host of antihousing initiatives, the administration has threatened to dismantle the infrastructure of the housing finance industry, and further exacerbate the problems of affordability, already plaguing this Nation's potential home buyers.

In closing, I anticipate that prolonged large deficits will shortly begin to choke off the private sector recovery through increasing interest rates. It is irresponsible for the Congress and the administration to keep fiddling with insignificant budget adjustments, as a pretext for dealing effectively with the budget crisis.

Thank you.

The CHAIRMAN. Is that it?

Dr. RIEDY. On the button.

The CHAIRMAN. Pretty good timing. Do you have more?

Dr. RIEDY. No.

[The prepared statement of Dr. Riedy follows:]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Dr. Mark J. Riedy
Executive Vice President
(202) 861-6501

STATEMENT OF

DR. MARK J. RIEDY

EXECUTIVE VICE PRESIDENT

on behalf
of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

Hearings on

DEFICIT REDUCTION PACKAGE

December 13, 1983

Mr. Chairman and Members of the Committee, my name is Dr. Mark J. Riedy. I am Executive Vice President of the Mortgage Bankers Association of America.* MBA is the trade association of the Nation's mortgage banking industry. Accompanying me are Burton C. Wood, MBA's Legislative Counsel, and Charles H. Fritts, MBA's Associate Legislative Counsel.

We appreciate the opportunity to appear before you today to express our views on Congressional efforts to reduce the Federal deficit. There can be no doubt that this Nation is facing an economic crisis today. The crisis is one of conflict between fiscal and monetary policies, and the result is exploding government deficits crowding out private spending and causing record high interest rates.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Pension Funds
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; Telephone: (202) 861-6500.

The essence of MBA's position is: cut government spending and increase taxes on a broad basis so that all sectors of the population and the economy are treated equitably. On the spending side, there is no choice but to limit cost of living adjustments in all non-means tested programs and to restrict further increases in defense spending.

On October 19, 1983, the MBA Board of Governors adopted the following resolution:

> "WHEREAS, the steadily increasing massive Federal budget deficits are resulting in prolonged high interest rates, and
>
> WHEREAS, these high interest rates are not only acting as a brake on the current recovery, but threaten its very existence, with dire consequences for the housing and financial markets, and
>
> WHEREAS, an immediate reduction in the rate of Federal spending, including entitlement programs and defense, as well as a deferment of previously enacted broad-based tax relief, are essential for the restoration of Federal financial stability and safety.
>
> NOW THEREFORE, be it resolved that the Mortgage Bankers Association of America supports immediate bi-partisan action by both the Administration and the Congress to slow Federal spending growth, including entitlement programs and defense, and to defer previously enacted broad-based tax relief proposals."

We do not see an end to increasing budget deficits unless Congress is willing to cut spending. The key economic problem is that the government spends too large a share of

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the gross national product (GNP). Tax increases alone will not solve this problem; spending must be cut as well.

The high deficits of the past three years are in part a result of the recessions of 1980 and 1981-1982. In normal times, the end of a recession would erase the deficit as tax revenues grew with rising profits and incomes, and as government transfer payments for unemployment and other assistance fell. The primary problem of the current deficit, though, is that it will not shrink significantly as the economy continues its recovery. That is, the scheduled tax cuts and defense and entitlement spending increases will more than offset increased tax revenues from rising profits and incomes and other spending reductions. This expansionary fiscal policy would generate new inflationary pressures, if it were not for the current monetary policy of the Federal Reserve. While the restrictive monetary policy successfully is bringing inflation under control, it also causes record high "real" interest rates. It is these high interest rates that have contributed to the recent recession, imposing high costs on the economy in terms of slow or no growth, high unemployment, and low utilization of our productive capacity.

The conflict between a restrictive monetary policy and an expansionary fiscal policy has resulted in:

1) historically high real rates of interest;
2) recession in the early 1980s and the risk of a stalled recovery in 1984 or 1985;
3) historically high unemployment; and
4) injury to key industries heavily dependent on credit—especially housing, automobiles, and agriculture.

The severe inflation problem of the 1970s required restrictive monetary policy. This policy, has been costly, but has produced positive results. Now that inflation is under control, the Federal Reserve could consider easing its policy. However, excessively expansionary fiscal policy is forcing the Federal Reserve to keep monetary policy relatively tight to avoid a resurgence of inflation. In fact, some analysts believe the Federal Reserve may have tightened monetary policy slightly in the last month in response to the rapid pace of economic growth.

So long as tight monetary policy keeps interest rates at or near record high levels, it could jeopardize the recovery of interest rate-sensitive industries, such as housing, agriculture, automobiles, and other consumer durables. Soon, the effects will hit public utilities, manufacturing, and other sectors heavily dependent on borrowed capital. The net result will be that our Nation will not add to its capital stock in sufficient amounts to provide the economic growth and productive capacity needed in future years. Our children will pay for our current irresponsibility in a reduced standard of living and in a less desirable competitive position compared with other nations.

In order to achieve a sustainable economic recovery this year, Congress and the Administration must reduce fiscal pressures by reducing the deficit, beginning in fiscal year FY 1984. This reconciliation of fiscal and monetary policy is the only way to bring about a relaxed monetary policy, which is the only way to reduce interest rates.

We believe it is imperative that the Congress carefully evaluate all government spending plans for FY 1984, 1985, and 1986, including both defense spending and increases in entitlement programs, including social security. It is questionable whether our industrial base and our defense bureaucracy can efficiently spend an additional $55 billion in FY 1985, as suggested by the Secretary of Defense. If such an increase in a short period of time exceeds our physical and managerial capacity to augment defense, then the excess dollars will be wasted or will push up prices. An excessive push in defense, would have additional damaging effects on the economy. It would compete with the private sector for machine tools, materials, and industrial capacity at the very time when the private sector heavy goods industry would be recovering, putting upward pressure on prices in those sectors that will be passed along to consumers later. In addition, the massive financing requirements for both defense and industrial production will put upward pressure on interest rates and/or inflation, at a time when government credit demands still will be high.

Defense spending also tends to be inflationary. The production of defense goods and services increases national income without increasing the stock of goods and services available for consumers to buy. The result is that consumer prices tend to be bid upward, inflating the economy. Because investors require a premium for inflation, interest rates are pushed upward as well. Congress should carefully review defense spending plans, to provide the defense capabilities we need over a reasonable period of time, consistent with our other needs and consistent with the needed growth of our productive capacity. Deferral of a portion of the planned defense buildup offers two benefits. First, any spending deferrals for the FY 1984 budget will reduce the deficit by a like amount, reducing pressure on Federal financing. Second, deferrals will allow the needed defense projects to be more carefully planned and reviewed. As a result, less useful projects could be identified and delayed or cancelled. More promising projects that are delayed could be better administered and benefit from emerging technology.

On the entitlements side, social security spending will grow in each of the next few years. Benefit levels are now much higher than were promised when current recipients began paying taxes into the program. Because these extra benefits—those in excess of the actuarially sound level based on contributions--are not subject to income tax, they constitute a double windfall gain that this Nation can ill afford. Our fully indexed support of the eligible retired is especially troubling at a time when we have reduced public assistance to many lower-income recipients of numerous assistance programs. Congress should once again carefully review the Social Security program, to examine not only the financial soundness of the program, but also the level of benefits and the automatic indexing of benefits.

MBA urges this Committee to act favorably on S 1627, which would restrict tax indexing provisions and cost of living adjustments in certain spending and tax programs. These types of programs require the government constantly to increase its outlays, thereby trapping it into an upward spending spiral. S 1627 known as the "Consumer Price Index (CPI) minus 3 percent" bill, would reduce the impact of the spending spiral.

Because spending cuts sufficient to control the deficit will be difficult to achieve, tax increases should be considered. However, Congress should take note of the importance of our reduced marginal income tax rates in encouraging saving and investment in the domestic economy. Government borrowing could soon absorb personal savings in our economy. Huge Federal deficits displace private sector investment and consumption. These deficits also cause interest rates to be higher than they would be otherwise. Any tax increases, such as surcharges, should be temporary and designed to minimize their potential negative impact on savings and investment. Congress should consider taxes on consumption, such as energy.

A further danger of increasing Federal deficits is that the cost of financing the national debt compounds itself. In each of the past few years, the deficit has increased and the interest rate has been high. The government has financed the growing interest bill by additional borrowing, which in turn, adds to future interest bills. It has been projected recently by the Congressional Budget Office that the interest bill could grow by over $50 billion by 1986.

With regard to the course of interest rates during the present recovery, the Committee should note that the industrial capacity utilization rate has now reached 78.6 percent, up from the recession low of 68 percent. As a result, some industries already are experiencing slow deliveries and price pressure is mounting.

One reason for the recent moderation in "nominal" interest rates has been that industry is not borrowing heavily. Instead, much of needed investment funds are being generated internally from profits. As the recovery continues and as capacity utilization rates increase, more of the funds needed for business expansion will have to be raised in the capital markets. It is at this point that the high level of Federal government borrowing could clash with growing private sector borrowing to push up interest rates.

HOUSING AND MORTGAGE OUTLOOK

Federal assistance to housing has been reduced by approximately 54 percent since 1980. In FY 1980, the Federal government spent approximately $35 billion on housing and community development programs. In FY 1984, the government proposes to spend $15.6 billion. As an industry, housing has suffered record high interest rates and more than its share of spending cuts.

Rising government deficits create a tremendous demand on the credit market. Solving the deficit problem by relying on tax increases also reduces the supply of available credit.

Thus, the best solution is to cut government spending. Lenders obviously prefer the security of lending to Uncle Sam to that of lending to the average borrower. If the government must pay 9 percent for short term borrowings, then the prime rate will be approximately 11 percent and mortgage interest rates will range from 13 percent to 14 percent. Term structure of interest rates in the market is a function of risk and liquidity.

The current massive deficits, as well as the projected increase, create fear of a future inflationary environment. Borrowers must pay a premium, which is reflected in the interest rates, to compensate lenders for this fear. This is particularly true in dealing with long term loans such as mortgages. The existence of large deficits and Congress's inability to control the growth of deficits keeps real interest rates on mortgages at record high levels.

Attached is an affordability study that the MBA has prepared recently. It demonstrates the relationship between interest rates and the ability to purchase homes. Our data assume an underwriting standard that the buyer's principal and interest payments do not exceed 30 percent of gross family income.

In 1963, the average mortgage payment to purchase a median price constant-quality new home was $122 per month on a 30 year note. In 1982, that monthly payment was $1,006, an increase of $884.

Table 2 of our study, on page 17, shows the gross family income necessary to qualify for a 30 year fixed-term loan at interest rates between 11 percent and 17 percent with a 10 percent downpayment. The number of families who can afford to buy homes declines drastically as mortgage interest rates increase.

For 1982, the median price of a new one-family home sold was $69,300. Assuming a 10 percent downpayment on this $69,300 home, the outstanding principal balance on a standard 30 year mortgage would be $62,370. If the mortgage interest rate is 11 percent, a family with an annual income of $23,760 could qualify for the necessary $62,370 loan. According to Census Bureau statistics, some 30.2 million American families, or 49 percent, have a gross income in excess of $23,760 and could afford to buy that median priced home in an 11 percent market. In a 15 percent mortgage market, that same house would require the family to have an income of $31,560. Only 20 million American families, or 33 percent, have a gross income in excess of $31,560 necessary to qualify for a loan to purchase that median price home in a 15 percent market.

At 16 percent, mortgage interest rates—a level we have reached and even exceeded in some areas—the number of families that could afford this median price home falls to 17.9 million, or 29 percent. A one percent increase in the mortgage interest rate would prevent approximately 2.1 million American families from qualifying to buy the median price home. In 1982, the prevailing average mortgage interest rate was 15 percent.

In 1977, approximately 58 percent of families could qualify for a mortgage sufficient to purchase the median priced home at the prevailing interest rate. In 1977, the prevailing mortgage interest rate was around 9 percent and the median price of houses sold was $48,800. As is readily apparent, rising interest rates have denied a great number of Americans the ability to purchase a home.

One critical cause of the affordability crisis in housing is the historically high cost of mortgage credit. Several factors are to blame, some macroeconomic or more general in nature, and others related more directly to the severe plight of the mortgage lending industry. The general causes—inflation expectations, excessive Federal deficits, and restrictive monetary policy—have already been detailed.

In FY 1981, the Federal deficit approached $60 billion. It advanced to $110 billion in FY 1982 and in FY 1983, the deficit reached $195 billion. Probably the best measure of the Federal deficit's burden on the economy is its share of GNP. The deficit has grown from about 2 percent of GNP ten years ago to 5.8 percent for FY 1983. The components of the deficit are revenue and spending. During the past ten years, Federal tax revenue as a percent of GNP has remained relatively level at 18.5 percent. Spending during the same period has increased from 19.6 percent of GNP to 25.6 percent, a gain of almost one-third.

Under present economic conditions and prospects, the most optimistic forecast of mortgage rates during 1984 would be a low of 12 to 13 percent by early summer, with rates gradually rising during the second half of the year. Tight monetary policy and the bloated credit demands arising from the huge Federal deficit militate against further declines in interest rates while simultaneously exacerbating the difficult conditions plaguing mortgage lenders and other interest rate sensitive industries.

The net result is that the huge Federal budget deficit represents the major economic problem for our economy and for our country. If left unchecked, it will continue to grow, add to the interest bill, and limit investment in homes, industrial plants, and equipment that we need to sustain our productive capacity and our standard of living.

The deficit problem is too important to be ignored any longer. Action must be taken by this Congress to begin to correct the problem. Additional action will be needed after the election, but failure to act now will only increase the hardship and difficulty that must be faced later.

We appreciate the opportunity to present our views and we will be glad to respond to any questions you may have.

HOUSING AFFORDABILITY THROUGH 1982

Using the average mortgage rate for conventional loans along with the average price of a constant-qualitv new home, a mortgage payment series was constructed on the basis of a 30-year level-payment amortization schedule. Graph 1 shows the increase in the average monthly mortgage payment from 1963 to 1982, a jump of $884 per month.

The average monthly payment shown in Graph 1 was annualized and divided by median family income to obtain the ratios shown in Graph 2. Since 1979, traditional mortgage rates have risen close to 5 percentage points. The affordability ratio broke the 50 percent level in 1982 and was 51.5 percent in 1982.

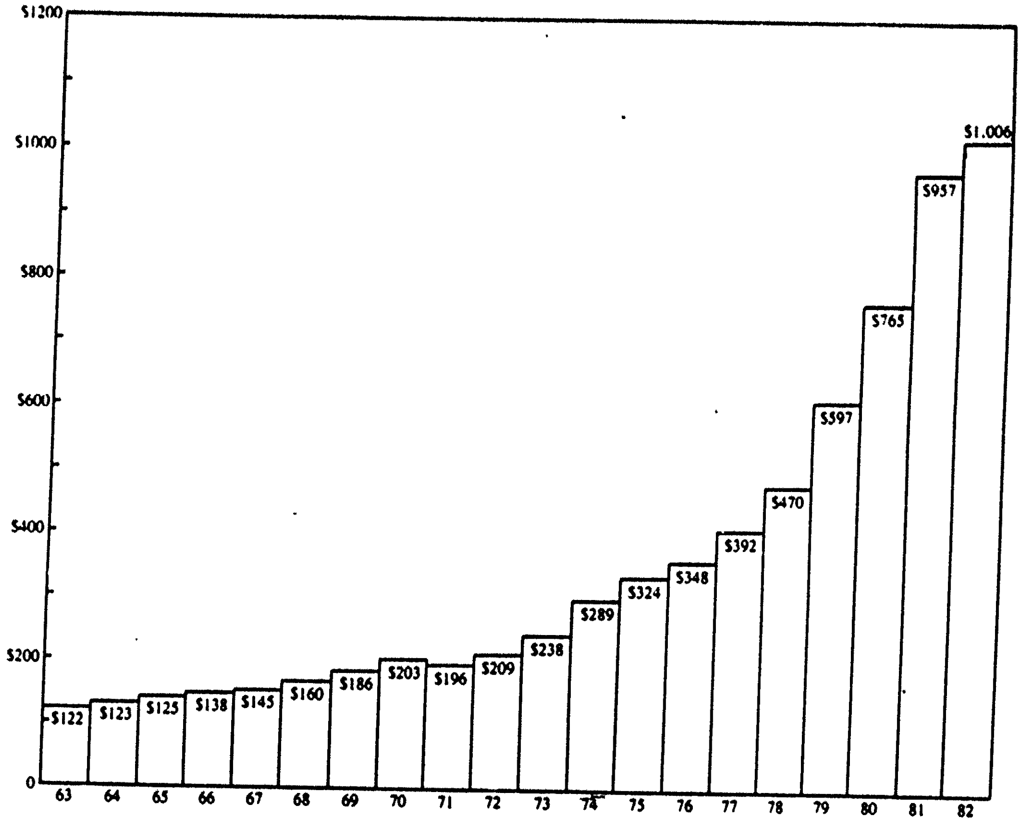
Using the most recent data available from the Commerce Department's Construction Report, a table showing the relative distribution of new home prices was reconstructed, as shown in Table 1. Using the same methodology as before, reference points were established for a given mortgage interest rate. Because new price classes were established by Commerce, new loan amounts had to be calculated. Table 2 shows the changes in qualifying income between mortgage rates of 11 to 17 percent. Table 3 distributes families by income into groups using the qualifying income levels arrived at in Table 2 for rates of 12, 14 and 16 percent. This table shows that a rise in mortgage rates from 14 percent to 16 percent removes 3.8 percent (from 55.3 percent down to 51.5 percent) of potential homebuyers from the market and a rise from 12 percent to 14 percent, eliminates 7.6 percent (62.9 percent down to 55.3 percent).

Replacing the income distribution of all families used in Table 3, data on the income distribution of families headed by persons aged 25 to 34 were used to construct Table 4. The effects of increasing mortgage rates on this age group results in a similar disallocation as in the all-families group, but with a greater magnitude.

Prepared by the MBA Economics Department, December 1983.

Graph I

Average Monthly Payment of Principal And Interest 1963-1982

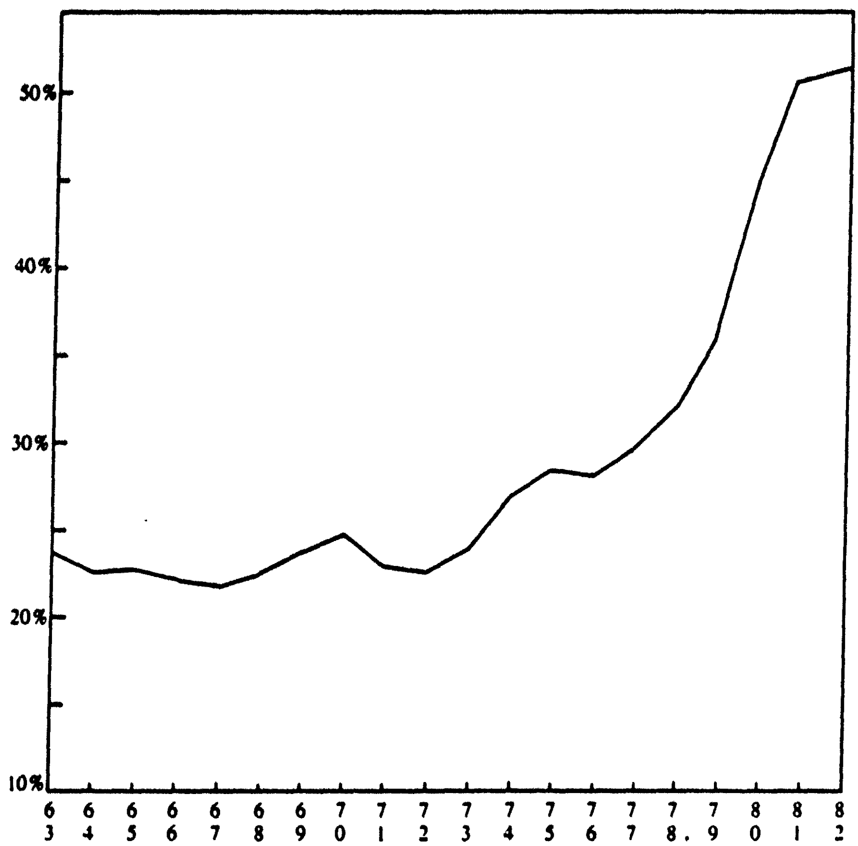


Source: U.S. Department of Commerce, Bureau of the Census Construction Report C-27, Quarterly

Prepared by the MBA Economics Department, December 1983

Graph 2

Ratio of Mortgage Payment* To Family Income 1963-1982



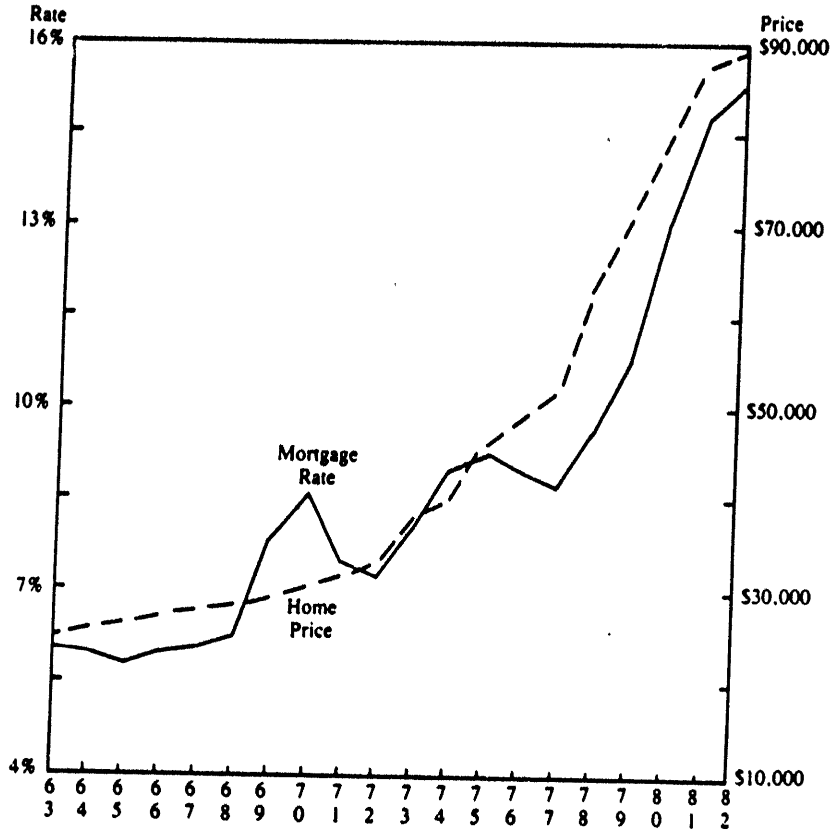
*Assumes 10% down, 30-year term. 1982 Revised.

Source: U.S. Department of Commerce, Bureau of the Census
Construction Report C-27, Quarterly

Prepared by the MBA Economics Department, December 1983

Graph 3

Average Mortgage Rates And New Home Prices 1963-1982



Source: U.S. Department of Commerce, Bureau of the Census Construction Report C-27, Quarterly, and Federal Home Loan Bank Board

Prepared by the MBA Economics Department, December 1983

TABLE 1

New Homes Sold During 1982

Percent Distribution by Sales Prices

Price Class	Percent of Total Sold
Less than $50,000	16%
$50,000 to $59,999	17%
$60,000 to 79,999	32%
$80,000 to 99,999	15%
$100,000 to 119,999	6%
$120,000 and Over	15%

Source: U.S. Department of Commerce, Bureau of the Census
Construction Report C-25, Monthly

Prepared by the MBA Economics Department, December 1983

TABLE 2

Qualifying Income-Fixed-Rate Level-Payment Mortgage
10% Downpayment -30 Year Term

Loan Amount		11%	12%	13%	14%	15%	16%	17%
$45,000	$	17,142	18,515	19,912	21,328	22,760	24,206	25,662
$54,000	$	20,570	22,218	23,894	25,593	27,312	29,047	30,794
$72,000	$	27,427	29,624	31,858	34,124	36,416	38,729	41,060
$90,000	$	34,284	37,030	39,823	42,655	45,520	48,411	51,324
$108,000	$	41,479	44,436	47,788	51,186	54,624	58,094	61,589

Extrapolated from U.S. Department of Commerce, Bureau of the Census Current Population Reports, P-60, No. 140

Prepared by the MBA Economics Department, December 1983

TABLE 3

Mortgage Rates and Affordability: All Families

Loan Amount	Percent Distribution by Price Group	Qualifying Income Mortgage Rates of: 12%	14%	16%	Percent Families with Qualifying Income: (Within Group) 12%	14%	16%	(Cumulative) 12%	14%	16%
$108,000	6%	$ 44,436	$ 51,185	$ 54,624	15.3%	10.4%	8.8%	15.3%	10.4%	8.8%
90,000	15%	37,030	42,655	45,520	8.4	6.9	5.6	23.7	17.3	14.4
72,000	32%	29,624	34,124	36,416	12.7	11.0	10.3	36.4	28.3	24.7
54,000	17%	22,218	25,593	27,312	16.4	16.8	16.2	52.8	45.1	40.9
45,000	16%	18,518	21,328	22,760	10.1	10.2	10.6	62.9	55.3	51.5

Source: Table 2 and Current Population Reports P-60, No. 140

Prepared by the MBA Economics Department, December 1983

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TABLE 4

Mortgage Rates and Affordability

Families with Household Head Aged 25-34

Loan Amount	Percent Distribution by Price Group	Qualifying Income Mortgage Rates of: 12%	14%	16%	Percent Families with Qualifying Income: (Within Group) 12%	14%	16%	(Cumulative) 12%	14%	16%
$108,000	6%	$ 44,436	$ 51,185	$ 54,624	8.4%	5.0%	4.1%	8.4%	5.0%	4.[illegible]
90,000	15%	37,030	42,655	45,520	7.8	5.1	3.5	16.2	10.1	7.[illegible]
72,000	32%	29,624	34,124	36,416	14.1	11.0	9.6	30.3	21.1	17.[illegible]
54,000	17%	22,218	25,593	27,312	19.8	19.5	18.8	50.1	40.6	36.[illegible]
45,000	16%	18,518	21,328	22,760	10.9	12.4	13.1	61.0	53.0	49.[illegible]

Source: Table 2 and Current Population Reports P-60, No. 140

Prepared by the MBA Economics Department, December 1983

The CHAIRMAN. If we could get you three guys to work it out, we would be all right.

I will just go in order of the witnesses. Dr. Rahn, I voted for the chamber's plan last year on the floor. I think it has a lot of merit. But let's face it, it doesn't have the votes. Now what do we do? Do we keep voting down the chamber plan and doing nothing until such time that passes, or failing in that, do we try to come back and do the best we can?

Dr. RAHN. I think we all realize that politics is the art of compromise. But I don't think it's our role to tell you people in the Congress how to compromise. You all seem to do perfectly well at that on your own.

I view our role as trying to lay out what we think the best course of action is for the economy, given the status quo. And the problem is that when we talk about tax increases and spending reductions—I can remember last year during TEFRA when at least a number of people in the administration seemed to think that Congress was going to come up with $3 of spending growth rate reduction for each dollar of tax increase, and we ended up with $1.14 of spending growth rate increase for each dollar of tax increase.

The CHAIRMAN. Much of that, I must say, is not the fault of the Congress. A lot of it was the fault of the administration.

Dr. RAHN. Well, I would say the two groups jointly share that responsibility.

The CHAIRMAN. They dropped nearly all of theirs.

Dr. RAHN. OK. But the point is that we ended up with a higher level of spending rather than lower levels of spending. And we ended up with bigger deficits rather than smaller deficits. And we will do everything we can to put the pressure on the spending side, and to see that those spending rate reductions are put up front before we enter into a discussion of where we ought to increase taxes.

Another thing that is particularly bothersome to some of us who have been involved in this effort for quite some time—I remember years ago when I first got involved in the capital formation effort, many Members of Congress weren't really aware of what capital formation is. Now everybody says we need more capital formation. But when it comes to voting for tax increases, often I see big increases on taxes on capital rather than consumption. And we also fear that.

The CHAIRMAN. Well, if you are opposed to tax increases, you aren't opposed to closing loopholes, are you? I mean you want to close all the loopholes and food stamps and farm programs. What about tax loopholes?

Dr. RAHN. If I can define the loophole, probably not.

The CHAIRMAN. You have a lot of members who enjoy loopholes, so I don't suppose you want to close them.

Dr. RAHN. I have a hard time seeing what these tax loopholes are. It seems to me you would have to look at whose income it is to begin with. And that the so-called loopholes, the big ones—I think the gentlemen on my right and left would be strongly opposed to reduction of deduction for mortgage interest and property taxes. And if we take a look at the things that are so-called big tax expenditures, I don't think many Members of Congress would want to run on a program of advocating elimination of those tax expenditures.

The CHAIRMAN. I haven't found any. [Laughter.]

There may be one, but I don't know who it would be. Somebody who is retired.

Dr. RAHN. I think working on spending would be a little more useful than that.

The CHAIRMAN. But I want to make sure that you are for tax compliance.

Dr. RAHN. We are all for tax compliance.

The CHAIRMAN. Unless it's withholding.

Dr. RAHN. And we are for cost-effective tax compliance also.

The CHAIRMAN. That's the difference.

My view is that if you could have it your own way, you could do most anything around here. I can put together a spending package, and use $18 billion in loopholes the administration proposes and I would be perfectly satisfied with it. But I don't have any votes for that. Maybe we don't give up. Maybe the principle is so important that we don't worry about the deficits until—I guess if it got bad enough maybe there would be a change in Congress, but I don't know which way it would change.

And you fellows may belong to the chamber. You may have a different view than the chamber. I'm never certain who represents the chamber. People in my State or a group back here who never go to Kansas.

Dr. RAHN. I would like to point out that the chamber is the most broad based of all the business organizations. We have members from every line of business—small business, medium sized, large business—and from every geographic area in the country. And it has the same type of discussions and disagreements within, but we come out in the program here, the spending reduction program—it was passed overwhelmingly by our board. Our board in February 1981 unanimously endorsed the President's original economic program. And we find within our committee meetings—we have a highly democratic structure—that once the issues are raised, the sense do rise, and I think the kind of statements that I and other representatives of the chamber have made before this committee and other committees do fairly represent the broad consensus of the American business community.

The CHAIRMAN. I don't quarrel with that, but I think that what you are saying is that we need consensus. And we hope that what we put together here reaches a broad consensus. I mean we obviously can't satisfy every member of the committee or every organization. Some might agree more with what you agree than someone else, but I think as Dr. Stein said this morning, if he had his way, he could fix up a neat little package, but he assumed that everybody would have to make some changes.

But, again, I guess having said that, do you think that if we could cut spending enough to take care of the deficits, should we do it now or wait until after the election? Do you think it's anything to worry about for the next year or two?

Dr. RAHN. Oh, ideally, you would do it now. Realistically, I don't expect you are going to. We are optimistic about the recovery. Last year, our economic growth rate projections turned out to be right on target, even though we were considered unduly optimistic a year ago. And we still see a strong recovery through the next year. Again, depending somewhat on the Federal Reserve maintaining a steady monetary policy, which they seem prone not to do.

But I think you will still have time shortly after the election to make major spending changes. I don't believe it is going to be the end of the world if you don't make major changes this year. But I would encourage you, if at all possible.

The CHAIRMAN. That's going to be a judgment that we are going to have to make.

Dr. RAHN. You are better off doing nothing than doing the wrong thing. And a major tax increase, particularly, one that hit the productive sectors of the economy would probably do more damage than to not do anything at all.

The CHAIRMAN. Right. What we have tried to do, as you know, is to go back and look at the President's 1984 budget, the same thing we did in 1983 when we put together TEFRA. Look back and see how many loopholes he wanted to close, and then try to close as many as we could. We added a few things to TEFRA, but just a few little footnotes.

Harry, I know you have had a nationwide effort to at least focus on the deficit. I know you had a press conference that I couldn't attend because we had a conflict, to sort of kick off your campaign. Has that been fairly successful so far?

Mr. PRYDE. Well, that was November 2.

The CHAIRMAN. Right.

Mr. PRYDE. Yes, we are beginning to get a lot of good response back from our locals across the country. There does seem to be a more rising of the temperature of deficits back from our locals. In traveling around the country I hear a lot more now on the deficit issue in asking what more we can do within our association in this effort. We are hopeful that you are hearing back too more than you were, say, last summer or early fall on the issue of deficits.

We are still undergoing a major effort on the deficit reduction. And, of course, as you know, contrary to our good friends at Chamber of Commerce—and I happen to be a member of the Chamber of Commerce of Seattle.– we believe you have to get involved in both spending reductions and tax increases, revenue enhancements, whatever you want to call it, in order to bring down the structural deficits. And as was mentioned in the earlier panel, the CBO came out just recently with the projection of 1989 of $275 or $280 billion. Of course, as we know, the chairman of the Economic Council said in 1988 it would still be $210. These are assuming good economic recovery and sustained economic recovery, as mentioned in your last panel.

But I think also, as was just briefly alluded to, when you just look at the discretionary domestic side of the budget, like fiscal year 1984—it was only about $135 billion, only about 15 percent of the budget. So if you took and just eliminated that entire area, for example, and stuck with entitlements and interest on the deficits and national defense, you would still have a deficit of around $75 billion, if you are assuming our deficit is $200 billion right now. So I don't see how there is any alternative to also getting into the tax increase side of the picture.

The CHAIRMAN. You state on page 9 of your statement a number of rather disturbing facts about housing starts, interest rates for mortgages started an upward spiral, new unsold inventory is increasing, construction unemployment stands at 15 percent. I mean these are somewhat disquieting.

Mr. PRYDE. I think especially the unemployment figure. We are surprised that is still so high.

The CHAIRMAN. It was 22 percent.

Mr. PRYDE. It was about 22. That's the highest. And then it got down to about 19, and then it went up a little bit. And then just this past month it did drop to 15. I think 15.3. But that's still quite high considering the activity that we have in the housing sector. It's the other side, the heavy construction, that is really down across the country, the commercial side. And that's why it's still so high. I think it's a very disturbing figure. It's unusual in recoveries for the unemployment to still be so high in construction.

The CHAIRMAN. If we are going to do anything, it's better to do it sooner than later, right?

Mr. PRYDE. Well, that's our position. That's what we have been saying.

The CHAIRMAN. If we could do what everybody wanted to do, we could do it immediately. But assuming we can reach some consensus, it's going to have to come, I assume, before the end of May or it won't happen anyway until after the election. I'm not so certain it won't happen next year. I think people underestimate Congress from time to time. May overestimate us, depending on your point of view.

But I wouldn't sell the Congress short yet, if we get that push we need from downtown.

You are pretty much in agreement with Mr. Pryde, as I understand.

Dr. RIEDY. Yes. As a former Federal Government economist, who got out before they started cutting——

The CHAIRMAN. Are you one of the 5,000 that Jack mentioned?

Dr. RIEDY. Right. I think we are living on borrowed time. And our members feel strongly that you really have to get on it before the business sector starts borrowing enough to push interest rates up farther than they already are.

The CHAIRMAN. I think the record ought to indicate that you would rather not have tax increases, too, I suppose. I don't think you have any differences with Dr. Rahn. You are not looking for a tax increase. If we could get it all in spending reductions, I assume that would be all right with you too.

Dr. RIEDY. Well, originally, we felt very strongly that it should only be on the spending side. But then I suppose reality set in and we said, No. 1, it isn't being done without a tradeoff on the tax side; No. 2, it probably can't be done strictly on the spending side. As I said, in October of this year, our board of governors switched its policy, and that was reluctantly so, to favoring both tax increases and spending cuts simultaneously at roughly the same proportion. If we had our druthers, we would prefer just spending cuts.

The CHAIRMAN. I notice the chamber statement didn't mention defense. Is that off limits?

Dr. RAHN. No, that's not off limits. We at the chamber, the board, debated what the appropriate level of defense spending should be, and I think it's a fair statement that nobody knew what it was for sure. And we basically went back to the President's——

The CHAIRMAN. If they knew what food stamps ought to be on the board—I assume they are all very active in that program.

Dr. RAHN. Well, food stamps, I think, all of us can identify with. We have been for an adequate food stamp program, and I don't think our members would have any trouble endorsing an adequate safety net.

In terms of defense spending though, we did go back to the President's original program which we had endorsed in February of 1981, and I think our members, for the most part, feel that the Defense Department ought to be examined carefully for duplication and urged to have greater management efficiencies and so forth. No program should be off limits in terms of spending.

The CHAIRMAN. I know Murray Weidenbaum had a whole list of things that the Defense Department spent money on in the last, what, 24 hours. Fifty-seven thousand softballs and all the other things that annoy people. I mean I know they play a lot of baseball and softball in the Pentagon. [Laughter.]

They need a lot of those softballs. But as Weidenbaum said, it's time to play hardball with the Pentagon.

Dr. RAHN. I think many chamber members would agree with Murray Weidenbaum on that.

The CHAIRMAN. And the Grace Commission also, which we intend to have hearings on—the part that we have jurisdiction of—made a number of recommendations for savings in the defense area as well as programs we have jurisdiction over. We don't suggest that we have gone through and weeded out all of the abuse and duplication and too generous benefits.

Anybody else have anything else to add for the record?

Mr. PRYDE. Mr. Chairman, I might just add, tieing in with an earlier comment you made to the first panel, that for home buyers the tax cuts that we have had haven't begun to cover the increased costs of owning a home. And, for example, interest rates before this last increase were around 9 percent, assuming 9 percent. Now we have 13 percent. You had your payment on a $60,000 mortgage increase by about $181 a month. So you extend that out for a year, you are about $22,172 more on a typical medium priced home. And that's mostly interest. So the tax cuts certainly didn't begin to even come close to what it costs in additional interest rates for owning just a medium priced home in this country. Home buyers are really lost in terms of what has happened in the past few years with interest rates now at such high levels.

Dr. RAHN. It seems to me there has been an implicit assumption with the previous panel and a couple members of this panel that deficits cause the high interest rates. And we have searched the economic literature carefully, have looked at Treasury studies, there was a conference with the Federal Reserve in Boston, and this direct relationship cannot be found. But we can find a strong relationship between Federal Reserve behavior and interest rates. And we are for lower interest, and I sympathize here with my friends who represent the home industry. But if we need to get those interest rates down, which we believe we need, we have to go after the Federal Reserve for a much steadier monetary policy than we have had for the last few years. And we can have low interest rates with high deficits, or we could have no deficits and high interest rates, depending on Federal Reserve behavior.

And I would hope that the committee would look more closely at the relationship between monetary growth, the stability of monetary growth, and interest rates. And we believe that the lack of stability in monetary growth has contributed a couple of points to the interest rates just because of the uncertainty of the engendering in financial markets.

I think the House Banking Committee came out with some positive recommendations on that the other day. For instance, forcing the Fed to go ahead and immediately release the minutes of the Open Market Committee. There is no reason for having that kind of risk or uncertainty about what the people intended to do. The Governors can make honest mistakes, but the market can arbitrage for those if they know what the policy is. And constantly keeping us in the dark of what Federal Reserve policy is increases uncertainty unnecessarily in the business community, and I think there is much we can do there to help bring down interest rates.

The CHAIRMAN. I agree with that. I think we ought to do more of that.

Dr. RIEDY. Just to go back to the previous panel in a comment unsolicited on the contingency tax idea, I think anything like that that would continue the uncertainty that exists in the capital market that has caused investors to demand high rates of return on long-term investments won't solve anything in terms of what we need for the good of the economy. And that is long-term capital investment, which is partly dependent on long-term interest rates. So the contingency tax is not a good approach in this situation.

Dr. RAHN. Mr. Chairman, let me toss up one other thing. I think the committee ought to look more closely at having index bonds or constant value bonds issued by the Federal Government. And this is a way of reducing interest costs in the short run, and sort of this cobwebbing effect that Rudy Penner had spoken of could partially be taken care of by that. And I think we ought to give much more serious consideration to them. I'm not giving a formal endorsement today, but as an idea of who I think ought to take a much more careful look at than we have in the past.

The CHAIRMAN. Dr. Meltzer raised that same—or made the same suggestion yesterday. And we are starting to look into it. Apparently it has worked in England.

Dr. RAHN. Yes. It has worked in a number of places.

Mr. PRYDE. I would just like to make one short comment. I find out on looking at the schedule that I am the only noneconomist here. [Laughter.]

Mr. PRYDE. But I will quote from other economists. And I did say earlier, like Mr. Greenspan did say and has been quoted recently as saying that the spectrum of continued high deficits at the levels we are talking about are contributing as much as maybe 4 percent higher interest rate at the present time. And we have talked to other economists that do say that if deficits were to get down to where they were before, to get under $100 billion, down to $50 billion that used to be so terrible—if they could get down in that range, that interest rates would be 2 to 3 percent lower. So there is, I think, a body of opinion out there that do feel that if we had lower deficits in that range that interest rates would be lower by that much.

Dr. RIEDY. Harry, I think deficits matter. I'm on your side.

Dr. RAHN. Well, I think they matter, but I think the Federal Reserve policy matters much more. And for the record, I disagree with Dr. Greenspan on that, if that is what he said. And I think that we would make much greater progress by getting much more stable monetary policy. But that we ought to get deficits down, and that it should be done through spending reductions.

The CHAIRMAN. Is there anything the economists agree on?

Dr. RIEDY. We are all underpaid.

The CHAIRMAN. Well, we have the same problem.

Mr. PRYDE. The noneconomists agree on certain areas. [Laughter.]

The CHAIRMAN. It is difficult. As you start looking at different numbers, you get—and I don't know what is going to be in the administration's budget. I assume you can fluff it up pretty good or you can have a fairly realistic budget, plug in some numbers. Anybody know what is going to be in the administration budget? I don't think so.

Dr. RAHN. You have closer contacts there than we do.

The CHAIRMAN. I might be able to tell you about one segment of the budget. [Laughter.]

OK. We will come back tomorrow morning at 10. We have two panels tomorrow morning. Thank you.

[Whereupon, at 3:23 p.m., the hearing was recessed, to reconvene on Wednesday, December 14, 1983 at 10 a.m.]

DEFICIT REDUCTION PROPOSALS

WEDNESDAY, DECEMBER 14, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senator Dole.

The CHAIRMAN. Let me welcome today's witnesses.

We will conclude the first phase of our hearings on deficit reduction this morning, and then either in mid-January or perhaps early February we will have the second phase on the general proposition, and then hopefully have a bill ready to present and maybe have 1 day of hearings on a bill itself.

As I have indicated in the last 2 days, what we are trying to do now is to make the case, or build the case, or build a foundation for deficit reduction. Different economists have different views on precisely what we should do and precisely what role deficits play, or what impact deficits have. And we are hoping today to continue the education process—the education of the committee.

I may be the committee today; I'm not certain other members will be here.

So we are pleased to have Dr. Sinai, chief economist, Lehman Bros.; Dr. Donald Straszheim, vice president, Wharton Econometrics of Philadelphia; and Dr. Lawrence Meyer, president, Lawrence Meyer Associates, St. Louis, Mo.

I would say at the outset, your entire statements will be made a part of the record. It would be helpful if you could summarize your statements, then we would have time for questions.

Allen, do you want to go first?

STATEMENT OF DR. ALLEN SINAI, CHIEF ECONOMIST, LEHMAN BROS. KUHN LOEB, INC., NEW YORK, N.Y.

Dr. SINAI. Thank you very much, Mr. Chairman.

The prospect of an unprecedented string of huge Federal budget deficits for the next 5 years, in my view, constitutes a major threat to the stability of the United States and the international economies.

In the short run, the deficits actually have been a plus, through the tax cuts and increased military spending which have helped bring about a very strong recovery, and even the resulting high interest rates can be interpreted positively as having prevented a runaway boom.

But longer run, by 1985 at the latest, sustained expansion for the U.S. economy will be very much at risk, because of the deficits and high interest rates that will accompany them.

Indeed, the deficits threaten to prevent the 3- to 4-year economic expansion to which the country is really entitled, especially after having borne such huge costs from the downturns of 1980 and 1981 and 1982.

Already, interest rates are rising—up some 50 to 150 basis points since the spring, with the continuing high deficits a major factor. Too much fiscal stimulus could bring substantially higher interest rates sooner than is anticipated, threatening a near repeat of the 1980–81 episode that caused a devastating upward surge of interest rates.

The current and prospective Federal budget deficits, in our research and in the context of the monetary growth targeting by the Federal Reserve, are responsible for 2 to 3 percentage points in the structure of long-term interest rates and 1 to 1½ percentage points in short-term interest rates. Over time, the high interest rates will tend to depress economic activity in interest rate sensitive industries in areas of the country and restrain expansion in the rest of the world.

Although there are a few major negative effects from the deficit so far, the longer Congress and the administration wait on deficit reduction, the greater is the risk that the economic expansion will be relatively short lived and unbalanced and that the international trade and Third World problems will worsen.

The United States and world economies, although showing considerable improvement, are not really out of the woods yet and remain vulnerable to any further considerable rises of already high interest rates.

As time goes on, the problems created by the deficits are really inescapable. Crowding out is going on even now as the 1- to 3-percentage-point premia in short- and long-term interest rates restrain growth in spending from what they would be otherwise for autos, housing, agriculture, long-lived capital goods, and exports.

There are really three possibilities for troubles: First, as the drag of high and rising interest rates overcomes the push of fiscal stimulus, the economy may just fade away in its growth. Second, a clash between surging private sector credit demands and the huge Federal Government financing could produce an upward turn of interest rates in 1985 that would bring a downturn. Third, and increasing in likelihood, a near-term risk is too strong growth in the economy, excessive monetary growth sometime in the next 6 months, and a tighter monetary policy—possibly interrupting the business expansion even in the 1984 election year. In all of these possibilities, the economy would fail no later than 1985 and perhaps also in 1986, before it had fully recovered from the last series of downturns.

Unfortunately, in the context of today's economy and financial markets, there is virtually no solution except to opt for deficit reductions and to change policy from its current loose fiscal/tight money mix to a tighter fiscal-easier money configuration.

Now, we currently project, Federal budget deficits of $194.5 billion to $242.5 billion over the next 5 fiscal years. We expect financing of anywhere from $190 billion to $253 billion, including both on and off budget financing, over the same period. These deficits and the financing that goes with it will range from 5 to 5.5 percent of nominal GNP, and those figures are unmatched in U.S. economic history.

Given the monetary growth targeting policies of the U.S. central bank, these out-year budget deficits and the expectations of them will sustain long-term interest rates a good 2 or 3 percentage points higher than would otherwise be the case, and short-term rates, through the sheer volume of Treasury financing, will be higher by 1 to 1.5 percentage points. More important, any leeway for accommodation by the central bank is severely limited by these deficits, so that the full impact of lower inflation on interest rates cannot be achieved.

Our economic assumptions underlying these projections are fairly sanguine; they include growth rates in real GNP of 5.7 percent in the this fiscal year, 3.4 percent in fiscal year 1985, then around 3 percent in the following 3 fiscal years. We think inflation rates will remain moderate, around 4 to 6 percent annual rates over the next 4 to 5 years, and we expect the unemployment rate to average 8 percent this fiscal year, 7.6 percent in fiscal year 1985, and then to fluctuate at around 7.5 to 8 percent thereafter. Interest rates should fluctuate within plus or minus a percentage point or two—at least, that's what we assume for these deficit projections over the next few years.

Now, why are these deficits so high? There are really four categories of reasons. One, of course, is the deep recession that we had in 1981 and 1982.

The CHAIRMAN. Right.

As I look at your reading the statement, it is 23 pages long. So we are going to ask you to summarize that, or we are not going to have enough time.

Dr. SINAI. Yes. I am actually just reading the introduction, which is very long itself.

The CHAIRMAN. All right. It's almost as long as the deficits.

Dr. SINAI. I will find a way to reduce the statement if you will find a way to reduce the deficit. [Laughter.]

The CHAIRMAN. That's good. We'll work on that.

Dr. SINAI. All right. And I'll try to help you do that.

The bottom line of why we have the deficits is that we had those big tax cuts of the Economic Recovery Tax Act in 1981, which far overshadow the sources of the deficits from recession and lower inflation rates, and even high interest rates. The tax cuts essentially put the budget in the hole, and there is no way out of it unless some combination of tax increases and spending cuts are legislated.

It is very clear that there is a good consensus that meaningful deficit reduction is necessary, but it is the means that are being disagreed upon.

My suggestion is that both tax increases and spending reductions of about $100 billion a year for the next 5 fiscal years will be necessary to make a real dent in interest rates and in the financial market reactions to these huge deficits that are in prospect.

I have said somewhat tongue-in-cheek in the past that probably the thing to do is to do it equally across all categories, inflict equal pain across all the various interest groups that are disagreeing on the means to reduce the deficits, and if one were going to cut $100 billion, to raise taxes one-third, cut spending—nondefense spending—by one-third, and defense spending by one-third in each of these years. I think the principle of that is very important, and it is embodied in the committee's and your $150 billion deficit-reduction proposals.

But it is very hard to cut spending a lot, quickly. It would be easier to raise taxes quickly. So a sliding scale of increases in taxes and cuts in spending over the next 4 to 5 years might be more appropriate.

Really, for the financial community to take any measures seriously, the Congress and the President have to agree on deficit reductions that won't lead to battling in the Congress, that won't lead to an impasse. You really have to agree to bite the bullet on some of the items of entitlements, and also agree that all of the sacred cows or the programs, the defense spending that the President doesn't want to cut and the nondefense spending that Congress may not want to cut, some of the tax increases the President may not want—really, we are going to have to have some of all of that to make a meaningful dent.

So, in terms of how much the deficit needs to be reduced to make an impact, I would say that $150 billion, which is a good start, is probably not enough, that we do need maybe upwards of $100 billion a year—cuts in the deficits. And it should be across the board.

In the statement there are some suggestions as to the measures that could be used to raise taxes more at first, and then to slide the tax increases down a little over subsequent years, to cut spending probably as much as is possible early, and then to increase the spending cuts as the years go by, so that there is a parity by fiscal year 1988.

I should also underscore the urgency of action soon. Lags in the effects of any meaningful deficit reduction program are such that you really wouldn't want the brunt of it to be occurring and having an impact in 1985 or 1986 when the economy might well already be slowing down.

It would be better to agree in 1984, in fact it is essential to agree in 1984, on a meaningful, credible, and feasible deficit reduction plan. It should have the kinds of elements that I have indicated.

To summarize as to the potential economic effects of what might occur if something like $75-to-100 billion of deficit reductions were to be agreed upon, planned, announced, to take effect beginning in fiscal year 1985, I believe you would see immediate and sharp rallies in the financial markets of considerable size. They are indicated in tables 7 and 8 in the testimony—interest rate reductions of anywhere from 2 to 4 percentage points in the first year, depending on the Federal Reserve response to the deficit reductions.

Certainly, the deficit reduction would hurt and weaken the economy early. That might be a good thing if the economy is growing as strongly as it is now, but as time went on, the lagged positive effects of the lower interest rates would more than offset the early restriction of the fiscal restraint, and we would have a better balanced expansion, less pain for the interest rate-sensitive areas, a weaker dollar, more balance in the expansion abroad, less difficulty for Third World countries. We would have a more balanced expansion and I think the deficit reduction would really be our insurance—it would be our insurance for a sustained expansion.

The CHAIRMAN. All right.

Dr. Straszheim.

[Dr. Sinai's prepared statement follows:]

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Deficit Reduction: The Problem, Prospects, and Possibilities

Allen Sinai
Senior Vice President and Chief Economist
Lehman Brothers Kuhn Loeb Inc.
New York, New York

Testimony prepared for the Senate Finance Committee, "Deficit Reduction Hearings," December 14, 1983.

Deficit Reduction: The Problem, Prospects, and Possibilities

by Allen Sinai*

The prospect of an unprecedented string of huge federal budget deficits for the next five years constitutes a major threat to the stability and well-being of the U.S. and international economies. Shorter-run, the deficits actually have been a plus as tax cuts and increased military spending helped bring a resurgence of the economy and the resulting high interest rates prevented a runaway boom. But longer run, by 1985 at the latest, sustained expansion for the U.S. economy will be very much at risk because of the deficits and high interest rates, nominal and real, accompanying them. Indeed, the deficits threaten to prevent the three to four-year economic expansion to which the country is entitled, especially after having borne such huge costs from the downturns of 1980 and 1981-82. Already, interest rates are rising, up 50 to 150 basis points since the spring, with the continuing high deficits a major contributing factor. Too much fiscal stimulus could bring substantially higher interest rates sooner than is anticipated, threatening a near repeat of the 1980-81 episode that caused a devastating upward surge of interest rates.

The current and prospective federal budget deficits, in the context of monetary growth targetting by the Federal Reserve, are responsible for 2 to 3 percentage points in the structure of long-term interest rates and 1 to 1-1/2 percentage points in short-term interest rates. Over time, the current high and perhaps rising interest rates will tend to depress economic activity in interest rate sensitive industries and areas of the U.S. and restrain expansion in the rest-of-the-world. Although few major negative effects from the deficits have appeared so far, the longer Congress and the Administration wait on deficit reduction the greater is the risk that the economic expansion will be relatively short-lived and unbalanced and that international trade and Third World problems will worsen. The U.S. and world economies, though showing considerable improvement, are not out of the woods yet and remain vulnerable to any further considerable rises of already high interest rates.

Near term, the deficits must share some of the credit for the strong growth in the economy that has occurred. Fiscal stimulus -- especially the tax cuts for individuals and business

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*Senior Vice President and Chief Economist, Lehman Brothers Kuhn Loeb Inc., New York, New York. The assistance of Jim Capra is gratefully acknowledged.

of the Economic Recovery Tax Act (ERTA) -- has propelled consumer spending and business equipment outlays higher. High interest rates have been depressing the speculative components of inflation that were so rampant in the late 1970s and keeping the dollar strong, the latter also holding inflation rates considerably lower.

But later, the problems created by the deficits are inescapable. Crowding-out is going on even now, as the 1 to 3 percentage point premia in short- and long-term interest rates restrain growth in spending for autos, housing, agriculture, long-lived capital goods, and exports. Three possibilities for troubles exist. First, as the drag of high and rising interest rates overcomes the push of fiscal stimulus, the economy may just fade away. Second, a clash between surging private sector credit demands and the huge federal government financing could produce an upward turn of interest rates in 1985 that would bring a downturn. Third, and increasing in liklihood, a near-term risk is too strong growth in the economy, excessive monetary growth some time during the next six months, and a tighter monetary policy -- possibly interrupting the business expansion in the 1984 election year. In all of these possibilities, the economy would fail no later than 1985 and perhaps also in 1986, before it had fully recovered from the last series of downturns.

Unfortunately, in the context of today's economy and financial markets, there is virtually no solution except to opt for deficit reductions and to change policy from its current "loose fiscal-tight money" mix to a "tighter fiscal-easier money" configuration.

What are the current prospects for federal budget deficits and the volume of Treasury financing in the next few years? What are the key factors underlying the deficit prospects? Could the deficits be lower than are expected or easily absorbed by the private sector and rest-of-the-world without rises of interest rates? What are the impacts of the deficits on interest rates, the U.S. economy, and the rest-of-the-world? What are the risks if nothing is done about the deficits? When and what actions might reasonably be taken in order to bring about meaningful deficit reduction? And, with what effects?

Briefly:

- Current Lehman Brothers Kuhn Loeb (LBKL) projections show federal budget deficits of $194.5 billion to $242.5 billion over fiscal years 1984 to 1988 (Table 1 below). These deficits will be accompanied by $190 to $253 billion of Treasury financing, on- and off-budget, over the same period (Table 1 below). The deficits and Treasury financing will range from 5% to 5-1/2% of nominal GNP, figures that are unmatched in U.S. economic history. Given the monetary growth targetting policies of the U.S. central bank, expectations of the out-year budget deficits will sustain long-term interest rates two to three percentage points higher than would otherwise be the case. The sheer volume of Treasury financing will sustain upward pressure on short-term interest rates, propping them by 1 to 1-1/2 percentage points. More important, any leeway for accomodation by the central bank will be severely limited, so that the full impacts of lower inflation on interest rates will not be achieved.

- The prospects of huge deficit prospects occur under an LBKL forecast of sustained economic expansion through the next five fiscal years: 5.7% in real GNP for FY1984, 3.4% in FY85, 3% for FY86, 2.7% in FY87, and 3.3% in FY88 (Table 2 below). Inflation rates will remain moderate by comparison with the recent past, at 4.3% to 5.7% annual rates, as sustained low unit labor costs and lower inflation expectations wind their way through the economy. The unemployment rate is forecast to average 8% in FY1984, 7.6% in FY1985, then to fluctuate between 7-1/2% and 8% in the next three fiscal years. Interest rates are expected to range from 8% to 9% on 90-day Treasury bills and 10% to 12% for 20-year U.S. Government bonds. The projections of the federal budget deficits assume no major changes in fiscal or monetary policy.

- Why such high deficits? The huge deficits in prospect arise principally from four causes: the deep recession of 1981-82, the huge tax cuts of the Economic Recovery Tax Act (ERTA) in 1981, dramatically lower inflation rates, and sustained high interest rates (Table 4 below). Only $45 to $60 billion can be attributed to economy weakness. Thus, economic growth and a return to full employment will not make the problem go away. The $750 billion of ERTA tax cuts over five years, offset by $99.5 billion of tax increases through the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, are responsible for $93 to $207 billion per year in the deficits from FY84 to FY88. Ironically, a major factor in establishing the chronically high deficits has been success in lowering inflation. The inflation rate that would exist at full employment now appears to be decidedly lower than previously. This has a bigger effect in reducing tax receipts at full employment than in lowering expenditures. A two percentage point higher inflation rate at full employment would not eliminate the deficits, but would reduce them by $6.2 billion to $82 billion over the next five years (Table 5 below).

- There really is no easy way out of the deficit problem. Smaller deficits would occur if the economy grew faster, inflation rates were higher, unemployment lower, or interest rates moved below those forecast in the LBKL baseline projections. However, the sensitivity of the federal budget to changes in the underlying determinants of real growth, inflation, unemployment, and interest rates is not sufficient to eliminate the structural deficits before FY88 (Table 5 below). The range of plausible possibilities suggests that no major declines can occur in the deficits without fundamental changes in fiscal and probably monetary policy as well. Savings propensities, while likely to rise in total during coming years, will not be sufficient to fully absorb the huge Treasury financing without rises for interest rates.

- The conclusion that the huge deficits in prospect and extraordinary volume of Treasury financing, under the monetary growth targetting policy approach by the U.S. central bank, are propping interest rates by 1 to 3 percentage points is based on econometric evidence that shows a highly significant impact for <u>expectations</u> of future budget deficits on long-term bond yields. Short-term interest rates, on the other hand, are higher from the larger volume of Treasury financing that must be absorbed by the private sector. The effects of these higher interest rates are being felt throughout the U.S. and worldwide economies, producing an unbalanced business expansion, with traditional interest rate sensitive industries and firms under continuing pressure, never to regain the share of total U.S. economic activity held prior to 1979. Growth, employment, inflation, the dollar, affordability, capital formation, and the rest-of-the-world economies all are being significantly impacted by the stimulative fiscal policy and relatively tight monetary policy currently in place and in prospect.

- If nothing is done to change the deficit outlook, huge risks confront the U.S. and worldwide economies. One risk is a runaway boom near term, the result of fiscal stimulus far more than offsetting the negative effects of high nominal and real interest rates. In this scenario, the central bank would be forced to tighten early in 1984, with subsequent sharp increases for interest rates of perhaps two or three percentage points. This scenario is extremely negative for the rest-of-the-world and Third World debt problems, since record highs for the dollar and worsening debt service burdens might well topple the world economy. Another risk is that a fading of the fiscal stimulus will permit high interest rates to hold sway, with real growth in the economy flattening and perhaps declining by 1985. A last potential difficulty is the clash that might arise in late 1984 or 1985 as private sector credit demands bump against the huge volume of Treasury financing. Here, a surge of interest rates would likely bring recession in 1985 or 1986. In all cases, the economy would fail by 1985, before realizing the full potential of the current expansion.

- A meaningful deficit reduction plan is necessary by early 1984, one that is feasible, credible, and sufficiently large to substantially lower the prospective structural deficits. Lags in the effect of changes in policy are such that the restraint of a tighter budget is better earlier than later. The stimulus of lower interest rates is considerably delayed. Early agreement, announcement, and implementation of a deficit reduction plan would insure a better timing for the changes in policy rather than destabilize the economy as has so often been the case before. A feasible program is one that would have sufficient points of compromise on the means to deficit reduction so that a good chance of passage and approval by the Administration and Congress would exist. A credible plan must be without gimmickry, e.g. unlikely contingency taxes or so far in the future that it would be irrelevant in the eyes of observers. Finally, the magnitude of the deficit reduction must be large enough to make a big dent in the deficits over coming years, although not necessarily fully eliminating them.

- Given so much disagreement on the means to deficit reduction, an effective program must be bipartisan in approach and represent a clear compromise by various interest groups. For purposes of illustration, deficit reduction could be accomplished by: 1) appointing, early in the New Year, a bipartisan committee; 2) establishing $100 billion of deficit reduction a year as a goal; 3) attacking head-on fundamental budget difficulties including entitlements and some on defense so that any tax increases need not be so huge as to require a revamping of the U.S. tax system; 4) securing agreement from the Administration and major House and Senate Committees; then 5) announcing that the deficit reduction plan will take effect in FY85. The principle that spending cuts and tax increases should go hand-in-hand needs to be followed.

- Such a program could well be a sliding scale of increases in taxes and cuts in spending that would fully satisfy no interest group. Since tax increases are more easily and quickly imposed than spending reductions, a sliding scale of tax hikes beginning with about $75 billion in FY1985 and reduced to $25 billion in FY1988, accompanied simultaneously by $25 billion of reductions in spending for FY85 and legislated to rise to $75 billion by FY88 would be sufficient. Parity in tax increases and spending cuts over the period should be a goal. The timing of such action should be as soon as possible, since the financial markets will respond only to believable and credible deficit reductions that can be legislated rather than ad hoc measures or ones that will only produce an impasse.

. If proposed, agreed upon, and implemented to begin in October 1984 or January 1985, ex-antè reductions in the deficits of approximately $100 billion a year for the next five fiscal years would produce massive rallies in the financial markets over the ensuing, months. The stimulus of lower interst rates would begin to impact during 1985 when budget restraint was slowing the economy. Depending on whether monetary policy was eased in a compensating fashion in 1985 and 1986, 1 to 4 percentage point declines would occur for interest rates. Real economic growth would weaken in the first year of the program, potentially a welcome effect if it occurs at a time of rapid economic growth. The interest rate sensitive areas of business and net exports would gain in activity. Consumption and some categories of business investment would weaken. But as time passed, the lagged impacts of sharply lower interest rates, especially if the central bank compensated for the budget tightening by raising M1 back to pre-fiscal tightening targets, would promote more rapid economic growth than before. A more balanced and sustainable expansion would be the result. Indeed, ex-pst, the realized budget deficit reductions would be greater than those legislated, as feedback effects on tax receipts and interest costs raised revenues and reduced outlays..

<u>The Problem of the Deficits and Impacts: Short- and Long-Run</u>

The problem is best understood in terms of the prospects for federal budget deficits and the necessary volume of Treasury financing. Under current prospects for the U.S. economy, financial markets and stabilization policies, the unified budget deficits over the next five fiscal years promise to range from approximately $190 billion to $245 billion, or some 5.1% to 5.5% of expected nominal GNP, figures unprecedented in U.S. economic history.

Table 1
Federal Budget Deficits and Treasury Financing
(Fiscal Years 1984 to 1988, Billions of Dollars, Unified Budget)*

	1984	1985	1986	1987	1988	Total
Revenues	655.0	728.1	796.4	866.5	967.5	4,013.5
Outlays	849.5	923.0	1008.9	1,108.0	1,210.1	5 099.5
Deficit	-194.5	-194.9	-212.5	-241.5	-242.6	-1,086.0
Percent of GNP	-5.5	-5.1	-5.1	-5.3	-4.9	-5.2
Treasury Financing (On-and Off-Budget)	190.5	204.9	218.5	251.5	252.6	1,118.0
Percent of GNP	5.4	5.3	5.2	5.5	5.1	5.3

*Lehman Brothers Kuhn Loeb Forecast, December 9, 1983, Averages of Fiscal Years.

These projections are based on a relatively sanguine outlook for the performance of the U.S. economy: sustained real economic growth of 5.7%, 3.4%, 3%, 2.7% and 3.3% over FY84 to FY88; inflation rates, which although accelerating, range between 4% and 6% per annum; unemployment of between 7-1/2% and 8%; and somewhat lower interest rates. No major changes in the approach or elements of monetary and fiscal policy are assumed.

Table 2
Economic and Financial Market Outlook:
Key Parameters Affecting the Deficit*

	1984	1985	1986	1987	1988
GNP	3556.5	3865.3	4181.1	4520.5	4935.0
(% Chg.)	10.2	8.7	8.2	8.1	9.2
Real GNP	1598.1	1652.8	1702.5	1747.7	1804.7
(% Chg.)	5.7	3.4	3.0	2.7	3.3
Implicit GNP Deflator					
(% Chg.)	4.3	5.1	5.0	5.3	5.7
Unemployment Rate					
(%)	8.0	7.6	7.9	8.0	7.7
90-Day Treas. Bills					
(%)	8.8	9.4	8.6	8.3	7.9
3-5 Year Treas.					
(%)	10.7	10.7	10.2	9.8	9.5
20-Year Treas.					
(%)	11.4	11.2	10.7	10.1	10.0

*Lehman Brothers Kuhn Loeb Forecast, December 9, 1983, Fiscal Years, Billions of Dollars, Average of Fiscal Years.

The problem of the deficits is longer-run, not short-term. Indeed, over the short-run, the deficits have been positive for the U.S. economy, reflecting fiscal stimulus that was necessary to achieve recovery and expansion and continuing high interest rates that have prevented a runaway expansion.

Over a longer period of time, however, the effects of the large deficits that are projected, in the context of monetary growth targetting by the Federal Reserve, must certainly create problems for U.S. economic performance, the composition of total output, and the rest-of-the-world economies. Principally, the interest rate effects stemming from the deficits are estimated to be responsible for two or three percentage points in the structure of long-term interest rates and 1 to 1-1/2 percentage points in short-term interest rates.

It is the levels of interest rates, both nominal, real and real aftertax, that have been shaping much of the pattern for U.S. economic performance in recent years, in terms of 1) growth, employment and inflation; 2) the composition of the shifts in aggregate demand and output; 3) the savings and financing propensities of the private sector; and 4) the economies in the rest-of-the-world. Never before in U.S. economic history has the fiscal-monetary policy mix and the role of deficits had such telling effects as since October 1979.

The high interest rates are producing an unbalanced expansion, with traditional interest sensitive industries and firms under continuing pressure, never to regain the share of total U.S. economic activity held prior to 1979. But there are many other effects on the economy from the policy mix and deficits, as well.

1) subpar real growth: The eventual restraint of high nominal and real interest rates on consumer durable goods spending, housing and construction, business capital outlays, inventory accumulation, and net exports will produce slower real economic growth, on average, for this expansion than often has occurred in the first few years after a deep recession. Initially, growth can be substantial, as the economy rebounds from highly depressed levels. But the durability of the expansion can be considerably at risk after the initial surge of growth as high and rising interest rates begin to take a toll. Indeed, even now, despite the apparent strong first year of recovery, high interest rates have been exerting considerable drag. First year real economic growth has been 6.6%, ranking as the fifth strongest of eight recovery episodes. Real final sales over the first year of expansion rank as the second lowest rebound of eight in the postwar period.

2) employment: With slower real economic growth, on average, over a number of years, high costs of working capital, and ongoing pressure on business balance sheets from high interest rates, rehiring in the interest rate sensitive sectors and areas is bound to slow. Unemployment, already a major worldwide problem, will stay at high levels. Continuing downward pressure on wages and fringe benefits is a by-product.

3) inflation: Although the near-term impacts on inflation from the lingering effects of the policy mix are positive, the longer-run prospects must be viewed with considerable concern. A weak recovery in capital formation may well offset the benefits of slower growth for demand-pull inflation. The deficits themselves can be a source of demand inflation in future years. Cutbacks in the capacity of the interest sensitive heavy industries may further prevent low inflation rates from being sustained as the years pass.

4) the dollar: The U.S. dollar has been propped by continuing high interest rates, both from the effects on capital account and on U.S. exports from the sluggish business expansion in the rest-of-the-world. In turn, lessened growth in U.S. foreign trade has depressed the U.S. economy and related employment, serving to limit inflation further. With high

interest rates intensifying Third World debt problems, the U.S. trade position has become even weaker. Lower costs of imported goods and the beneficial effects on the demand-pull component of inflation from this factor have sustained strength for the dollar, in a self-reinforcing process. So long as the policy mix and deficits continue to prop nominal interest rates, there is no way out of this gridlock.

5) affordability: The continuing high nominal interest rates are affecting monthly payment streams for automobiles and houses, eventually limiting the growth in demand for big ticket items until balance sheets improve and income growth catches up. The interest rate effects of the deficits are not the only source of lessened affordability, however. Deregulation of interest rates and the wide variety of new deposit instruments that can be offered by financial institutions also have propped up borrowing rates. No sustained expansion is possible in consumer expenditures for durable goods, especially autos and housing, under these conditions. Eventually, the share of total GNP in these interest rate sensitive industries and related activites must be much less than in prior years, with significant implications for trends in employment and economic activity.

6) capital formation: The biggest casualty of the policy mix and deficits is capital goods spending, especially for longer-lived equipment and plant. So long as nominal and real interest rates remain high, sales growth is slow, and factory utilization rates rise only slowly, the prospects for capital formation in heavy capital goods will be dim. Rises certainly can and will occur, but not near the magnitude that typically follows a deep recession. The 6% to 10% growth in real capital spending during 1984 and 1985 that is currently forecast is probably inadequate to provide the sustained impetus that the business sector usually contributes in a long expansion.

7) the-rest-of-the-world: A strong dollar, slow U.S. economic growth, and high interest rates from the deficits are restraining growth in the Western industrialized economies and the Third World as well. The unusually long period of weakness in the rest-of-the-world economies has created new highs for unemployment as an ongoing worldwide economic problem.

More importantly, the risks to continued expansion will increase over time. Deficit reduction now can be the insurance necessary to bring about the sustained expansion the American people deserve after the long, severe downturn that occurred during 1979 to 1982.

Why Are the Deficits High?

Why are the federal budget deficits so large? There are five reasons.

Table 3
"Structural" or "Full Employment" Budget
Deficits: History and Forecast*

	1982	1983	1984	1985	1986	1987	1988
Receipts	665.7	659.2	699.0	769.7	837.4	911.2	1017.4
Outlays	709.2	776.7	838.1	913.3	100.1	1099.2	1201.3
Deficit	-43.5	-116.8	-139.1	-143.6	-162.7	-188.0	-193.9
(Percent of GNP)	-1.2	-2.9	-3.8	-3.7	-3.9	-4.2	-3.9
Change	--	-73.3	-22.3	-4.5	-19.1	-25.3	-5.9

*Estimates by Lehman Brothers Kuhn Loeb, 6% full employment unemployment rate, 3% growth in potential real GNP.

First, the $750 billion of reductions in personal and business taxes from the Economic Recovery Tax Act (ERTA) in 1981 permanently removed a huge amount of tax receipts from the federal government. The $99.5 billion tax increase of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 still left near $650 billion of tax reductions over a five year period, concentrated in 1983 to 1985. Sharp rises in military spending and only a relatively small offset on nonmilitary spending also drained funds.

Second, the recessions of 1980 and 1981-82 greatly reduced tax receipts and raised government spending. A one percentage point reduction in real economic growth would raise the deficit by $3.9 billion to $73.1 billion over the next five years. LBKL estimates suggest that $45 billion to $60 billion of the deficits that are currently projected result from less than full employment in the economy.

Third, considerably lower inflation rates, down sharply from the average 13.4% rate of 1980 to only 3.9% for the CPI-U over the past year, have cost the U.S. Treasury dearly. For every one percentage decline in the rate of inflation, the federal budget deficit would be about $20.3 billion a year less over the coming five year period.

Fourth, net interest paid, now the third largest source of federal budget outlays, has soared in recent years, in part from the high deficits themselves and the related Treasury financing. With interest rates projected to remain relatively high over the coming five-year period, interest expense will remain an important source of the deficits. A one percentage point rise for interest rates cost an average of $9.1 billion in the net interest expense of the federal government.

Most fundamentally, it was the reductions of $750 billion in taxes through ERTA that pushed the budget into permanantly deep deficits. Table 4 shows that if what remains of the ERTA tax reductions after TEFRA were to be repealed or offset by new tax increases, the full employment budget would be in balance by fiscal year 1988. Even allowing for the feedback effects on tax receipts from the stronger economy, $0.25 to $0.40 per dollar of tax reduction, the ERTA tax cuts still account for the lion's share of the high deficits.

Ironically, the second most significant factor in establishing the chronically high deficits has been the success of bringing down inflation. The full employment inflation rate is now lower than previously, given the major downward turn in the pace of wage and price rises. This has a bigger effect in reducing full employment tax receipts than expenditures. A two percentage point higher inflation rate at full employment would not eliminate the structural deficits, but would reduce them by $6.2 billion to $82 billion over the next five years.

That tax revenues might rise more than the original tax reductions of ERTA because of the resulting economy-wide stimulus was a fallacy of supply-side economics. So was the expectation that nondefense spending could be cut sufficiently to offset the tax reductions and large increases of military outlays. Another miscalculation lay in underestimating the decline of inflation that occurred from the deeper-than-expected recession. Finally, the unexpected rises for interest rates caused by the deficits themselves also bear some responsibility for the higher deficits.

Table 4
Sources of the Structural Deficits

	1983	1984	1985	1986	1987	1988
Current Full Employment Deficit Forecasts*	-116.8	-139.1	-143.6	-162.7	-188.0	-193.9
Difference Between ERTA & TEFRA** (Net tax reductions)	-68.0	-93.0	-121.0	-154.0	-178.0	-207.0
Adjusted Deficit for Rest of 1981 Tax Cuts***	-48.8	-46.1	-22.6	-8.7	-10.0	13.1
Assume Inflation Two Percentage Points Higher****		6.2	21.0	37.0	56.4	82.0
Adjusted Deficit for Higher Inflation		-132.9	-122.6	-125.7	-123.6	-111.9

*Lehman Brothers Kuhn Loeb Estimates
**CBO 2/83 "Baseline Budget Projections," pp. 26-27
***Removal of remaining ERTA not offset by TEFRA
****CBO 9/82, "The Economic and Budget Outlook: An Update," p. 89, estimated revenue gains

NOTE: Inflation and legislative adjustments are based on CBO forecasts of nominal incomes at expected (not full) employment levels. The tax loss estimates, in addition, are static, with no estimate of feedback.

If Nothing is Done -- Will the Problem Go Away?

If nothing is done soon through binding legislation, the problem of the deficits will not go away. Table 3 showed that the deficits would exist even if the economy were at full employment. Thus, greater than expected economic growth alone cannot remove the deficit. Table 5 shows the reductions in the deficits that could occur if economic, inflation, and financial market conditions were not those assumed in the current Lehman Brothers Kuhn Loeb Inc. forecast shown in Table 2. But any combination of changes from the baseline forecast necessary to produce near budget balance are highly unlikely.

From the point of view of the financial markets, prospects of continuing high deficits and expectations of a relatively nonaccommodating Federal Reserve policy lead to expectations of higher future interest rates. These expectations are discounted into current bond yields. In addition, the huge volume of Treasury financing props key short-term interest rates, such as the 90-day Treasury bill rate and federal funds rate. In addition, the financial market reactions to no action or inadequate measures would be negative as in previous years.

Table 5
Sensitivity of the Deficit to Economic Assumptions*
((-) represents a worsening of the deficit)
(billions of dollars)

Case	1984	1985	1986	1987	1988	Average
1	3.9	11.3	13.6	15.9	18.4	12.6
2	3.9	16.2	32.2	49.6	73.1	35.0
3	3.1	7.0	7.0	8.0	9.6	6.9
4	3.1	10.5	18.5	28.2	41.0	20.3
5	2.6	5.6	6.4	7.4	8.2	6.0
6	12.1	34.1	40.7	48.3	56.8	38.4
7	-2.0	-5.4	-9.4	-13.1	-17.1	-9.4

Case 1 -- 1.0 percent higher real GNP growth (84:4 over 83:4)
Case 2 -- 1.0 percent higher real GNP growth (Q4 over Q4 in every year)
Case 3 -- 1.0 percentage point higher inflation (84.4 over 83:4)
Case 4 -- 1.0 percentage point higher inflation (Q4 over Q4 in every year)
Case 5 -- 1.0 percentage point lower unemployment by end of 1984 (assumes no change in the GNP forecast)
Case 6 -- 1.0 percent lower unemployment by end of 1984 (assumes -GNP growth (84:4 over 83.:4) is 3.0 percentage points higher.
Case 7 -- 1.0 percentage point higher interest rates (in every year)

Cases 3 and 4 (higher inflation) would very likley be partially offset by higher interest rates. For example the combined effect of a 1.0 percent increase in inflation and increase in interest rates would be to lower the deficit by $1.1, $5.1, $9.1, $15.1, $23.9 billion in 1984-88, respectively.

Case 5 represents the case of unemployment decreasing with no increase in real growth. Case 6 has that same unemployment result combined with 3.0% additonal GNP growth.

*Lehman Brothers Kuhn Loeb Estimates

Thus, the only solution is deficit reduction and an accompanying shift in monetary policy to an easier stance.

<u>What Should be Done?</u>

Widespread agreement exists on the need to reduce the outyear federal budget deficits, but there is considerable disagreement over the means. The administration wishes to accomplish deficit reduction through cuts in nondefense spending, with tax increases later, if necessary. Congress prefers to raise taxes, cut defense spending, and to limit any further reductions in nondefense spending. So long as disagreement over the means for deficit reduction remain, there is little chance for any meaningful action and interest rates will remain high.

What should be done? There are essentially three choices.

In the "Chip Away" approach, minor increases in taxes and small reductions in spending are legislated, with the hope that the economy will somehow muddle through. Using a year-by-year approach, $8 or $9 billion of deficit reduction might be accomplished for FY1985 and each year a new assessment of the potential problems from the deficits would be made. Here, the FY1985 budget of the administration would project much lower deficits in future years, using a contingency tax or some other measures that would neither deal with the fundamental difficulties of the budget nor aim for a major compromise with Congress. With so little trouble from the deficits currently occurring, such an approach may be tempting. But eventually it would fail, with a repeat of either inflationary pressures or much higher interest rates causing major difficulties for U.S. economic performance in late 1984 or 1985.

"Fundamental Reform" would utilize a major revamping of the tax structure to generate a huge amount of revenues in future years, sufficient to eliminate the budget deficits. Here, a flat rate tax or value added tax (VAT) might be part of the approach. Raising revenues in this manner has many advantages, most principally in shifting incentives away from consumption toward saving. A major negative is that it would take immense study, analysis, and legislative time before being enacted. Time is running out for the type of considered evaluation of the U.S. tax structure embodied in this approach.

The "Bipartisan Reform" approach is the only one that makes sense now and might consist of the following.

1) First, a bipartisan commission should be appointed immediately. This commission, similar to the one on social security, would be charged with determining the amount of deficit reduction that is necessary, establish several alternative choices for accomplishing it, and making recommendations on the timing and implementation of the deficit

reduction plan. Since there is widespread consensus on the need for deficit reductions, but disagreement only on the means, the appointment of such a commission seems eminently reasonable.

2) Second, the amount of necessary reduction in the deficits must be established. Roughly, enough deficit reduction to move the full employment budget deficits closer to balance over a period of four or five years is one possibility. Some $75 to $100 billion of planned deficit reductions for each year might well be sufficient.

3) Agreement should be made to cut all areas of spending, affecting and interest groups, all also to raise taxes. Legislation, in advance, to tie the necessary spending cuts and tax increases together over current and future years is a necessary characteristic.

4) Agreement should be secured from the Administration and Congress early in 1984, with the intention to implement and pass legislation in time for FY85.

Table 6 suggests a possible deficit reduction package that has characteristics of essentially equal cuts in spending and rises in taxes, is of substantial magnitude, could be implemented early, and that would relieve financial market concerns over the outyear deficits.

This deficit reduction package also meets head-on some of the questions on entitlements and indexing, with sacrifices indicated across almost all interest groups in the U.S. economy. It is indicated here only as an illustration of a deficit reduction program plan that could be reached through compromise as well as implemented reasonably soon.

Impacts of Deficit Reduction

The impacts of deficit reduction, with and without a compensating ease in Federal Reserve policy, have been analyzed by me in several other studies dating back to last spring.[1] They were based on work with a version of the DRI model that incorporated new results for the effects of expected deficits and Treasury financing on long- and short-term interest rates.

Table 6
Possible Deficit Reduction Package
(Billions of Dollars, Fiscal Years)

Revenue Increases

	1985	1986	1987	1988
Employer Health	2.3	4.4	6.0	8.0
Civil Service Contributions	1.2	2.3	2.1	1.9
Interest Exclusions (Delay)	1.0	2.9	1.9	--
Charitable Contributions	0.4	2.5	4.1	--
Cancel Other Scheduled Tax Cuts	0.7	5.0	7.0	7.9
Public Property Leasing	1.0	1.8	3.2	5.0
Modified Income Averaging	0.3	1.3	1.4	1.5
Energy Tax (5% Excise)	10.5	15.0	15.8	16.5
10% Individual Tax Surcharge (1985 only)	25.0	7.0	--	--
10% Corporate Surcharge (1985 only)	6.0	2.0	--	--
CPI-Two to Reduce Indexing	2.4	6.6	11.4	17.0
Total, on Revenues	50.9	50.8	52.9	57.8
Outlay Cuts				
Indexing, CPI-Two	3.6	8.4	13.7	19.2
Medicare, 1985 Freeze on Prospective Payments	4.1	4.4	4.7	5.1
Medicare, Change Toward Means Test	--	2.0	4.0	7.0
Include All Social Security in AGI Above $20,000*	1.2	4.7	5.5	6.4
Perform Civil Service Annuities	0.1	0.6	1.6	2.7
Freeze Non-Pay Operating Funds (1985 and 1986)	0.7	2.0	2.1	2.2
Freeze Grants Appropriations (1985 and 1986)	1.4	4.1	4.3	4.5
Reduced Growth for Defense (1%, and Continue 1984 Cuts)	3.1	7.1	11.6	14.9
Total, Outlays	14.1	33.3	47.5	62.0
Total, Deficit Reduction	65.0	84.1	100.4	119.8

*Technically a revenue item.

Two programs have been analyzed. The first is a deficit reduction program of $100 billion a year, without any compensating ease in monetary policy (Table 7). The reductions are achieved through cuts in spending that equal the rises in taxes. It is assumed that the package is agreed upon and announced during 1984 and set to begin on October 1, 1984.

Table 7
$100 Billion of Spending Reductions and Higher Taxes:
Impacts on Deficits, Interest Rates, and the Economy
(Changes relative to baseline)*

	Fiscal Years			
	1985	1986	1987	1988
90-day Bill Rate (%)	-1.52	-2.35	-3.20	-3.96
New Issue Corporate Bond Rate (%)	-1.94	-2.30	-2.22	-2.09
Housing Starts (Mils. Units)	0.094	0.206	0.278	0.376
Auto Sales (Mils. Units)	-0.5	-0.5	-0.2	0.1
Bus. Fixed Investment (Bils. 72 ($'s)	-0.5	-1.4	-1.1	0.4
(% of baseline)	-0.3	-0.9	-0.6	0.2
Net Exports (Bils. 72 $'s)	1.7	2.5	1.9	0.9
(% of baseline)	7.4	11.3	7.9	3.3
Real GNP (%)	-2.7	0.0	0.8	0.8
Unemployment Rate (%)	0.9	1.2	0.8	0.5
GNP Deflator (%)	0.0	-0.01	-0.03	-0.04
NIA Deficit (Bils. of $'s)	69.1	69.6	84.5	105.0

*Ex-ante reductions of $100 billion a year in NIA deficits from reductions in government spending and higher personal, corporate and Social Security taxes, uncompensated by any changes in monetary policy.

The sustained $100 billion reductions in the deficits bring about large declines for short- and long-term interest rates, primarily because of the weaker economy and the expectations effects on bond yields from the lower deficits. Growth in real GNP is 2.7 percentage points lower than the baseline in FY85, principally the result of lower consumption, but also due to related declines in the interest rate sensitive areas of business fixed investment and auto sales. These categories of spending are lower because of the negative effects from the spending cuts and higher taxes and would show even bigger declines except that the initial, quick reductions of interest rates provide an offsetting stimulus. In the outyears of 1987 and 1988, real GNP grows more rapidly than in the baseline, by 0.8 percentage points a year.

Throughout the period analyzed, other interest rate sensitive areas, including housing starts and net exports, show strength. As would be expected, the tightening of fiscal policy "crowds-in" housing and residential construction. Housing starts are 94,000 units higher in 1983 and a large 376,000 units above the baseline in 1988. Net exports, in real terms, also rise relative to the baseline, reflecting the effect of lower interest rates on the dollar and the rest-of-the-world economies, with a relatively quick impact on spending here from abroad.

The rate of inflation is essentially unchanged and eventually interest rates are two to four percentage points lower than without the reduction in the deficits.

In this simulation, monetary policy is unchanged, with nonborrowed reserves growing at the same pace as in the baseline. The result is less growth in M1 and M2 during the early years, from the weakness in the economy and a reduced transactions demand for money.

In a second computer simulation, a compensatory easing of monetary policy is instituted, defined as maintaining M1 growth at the original baseline levels. This shift of policy to a "tighter fiscal-easier money" configuration produces more desirable results than in the case of only a budget tightening.

Table 8
$100 Billion of Spending Reductions and Higher Taxes
With Compensating Ease of Monetary Policy:
Impacts on Deficits, Interest Rates, and the Economy
(Changes relative to baseline)*

	Fiscal Years			
	1985	1986	1987	1988
90-Day Bill Rate (%)	-4.15	-3.17	-4.02	-4.34
New Issue Corporate Bond Rate (%)	-1.96	-1.97	-1.9	-1.81
Housing Starts (Mils. Units)	0.409	0.534	0.415	0.450
Auto Sales (Mils. Units)	-0.2	-0.1	0.1	0.3
Bus. Fixed Investment (Bils. 72 $'s)	0.1	2.3	3.6	4.8
Real Net Exports (Bils. 72 $'s)	1.4	1.2	0.9	0.2
(% of baseline)	6.0	5.6	3.6	0.8
Real GNP (%)	-1.7	0.6	0.1	0.5
Unemployment Rate (%)	0.6	0.5	0.4	0.3
GNP Deflator (%)	0.00	0.00	-0.01	-0.02
NIA Deficit (Bils. of $'s)	86.8	102.7	112.8	129.5

*Ex-ante reductions of $100 billion a year in NIA deficits from reductions in government spending and higher personal, corporate, and Social Security taxes. The central bank sustains M1 at baseline levels through a compensating ease in monetary policy.

The reductions in the economy that is caused by the fiscal restraint and easier monetary policy have an immediate and large impact on interest rates, reducing long-term corporate bond yields by almost 2 percentage points and short-term interest rates by four to five percentage points. The reductions of long-term interest rates come primarily from expectations effects of the lower deficits on current interest rates but also from the initial weakness in the economy caused by fiscal restraint. The compensatory easing of monetary policy is responsible for an additional 2-1/2 percentage point decline for short-term interest rates compared with the uncompensated deficit reductions.

Real economic growth still declines in FY85, down 1.7 percentage points from the baseline value. This net drop reflects the quick impact of fiscal restraint on real final demands, but is one percentage point less than in the simulation of the uncompensated tightening of fiscal policy. The impacts of lower short- and long-term interest rates on the stock market, affordability, and interest rate sensitive activities are lagged, occurring subsequent to the initial decline in the economy.

For the rest of the simulation horizon, both short- and long-term interest rates are sustained about two to five percentage points below the baseline, providing a continuing stimulus to the interest rate sensitive areas of the economy -- housing, auto sales, business fixed investment, and net exports. Growth in real output is sustained above the baseline values and there are rises in potential output.

The twist of policy away from loose fiscal-tight money to tighter fiscal-easier money has no effect on inflation. The unemployment rate is somewhat higher than the baseline, the result of economic weakness early from the fiscal restraint.

By 1988, the deficit has improved well in excess of the original attempts at reductions, reflecting the positive feedback effects of the stronger economy on tax receipts, outlays, and interest rates.

Conclusions

Deficit reduction and a compensating ease in monetary policy is the only way to ensure a sustained expansion of the U.S. economy through 1985 and 1986. A feasible, credible, and sizeable deficit reduction program must be agreed upon and implemented in 1984. About $100 billion of planned deficit reduction each year would bring major rallies in the bond and stock markets. Eventually, a redressing of the imbalance that has arisen in the economic expansion would occur, with beneficial effects for the U.S. and rest-of-the-world economies.

The final results of the type of program suggested in this testimony appears in Table 9, where the unified budget deficits for FY85 to FY88 appear after the changes recommended for the economy in the manner that is indicated in Tables 7 and 8.

An additional calculation in Table 9 reflects the impacts on the federal budget deficit of the estimated reductions for interest rates that arise as a result of the deficit reduction plan and the effects of changes in Treasury issues and debt outstanding.[2] As the table shows, the feedback effects of the program in lowering the interest costs of the federal government are substantial and should be taken into account in estimating the benefits from any deficit reduction plan.

Table 9
Effects on Federal Budget Deficits of Illustrative
Deficit Reduction Plan
(Billions of Dollars)

<u>Case 1</u> - <u>No Compensating Easing of Monetary Policy</u>

	1985	1986	1987	1988
Deficit Reduction Action	65.0	84.1	100.4	119.8
Interest Rate Effect	8.0	17.5	29.8	41.3
Debt Outstanding Effect	2.6	8.6	16.0	25.1
GNP Effect	-21.8	-33.0	-30.0	-28.6
Net Deficit Reduction	53.8	77.2	116.7	158.6
Baseline Deficit	-194.9	-212.5	-142.4	-83.0
Deficit, With Changes	-141.1	-135.3	-143.4	-85.0

<u>Case 2</u> - <u>With Compensating Easing in Monetary Policy</u>

	1985	1986	1987	1988
Deficit Reduction Action	65.0	84.1	100.4	119.8
Interest Rate Effect	9.4	19.7	32.3	43.5
Debt Outstanding Effect	2.6	8.4	15.6	24.6
GNP Effect	-15.1	-12.5	-11.8	-8.8
Net Deficit Reduction	61.9	99.7	137.0	180.4
Baseline Deficit	-194.9	-212.5	-241.5	-242.6
Deficit, With Changes	-133.0	-112.8	-105.0	-63.6

By FY1988 the federal budget deficit is $63.6 billion in a situation with a compensating easing of monetary policy and -$83 billion without. These deficits and the progression of improvements that precede them in either case likely would mitigate the deficit problems in the future sufficiently to insure a sustained and balanced expansion in the economy.

Footnotes

[1]Allen Sinai and Peter Rathjens, "Deficits, Interest Rates and the Economy," DRI Economic Studies #113, June 1983; Allen Sinai, "Policy Mix, Deficits, and the Economy," Summary of remarks presented at the National Tax Association, Tax Institute of America, 76th Annual Conference, Seattle, Washington, October 3, 1983; Allen Sinai, "Interest Rates: Some Postwar History, Impacts and Prospects," Paper presented at the Monetary Policy Forum, Arlington, Virginia, November 1, 1983.

[2]The results presented here are preliminary and still in the process of study and refinement. This should be kept in mind when reading and analyzing the material presented in this testimony.

STATEMENT OF DR. DONALD STRASZHEIM, VICE PRESIDENT, WHARTON ECONOMETRICS, PHILADELPHIA, PA.

Dr. STRASZHEIM. Mr. Chairman, I am pleased to have the opportunity to appear before this committee to discuss the relationship between the deficit and the economy in the coming years.

The economy is recovering nicely now. The forecast which underlies these comments, prepared by the staff at Wharton Econometrics, envisions still above-trend growth persisting throughout 1984 but slowing to a 4.9-percent rate fourth quarter to fourth quarter, down from the 6.6 percent rate in the four-quarter period just ending.

Inflation has slowed dramatically, and the outlook for inflation is favorable indeed, as wages are down, and demand pressures are low. Interest rates were cut sharply during the recession and will not begin their major cyclical advance until well into 1984. However, while the 1984 economy looks good, as 1983 has been, trouble signs are already evident, and they relate in part to the persistently high Federal deficit.

Wharton forecasts the unified Federal budget deficit between $175 and $186 billion in each of the next 3 fiscal years, compared to the $195.4 billion recorded in the 1983 fiscal year just ended. This prospect is unusual and it is worrisome.

The near $200 billion deficits of 1983 and 1984 have not been and will not be a major problem. Indeed, this fiscal stimulus is partly responsible for the solid recovery. But similar sized deficits in 1985 and 1986 are troublesome.

The $195.4 billion deficit in fiscal 1983 was 6.1 percent of GNP. This figure compares unfavorably to the prior post-World War II record of 4 percent recorded in 1975.

There are three main reasons why the deficit is and will remain so large over the next few years, and these reasons are no mystery:

First, the severity of the 1981-82 recession following so closely on the heels of the short but sharp 1980 recession is a major contributor. Normally, when the economy is weak, the deficit rises.

Second, the 1981 Economic Recovery Tax Act substantially reduced tax receipts further over 3 years. In particular, the 5-10-10 individual tax reduction and the 15-10-5-3 accelerated cost recovery system sharply reduced tax liabilities for both individuals and corporations.

Third, on the outlay side of the budget, a major buildup in defense spending was put in place. In addition to that, transfer payments have been increasing rapidly, and net interest costs have mounted along with the debt.

The joint consequence of tax cuts and spending increases on top of a major low cyclical starting point is a deficit that is structurally far from balance. The structural deficit, measured in almost any way, is now in the vicinity of $80 to $120 billion. It is ever so unlikely that the economy can grow its way out of this deficit situation.

How far might the deficit fall in the next 2 years? To bring the deficit down by, for example, $50 billion, or from our $175 billion estimate to $125 billion in fiscal 1984, or to 3.2 percent of GNP, still a very high share, seems to us ever so unlikely.

During the four quarters of fiscal 1983, the Federal Government accounted for just under 50 percent of all funds raised in the credit markets. During fiscal 1975, the previous post-war high, Federal credit demands accounted for 38 percent of total funds raised. Importantly, in 1976 and 1977, this share fell to just over 20 percent within 2 years, an event which is not in prospect for 1984-85.

Usually, during recessions, private sector credit demands fall, and public sector credit demands rise; whereas, during recovery, the reverse holds. In the Wharton forecast, as the economy recovers the public sector will continue to demand an extraordinarily large share of credit, rather than getting out of the way of the recovery-driven rising need for credit in the private sector. Interest rates will tend to be bid up, the credit-sensitive sectors of the economy will weaken, and the economy will lose its forward momentum.

A growth pause at best, another recession at worst, is in store for 1986 in the present scenario.

We all know that in order to reduce the deficit, taxes must be raised, spending must be cut, or some combination of the two. Rather than prescribing in these two areas, I would like to make a couple of points which are often overlooked in these discussions.

First, with respect to receipts, given the sharp decline in the inflation rate, it is clear that the 5-10-10 measure on individual taxes reduced real per capita individual income tax liabilities and did not simply offset the bracket creep effect of rising nominal incomes and a progressive Tax Code.

Second, the 15-10-5-3 accelerated cost recovery system will grow in importance as the years pass. Over time, a cumulatively increasing share of the total capital stock will be depreciated using the accelerated schedules.

Since tax liabilities fall, in this provision, only to the extent that investment occurs, in contrast to the unconditional tax reduction on the individual side, for every dollar of tax revenues foregone this measure will prove to have been the more effective supply-side stimulus of the two.

Note also, as a consequence of this measure on the corporate side, while the public sector demand for borrowing increases because of the lower tax revenues, the private sector's demand for borrowing falls also because of the improvement in cash flow.

With respect to spending, all Federal spending does not contribute equally to economic growth. The composition of Federal spending must be considered; as will as its level. While direct measurement is difficult, it is clear that spending on education, which builds human capital, or on interstate highways, for example, which facilitate commercial transit, contribute to future economic growth by improving productivty in a way that net interest payments, for example, do not.

The Wharton forecast shows real defense spending increasing rapidly for the next 3 years, continuing an advance which began in 1980. Whether this spending profile is too much, about right, or too little is left for others to argue; but it is worth pointing out that while the contribution of any kind of spending to long-run economic growth is not the only budget criteria, it is reasonable to conclude that defense spending does not, for the most part, directly lead to increases in the Nation's productivity and hence to long-term growth prospects like spending on the Nation's infrastructure might.

Both tax and spending measures are available to reduce the deficit.

The Wharton base-line forecast assumes tax increases to be effective on July 1, 1985, and again on January 1, 1986. These deficit-reducing measures take effect at a time in which the economy will be cyclically slowing, in any case.

The economy skirts recession. To contemplate enacting at that time sharply more restrictive measures under the guise of reducing the deficit would increasingly run the risk that the slowdown in the economy would be converted into a full-fledged recession and thereby, with a sick economy, actually cause the deficit to rise.

With Wharton's base-line forecast of the economy gradually slowing across 1984 and 1985, the trade-off on deficit-reducing actions would appear to be as follows:

Growth still above trend during 1984 suggests that the earlier that fiscal restraint is applied, the less would be the risk that the economy would fall into recession, and the more shallow the economic slowdown would be.

Conversely, the later that fiscal restraint is applied, when the credit-sensitive sectors of the economy have weakened further and interest rates have risen more, when inflation is higher and the economy has slowed more of its own momentum, the greater would be the risk that slowdown would give rise to recession.

In conclusion, Mr. Chairman, let me just say that fiscal stimulus applied to the economy over the last 2 years is partly responsible for the economy's robust 1983 recovery.

However, economic growth, rapid now, will slow across 1984 and 1985 as interest rates rise in response to growing congestion in financial markets.

Thank you, Mr. CHAIRMAN.

The CHAIRMAN. Thank you very much.

Dr. Meyer.

[Dr. Straszheim's prepared statement follows:]

Statement by

Donald H. Straszheim

Vice President, U.S. Services

Wharton Econometric Forecasting Associates, Inc.

before the

Senate Finance Committee

U.S. Senate

December 14, 1983

I am pleased to have the opportunity to appear before this committee to discuss the condition and prospects for the economy, the federal deficit and its prospects, and the relationship between the deficit and the economy in the coming years.

From the perspective of economic growth, 1979-82 were the four worst years back-to-back for the U.S. economy since 1932-35. The economy hit bottom in December 1982, and we are now one year into a solid and robust recovery. But the hole created by our prior troubles was so deep that, despite the 8.4% unemployment rate reported for November, the economy is a long way from full utilization of our resources. While all are hoping to see the economy on an above-trend growth path for the foreseeable future, risks are evident. The budgetary situation on the horizon—federal deficits in the \$150-\$200 billion range for many years to come—is unprecedented.

What is to be made of these deficits? The U.S. economy has never been there before—not even close, so conclusions should be cautious. Can the economy continue its above-trend growth under these conditions, or might such deficits create other problems which will halt the recovery prematurely? How did this situation arise? If this is a troubling situation, what is the escape?

1. Economic Prospects in the Wharton "Baseline" Forecast

The end of the recession in late 1982, and the quite satisfactory recovery during 1983 is old news. The economy is now in transition, from having been led during the first year of recovery by consumption and housing, to being led during the next year by inventory accumulation and business fixed investment. The forecast which underlies these comments, prepared by the staff at Wharton Econometrics, envisions still-above-trend growth persisting throughout 1984, but slowing to a 4.9% rate fourth quarter to fourth quarter, down from the 6.6% rate in the four quarter period just ending.

Inflation slowed dramatically throughout the recession from a near double-digit rate in 1980-81 to the 4%-5% rate at present. The outlook for inflation is favorable indeed. Wage pressures have fallen dramatically, and demand pull pressure does not characterize the economy. The supply-demand balance in the energy and agricultural sectors have further slowed inflation. The inflation rate will begin to pick up somewhat, as unemployment declines further and as product markets tighten. The Wharton forecast is for 5.5% inflation in 1985, 5.9% in 1986.

Interest rates, cut dramatically by the recession, have been relatively stable in recent months. With inflation staying moderate, money supply growth within the Federal Reserve's announced targets and the economy's growth rate slowing, prospects are that interest rates will not begin their major cyclical advance until well into 1984.

However, while the 1984 economy looks good, as 1983 has been, trouble signs are already evident, and they relate in part to the persistently high federal deficit. Wharton forecasts the unified budget deficit between $175 and $186 billion in each of the next three fiscal years, compared to the $195.4 billion recorded in the 1983 fiscal year just ended. This prospect is both unusual and worrisome. In our postwar history, deficits usually have risen during recessions, partly because of discretionary countercyclical fiscal actions to stimulate the economy—tax cuts and spending increases, and partly because of the workings of the so-called "automatic stabilizers" in the budget—which reduce tax collections and raise spending without requiring discrete fiscal action by the government. Conversely, deficits usually have declined during recoveries for the same reasons, as discrete stimulative actions end or are reduced, and as the slowing effects of the reverse side of the "automatic stabilizers" in the budget take hold.

The near-$200-billion deficits of 1983 and 1984 have not been and will not be a major problem. Indeed, this fiscal stimulus is partly responsible for the solid recovery. But similar-sized deficits in 1985 and 1986 are troublesome.

As the recovery proceeds public sector credit demands will remain high at the same time that private sector credit demands begin their usual cyclical advance. This is not the usual circumstance. The result will be gradually increasing congestion in the credit markets, rising interest rates, and a slowdown in growth.

While precision cannot be claimed on forecasts so far in the future, the general profile seems clear-cut, and the Wharton baseline shows real GNP growth falling to fractional levels in 1986. The precise timing of the economy's troubles and their intensity depends in part on various events and measures taken between now and then.

2. Fiscal Policy Assumptions

The Wharton baseline forecast shows a unified budget deficit of $184.3 billion in fiscal 1984, $175.7 billion in fiscal 1985 and $186.0 billion in fiscal 1986.

Federal budget receipts are expected to increase by 10.7%, 11.0%, and 8.7% in fiscal years 1984-86, representing approximately 3%-5% annual increases in real terms.

Wharton assumes that individual income taxes will be indexed effective January 1, 1985, as legislated in the 1981 Economic Recovery Tax Act. We further assume a progressive surtax yielding approximately $14 billion at an annual rate will become effective on July 1, 1985, and that indexing on January 1, 1986 will be reduced to 70% of the change in prices as opposed to the full 100% encompassed in the 1981 tax legislation. The revenue difference between 70% indexation and "full" indexation is approximately $4-$5 billion at an annual rate.

Wharton further assumes that a corporate income surtax yielding $7 billion at an annual rate will be implemented effective July 1, 1985. No other major tax law changes are assumed.

On the expenditure side of the federal budget, outlays are expected to increase by

6.7%, 7.6%, and 8.1% in fiscal years 1984-86. These outlay increases are approximately 2%-3% in real terms. Government pay increases are assumed in 1984 and 1985. No change to existing law in entitlement payment schedules is assumed.

3. The Deteriorating Deficit Situation

The $195.4 billion unified budget deficit in fiscal 1983 was 6.1% of GNP, up from $110.7 billion or 3.6% of GNP in 1982, and $52.6 billion or 1.9% of GNP in 1981. The 1983 figure also compares unfavorably to the prior post-World-War-II record of 4.0% of GNP recorded in 1975. It is normal for the deficit to rise slightly in the first year of recovery, as outlays stay high, and as the tax throw-off of recovery builds somewhat slowly. While fiscal 1983 was predominantly a recovery year, the size of the deficit increase from 1982 to 1983 is entirely without precedent. There are three main reasons why the deficit is and will remain so large over the next few years.

First, the severity of the 1981-82 recession following so closely on the heels of the short but sharp 1980 recession is a major contributor. The result was an unemployment rate which reached a postwar record, capacity utilization which fell to its lowest level in forty years, and generally the worst conditions with respect to economic activity in decades. As a consequence, the workings of the automatic stabilizers reduced the tax take and increased automatic entitlements payments greatly. These budget characteristics were entirely predictable.

Second, the 1981 Economic Recovery Tax Act substantially reduced tax receipts further over three years. In particular, the "5-10-10" individual income tax reduction and the "15-10-5-3" accelerated cost recovery system sharply reduced tax liabilities for both individuals and corporations from what they otherwise would have been.

Third, on the outlays side of the budget, a major build-up in defense spending was put in place, transfer payments have been increasing rapidly, and net interest costs have mounted along with debt.

The joint consequences of tax cuts and spending increases on top of a major low cyclical starting point is a deficit that is structurally far from balance. The structural deficit, measured in almost any way, is now in the vicinity of $80-$120 billion. It is ever so unlikely that the economy can "grow its way" out of this deficit situation.

The Wharton forecast reflects this condition. Even though 1984 real GNP growth is expected to be a substantial 5.9%, the fiscal 1984 deficit falls by only $11 billion, and stays at a high 5.2% of nominal GNP. The deficit will fall only an additional $9 billion in fiscal 1985, and credit market congestion will begin to appear.

How low might the deficit fall in the next two years? The Wharton Baseline shows a $184.3 billion federal deficit in fiscal 1984, or 9.2% of GNP. This forecast is close to the consensus, and the date is late for major tax or spending changes to affect 1984. For fiscal 1985, the Wharton Baseline is a $175.5 billion deficit, or 4.5% for GNP. To bring the deficit down by, for example, $50 billion, or to 3.2% of GNP, seems ever so unlikely.

Assume that such a deficit reduction were to be split evenly between receipts and outlays. On the receipts side, to raise an additional $25 billion, with a 5.5% inflation rate, implies a receipt advance of 9% in real terms. The only year during the last decade in which real receipts rose this rapidly was 1977, when real economic growth substantially exceeded what is anticipated for 1985. Or, to supplement 1985 receipts with a new tax increase, of whatever sort, would tend to slow the economy further, additionally calling into question such a revenue advance.

On the outlays side, to reduce spending an additional $25 billion with 5.5% inflation would yield a 0.5% real decline in outlays. At no time during the last decade has spending been this weak, in real or in nominal terms. Even if these targets were achieved, with a $125 billion—not a $175 billion—fiscal 1985 deficit, a rise in the federal debt of another $125 billion implies, by itself, a substantial further increment in net interest payments, leaving even less room in the remainder of the budget components to hit such a target.

Stronger growth would generate additional revenues and reduce entitlement payments for unemployment benefits, but the indexing of individual income taxes eliminates the revenue windfall which the government has enjoyed in the past because of the joint interaction of a progressive tax code and rising nominal incomes.

4. Financial Sector Considerations

One can envision two impacts on the financial sector of the economy from these persistent deficits—the impact on inflationary expectations, and the public sector's demand for credit.

The viewpoint that the deficit will remain extraordinarily high by any measure for the foreseeable future is widespread. While it is difficult to quantify such assessments, many people associate persistently high deficits with higher future inflation, and a larger inflation premium in interest rates, keeping borrowing costs higher than they otherwise would be. While the real rate of interest—as opposed to the nominal rate—is not a directly observable concept, by most definitions the real rate has been unusually high over the last year or two. Despair on the part of many that the high public sector deficits would ultimately lead to more inflation is one possible explanation.

The outsized public sector borrowing requirements are directly observable, and these impacts are even more clear-cut. During the four quarters of fiscal 1983, Federal Reserve Board flow of funds data reveal that the federal government accounted for just under 50% of all funds raised in the credit markets. During fiscal 1975, the previous postwar high, federal credit demands accounted for 38% of total funds raised.

Importantly, this share fell to just over 20% within two years—an event which is not in prospect in 1984-85.

Usually during recessions, private-sector credit demands fall and public-sector credit demands rise, whereas during recovery the reverse holds. In the Wharton forecast, as the economy recovers the public sector will continue to demand an extraordinarily large share of credit rather than "getting out of the way" of the recovery-driven rising need for credit in the private sector. Interest rates will tend to be bid up, the credit-sensitive sectors of the economy will weaken, and the economy will lose its forward momentum.

A "growth pause" at best, another recession at worst, is in store for 1986 in the present scenario. Housing and consumer durables are hurt first by the higher interest rates, followed by weaker business investment spending. Wharton assumes that money growth will remain in the 5%-8% range, completing the picture of increasing tension in the credit markets, higher interest rates, and renewed economic weakness. Furthermore, as the economy staggers in 1986, the revenue gain will slow, outlays will rise somewhat faster, and the fiscal 1986 deficit will be higher than fiscal 1985.

5. Issues in Federal Receipts

By definition, deficit remedies must look to higher receipts or lower outlays, or any combination thereof. Rather than prescribe in these areas, a couple of points which are often overlooked deserve to be highlighted.

First the individual income tax reduction enacted in the 1981 tax act which reduced tax rates by 5%, 10% and 10% in three years successively, sharply reduced the growth in personal tax receipts, and actually cut receipts in fiscal 1983. Importantly, that legislation was enacted during a year in which the inflation rate was approaching

10%, and it was widely regarded at that time as not greatly exceeding a reduction that would simply offset the "bracket effect" of higher tax liabilities resulting from the intersection of rising nominal incomes and a progressive tax code. In retrospect, with the sharp decline in the inflation rate, it is clear that the "5-10-10" measure reduced real per capita individual income tax liabilities. Conversely, the budgetary consequences of indexing, or a change in the indexing provisions, is much reduced with nominal incomes rising by near 10% annually as opposed to the roughly 15% earlier annual increases.

The 1981 corporate income tax cut encompassed in the "15-10-5-3" Accelerated Cost Recovery System will grow in importance as the years pass. Over time, a cumulatively increasing share of the total capital stock will be depreciated using the accelerated schedules, increasing the revenue loss of this tax action year after year. The corporate share of federal receipts will continue to decline. Corporate profits taxes were approximately one-fourth of total receipts in 1950, 13% in 1980, will be 10% in 1986, and an even lower share thereafter. Since tax liabilities fall in this provision only to the extent that investment occurs, in contrast to the unconditional tax reduction on the individual side, for every dollar of tax revenues foregone this measure will prove to have been the more effective "supply side" stimulus.

One offsetting influence of the accelerated depreciation rules bears importantly on the interpretation of the newly enlarged federal deficit. Higher depreciation costs reduce before-tax profits and hence tax liabilities, but they also increase corporate cash flow. As a consequence, while the public-sector demand for borrowing increases because of the lower tax revenues, the private sector's demand for borrowing falls because of the improvement in cash flow.

6. Issues in Federal Spending

Just as with taxes, spending needs to be considered by type as well as by overall level. All federal spending does not contribute equally to economic growth. While direct measurement is difficult, it is clear that spending on education (which builds human capital) or on interstate highways (which improves commercial transit) contributes to future economic growth in ways that net interest payments, for example, do not.

The Wharton forecast shows real defense spending increasing rapidly for the next three years, continuing an advance which began in 1980. Whether this spending profile is too much, about right, or too little is left for others to argue. It is worth pointing out that while the contribution of any kind of spending to long-run economic growth is not the only budget criterion, it is reasonable to conclude that defense spending does not for the most part directly lead to increases in the nation's productivity and hence to long-term growth prospects like spending on the nation's infrastructure might.

Grants-in-aid from the federal to the state and local sector grew rapidly during the decade of the 1970s and have since leveled off, with the Wharton forecast showing only modest expansion in this area in the coming years, after being essentially flat from 1980 to 1983. Grants from the federal sector to the state and local sector represent "fiscal shifting" which is somewhat analogous to the higher deficit-higher cash flow resulting from accelerated depreciation. Indeed, other things being equal, a reduction in grants would reduce the federal deficit, only to be offset in the state and local budget accounts. In that sense, it is useful to think of the budgetary balance of the entire public sector, not just of the federal sector.

Interest paid on the federal debt has been growing rapidly in recent years—the cross product of more federal debt outstanding and higher interest rates. In the Wharton baseline, even the deficit-reducing measures which we assume leave interest payments continuing to rise rapidly both in dollar terms and in terms of their relative importance in the budget. Even more than entitlement payments and multi-year procurement programs in defense spending, net interest costs are not subject to short run adjustment.

7. Deficit-Reducing Measures

Both tax and spending measures are available to reduce the deficit. If such fiscal restraints are enacted, the economy's slower growth path will reduce congestion in the money and credit markets, reduce interest rates, and subsequently lift spending in the credit-sensitive sectors of the economy.

The Wharton baseline forecast assumes tax increases to be effective on July 1, 1985 and again on January 1, 1986. These deficit-reducing measures take effect at a time in which the economy will be cyclically slowing in any case. The economy skirts recession. To contemplate enacting, at that time, sharply more restrictive measures, under the guise of reducing the deficit, would increasingly run the risk that the slowdown in the economy would be converted into a full-fledged recession, and thereby, with a sick economy, actually cause the deficit to rise.

With Wharton's baseline forecast of the economy gradually slowing across 1984 and 1985, the tradeoff on deficit-reducing actions would appear to be as follows. Growth still above trend during 1984 suggests that the earlier restraint is applied, the less would be the risk that the economy would fall into recession, and the more shallow the economic slowdown would be. Conversely, the later that restraint is applied, when the credit-sensitive sectors of the economy have weakened further and interest rates have risen more, inflation is higher and the economy has slowed more of it own momentum, the greater would be the risk that slowdown would give way to recession.

8. Conclusion

Fiscal stimulus applied to the economy over the last two years is partly responsible for the economy's robust 1983 recovery. However, economic growth, rapid now, will slow across 1984 and 1985 as interest rates rise in response to growing congestion in financial markets. These interest rate pressures are associated, in part, with public-sector credit demands remaining at unprecedented levels at the same time that private-sector credit demands are rising rapidly. While caution is in order in any uncharted territory, as this is, measures designed to restore the budget to its more normal relationship to the economy deserve consideration.

Table 1

MACROECONOMIC FORECAST SUMMARY

	Real GNP $ billions	%	GNP Price Deflator 72=100	%	Civilian Unemployment Rate %	13-Week Treasury Bills %	AAA Corporate Bonds %
1970	1085.6	-0.2	91.4	5.4	5.0	6.39	8.04
1975	1231.6	-1.2	125.7	9.2	8.5	5.77	8.83
1980	1475.0	-0.3	178.4	9.2	7.2	11.43	11.94
1981	1513.8	2.6	195.1	9.4	7.6	14.02	14.17
1982	1485.4	-1.9	206.9	6.0	9.7	10.61	13.79
1983	1536.8	3.5	215.5	4.2	9.7	8.60	12.01
1984	1628.1	5.9	225.4	4.6	8.4	9.00	12.30
1985	1688.0	3.7	237.9	5.5	7.6	10.26	12.59
1986	1720.2	1.9	252.0	5.9	7.6	10.65	12.27

Wharton "Baseline" 11/83

Table 2

FEDERAL BUDGET SUMMARY, UNIFIED BASIS, FISCAL YEARS
(Billions of Dollars)

	Receipts	% Change	Outlays	% Change	Surplus or Deficit
1975	280.3	2.6	340.9	22.9	-60.5
1980	520.1	11.6	579.6	17.4	-59.5
1981	600.9	15.5	653.4	12.7	-52.6
1982	619.0	3.0	729.6	11.7	-110.7
1983	600.6	-3.0	795.9	9.1	-195.4
1984	664.8	10.7	849.1	6.7	-184.3
1985	738.0	11.0	913.7	7.6	-175.7
1986	802.1	8.7	988.1	8.1	-186.0

BUDGET RELATIONSHIP TO GNP, FISCAL YEARS
(Percent)

	Receipts/GNP	Outlay/GNP	Deficit/GNP
1975	18.5	22.5	-4.0
1980	20.2	22.5	-2.3
1981	20.8	22.7	-1.9
1982	20.3	23.9	-3.6
1983	18.6	24.7	-6.1
1984	18.6	23.7	-5.2
1985	18.7	23.2	-4.5
1986	18.9	23.3	-4.4

Wharton "Baseline" 11/83

Table 3

FEDERAL BUDGET RECEIPTS, NIA BASIS, FISCAL YEARS, AND ANNUAL PERCENT CHANGE
(Billions of Dollars)

	1980	1981	1982	1983	1984	1985	1986
Personal Tax & Nontax	250.3	291.2	304.8	297.9	309.7	338.5	367.0
%	12.6	16.3	4.7	-2.3	3.9	9.3	8.4
Corporate Profits	69.9	70.3	51.3	54.3	73.3	83.1	84.7
%	-8.1	0.5	-27.1	5.9	35.0	13.3	1.9
Ind Bus Tax/Nontax Accr	35.3	53.7	50.0	52.1	53.6	55.5	59.0
%	20.3	52.2	-6.9	4.2	2.8	3.6	6.2
Contrib for Social Ins	170.1	197.1	215.3	229.1	257.6	287.8	314.4
%	10.4	15.9	9.3	6.4	12.4	11.7	9.2
Tot Receipts, NIA Basis	525.7	612.4	621.5	633.5	694.2	765.0	825.1
%	9.1	16.5	1.5	1.9	9.6	10.2	7.9
Shares of Receipts (%)							
Individual	47.6	47.6	49.0	47.0	44.6	44.2	44.5
Corporate	13.2	11.5	8.3	8.6	10.6	10.9	10.3
Indirect	6.7	8.8	8.0	8.2	7.7	7.3	7.2
Contributions	32.4	32.2	34.6	36.2	37.1	37.6	38.1
Relationship to GNP (%)							
Individual	9.7	10.1	10.0	9.2	8.7	8.6	8.6
Corporate	2.7	2.4	1.7	1.7	2.0	2.1	2.0
Indirect	1.4	1.9	1.6	1.6	1.5	1.4	1.4
Contributions	6.6	6.8	7.1	7.1	7.2	7.3	7.4

Wharton "Baseline" 11/83

Table 4

FEDERAL BUDGET OUTLAYS, NIA BASIS, FISCAL YEARS, AND ANNUAL PERCENT CHANGE
(Billions of Dollars)

	1980	1981	1982	1983	1984	1985	1986
Purch of Goods & Svcs	189.8	218.8	251.0	276.3	293.0	330.3	364.1
%	15.5	15.2	14.7	10.1	6.0	12.7	10.2
National Defense	126.2	147.1	173.4	196.6	222.3	250.0	276.3
%	16.7	16.6	17.9	13.4	13.0	12.5	10.6
Nondefense	63.6	71.7	77.6	79.7	70.7	80.3	87.8
%	13.3	12.6	8.3	2.7	-11.3	13.6	9.3
Transfer Payments	239.1	279.6	309.9	343.9	354.6	373.6	397.6
%	18.6	16.9	10.8	11.0	3.1	5.3	6.4
Grants-in-Aid	86.7	89.9	83.7	86.2	91.8	95.7	99.3
%	9.4	3.8	-6.9	3.0	6.6	4.2	3.7
Net Interest Paid	50.5	67.6	82.4	92.5	107.3	121.0	135.2
%	24.6	33.9	21.9	12.3	16.0	12.7	11.7
Other Federal Expend	10.9	12.1	13.3	20.3	30.1	22.8	24.7
%	15.3	10.7	10.1	52.1	48.2	-24.1	8.1
Tot Outlays, NIA Basis	577.1	667.9	740.5	820.1	816.9	943.5	1020.9
%	16.5	15.7	10.9	10.7	6.9	7.6	8.2
Shares of Outlays (%)							
Defense	21.9	22.0	23.4	24.0	25.4	26.5	27.1
Nondefense	11.0	10.7	10.5	9.7	8.1	8.5	8.6
Transfers	41.4	41.9	41.9	41.9	40.4	39.6	38.9
Grants in Aid	15.0	13.5	11.3	10.5	10.5	10.1	9.7
Net Interest	8.8	10.1	11.1	11.3	12.2	12.8	13.4
Other	1.9	1.8	1.8	2.5	3.4	2.4	2.4
Relationship to GNP (%)							
Defense	4.9	5.1	5.7	6.1	6.2	6.4	6.5
Nondefense	2.5	2.5	2.5	2.5	2.0	2.0	2.1
Transfers	9.3	9.7	10.1	10.7	9.9	9.5	9.4
Grants in Aid	3.4	3.1	2.7	2.7	2.6	2.4	2.3
Net Interest	2.0	2.3	2.7	2.9	3.0	3.1	3.2
Other	0.4	0.4	0.4	0.6	0.8	0.6	0.6

Wharton "Baseline" 11/83

STATEMENT OF DR. LAURENCE H. MEYER, PRESIDENT, LAURENCE H. MEYER & ASSOCIATES, LTD., ST. LOUIS, MO.

Dr. MEYER. The overall expansion and the performance of investment in particular during the first year of recovery have been stronger than had generally been anticipated. Even without deficit reduction, the recovery is likely to continue for the next couple of years, although at a progressively slower rate. The compelling case for reducing the deficit is therefore not how bad the situation is now, nor even how bad it is likely to be in the next year or two, but rather the long-run implications of deficits far outside the bounds of post-war experience.

Deficit reduction, however, without an accompanying change in monetary policy, will weaken the economy, lower production, and despite lower interest rates, weaken investment for at least a couple of years. The challenge is to design a policy which will yield the desired results of lower interest rates and an improved environment for investment without weakening the expansion in the short run.

Fortunately, monetary policy is not likely to remain unchanged in the face of congressional action to cut the deficit. Assuming a move toward greater monetary accommodation, a move the Chairman of the Federal Reserve has suggested will be linked to congressional action on the budget, deficit reduction could be accomplished without weakening demand. Such a change in the mix of monetary and fiscal policy would lower both nominal and real interest rates and shift the composition of output in favor of investment and other interest-sensitive sectors while still lowering the deficit substantially.

The high employment deficit as a percentage of GNP is projected to increase sharply in the mid-1980's to a level almost double that achieved previously in the post-war period. This suggests that if deficits matter, they will matter a lot in the mid-1980's, and indeed the situation will actually worsen as the decade unfolds.

While the economy is likely to expand in 1984 and 1985 even without deficit reduction, the degree to which a deficit problem will worsen in the mid-1980's suggests that a prudent policy would be to act now to prevent a more serious problem from developing then.

A legitimate source of concern, then, is the long-run consequences of high Government expenditures and high deficits. In the long run, higher Government spending necessarily means lower private spending. And if higher Government spending is financed by deficits, investment will almost certainly be lower.

In the short run, on the other hand, a change in the deficit may have two effects: a demand effect, and a financing effect. A decline in the deficit, for example, by lowering Government spending or raising tax rates, will lower demand and weaken the economy. This is the demand effect. The financing effect refers to the impact of continued deficits on interest rates as the result of continued debt issue by the Treasury. Will deficit reduction, by reducing the financing needs of the Treasury, lower interest rates enough to offset the demand effect? This seems to be what many are suggesting.

But if lowering the deficit would stimulate the economy, it follows that we have been carrying out fiscal policy backwards all these years. To combat a recession, according to this new view, we should lower Government expenditures and raise tax rates. Surely, no one believes this.

My written testimony reports simulations with the Washington University model of the U.S. economy. A deficit reduction of the magnitude of that proposed in the deficit reduction package—$31 billion in 1985 and $50 billion in 1986—would, according to these simulations, lower real GNP growth, lower interest rates, and lower investment in both 1985 and 1986. But a combination of deficit reduction beginning in 1985, and a move toward increased monetary accommodation beginning in 1984, would maintain demand conditions while it would lower the deficit and interest rates, and increase investment. By maintaining income growth and further lowering interest rates, such a move to a more accommodative monetary policy would reinforce the impact of expenditure cuts and tax increases on the deficit, permitting a $60 billion reduction of the deficit by 1986.

Congress can now directly decide on whether to reduce the deficit, and can indirectly influence the posture of monetary policy. The political obstacles to such a shift in the mix of monetary and fiscal policy may be less the difficulty in achieving coordination with the Federal Reserve than in convincing the Reagan administration to accept cuts in defense spending and to accept some increase in taxes.

The formula for a solution to the deficit problem is cooperation from the administration and coordination with the Federal Reserve. This combination could make cuts in the deficit both politically possible and economically desirable.

[Dr. Meyer's prepared statement follows:]

DEFICIT REDUCTION AND THE MIX OF MONETARY AND FISCAL POLICY

Laurence H. Meyer

Testimony before the Senate Finance Committee

Washington, D.C., December 14, 1983

The overall expansion and the performance of fixed business investment in particular during the first year of the recovery have been stronger than generally anticipated. Even without deficit reduction, the recovery is likely to continue for the next couple of years, although at a progressively slower rate. The compelling case for reducing the deficit is not how bad the situation is now, nor even how bad the situation is likely to become in the next year or two, but rather the long-run implications of deficits which are far outside the bounds of postwar experience.

Deficit reduction, however, without an accompanying change in monetary policy, would lower demand, weaken production and, despite lower interest rates, reduce fixed business investment for at least a couple of years. The challenge is to design a policy that yields the desired long-run results of lower interest rates and an improved climate for investment without weakening the expansion in the short run.

Fortunately, monetary policy is unlikely to remain unchanged in the face of Congressional action to cut the deficit. Assuming a move toward greater monetary accomodation, a move the Chairman of the Federal Reserve has suggested is linked to Congressional action on the budget, deficit reduction could be accomplished without weakening demand. Such a change in the mix of monetary and fiscal policy would lower both nominal and real interest rates and shift the composition of output in favor of investment and other interest sensitive sectors while substantially lowering the deficit.

I. Measuring Deficits

The first step in evaluating the severity of the "deficit problem" is to develop a meaningful measure of the federal deficit, one that accurately reflects the potentially harmful effects of deficits on credit markets. Several adjustments to the official deficit in the unified budget are appropriate:

(1) Deficits should be measured as a percentage of GNP in order to reflect the economy's growing ability to both service and absorb debt over time.

(2) Deficits should also be measured on a "high employment" basis; i.e., transfers and taxes should be adjusted to levels that would prevail if the economy were operating at "full employment."

High employment or "active" deficits need to be distinguished from the cyclical or "passive" deficits that arise when income falls during recessions. The tendency for deficits to rise during recessions helps stabilize aggregate demand. Given the importance of aggregate demand as a determinant of investment, it is likely that cyclical deficits stabilize investment as well as overall GNP. Furthermore, because cyclical deficits increase when the economy weakens, rising cyclical deficits are generally associated with falling interest rates. This pattern was evident, for example, in 1982.

(3) The high employment deficit should be "inflation adjusted." When inflation increases, nominal interest rates rise and interest payments on the debt increase. Such an increase in the deficit does not, however, put upward pressure on interest rates. The reason is that the increase in interest income associated with inflation merely compensates wealth owners for the accompanying decline in the real value of their bondholdings. This inflation-induced portion of interest income should therefore be saved.

(Indeed, it is really not income at all, but replacment of "real" principal). The increased saving, in turn, should offset the effect on interest rates of the component of the deficit attributable to the impact of inflation on federal interest payments.

Official deficits may stabilize at $200 billion for the next several years, and actually decline as a percent of GNP over the same period. However, an examination of movements in the high employment deficit relative to GNP suggests the problem is worsening. In the decade of the 1960's, the federal government ran, on average, a high employment surplus equal to .2% of GNP. In the decade of the 1970's, the U.S. swung into the red, averaging a high employment deficit equal to .8% of GNP. In the period from 1983 through 1988, the high employment deficit is likely to increase further to an average of 3% of GNP, and it could exceed 4% of GNP by 1988. The highest value of the high employment deficit before 1980 was 1.9% in 1967 and again in 1975.[1]

Adjustments for inflation can at times substantially alter one's view of the high employment deficit. For example, without adjusting for inflation, there was a high employment deficit equal to .5% of GNP during the period 1977 through 1981. After adjustment for inflation, however, there was actually a high employment surplus measuring nearly 2% of GNP. During the 1980's, however, high employment deficits increase relative to GNP whether or not we adjust for inflation. From 1983 through 1988, the inflation-adjusted high employment deficit is projected to average 1.5% of GNP and to be above 2.5% of GNP by 1988. The largest value before 1980 was .6% of GNP in 1970.[2]

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[1]The projections for the high employment deficit relative to GNP are based on a recent study by Eisner and Pieper (forthcoming, 1984) and, in turn, are based on CBO projections of the deficit.

[2]The figures on the inflation adjusted high employment deficit as a percent of GNP are from Eisner and Pieper's forthcoming paper.

We conclude from the above measures of the deficit that, if deficits matter, they will matter a lot in the mid 1980's, and that the problem will progressively worsen as the decade unfolds.

II. The Economic Outlook Without a Deficit Reduction Bill

Laurence H. Meyer and Associates, Ltd. (LHM & A) is forecasting continued but slowing growth in real economic activity through 1986, with real GNP increasing at rates of 4.0, 3.6, and 2.9 over the next three years. Business fixed investment will remain quite strong, although it too slows after 1984. Market interest rates will fall as the expansion slows, but interest rates adjusted for inflation, while falling, will remain historically high. The deficits also will remain high, though below the level of $200 billion many have forecast; the difference stems primarily from the lower interest payments on the debt associated with our relatively optimistic forecast of interest rates.

Business fixed investment expanded strongly in 1983. This seems to be a well kept secret in some circles. On average, investment increases at a 5.7% rate in the first year of an expansion. In the first year of this recovery, investment will increase by over 8%. Next year, we expect investment to exceed the 8.5% average increase in the second year of expansions.

Why is business investment doing so well in the face of high deficits and high interest rates? There are at least two good reasons. First, the tax cuts passed in 1981 did in fact stimulate the economy (contrary to what is implied by the view that raising taxes now will stimulate the economy). The rise in economic activity during the recovery has helped to stimulate the rebound in investment. Second, the tax cuts were, to a considerable degree, business tax cuts and specifically tax cuts which stimulate investment. The

Accelerated Cost Recovery System (ACRS) both increased the return to investment and increased cash flows to firms, thereby providing for increased internal financing of investment. The high real rates are only partially offsetting the stimulus to investment associated with the 1981 tax cuts. Indeed, our measure of the cost of investment in business equipment that includes the effects of both accelerated depreciation and real interest rates has never been lower at this stage of a post-war expansion.

I do not want to leave the impression that the deficits ultimately won't squeeze out private investment. After all, we are just beginning to get the sharp rise in the high employment deficit that is the real source of concern. And, in the long run, there will be no escape from the requirement that higher government expenditures mean lower private spending and probably lower investment. Action is in order not because investment is unusually weak now, but because, by the late 1980's and beyond, investment may very well be a smaller percentage of GNP than we would prefer.

III. Demand and Financing Effects of Deficits in the Short and Long-Runs

(1) Long-run and short-run effects of changes in the deficit

The effects of an increase in government expenditures (or a reduction in tax rates) can be quite different in the short and long runs. In the long run, an increase in government expenditures must reduce private spending. At full employment levels of production, government spending necessarily absorbs resources that otherwise would be absorbed by private spending. The method of financing government expenditures determines which components of private spending get "crowded out." Taxation, particularly personal income taxation, primarily crowds out consumption, while bond financed deficits probably largely crowd out investment.

If there is slack in the economy, an increase in government spending (or a reduction in tax rates) will increase aggregate demand and, at least temporarily, increase output and employment. It will also increase interest rates. However, because investment depends so critically on aggregate demand, investment will generally increase despite the rise in interest rates. Deficit reduction, in turn, lowers demand and, in the short run (meaning at least a couple of years), lowers output, interest rates and investment.

(2) Demand and financing effects

Deficits may affect aggregate demand through two channels: the "demand effect" and the "financing effect." Recent concern about deficits focuses on the financing effect and often ignores the demand effect. However, there is far more reliable evidence on the nature and size of the demand effect than on the magnitude of the financing effect.

The demand effect refers to the increase in aggregate demand associated with an increase in government spending or a reduction in tax rates. This is a one-time effect. An unchanging high employment deficit indicates that the size of the demand stimulus associated with fiscal policy remains unchanged.

The financing effect is the indirect impact on aggregate demand of changes in interest rates associated with the financing of a continuing deficit. The financing of deficits is generally expected to raise interest rates through one of two channels: monetization of the debt or financial crowding out.

(a) Monetization refers to the increase in monetary growth that may be induced as the Federal Reserve tries to prevent interest rates from rising in the face of large deficits. But the monetary growth induces inflation, which, in turn, increases interest rates.

(b) Financial crowding out may occur if the Federal Reserve does not monetize the deficit. In this case, the continuing increase in the supply of bonds resulting from ongoing deficits may put upward pressure on interest rates. Thus, while the demand stimulus associated with the deficits may remain unchanged, the process of financing the deficits may progressively raise interest rates and weaken the economy.

(3) The implications of deficit reduction

The projected increase in the high employment deficit indicates a move toward additional fiscal stimulus over the mid 1980's. Even with this increased stimulus, we project real GNP growth of 4% in 1984 and less than 4% in the following two years. Measures to cut the deficit will reduce fiscal stimulus and weaken aggregate demand; they also will reduce financing needs. Will the "financing effect" more than offset the "demand effect?" If we believe that this is the case, we never should have lowered tax rates during the recession because, by this view, the lower tax rates weakened the economy. By the same token, we should raise government spending when we wish to cool down the economy. Does anyone really believe this? Of course not. So reductions in government spending or increases in tax rates will weaken demand and lower production and employment in the short run. We may want to tolerate this temporary loss of output because, as the economy gravitates back to full employment, the share of government spending in output will be smaller, investment may be larger, and the economy may grow more rapidly. But do not ignore the price to be paid during the transition. For a couple of years at least, output and employment will be lower as a consequence of measures to reduce the deficit.

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IV. Empirical Evidence on the Effect of a Deficit Reduction Bill

The Deficit Reduction Package proposes to cut the deficit by about $31 billion in fiscal 1985 and $50 billion in fiscal 1986. We introduced the proposed changes into the Washington University Macroeconometric Model of the U.S. Economy and compared the "base" and "policy" simulations to determine the demand effects on the economy of the proposed bill. The negative demand effect induces a decline in production, employment and interest rates relative to the base case. Growth in real GNP slows 0.8% points in 1985 and 0.5% points in 1986, and long-term interest rates fall almost 50 basis points by the end of the period, relative to the base case. Investment also increases more slowly in 1985 and 1986 (relative to the base case) because the demand effects outweigh the effect of lower interest rates. The deficit falls by almost $40 billion by the end of 1986.

In the long run, these smaller deficits will mean lower interest rates (relative to the base case) even when the economy gravitates back to full employment. Therefore, 4 or 5 years following passage of such a bill, investment may indeed be higher. But the demand effects dominate for at least the first couple of years.

We have ignored financing effects in our empirical analysis because there is virtually no refereed scholarly work to support the view that the financing of a continuing deficit raises interest rates, independent of the demand effect. There have been numerous studies of the effect of deficits on interest rates, several of them completed within the last year or two. These studies consistently find negligible financing effects on interest rates.[3]

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[3]See, for example, Hoelscher (1983), Motley (1983), and Evans (1983) for evidence on financial crowding out and Blinder (1983) for evidence on the monetization of deficits.

Recently, however, some have alleged that the continued deficits of $200 billion have raised real interest rates by 2 to 3 percentage points. It is then argued that action to reduce the deficit would lower interest rates beyond the decline associated with the demand effect, so that deficit reduction would actually have a positive net effect on demand and hence would stimulate the economy. If this were true, and it surely is not, then we have been carrying out stabilization policy backwards all these years. When the economy moves into a recession, according to this "new view", government spending should be lowered and tax rates should be raised in order to stimulate the economy! The mistake we apparently made in 1981 was lowering tax rates as the economy was headed into a recession. Had we raised taxes instead, it follows that we could have avoided the recession. This view surely cannot be taken seriously. Indeed, it makes even less sense than the now discredited. propostion that lowering tax rates will raise tax revenue and thus help to balance the budget!

V. The Deficit Reduction Bill as Part of a Shift in the Monetary-Fiscal Policy Mix

Concern over continuing deficits has generally focused on the potential for monetization or financial crowding out. Monetization assumes the Federal Reserve moves to a more accomodative policy in response to deficits. Financial crowding out presumes the absence of monetization. There is, however, a third possibility: the Federal Reserve might move to a more restrained policy in response to deficits. This is the response to continuing deficits that seems most relevant to the current situation.

According to recent statement by Mr. Volker, Chairman of the Federal Reserve Board, monetary policy is currently being set in relation to the prevailing fiscal policy. The growing stimulus of fiscal policy is being counterbalanced, at least of late, by monetary restraint. If a package to reduce deficits is passed, it is highly likely that the Fed will pursue a more accomodative policy, allowing more rapid growth in reserves than otherwise, further lowering interest rates. The net effect of such a shift in the mix between monetary and fiscal policies would be to lower nonimal and real interest rates, keep overall growth in demand and output relatively unchanged, and shift the compositon of output in favor of investment and other interest sensitive sectors.

There are at least three complications to this scenario. First, the timing of the impacts of monetary and fiscal policies differ. Fiscal policy has a rapid effect on demand. Monetary policy has a more gradual effect. To counterbalance the demand effects of a move to reduce the deficit, the move to a more accomodative monetary policy should preceed the implementation of the deficit-reduction.

The second complication is that monetary and fiscal policies are set very differently politically -- monetary policy by the Federal Reserve Board (not without influence by the President and Congress), fiscal policy by Congress and the Administration. There is no policial vehicle for striking a "deal" between the Administration and Congress, on the one hand, and the Federal Reserve, on the other, as there is, in principle, between the President and Congress. However, as indicated above, the Chairman of the Federal Reserve has suggested that the degree of monetary restraint recommended by the Federal Open Market Committee will be influenced by whether or not Congress votes to reduce the deficits. For this reason, Congress can now both control the degree of fiscal stimulus and influence the degree of monetary restraint.

The third complication is that some will object to a relaxation in monetary restraint because of concern over a resurgence in inflation. This concern is unwarranted for two reasons. First, the relaxation of monetary restraint would merely offset the reduction in fiscal stimulus. In our analysis demand conditions and hence unemployment and inflation are unaffected by the change in the mix of policy. Second, the increase in monetary growth required to offset the deficit reduction is only about half a percentage point at an annual rate and the resulting monetary growth would still be well within the monitoring range set for 1983 and the one tentatively set for 1984.

A second policy simulation assumes the Fed becomes more accomodative in 1984 following passage in 1984 of a package to reduce the deficit beginning in 1985. Monetary growth is about 1/2% point higher through 1986, compared to the case of no monetary accomodation. The easing of monetary policy offsets the decline in demand associated with the deficit reduction, so that growth in real GNP is about the same as in the "base" run. Interest rates are lower. Long-term rates fall by 120 basis points compared to the base forecast, and by 80 basis points compared to the scenario in which monetary policy is not more accomodative. As a result, investment is about the same as in the "base" run for 1985, but higher in 1986. And deficits fall still further, in part due to a recouping of tax revenues as demand increases, and in part due to lower interest payments. The total reduction in the deficit is over $60 billion in 1986 in this scenario. Table 1 summarizes the impact of deficit reduction with unchanged monetary policy and deficit reduction accompanied by increased monetary accomodation.

VI. Conclusion

There is a compelling case for deficit reduction accompanied by a relaxation of monetary restraint. While there is a great deal of uncertainty about the effects of the financing of continued large deficits, it would be prudent to avoid allowing deficits to rise to levels unprecedented in the postwar period.

Nevertheless, deficit reduction without relaxed monetary restraint would weaken the economy at a time when it is naturally slowing down. Although such a policy would lower interest rates, it would weaken both real GNP and investment for at least a couple of years.

There are at least three major obstacles to achieving the proposed change in the mix of monetary and fiscal policy. The first is the problem of achieving the desired coordination with the Federal Reserve. Here, I believe Congress can count on the Federal Reserve to adjust the degree of monetary restraint in the desired direction in response to action on the deficit. I urge the Chairman of the Federal Reserve to reaffirm this intention and Congress to accept his commitment.

Second, a political environment preceding a Presidential election is not conducive to making difficult choices or writing good legislation. Therefore, if action is to be taken, it is imperative that Congress move swiftly. Otherwise, a serious effort to reduce the deficit may be postponed until after the election. The longer we delay, the greater the chance that by the time Congress is ready to act, a recession will be upon us, precluding a move to reduce the deficit as the decline in income pushes the deficit to still higher levels.

Third, sizeable reductions in expenditures are facilitated when there is a willingness to spread the cuts amont the major expenditure components. Thus, the Administration's reluctance to pare the defense budget does hinder progress on reducing the deficit. The same can be said of the President's committment to hold the line on any additional tax increases. The formula for successful deficit reduction is cooperation between the Administration and Congress, and coordination with the Federal Reserve. If this cooperation and coordination are forthcoming, then deficit reduction may be both politically possible and economically desirable.

The CHAIRMAN. Well, is it fair to say at the outset that—you are all three about the same age. What, about 25, 28? [Laughter.]

Dr. SINAI. Pretty close.

The CHAIRMAN. All young economists.

You all agree that the deficit is a problem, right? No one disagrees with that. I think you have a little different approach. I assume we should have, but we haven't really focused on what effect monetary policy changes would have; and I think you are right. I think if we did something fiscally responsible, it certainly would make Chairman Volcker's and the other Board members' job a little easier. I don't suggest he said he would do anything, but we did meet with Mr. Volcker, and he is obviously concerned about our problem and we are concerned about his.

Dr. MEYER. Well, I think there is one difference that may have emerged, perhaps, between the testimony of Allen Sinai and myself this morning. I think he suggested that the deficit reduction would stimulate the economy because interest rates would fall so much, even with unchanged monetary policy, or that's the way I interpreted it.

Dr. SINAI. Oh, no.

Dr. MEYER. I certainly disagree with that.

The CHAIRMAN. Well, you would be willing to have a little change in——

Dr. SINAI. Oh, no, no. I think it is very clear—over the last couple of years the problem is policy mix. You really can't just have deficit reduction without a compensating ease in monetary policy. It is not really an ease in an absolute sense, it is just to keep money growth where it would have been before the deficit reduction.

Dr. MEYER. I disagree. Keeping money growth where it would be before the change in the deficit is what I would view unchanged monetary policy. Deficit reduction in that context would lower interest rates but would weaken the economy.

Dr. SINAI. Initially.

Dr. MEYER. Initially. And that initially means in a year or two at least—probably at least 2 years, maybe more.

So what I am advocating is not maintaining unchanged monetary growth; what I am advocating is that the Fed should balance a move with deficit reduction with somewhat more accommodative monetary policy, a slightly higher—and in our simulations, a half a percentage point a year—more rapid monetary growth.

If you begin that prior to deficit reduction, if you pass that bill so they know it is going to happen in 1985, that accommodation will begin before deficit reduction, and that will lead to an extremely smooth transition.

Dr. SINAI. I would be a little cautious on that, because I think the financial markets are very sensitive to any easing by the Fed. It's a bit like what happened in 1968, where an income tax surcharge was levied or talked about. The Fed eased in advance, and we ended up having too long a boom.

But deficit reduction alone, without at least a compensating—in the sense that I discussed it or maybe even a little more accommodation, as Larry puts it—a deficit reduction alone really, over time, is going to give you a lower path for the economy than you would have otherwise.

The CHAIRMAN. Does Wharton agree with that?

Dr. STRASZHEIM. Let me suggest an analogy, Mr. Chairman, that maybe my two colleagues would agree with.

You can think of fiscal policy as the accelerator and monetary policy as the brake. In some sense in the last couple of years we have run the economy with both feet hard down on each of those pedals. I think what we are suggesting is perhaps an easing up of the right foot pedal, the accelerator, fiscal policy, to be accompanied by an easing up of the left foot pedal, the brake, monetary policy. Perhaps our economy would operate a bit better if we relaxed both of those pedals and not just one or the other.

The CHAIRMAN. Well, no one disagrees with that, as far as I know. I mean, economists don't always agree with each other. We have had 16 so far, and I think we have found some areas of dispute. But everyone has said the deficit is a big concern.

You are all agreed that 1984 looks pretty safe?

Dr. SINAI. I think, generally, it looks pretty safe, but I do note the nervousness that is shown in the financial markets over the last 3 to 6 months as a cause for some concern.

The deficits, and the monetary growth targeting policy that goes along with it, is keeping rates so high—I think there is some risk for 1984. I don't think I thought that 2 or 3 months ago.

So my feeling that it is urgent to do something soon is just underscored.

The CHAIRMAN. In your own private thoughts, do you think Congress will do anything in 1984?

Dr. MEYER. Well, let me say this. As a forecaster, we have to make projections of fiscal policy, and, frankly, Mr. Chairman, we have presumed that Congress will do nothing.

The CHAIRMAN. Do you have precedent for that?

Dr. MEYER. No comment. [Laughter.]

The CHAIRMAN. Does anybody believe Congress will do anything?

Dr. SINAI. Well, we are forecasting no change; but perhaps something will happen, and that would be terrific.

Dr. MEYER. This is one case when we would be pleased if we forecast incorrectly.

Dr. STRASZHEIM. We would agree, Mr. Chairman. Our assumption on the fiscal policy side for calendar 1984 is that no major changes will be enacted.

The CHAIRMAN. That is generally shared, I assume, by people in your profession.

Dr. STRASZHEIM. I think it's safe to say that most of the forecasters hold that same view.

Dr. SINAI. But the problem is, if it doesn't happen in 1984 and something happens after the election, then the impact of the deficit reduction will come at a time when the economy is fading anyway, and we may go through another time of mistiming policy changes, getting destabilization rather than stabilization.

The CHAIRMAN. You may be wrong—I hope you're wrong. You probably hope you are wrong, too, on what the Congress might do.

Dr. SINAI. Absolutely.

The CHAIRMAN. Occasionally we do the responsible thing. It's not habit forming around here, and it's not required; but maybe by accident we may come up with something that would work; but obviously, if we don't do it in 1984, it may be harder to do in 1985, or it may not be the right thing to do in 1985, if, in fact, these things are happening that you seem to suggest. Then we won't be able to move on the revenue side, and some would say you can't move on the spending side because of a weaker economy.

Now, that's why I believe there is a real chance the Congress will act in 1984. It would have to come, I assume, before mid-May.

Dr. MEYER. I think the timing is so essential because swift action is necessary to avoid the pressures that will be coming up in the period leading up to the election. And if Congress doesn't act before that, then there may be no right time to act afterward.

The CHAIRMAN. Well then, what happens?

Dr. MEYER. Then what happens is this: The deficits remain at the $200 billion + level, the economy begins to weaken, and there is no chance for a deficit reduction in that environment; if we begin from $200 billion and into another recession, we will be up to $300-350 billion. That's probably the prospects.

The CHAIRMAN. Normally, there are a lot of people who would say it's all right to do these things as long as it doesn't impact on me or my company or my farm or whatever.

Would it be fair to assume that they are going to be a lot worse off if we do nothing than if we take some corrective action? Dr. Sinai has a very specific proposal on page 17 of his statement.

Dr. SINAI. Many of them really come from your proposal.

The CHAIRMAN. That's right.

How do you get the public concerned about the deficits and what the consequences might be in a period of fairly strong recovery? I mean, every time you turn on the tube the retail sales are up, people are going back to work, and it looks great.

Dr. SINAI. I think those deficits, by our calculations 2 or 3 percentage points in long-term rates—that would be mortgage rates—you are talking about a 10 percent mortgage rate instead of 13. That can be translated into dollars-per-month. You are still talking about a huge number of people on layoff in the auto industry, even though they are employing more. The daily impacts are still very striking.

This is actually the right time to have some fiscal restraint, probably now, because the economy is growing well beyond what most of us thought it would be doing. The effects of the fiscal stimulus are very, very strong.

The CHAIRMAN. Do you have a lot of contacts with the Speaker and the President so that you could——

[Laughter.]

The CHAIRMAN. Before you leave town, could you stop by and see the Speaker and the President?

Dr. MEYER. If you would arrange the appointment, I would be happy to. [Laughter.]

The CHAIRMAN. If I could arrange one, I'd go myself. [Laughter.]

Dr. STRASZHEIM. The real risk here, Mr. Chairman, if I could go back to this issue of timing, really is that nothing is done over the next year, and by 1985 the economy will be slowing substantially of its own momentum. And to contemplate at that time a major measure to reduce the deficit every so likely would convert what in our scenario is a growth pause into a serious downturn with the consequences, as Dr. Meyer suggests. When the economy goes in the tank the deficit will go straight up because of the working of the automatic stabilizers. And then you end up with deficits far above your $200 billion mark which we now contemplate.

The CHAIRMAN. How are we going to be able to pay the interest on the debt if it keeps going up? Do you assume we are going to double the national debt in the next 6 or 7 years? Does anybody disagree with that? Unless we start something, I mean.

Dr. STRASZHEIM. We will be able to pay that interest, but it is an important point to keep in mind, that the interest component of our total spending is rising and rising rapidly, and that is in some sense unproductive spending that leverages the public sector increasingly.

Any private sector firm realizes the consequences of rising debt payment responsibilities when the economic conditions get sick for a company, or when receipts fall off for the public sector. That is going to be a much worse problem in 4 or 5 years than it is now.

The CHAIRMAN. How many jobs do we create by paying interest on the debt? I mean, is that a job-creating program? Does it create any farm programs or health programs?

It seems to me the increased interest, depending on whose figures you use, goes up $15 billion a year. That seems to equal the cost of the food stamp program, almost the Federal share of medicaid. You can do a lot with the numbers.

But it seems to me that across the board, whatever income group you are in, it is much better if there is a shared sacrifice now than if we postpone it. It may not be our problem, but it's going to be—what do you think, 85, for certain?

Dr. SINAI. I am just looking at some calculations here. The change in the policy mix—$100 billion is kind of an illustrative number. But suppose there was a change, a deficit reduction of $100 billion a year and a compensating ease in monetary policy. It's on page 22 of the document. The interest rate effect is that you would actually get $43.5 billion less interest rate payments by fiscal year 1988 from that kind of shift, and you can think about what you could do. You probably shouldn't spend it but just have it go to continued deficit reduction.

The CHAIRMAN. You meet with a lot of normal people, too, don't you? I mean, economists have, like we do——

Dr. SINAI. Very few. None of them are normal.

The CHAIRMAN. I mean, you are not abnormal, but you have all this knowledge that the rest of us don't have. Fortunately, we are not burdened with it. If I knew all you knew, I would really be worried. [Laughter.]

But in your age group is there a lot of concern about the deficit? Outside your profession—I guess that is the question.

Dr. MEYER. Well, I think there is a lot of confusion. There are so many crosscurrents, so many people saying different things. As you indicated, economists don't fully agree on this, either.

I think you are right to say that the serious implications here are longer run ones that people can sort of disregard right now, and they accept the fact that the recovery is really going a lot better—unemployment is falling, incomes are rising—and they see the good aspects now of the momentum, and I think they are not as worried about it.

That means, of course, that this is the time when political leadership is essential, because they have to be led into a realization that action now is necessary so that support is mobilized for the rest of political leaders to act.

Dr. SINAI. I have seen some polls that suggested, or a sample, that they thought it was the No. 1 economic problem.

But it is difficult for any bottom line decisionmaker to do anything when things are going very well. It is very hard for anyone—the Congress, the administration, or any of us—to do something 2 years in advance of when the problem is, without a question.

The CHAIRMAN. You have clients who are concerned. There is a lot of capital investment. I think one of the statements pointed that out. It has been sort of a well kept secret.

Dr. SINAI. Exactly.

The CHAIRMAN. What do you tell your clients who are concerned about what they see down the road?

Dr. STRASZHEIM. Mr. Chairman, our clients are clearly concerned, because they see economic prospects in ways which are similar to what we see.

But let me just go back, if I might, to your question about the general populace. I am not at all sanguine that the American public is going to become quickly interested in the deficit, just in some ways as I don't think the American public has ever become very interested in the money supply.

What the American public is interested in, it seems to me, is inflation, prices they confront in product markets. They are interested in interest rates that they confront when they take out a mortgage. They are interested in employment and good job prospects; they are interested in steady growth. And they don't really care whether the money supply is going up, down, or sideways, or whether the deficit is going up, down, or sideways. They are concerned about those things that they confront on a day-to-day basis.

The CHAIRMAN. I think that is very accurate. I think there may be a little more general understanding of deficits and interest payments, and obviously most people believe when you are in debt you have a problem. And when they look at the Government debt, they understand that we've got a problem.

When you take a poll, most people say "cut spending." And I guess you also recognize the realities in this town. I mean, you have Tip O'Neill, who has a hundred-vote margin in the House, who would probably reduce the deficit by more taxes without much spending change. You have President Reagan who has a different view; he would rather reduce spending and not do anything on the tax side except maybe loophole closing.

It seems to me that a lot of people have great ideas but they don't have any votes. Some would say "cut spending," some would say "raise taxes." And I think the only way we are going to do it is to do some of each. We have to do some of each.

Dr. MEYER. It seems to me that those who maintain that you have to only raise taxes, or you only have to lower Government expenditures, are taking a position that they know is untenable and simply can't work.

The only way it can work is if there is a balancing across taxes and expenditures, and across expenditure components. And to take any other position, to me, seems to block action.

The CHAIRMAN. Well, some people make a living advocating one or the other. You know, they get members who pay dues to hear that you ought to do only one thing. But others of us have to deal with it. We have a 20-member committee, and we are talking about billions. The magic number here is 11—11 votes to get anything done. So we may talk big, but we don't have any—if we don't have 11 votes.

Well, I appreciate it very much.

Would it embarrass you to ask your age? I think it is interesting.

Dr. MEYER. Thirty-nine.

Dr. SINAI. I am 44.

Dr. STRASZHEIM. Forty-two.

The CHAIRMAN. Well, you are well-preserved. [Laughter.]

Dr. MEYER. We don't have to run for office every 6 years.

The CHAIRMAN. Well, maybe you have some new theory that we ought to look into.

Well, we appreciate it very much, and we are serious about what we are doing. We think you have helped us make the case that the deficits are a real problem, maybe not short run but long run, and they ought to be addressed at the earliest possible time, hopefully by next May, or something.

Dr. SINAI. Even that is pretty late. The budget is a real watershed. Again, if we see a budget which has a contingency tax increase, or a revenue plug, or some think ad hoc, we will have very negative reactions in the financial markets.

I was going to point out something to you. And this is from a crowd that are not necessarily ordinary persons on the street. The stock market is very clearly registering, for six months now, really a very, very negative view of the future. It is really 1985 and 1986 uncertainties, and the deficits have a lot to do what that, because the sustainability of the expansion is in question. There is really no way that stocks or equity prices are going to go higher in this environment of high interest rates and really so much confusion over whether we will still have an expansion in 1985.

So there is a place where votes are being registered in terms of the future, a kind of an opinion poll, which is generally fairly accurate.

The CHAIRMAN. One school of thought is that you wait until after the election when we have a mandate—whoever it is, whether it is Glenn, Mondale, Cranston, Hollings, Hart, Askew, or McGovern, or Reagan. And then you have a mandate, and then you come in and clean it all up at once. That's not my view, but that's the view that is around town.

Dr. SINAI. It would take Congress a year or two to work its way through the analysis of a VAT or a flat-rate tax, a total restructuring of the tax system, and we probably wouldn't see legislation until 1986 or 1987.

The CHAIRMAN. Do you have any faith in a contingency tax, or is it better to just go ahead and do something rather than to wait?

I think Herb Stein said yesterday, you know, the contingency has already happened. We have got massive deficits; we don't need to wait for anything else to happen.

Dr. MEYER. A contingency tax that is linked to other uncertain events, like spending reductions, et cetera, simply doesn't fool financial markets or anybody else.

The CHAIRMAN. They just discount it, then.

Dr. MEYER. That is simply a sort of political statement that we care about the deficit, but we don't care enough to really do something.

The CHAIRMAN. Does anybody disagree with that?

Dr. SINAI. There is something else about the budget, too. If the proposals in the budget, which certainly will appear to produce lower deficits in future years, are proposals that are bound to put the administration at loggerheads with Congress so that nothing will happen, the financial markets will see through that, too, and react very negatively.

Compromise is critical here. It has to show up in the budget that's produced at the end of January and in all of the deliberations that are going on.

The CHAIRMAN. Well, we think we did have some impact on the stock market last year with TEFRA, maybe.

Dr. SINAI. That was a prime example of how that could work. And also, the spirit of your proposals is really in the direction that is most constructive.

Dr. MEYER. I would point out, when we talk about the stock market and high interest rates very recently, that I have maybe a little different interpretation. I believe that it is a signal, perhaps too subtle a signal, from the Federal Reserve. I think a current degree of monetary restraint is inappropriate, given the natural slowing of the economy next year, but I believe it is a signal to let you know what the environment will look like without deficit reduction. This reflects the counterbalancing of the fiscal stimulus with increased monetary restraint I referred to earlier.

The CHAIRMAN. Well, we appreciate it very much, and your entire statements will be made a part of the record.

We will not burden you, but there may be some written inquiries we would like to submit, if it is all right, after we have had a chance to review your testimony.

Thank you.

Our next panel will be Arnold Cantor, assistant director of the Department of Research, AFL-CIO; David Keating, executive vice president, National Taxpayers Union; and Bill Hutton, executive director, National Council of Senior Citizens.

Let's see. Arnie, do you want to start out?

STATEMENT OF ARNOLD CANTOR, ASSISTANT DIRECTOR, DEPARTMENT OF RESEARCH, AFL-CIO, WASHINGTON, D.C.

Mr. CANTOR. My name is Arnold Cantor. I am accompanied by Steve Koplan our legislative representative.

I have a 10-page statement which I would like to put in the record. I will summarize quickly.

The CHAIRMAN. It will be made a part of the record, and we appreciate that.

Mr. CANTOR. The AFL-CIO believes that the budget deficit and continued economic recovery are on a collision course. Failure to reduce deficits will force even higher interest rates, choke off recovery, and throw more people out of work. The current recovery would be short-lived, and the longer-term legacy of inaction would be a weaker, more unstable economic structure with fundamental problems growing and festering.

We believe the major source of the deficit problem is the 1981 tax cut, and we believe that speedy and fair action on taxes is essential.

We are here to recommend consideration of an equitable tax program which could easily meet the committee's 4-year $150 billion deficit reduction goal in a manner that is fair to all.

We also must reject the deficit reduction approach currently being considered by the committee, since it calls for even deeper cutbacks in programs by guaranteeing that each dollar in revenue raised would be matched by a spending cut.

We also feel that tax policy must deal specifically with the budget effects of the rapid increases in defense spending that are taking place. The AFL-CIO has called for a lower rate of increase in defense spending than that recommended by the President, and any extra spending for defense should be financed by equitable taxes, not by cuts in social programs or enlarged deficits.

The remaining body of the testimony, Mr. Chairman, is specifically addressed to the three questions that were raised in the committee's press release, that is, (1) What are the economic consequences if the administration and Congress do nothing to address the problem? We feel the consequences would be very severe and adverse.

(2) Our answer to your second question, Do we need to act in early-1984 or can we afford to wait to address the deficits until 1984? is a most emphatic No. I think we have to deal with it immediately.

And with regard to suggestions for specific legislation, the full statement describes a tax program which fundamentally was recommended last February by the AFL-CIO Executive Council and was embodied in legislation that is before the House. It spells out a major, fundamental loophole closing and tax restructuring program.

I would be happy to answer questions.

[Mr. Cantor's prepared statement follows:]

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STATEMENT OF ARNOLD CANTOR, ASSISTANT DIRECTOR,
DEPARTMENT OF ECONOMIC RESEARCH
AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE SENATE FINANCE COMMITTEE ON
A DEFICIT REDUCTION PACKAGE

December 14, 1983

The AFL-CIO appreciates the opportunity to present its views on ways to reduce the federal budget deficit.

The budget deficit and continued economic recovery are on a collision course. The failure to reduce deficits will force even higher interest rates, choke off recovery and throw more people out of work. The major source of the problem is the tax structure, which, as a result of the Administration advocated 1981 cut, is no longer capable of producing the revenues néeed to finance the government -- regardless of the condition of the economy.

We believe that speedy and fair action on taxes is essential to reduce deficits, lower interest rates and allow the recovery to continue. We are here to recommend consideration of an equitable tax program which could easily meet the committee's 4-year, $150 billion deficit reduction goal in a manner that is fair to all.

The 1981 tax cut ravaged the treasury, triggered a sharp rise in interest rates and a deep, prolonged and senseless recession. The legacy continues because even the more optimistic forecasts of economic growth and tax receipts show that the tax structure cannot generate the revenues needed to sustain a healthy and balanced recovery.

Before 1981 the federal tax structure left much to be desired in terms of equity; but, at least it was productive. Now it fails miserably on both counts.

The 1981 Act, for example, has reduced 1984 anticipated receipts by $130 billion --an amount equivalent to three-fourths of the projected deficit. And, even after taking into account subsequent action by Congress to recoup some of the revenue loss through the 1982 Tax Equity Fiscal Responsibility Act (TEFRA) and gas tax hikes, some $350 billion or well over half the next 3-year's projected deficits can be attributed to the 1981 giveaways.

The tax cuts for corporations and the rich were at the expense of programs for school children, the elderly, the unemployed and the disabled and the disadvantaged. Those who are paying for these giveaways are the victims of massive cuts or elimination of health services, aid to schools, food stamps, aid to localities and a long list of other social programs to help people who have no place to turn. The unfair, costly measures widened the gap between the nation's haves and have-nots and imposed a huge, continuing, destabilizing drain on our resources.

These people have suffered more than enough. Therefore, we cannot go along with the deficit reduction approach currently being considered by this committee, which envisions even deeper cutbacks in programs by "guaranteeing" that each dollar in revenue raised would be matched by a spending cut. Some of the tax raising measures outlined are appropriate -- particularly the tax on corporate "economic income." That measure would trim many corporate avoidance opportunities and reestablish the concept of depreciation which was destroyed by the 1981 Accelerated Cost Recovery System. But much more is needed.

Tax policy must also deal specifically with the budget effects of the rapid increases in defense spending that are taking place. The AFL-CIO has called for a lower rate of increase in defense spending than that recommended by the President. Moreover, we believe any extra spending for defense should be financed by equitable taxes, not by cuts in social programs or enlarged deficits.

In announcing these hearings the Chairman raised three questions:

1. What are the economic consequences if the Administration and Congress do nothing to address the deficit problem?

2. Do we need to act in early 1984 or can we afford to wait to address the deficits until 1985 of thereafter? and;

3. What specific legislation would the witness recommend that Congress enact to reduce the deficits?

As to the first question, we believe that the consequences of failure to raise revenue would be severe. The current recovery would be short-lived and the longer-term legacy of inaction would be a weaker, more unstable economic structure with fundamental problems growing and festering.

Without action the deficit will worsen, even if the recovery were somehow to persist. The Congressional Budget Office has indicated, for example, that under current law, with continued recovery, the deficit will be around $200 billion in 1984-1986 and then rise in future years.

Huge federal net interest payments which are both a cause and an effect of the deficit problem will grow by $56 billion between 1982 and 1986 if rates stay at present levels according to the Congressional Budget Office. And, if interest rates should rise by one percent that total would be increased by $70 billion. By 1986, publicly held debt will amount to $1.7 trillion, twice the size it was prior to the Reagan Administration taking office. The doubling of the national debt as a result of huge tax cuts, massive increases in military spending and overall faulty economic fiscal and monetary policies have created a large, built-in "structural deficit," one which no amount of cutting social programs will eliminate.

The deficits that would result from a failure to act would keep interest rates at destructive levels, and would cause cutbacks in housing, autos, business investment and exports. The result could be another, even more severe economic downturn coming at a time when the federal governments budgetary situation would preclude appropriate counter cyclical action.

A weakening in housing starts has already occurred, and sales of domestically made automobiles have likely reached a plateau. The high value of the U.S. dollar, up 45 percent in the last 3 years, is another by-product of high interest rates severely effecting trade balances by making export sales more difficult and encouraging an increased flood of imports.

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Question two: Do we need to act in early 1984 or can we afford to wait to address the deficits until 1985 or thereafter?

We believe immediate action is required. Delay until 1985 or later would increase the probability of a clash between financing needs and available funds and quickly be reflected in higher interest rates.

While interest rates have declined from their 1982 peak levels, real interest rates -- i.e., reported rates adjusted for inflation -- remain painfully high by historical standards. For example, the 8.88 percent nominal rates on 3-month U.S. Treasury bills (as of December 2, 1982) translates into a "real" rate of approximately 4 percent, which is far beyond the historical average of 1 percent. Long-term rates are also well above their normal range, as indicated by the 11.65 percent nominal yield on 20-year constant-maturity treasury bonds (as of December 2, 1983), as well as the abnormal differential between short and long-term rates (2.77 as of December 2, 1983, versus the 1960-1982 average of .90). This is reflected in a very high cost of capital for other sectors of the economy and already places constraints on the recovery.

Question three; Specific Reduction Measures:

The AFL-CIO will continue to advocate and support measures to undo the damage of the 1981 Act and generally promote an equitable and productive federal income tax structure.

The AFL-CIO supports **capping** the ERTA in a fashion which limits the third year of the Reagan tax cut to $700 as an important step towards equitably preventing the 1981 losses to continue and maintaining needed consumer purchasing power.

More basically we recommend the approach adopted last February by the AFL-CIO Executive Council and which is generally embodied in H.R. 3585 introduced on July 18, 1983. That program, through a combination of measures addressed to the 1981 Act and some fundamental reforms, would raise the needed revenues, and lead to a fairer tax code, capable of sustaining economic recovery.

A key element of H.R. 3585 and the AFL-CIO's tax justice program, is repeal of the indexation provisions of the Economic Recovery Tax Act of 1981.

Indexing repeal will increase revenues by $6.2 billion in fiscal year 1985 and $16.7 billion in fiscal year 1986.

Without indexing, the system of progressive tax rates automatically serves as a contracyclical force, moderating excessive demand during inflationary periods and helping to sustain purchasing power during recessions. If indexing goes into effect, however, the tax structure will automatically adjust in a procyclical fashion, adding momentum to inflations and recessions. Moreover, the ability of government to use discretion in the conduct of tax policy would be severely curtailed by the linking of tax rates to the rate of inflation. Monetary policy would become an even more dominant factor in the economy.

The AFL-CIO supports scaling down the so-called savings incentives. We particularly urge repeal of the 15 percent net interest exclusion. This should be repealed before it goes into effect in 1985 to save some $4 billion in 1984-1986 revenue.

Another tax loophole mistakenly characterized as a savings incentive is the exemption from taxation of individual retirement accounts. The higher a taxpayer's income, the greater is the tax windfall this gimmick provides. To make the IRA somewhat more equitable, the tax benefit should be changed from an exclusion from gross income to a credit which would provide the same dollar benefit amount regardless of the taxpayer's bracket.

These "savings" devices cost billions of dollars in lost revenue, and despite their title and intent, result in direct and immediate reduction in national savings. For savings to actually increase, private savings must increase more than this reduction in the Treasury's revenues. Most of the funds attracted by these tax gimmicks are not new or additional savings, but are merely shifts reallocated from other assets. Further, these gimmicks, along with the increased deficit, add to the competition for funds and push up interest rates.

Another feature of the tax code high on our list is the 60 percent exclusion from income of capital gains. Combined with the lowering of the maximum tax rate to 50 percent by the ERTA, this exclusion reduces the maximum tax rate on capital gains to only 20 percent. This exclusion costs the Treasury $18 billion a year in revenues and primarily benefits the wealthy -- with the top 5 percent of taxpayers getting 60 percent of the benefits.

The AFL-CIO supports restoring the capital gains exclusion to the 50 percent level that prevailed before 1979, and beginning in 1985, the exclusion should be phased out over a 5-year period, with adequate protection for homeowners. This would raise nearly $3 billion in FY 1985 and over $5.0 billion in FY 1986.

The federal tax system was tilted further in favor of the wealthy by the virtual elimination of the Estate and Gift Tax in 1981 by ERTA. By 1987, when the rate cuts and increases in exemptions enacted in 1981 will be fully phased in, only 0.3 percent of all estates will be subject to estate taxes, and the liabilities of these few estates that are taxed will be substantially reduced.

The reduction of estate and gift taxes eliminates an important and equitable constraint on the accumulations and intergenerational transfers of vast fortunes. Equity considerations require effective taxation of accumulated wealth and the recent array of exemptions of capital from taxation makes this even more urgent.

Restoration of the estate and gift tax to its former structure, which allowed $250,000, or over half of the estate (whichever is greater) to be passed on to the surviving spouse tax free and provided generous credits for heirs would raise $3.7 billion in FY 1985, and $5.0 billion in FY 1986.

As a result of the business provisions of the Economic Recovery Tax Act of 1981, the corporate income tax has been virtually eliminated. We call for reinstatement of the corporate income tax as a source of revenue, equity, and economic balance. Primarily because of the accelerated cost recovery (ACRS) provisions of the 1981 act, corporate tax revenues for the 1983 and 1984 budgets are estimated at only $35.3 and $64 billion, respectively. At these levels, corporate receipts will be only 5.9 percent of total 1983 budget receipts and 9.6 percent of anticipated 1984 revenue. In 1980, the ratio was 12.5 percent, and in 1970, it was 17 percent. In 1960 -- before the enactment of depreciation speed-ups, the investment tax credits, and rate reductions -- the corporate income tax financed nearly 25 percent of the entire federal budget. If the corporate income tax were to bear the same share of the federal tax burden in 1984 as it did in 1980, receipts would be $20 billion higher.

This massive volume of revenues given away by ACRS failed to generate the huge increase in corporate capital investment and general economic growth and prosperity that was the basis of its enactment. Instead, after the passage of the 1981 Tax Act, the economy plunged into the worst downturn since the Great Depression. The drop in business investment was even worse than the overall economic decline.

Moreover, ACRS -- which was justified largely as a means to correct depreciation allowances for inflation's affect on replacement costs, radically shortened the writeoff periods. However, any correlation between these tax "cost" recovery periods and inflation or useful life is purely accidental. Also by favoring more heavily capitalized firms and industries, the ACRS provisions have made it more difficult for small firms to compete, more advantageous to use "capital" instead of labor and have severely distorted investment decisions. In sum, the ACRS provisions violate the principles of equity and efficiency and have significantly contributed to the federal deficit problem.

We also support the restoration of a portion of lost corporate tax receipts by ending the tax subsidies that encourage the overseas operations of U.S.-based multinational corporations. These preferences have eroded the tax structure, destroyed American jobs, and spurred the outflow of U.S. capital, technology, and know-how.

Specifically:

- **Foreign Tax Credit:** The present practice of allowing dollar-for-dollar credits against a multinational company's U.S. income tax liability is a loophole which encourages U.S. corporations to produce abroad. Foreign taxes should be deducted just like other costs of doing business.
- **Deferral:** The deferral privilege allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home — which may never occur.
- **DISC:** Elimination of the Domestic International Sales Corporation (DISC) which allows corporations to spin off income and profits into export subsidiaries in order to defer, perhaps indefinitely, taxes on export profits.

Ending these three foreign tax subsidies would raise $6.5 billion in revenues in FY 1984 and over $33 billion in the 1984-1986 period.

The Investment Tax Credit: In 1982 Congress went halfway toward eliminating the practice of deducting, as depreciation allowances, costs that were already deducted as investment credits. If the job was completed and business was required to reduce the depreciation base by the full ITC rather than only one-half, over $4 billion would be recaptured in the 3-year 1984-1986 period. Cutting the credit back from 10 percent to its previous 7 percent level would raise over $14 billion in the 1984-1986 period.

The "Small Business" Rate: Under present law, the first $100,000 of corporate net profit is taxed at a maximum of 26.75 percent. This low rate, justified as a device to cut taxes on small business, also applies to large corporations. Moreover, the largest corporations receive the lion's share of the tax break. Limiting this lower rate to smaller corporations (phased out between $100,000 and $200,000) would raise over $4 billion in the 3-year 1984-1986 period. It should also help the competitive position of smaller businesses.

Oil and Gas: High on the list of unfinished business is the elimination of the special tax loopholes for the oil and gas industry. Eliminating percentage depletion and the immediate expensing of drilling costs and terminating ERTA's Windfall Profit Tax changes would increase revenue in 1984 by $3.7 billion and generate a cumulative revenue increase of over $15 billion during the 1984-1986 period.

We also believe that a temporary surtax should be enacted to meet the current defense budget needs. Such a tax should be levied on both corporations and individuals; the rate should be graduated, and it should include as part of its base the income that currently escapes tax through phantom write-offs, special exclusions and shelters -- it could raise annual revenues by as much as $30 billion.

In conclusion, we believe that restoring equity and productivity to the tax structure is the means to deficit reduction and the key to continued recovery and jobs for 9.4 million unemployed American workers.

The CHAIRMAN. Why don't we hear from the other members of the panel? Let's hear from Bill Hutton, and then we will hear from Dave Keating. I think Dave has a little different approach. You would do taxes; he would do spending.

Mr. HUTTON. I wouldn't be surprised.

The CHAIRMAN. But his is a union, too; it's the National Taxpayers' Union. So you are all union people. [Laughter.]

STATEMENT OF WILLIAM R. HUTTON, EXECUTIVE DIRECTOR, NATIONAL COUNCIL OF SENIOR CITIZENS, WASHINGTON, D.C.

Mr. HUTTON. I am Bill Hutton, executive director of the National Council of Senior Citizens, an organization that serves some 4.5 million older people in clubs across the country.

You have my full testimony. I would be grateful if you would introduce that to the record.

The CHAIRMAN. Right. It will be in the record in full.

Mr. HUTTON. Then I will concern myself with just a few highlights, within a couple of minutes or so.

Mr. Chairman, the National Council is faced with a very real problem: older people living on reduced incomes in retirement face a terrible future in America. What little savings they have had are being savagely depleted, and they are down to bare essentials.

Threats to cut the entitlement programs, which have been made by White House spokesmen, are actually life threatening to millions of older, poor Americans.

Over the past three years, older Americans have endured severe cutbacks in the number of programs upon which they depend for their survival. In addition, the cost of health care and energy has continued to escalate. Soon our telephone service costs will be doubling and tripling.

And over the same period, wealthy Americans and businesses, two groups that are not affected by domestic spending cuts, have had their tax rates dramatically reduced.

Yet, thus far, all of the deficit reduction proposals which have surfaced suggest that a combination of equal tax increase and domestic spending cuts is an equitable approach to reducing the deficit. And the National Council of Senior Citizens disputes this assumption.

I would say to you, sir, that to achieve equity we need to increase taxes, reduce defense spending, and restore many of the cuts that have been made in programs such as medicare, social services, food stamps, and assisted housing, et cetera.

As Martin Feldstein said, "It is the tax cut and military spending increase that have contributed to the deficit," and it is in these areas that we must look if we want to reduce it fairly.

Attempts to tax social security to reduce the deficit would violate the 1983 compromise and jeopardize both trust fund stability and recipient financial security. The system's short-term and long-term financing was assured when a delicate political compromise was finally passed, and the system itself doew not directly contribute to or subtract from the Federal deficit.

Medicare's rising costs and financial need to be addressed really can best be addressed first through a systemwide health care cost containment program—that, first, before you begin to talk about deficit reduction and budgetary policy.

Medicare's impending funding shortfall must not be used as an excuse for cutting benefits or eligibility, or increasing beneficiary cost-sharing for the sake of deficit reduction.

Now, I think, finally, sir, we believe we must reevaluate President Reagan's commitment to massive defense outlays in the context of our current $200 billion deficit.

During the past 3 years, domestic programs have been cut while military expenditures have increased dramatically. To restore to the budget and to reduce the deficit, we urge reexamination of military spending priorities.

Thank you, sir.

The CHAIRMAN. Thank you.

Mr. Keating.

[Mr. Hutton's prepared statement follows:]

Statement by

William R. Hutton, Executive Director
National Council of Senior Citizens
925 15th Street, N.W.
Washington, D.C. 20005

before the

U.S. Senate Committee on Finance
Hearings on Reducing the Federal Deficit

December 14, 1983

Mr. Chairman, I am William R. Hutton, Executive Director of the National Council of Senior Citizens. The National Council is a membership organization representing over four million older persons through more than 4,500 clubs and state and area councils throughout the country.

I appreciate the opportunity to appear today on behalf of our members. The National Council works toward a better life for senior citizens, and we are especially concerned about their health and income security. Our advocacy on behalf of adequate Social Security, and Medicare benefits spans more than twenty years. It is these areas that I will discuss in relation to your deficit reduction efforts.

Frankly, Mr. Chairman, the recent debate concerning the deficit often misses the point. It seems that most of the discussion centers around where to cut spending to decrease the deficit. There seems to be little discussion about the causes of the dramatic increase in the deficit over the last two years and how to attack the root causes to achieve deficit reduction. Would this latter discussion not lead to a more permanent solution?

The statements about equity being made regarding the nature of deficit reduction proposals are misleading. We are being told, for example, that spending must be decreased in equal amounts to revenue increases. Moreover, new revenue increases will be triggered only if Congress fails to enact spending cuts. The members of NCSC need no reminding that this Administration recommended, and Congress enacted, deep cuts in domestic spending in the last three fiscal years. Citizens were told that such cuts were necessary to achieve the goals of revitalizing the economy and balancing the budget.

While elderly and low-income Americans have endured cuts in Social Security, Medicare, Food Stamps, assisted housing and social services, upper middle-income and wealthy Americans received a major tax break. Now it is being suggested that to reduce the deficit, we must cut domestic spending again and raise taxes in equal proportions. Although this notion may have the superficial appearance of equity, it ignores the impact of three years of regressive fiscal policy, a policy which prevails today. Moreover, it ignores the contribution of a vast military build-up to our current deficit.

We have heard arguments between Administration officials, some claiming that deficits don't have a harmful effect on the country's economy and others stating the exact opposite. We have heard more recently the President's own Chairman of the Council of Economic Advisors, Martin Feldstein, state that, contrary to the President's claims, increases in military spending and cuts in taxes have contributed to the deficit.

We agree with Mr. Feldstein. It is the Reagan Administration which has, through its policies, contributed significantly to the growth of the deficit. How ironic that an Administration pledged to fiscal austerity is now facing the largest Federal deficit, relative to GNP, in peacetime history.

How is it that a President, originally so dedicated to balancing the budget, has instead more than tripled the deficit over the past three years? We might recall some other promises made by the President when he first took office: to cut domestic spending, to restore the military and to cut taxes. He has been far more successful in fulfilling these promises, and it is these successes that have increased the deficit and plunged the country further into recession.

Hailed by the President as an across-the-board cut for everyone, the President's 1981 tax cuts actually provided massive tax breaks for large corporations and wealthy individuals. The average individual saw little if any difference in his paycheck. The victim of these cuts was the government. These changes significantly reduced the revenues available to the government to finance domestic and military programs: it was projected that during the first six years of the tax cuts, $1 trillion of revenues would be lost. At the same time, there has been a massive increase in military spending, starting in 1981, and continuing with each successive budget. Over a period of five years, the President's plan cost $1.5 trillion more for defense. The result of these two budgetary and fiscal policies had to be huge deficits and economic chaos.

After one year of the President's "economic recovery" program, the country plunged further into recession and the deficit continued to grow. The sustained growth promised by supply-side economics failed to materialize. In 1981, the deficit was $58 billion; in 1982 it was $111 billion. In response, Congress passed, and the President reluntantly signed, the Tax Equity and Fiscal Responsibility Act of 1982, which, as the name implies, restored some fairness to the tax system. Shortly after passage of this legislation, the country's economic recovery began.

If, however, the government retains current spending and taxing patterns, it is likely that the recovery, for which the Administration takes total credit, will end swiftly -- the deficit will rise from $194 billion in 1983 to $280 billion in 1989 and the national debt will expand by $1.3 trillion. In more ordinary recoveries, the deficit would shrink automatically as tax revenues rose and outlays for welfare programs necessitated by high unemployment declined. Yet this is no ordinary recovery: unemployment still remains high and the President's tax cuts have made the government permanently poorer.

One of the dangers associated with a growing deficit, which contributes to the expanding Federal debt, is that financing the debt absorbs a larger and larger portion of the annual Federal budget. This is money which could otherwise be used to fund domestic programs. In 1983, spending for social programs will total $63.6 billion; interest on the Federal debt is projected to be $87 billion.

It is clear that a policy must be developed that will address overall national long-term interests, and not short-term political interests. Without major fiscal and budgetary changes, we will be thrown once again into an economic downturn accompanied by high interest rates, sluggish business investments, slowed economic growth, reduced tax revenues and increased spending for unemployment and welfare.

We believe that there are legitimate ways to distribute the costs associated with formulating an economic policy that will ultimately result in reduced federal deficits, and we hope you will seriously consider them when they are presented to you. We believe that, in general, tax reforms coupled with restraints on military spending would be appropriate. Tax loopholes allow many people and corporations to avoid taxes. Tax shelters invested in by high-income individuals have reached a new high. The corporate tax is almost gone -- in 1976 corporations paid 1/6 of the nation's tax bill; that has been reduced to 1/12. The Federal tax rate for major corporations now averages only about 16 percent -- this is the same rate as for a family of four with an income between $12,000 - $16,000.

In order to raise revenues, we would propose, for example, reducing the oil depletion allowance, increasing the minimum tax on corporations and restructuring the basic system of depreciation and investment tax credits. We, unlike the President, do not believe that tax increases enacted now would jeopardize the recovery -- we believe they would preserve and extend it.

Moreover, we do not believe, as does the President, that Congress would view increased revenues as a license to start spending. Congress has, for the past three years, followed the President's mandate and reduced spending, especially for domestic programs. Spending on domestic programs will be $230 billion less between 1986 - 1988, than if earlier policies prevailed; in future years these programs will shrink to the same share of the GNP as in the 1960's. It is interesting to note here how much -- or rather how little -- of the Federal budget actually goes to social programs. Excluding Social Security programs, which are financed by a separate revenue source, in 1982 social programs absorbed only about 18 percent of the budget. Military spending accounted for about 60 percent. How much more can domestic spending possibly be cut, and at what cost, to have any impact on the deficit?

At the rate the government is currently spending, it will absorb more than one-half of domestic savings (available as loans both to the public and private sector) to finance what it spends in excess of revenues. We believe there must be a total restructuring of economic policy, not a piecemeal approach which focuses solely on cutting programs which have already been cut to the bone. We believe there should be a shift in spending patterns, coupled with an increase in revenues.

Now, Mr. Chairman, I will direct my testimony to the areas which will be likely targets of deficit reduction plans. While many domestic programs potentially can be included in such plans, I will concentrate my comments on Social Security and Medicare.

I do so because they form the basis for the elderly's health and income security; they are the major components of the nation's public policy on aging; and they are the major targets of domestic spending cuts in many of the deficit reduction plans currently being developed.

Social Security

Many proposals to squeeze money out of the Social Security system have been floated during recent weeks. Ideas range from a fixed percentage reduction in the cost-of-living adjustment (COLA) to a rounding of the COLA increase to the next lower percentage. Regardless of how COLA or any other part of Social Security would be altered to free up money for the general treasury, the National Council of Senior Citizens opposes all such measures. There are many reasons for our position.

1. The Social Security system has just undergone major revision for the sake of assuring its short- and long-term solvency. Further change not only is unnecessary for trust fund stability, but would also be an injustice to the program's 36 million recipients. H.R. 1900, as Mr. Dole and this committee know well, was a bi-partisan compromise which no group or individual liked in its entirety. However, it was accepted as a compromise and declared to be a measure for which everyone had to give up something. The elderly were forced to sacrifice the COLA due in July 1983. Consequently, the average beneficiary will experience a two percent benefit cut over his or her lifetime. The NCSC believes that this is not a small sacrifice.

2. The National Council of Senior Citizens supported the Social Security compromise in spite of the sacrifice it required of the elderly because we recognized it as a compromise. We believed the package was probably the only vehicle possible in the political and economic environment in which it was developed, that would assure solvency without devastating either the program or its beneficiaries.

Now Social Security recipients are being threatened with additional sacrifices. The delayed COLA has not yet been granted, and Congress is already discussing ways to reduce the COLA once again. The NCSC views such proposals as a serious breach of the compromise, a mockery of the compact made in good faith between citizens and their government, and a threat to the well-being of Social Security recipients.

3. Social Security cash benefits are the major source of income for older people, and the annual cost-of-living adjustment to these benefits are therefore critical to maintain the relative value of the monthly benefits over time. Because Social Security cash benefits are indexed to inflation, millions of people are kept out of poverty. Many older persons unfortunately live precariously close to poverty. Even those with adequate incomes are threatened, knowing that a long-term illness or need for extended care could deplete their financial reserves. The point is that an increase in monthly income of only $19 (the increase due in January 1984 for an average retired worker) is a very significant amount for most older people.

4. The COLA decreases as the Consumer Price Index (CPI) decreases. However, many of the goods which older people need to buy in disproportionate amounts compared to younger persons are defying the CPI trends. Health care is a primary example:

- The CPI was 3.9 percent last year and the COLA for 1984 will be 3.5 percent. Yet the Medicare Part A deductible in 1984 will be 17 percent higher than it was in 1983 and the Part B premium will be 20 percent higher.

- The price of prescription drugs has been rising at rates two to three times the CPI. The elderly must pay for their drugs out-of-pocket unless they are hospitalized.

5. If Congress and the Administration continue to view the Social Security Trust Funds as a financial well to tap for infusion to the general fund, we believe that recipients will lose faith in their elected officials. We also fear that today's workers will lose faith in the system's longevity and capacity to protect them when they grow old.

Social Security is a self-sustaining system, and payment of benefits is based on a pay-as-you-go method. It is also a compact between workers and

> the government which assures that workers will be protected when their earning capacity ceases due to old age, death, or disability. It is our nation's social insurance system which protects not only current and future recipients, but also society in general.
>
> We believe that Congress and the public recognized the importance of Social Security when the system faced insolvency last year. That is why a compromise was developed; that is why sacrifices had to be made; and that is why no further change is needed or appropriate for many years hence.

Medicare

The National Council of Senior Citizens is alarmed at how frequently we hear that Medicare must be cut to reduce the deficit and how severe the cuts must be to reach the target reduction levels. Several proposals have been discussed by Finance Committee Chairman Dole, members of the committee, and other Senate members. We understand that Medicare cuts would constitute a major source of the proposed savings measures.

We are among the strongest advocates of saving Medicare dollars, of spending the program's money efficiently, and of delaying and ultimately eliminating trust fund insolvency. We believe that proposals to reach these objectives must not sacrifice the health security of the aged or unjustly burden the parties affected by Medicare. We urge the Senate Finance Committee to seek ways to reach these objectives according to these criteria.

After reviewing the nature of proposals revealed thus far, however, we conclude that the suggested ways to reduce Medicare spending would not achieve the objectives I have outlined. These plans would impose an inordinately heavy burden on the beneficiary. A few words about Medicare's financing problems relative to the program's spending increases can explain our position.

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The NCSC recognizes that Medicare Part A and B outlays are increasing at annual rates of 18 to 20 percent. We realize the potential danger to the beneficiary if Medicare outlays continue to exceed revenues. We acknowledge the threat such a situation poses for the elderly's health protection. In spite of the gravity of Medicare's financing problems, the major causes are not unique to Medicare. Therefore, equitable and effective solutions, whether they be for the short or long term, must not be confined to Medicare.

One need not be an economist, or indeed even a financial expert, to identify the causes of the rapid rise in Medicare spending. Nor does it take more than a sense of deductive reasoning to develop a plan to slow spending growth. For example, is it really a surprise to anyone that the Hospital Insurance Trust Fund outlays exceed payroll tax revenues when hospital inflation rates have reached and even exceeded 20 percent in recent years? Should a logical solution to the HI problem therefore not be to control the rising costs of all hospital care?

What I am suggesting here is that Congress ought not to attempt slowing Part A Medicare spending merely by restricting payments to hospitals, or requiring beneficiaries to pay more out of pocket, or any other such plan. Moreover, Congress should not try to reduce Part B spending growth by raising the deductible or premium amounts, by altering eligibility, or any plan which fails to achieve savings through provider efficiency and cost containment.

The NCSC recommends instead that the Congress act to stop the inordinate and excessive growth in the cost of medical care in order to slow the growth of Medicare outlays. The benefits of such a plan will be realized by the Medicare program, other insurors and users of health care, and potentially the Federal budget.

We believe that the primary reason to make changes in the Medicare program at this time should be to make its payment and administrative systems efficient, protect its beneficiaries, and assure its solvency. The program's financing and the problem of rising costs must be addressed separately from any other issue such as the Federal budget or growing deficit. However, improvement in the budget and the deficit situation can be a secondary impact of Medicare proposals.

The major step that the National Council of Senior Citizens recommends toward achieving these objectives is the implementation of an across-the-board, comprehensive cost-containment plan which would include all public and private payors and at least hospitals and physicians. We believe that Congress must enact such a plan in order to maintain increases in national health care costs at acceptable levels and to put Medicare financing on a track which will achieve solvency.

The elements of a plan we believe will achieve these goals are currently being drafted into a bill that Senator Kennedy and Representative Gephardt will introduce when Congress convenes for the second session of the 98th Congress. Based on an all payor concept, the plan would call for immediate controls on the rate of growth in hospital costs and physicians' fees.

The Kennedy-Gephardt plan would call for limitations on the rate of growth in payments that public and private insurors make to hospitals and physicians. Payments to physicians for services rendered to hospital in-patients would be made through the hospital. Financial disincentives will be provided for provision of unnecessary physician services or unnecessary hospital admissions. State cost-control plans will be encouraged and to ultimately maintain the growth rates stabilized by the initial phase of the plan.

We recommend such a plan because it would save health care dollars across-the-board, encourage cost-effective behavior of providers, eliminate the problem of cost shifting, and stem the rising cost of Medicare without penalizing the beneficiary as would so many other plans. Moreover, preliminary estimates indicate that passing such legislation next year will save as much as $25.4 billion between FY 1985 and FY 1989, and help to create a surplus in the Medicare Trust Fund until the year 2005.

We urge this Committee and all of the Congress to adopt such cost-containment measures as a means to control Medicare spending We believe this approach would be equitable, logical, and effective in the short and long run. If this Committee wishes to take intermediate steps, the NCSC also recommends looking into the areas of capital spending, program management, fraud and abuse, and such private sector innovations as ambulatory surgery, second opinion, and preadmission certification to ensure that Medicare dollars are better spent.

STATEMENT OF DAVID KEATING, EXECUTIVE VICE PRESIDENT, NATIONAL TAXPAYERS UNION, WASHINGTON, D.C.

Mr. KEATING. Thank you, Mr. Chairman.

I appear on behalf of the 120,000 members of the National Taxpayers' Union. Thank you for the opportunity to appear today.

Congress should act as soon as possible. It should act deliberately, but it must act quickly. The higher interest costs caused by the increased payments for interest on the national debt makes it extremely hard for Congress to act in future years. Interest payments are rising faster than Congress has shown its ability to cut spending.

We believe that the deficit should be reduced only through spending cuts. We know that taxes in future years, 1985, 1986, and beyond will reach new highs when you adjust for inflation. New taxes will also harm economic growth and make it harder to balance the budget in the long run.

Table 2 on page 3 of my testimony shows real spending growth, I think, is primarily the problem. We had real inflation-adjusted spending growth of 4.2 percent in 1983, despite domestic spending cuts. Federal spending took 25 percent of the gross national product in 1983, a peacetime record, up from 21.4 percent in 1979.

My suggestions for reducing the deficit by spending cuts are straightforward. Congress should first act by preventing the problem from becoming worse. In that regard, Congress should adopt an across-the-board spending freeze such as that proposed by Senator Grassley. This would include the defense budget, as I think it must.

Right now we have a bipartisan problem: The President would like to see massive increases in defense spending, while Tip O'Neill, the Speaker of the House, would like to see continued growth in social welfare programs.

A deficit-reduction package must also be accompanied by the Armstrong-Long amendment to control increases in the national debt. It must be incredibly frustrating for the committee and Congress to pass a deficit-reduction measure and then find the deficit continues to climb. If you can keep the deficit within control of what the committee and Congress decides, I think that will encourage future action.

The President should be given some discretion in setting cost-of-living adjustments. He has this type of discretion for setting pay increases for Federal employees. After the Federal spending freeze Congress should set a basic floor for a mandatory cost-of-living adjustment—say, for example, the first $500 in total monthly benefits for any individual or family. After that, the President would have full discretion up to a full COLA if economic and Federal budgetary conditions permitted.

Finally, I think Congress should act as soon as possible to study and implement the Grace Commission recommendations. I think it would be a terrible message to send to the American people if these proposals gathered dust. I realize the Senate is on record as supporting action as soon as possible.

Finally, I would like to urge the committee, to the extent possible, to preserve income tax indexing. I think tax indexing has served as a very useful tool for the committee and for Congress to act accountably and to realize the deficits must be addressed directly through open votes, in committee and on the floor.

Thank you very much. This concludes my remarks.

[Mr. Keating's prepared statement follows:]

Statement of David L. Keating

Executive Vice President

National Taxpayers Union

before the

Committee on Finance, United States Senate

on

Deficit Reduction Proposals

December 14, 1983

Mr. Chairman and members of the Committee, thank you for the opportunity to present testimony on deficit reduction proposals. I appear representing over 120,000 members of the National Taxpayers Union.

Witnesses have been asked whether Congress needs "to act in early 1984 or can we afford to wait to adjust the deficits until 1985 or thereafter?" Congress needs to act as soon as possible. I commend the Committee for holding hearings on this important subject and beginning the process to control federal spending.

Later action will be more difficult because federal budget deficits of over $200 billion per year quickly add to the interest burden on the national debt. A $200 bilion budget deficit adds approximately $20 billion in increased interest expenditures for each succeeding fiscal year. Since it is rare that Congress ever finds the political courage to cut $20 billion from the budget, the longer Congress waits, the harder it will be to act.

If earlier additional spending reductions had been made in 1980 or 1981, drastic action would not be needed now. Small adjustments can have large long-term effects. But yesterday's long term is today's short term. Record deficits have arrived.

In fiscal year 1983, the federal government spent $128.8 billion to pay interest on the national debt. That is over $245,000 per minute. It represents 45 percent of individual income tax receipts for that year.

The Myth of Reduced Federal Revenues

There is a myth that tax cuts have caused a dramatic loss of federal revenues. Nothing could be further from the truth. Adjusted for inflation, federal revenues for fiscal year 1985 will be the second highest in our nation's history. In fiscal year 1986, and for every year thereafter under current law, federal revenues, again in constant dollars, will reach record-high levels.

As Table 1 clearly shows, the amount of the inflation-adjusted federal revenues expected in 1984 is almost identical to the amount collected in 1980. In 1985, the real increase is expected to be almost $28 billion. By 1988 this real increase will top $118 billion.

Table 1

The Continued Real Growth of Federal Taxes
(Dollar Amounts in Billions)

	1980	1984	1985	1986	1987	1988
Baseline Revenues	$517.1	$653.9	$717.8	$773.5	$827.1	$882.4
Social Security Law		+ $8.2	+ $5.2	+ $8.1	+ $9.2	+$19.7
Total Baseline Revenues	$517.1	$662.1	$723.0	$781.6	$836.3	$902.1
1980 Revenues, Adjusted For Inflation		$664.2	$695.4	$726.0	$755.1	$783.8
$ Increase Over 1980 Revenue Base, Adjusted For Inflation		-$2.1	+$27.6	+$55.6	+$81.2	+$118.2
% Increase Over 1980 Revenue Base, Adjusted For Inflation		-0.3%	+4.0%	+7.7%	+10.8%	+15.1%

Source: National Taxpayers Union Staff Computations.

The GNP deflator was used to adjust for inflation. Estimates for GNP deflator for 1983-1988 from February CBO baseline.

At the same time, federal spending continues to grow faster than taxes. Table 2 shows how federal spending has grown dramatically, despite some domestic spending cuts.

Table 2

The Continued Real Growth of Federal Spending
(Dollar Amounts in Billions)

	1979	1980	1981	1982	1983
Federal Spending (Including Off Budget Items)	$503.5	$590.9	$678.2	$745.7	$808.3
% Increase Over Previous Year, Adjusted For Inflation	1.4%	6.5%	4.2%	2.6%	4.2%
% Increase Since 1979, Adjusted For Inflation		6.5%	10.9%	13.7%	18.5%
Federal Spending, Percent of GNP	21.4%	23.0%	23.6%	24.6%	25.0%

Virtually all of the increase in the federal deficit since 1980 is the result of the failure of the president and Congress to control federal spending.

The National Taxpayers Union is strongly opposed to tax increases at this time as a method of reducing the deficit. Further tax increases would burden our fragile economy and make the federal tax system more oppressive.

To control the federal budget deficit, the president and Congress must control federal spending. The American taxpayer is already expected to pay record-high amounts of federal taxes.

Further tax increases will not be tolerated by American taxpayers. Strong evidence of this was shown last month when two Michigan state senators who voted for a substantial state income tax increase were recalled from office, each by more than a two to one margin. That was the first time in Michigan's history that a state legislator has ever been recalled.

Deficit Reduction Proposals: Political Realities

The chairman's request that political feasibilities be considered when making deficit reduction proposals must not stand in the way of proposing measures that make sense. It takes political leadership to acknowledge the problem. It will take political leadership to face up to the special interests and solve it.

Congress should adopt an across-the-board federal spending freeze such as the spending freeze proposed by Senator Charles Grassley. This spending freeze would apply to all budget functions and would include the defense budget, as Senator Grassley proposes. This spending freeze should last for a minimum of two years. A three year freeze is preferable.

A federal spending freeze should be accompanied by a moratorium on new programs until the budget is balanced.

Any deficit reduction measure should be accompanied by the proposal made by Senators Bill Armstrong and Russell Long to control the deficits during the fiscal year. Under this proposal, quarterly limits for increases in the national debt are set. If spending or taxes would cause these limits to be exceeded, the president must cut spending so that the debt limit remains on target for each quarter. The president's authority would be limited so that no program could be reduced by more than 20 percent and no level of benefits could be reduced to any individual.

This proposal should be expanded. The president should have the same discretion for setting cost of living adjustments for any type of program as he has for setting levels of federal pay increases. Congress could set priorities for such adjustments. A reasonable floor could require that cost of living adjustments must be at least half the rate of inflation for the first $500 of monthly total benefits for any individual or family. The president would have full discretion for further cost of living adjustments, as long as they did not exceed a full inflation adjustment.

Act on the Grace Commission Recommendations

The President's Private Sector Survey on Cost Control has made 41 reports to President Reagan covering the vast majority of government agencies and operations. These documents contain a treasure trove of ideas to reduce unnecessary spending and waste from the federal budget. Over a three-year period, full implementation of deficit reduction recommendations could total over $300 billion. Congress must not allow these proposals to gather dust while the deficit problem worsens. By ignoring these recommendations, Congress could hardly send a worse signal to the American people.

I will now address my remarks to national defense, Social Security and Medicare, the most expensive and most rapidly growing programs in the federal budget.

National Defense

In addition to freezing budget authority for the Defense Department, two additional steps should be taken as soon as possible. The first is that we must force our allies to pay a larger share of their own defense. The second is that we must reform our military retirement system.

It is a fact that the United States spends far more on national defense than do our allies. According to the Congressional Budget Office, our NATO allies spend an average of 3.8 percent of their gross national product (GNP) on defense spending. The United States will spend almost seven percent of its GNP on national defense in the current fiscal year. Much of our national defense spending is actually spent for the defense of our European allies and Japan. If we gradually reduced our commitments to defending our allies over a ten year period, we could realize substantial budget savings, while improving our nation's defense. Conservative estimates indicate that we spend between

$85 billion and $100 billion defending our allies each year. In view of record federal budget deficits, we simply can't afford to continue such a commitment, particularly when our allies are not paying their share.

Our military retirement system is awesomely expensive. The most recent report by the Defense Department's Office of the Actuary shows that for an individual entering the service now, "continuously placing 50.7 percent of this basic pay in a fund would be sufficient to pay for future retirement and survivor benefits of those who eventually qualify for these benefits."

If the military retirement system had been on an accrual basis accounting system, a deposit of $527 billion would have been needed at the beginning of fiscal year 1983 to pay benefits for current and future retirees.

The military retirement system is too generous and must be reformed. In addition to temporarily freezing cost of living adjustments, Congress should make permanent the current half-COLA provisions for military retirees who are under age 62.

Military retirement pay is currently based on an individual's pay for the last year. Congress should quickly phase in a high-three or a high-five average salary requirement for the base period used in computing the initial benefit. For non-combat personnel, we should also give serious consideration to requiring 30 years of service before retirement. At this time, it makes no financial sense for anyone in the military to work more than 20 years.

Social Security and Medicare

Although it is doubtful that Congress will touch Social Security unless a default is threatened, action must be taken if drastic cuts are to be avoided in other programs. Congress took tentative, minor steps earlier this year when it decided to tax Social Security benefits if income exceeds certain levels. If Congress would simply admit to the fact that Social Security is largely another income maintenance program, it could seriously target the benefits to the elderly who are genuinely in need.

In general, Congress should reduce transfer payments as much as possible to those who really don't need them. It is time to end welfare for the middle class.

Medicare is in serious trouble. In 1970, Medicare and Medicaid accounted for one percent of the gross national product. Today, it is 2.4 percent of GNP and is expected to grow to three percent of the GNP by 1988. Medicare pays far too much to those who don't need any benefits. At the same time, health care costs remain high for the elderly poor. The system is also inordinately complex and bureaucratic.

A proposal made recently by Peter F. Drucker, Clarke professor of social sciences at the Claremont Graduate School, would make Medicare more affordable, simpler, and targeted to those who really need help. Simply stated, his proposal would give virtually full health care reimbursement to those below the poverty line. Those above the poverty line would be required to pay approximately 15 percent of their pre-tax income on health care expenses before qualifying for any Medicare payment. Expenses above the 15 percent pre-tax income amount would be reimbursed.

This would be a far more simple system to administer, would generate increased health care competition, eliminate benefits for those who don't need them, and provide more protection for the poor and those with unusually high medical costs.

<u>Federal Pay and Pension Benefits</u>

Federal employee retirement system pension benefits remain out of control.

The system presently has an unfunded liability of over $500 billion. Even though the Social Security retirement age is gradually being raised to age 67, federal workers can still retire, after 30 years of service, at age 55. Their benefits are based on a very generous formula.

Two features account for almost all of the system's unfunded liability. The first is the retirement age. It should be raised to age 65, which is the standard prevailing in the private sector, as soon as possible. The second is the full cost of living adjustments, which should be suspended until the federal budget is balanced. After that, cost of living adjustments should be comparable to those given by private sector pension plans.

Federal pay is supposedly based on an annual comparability study. But even though federal employee retirement benefits are among the most generous in the world, the comparability study doesn't take them into account.

Another flaw in the comparability system is the fact that federal job descriptions are compared with actual private sector federal jobs. Recent studies show federal job descriptions are often inflated descriptions of the actual job.

Federal pay should be immediately frozen. Many state governments are already doing this. Nineteen states are not providing any salary increases to their employees during the current fiscal year. Nineteen states are also banning merit increases for their employees this year.

State and Local Grants

Congress should reduce or eliminate general revenue sharing to localities. The reason is simple. There is no federal revenue to share, yet state and local governments are projected to have surpluses next year. Other state and local grant programs should be reduced as well. These grants, not including entitlement program grants, cost about $45 billion per year. Even a ten percent reduction of these programs would save $4.5 billion annually.

To make the budget cuts more fair, Congress should also make spending cuts in harmful programs, overgenerous programs, and subsidies to business and the wealthy. Many of these reductions would have to be made in programs that are currently considered "sacred cows." But Congress must act immediately on these "sacred cows" if we are to make genuine progress on reducing the federal budget deficit. What follows is a sampling, not an exhaustive list, of programs that ought to disappear as soon as possible.

Congress ought to immediately repeal the Davis-Bacon Act. This monument to big labor costs taxpayers billions of dollars by inflating federal construction costs. Under the Davis-Bacon Act, construction projects undertaken with federal funds must pay "prevailing wages." Of course, prevailing wages are defined in such a way as to force payment of nearly the highest wages in the area. Absent Davis-Bacon, contractors would of course have to pay prevailing wages. Otherwise, no one would work for them. This requirement also serves to raise unemployment, because workers must be paid more under the Davis-Bacon Act provisions, thus fewer workers are hired.

Subsidies to business and commerce should be eliminated. The Congressional Budget Office estimates that on-budget outlays for business subsidies, not including agriculture subsidies, are approximately $7 billion.

Congress should begin by abolishing subsidies for the maritime industry, which cost over $400 million per year. These subsidies line the pockets of American shipbuilders, ship operators, and union sailors. According to the Congressional Budget Office, American shippers currently have operating expenses that are 50 percent more than foreign carriers. At a time when many American union members have to take pay cuts to compete in a newly deregulated market or to meet foreign competition, it's unfair that the federal government continues to subsidize inefficiency in the maritime industry.

Other actions should be taken to reduce Export-Import Bank aid, curb Small Business Administration loans, Rural Electrification Administration loans and loan guarantees, and Farmers Home Administration loan subsidies.

Congress should take steps to abolish agriculture subsidies as soon as possible. In fiscal year 1983, farm price supports accounted for approximately 10 percent of the $200 billion budget deficit. Congress could reduce these subsidies by cutting the price support levels by one-third per year so that they are eliminated within a three-year period. Better yet, it could abolish them overnight.

The federal government looks foolish paying farmers not to produce. Already cartoonists and satirists are urging Congress to pay them not to work. A serious deficit reduction must stop this policy.

In recent years many people have complained about how the federal government worked at cross purposes concerning cigarette smoking. It was spending money encouraging people not to smoke cigarettes while subsidizing the production of tobacco.

A similar, more reprehensible situation occurs on an even larger scale with other agriculture programs. The federal government is paying farmers not to produce food while giving money to people so they can afford to buy food. Other federal policies driving up staple food prices make the deficit worse, and make it more expensive for consumers to purchase food.

Procedural Reforms

The tendency for government to take an ever greater share of the national income is common to many countries with representative government. In spite

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of many promises to the contrary, no leader has succeeded in actually reducing government spending. There is a reason for this uniform failure. It is not a coincidence. A distinct political bias, an institutional defect, exists in our system in favor of deficit financing and excessive spending.

This bias can only be corrected by a constitutional amendment limiting deficits and taxes such as S.J. Res. 5, the Balanced Budget-Tax Limitation Amendment. This amendment passed the U.S. Senate by a 69 to 31 vote last August.

Through the efforts of the National Taxpayers Union, 32 of the required 34 state legislatures have made application to Congress to call a limited constitutional convention for the sole purpose of drafting a balanced federal budget amendment. In view of the record federal budget deficits and Congress's continued reluctance to approve the Balanced Budget-Tax Limitation Amendment, I am confident that we will be able to obtain the final two states needed for action within the next 14 to 15 months.

Passage of this amendment is critical if we are to restore long-term federal fiscal responsibility.

In summary, Congress must take a new look at all federal spending programs. On the surface, many of these programs appear to be good. But the proper question which Congress should now ask is "can we afford this program now?" Unless strong actions are taken to curtail spending, federal budget deficits will continue to grow.

The CHAIRMAN. Well, I certainly share your view on tax indexing. It seems to me that ought to be about the best thing you could tell your workers—if there is a cost-of-living adjustment you don't get a tax increase. I have always thought that unions really ought to support indexing. Is there any shift in your position?

Mr. CANTOR. No, sir. I think from the day it was proposed we have been opposed to it.

There are several aspects of our objections. First, I remember the days of "fiscal dividends." But, now we have structural deficits.

Also, I think a key factor here is that indexing does put an end to automatic stabilizer in the economy. When the economy would overheat every once in awhile, the tax structure would automatically come in and cool things off.

Now, I think we have a situation where we are already relying much, much too much on monetary policy for economic management. Indexing would increase such reliance even more.

Also, there is a big difference between indexing wages by cost-of-living indexes and indexing taxes because you are trying to preserve "real" purchasing power, not "real" tax burdens.

So what happens when you index the tax structure is that it really increases the purchasing power of the higher income groups much more than it increases the purchasing power of lower income groups, even though in percentage terms of tax burdens the result is different. I think it is an entirely different issue, and I think workers are better off without an indexed tax structure. And I think, as important at this point is the fact that indexing has not gone into effect yet. That is something going for repealing it right now. I think all here at least agree to a need for deficit reduction. What better way of doing it than to have something repealed that hasn't already taken effect?

As I understand the figures, there is a lot of money to be saved in not letting indexing go into effect. Now, that is a purely pragmatic advantage.

The CHAIRMAN. Well, we had a proposal from Senator Wallop, Senator Danforth, and Senator Boren to reduce the indexing but also the COLA to CPI-minus-3. I guess on the House side Carroll Campbell and Jim Jones had a CPI-minus-2. But I assume you are opposed to the COLA side of that one.

Mr. CANTOR. Again, Senator, as Mr. Hutton pointed out, there is a kind of logic—a King Solomon's logic—we will cut the baby in half. I don't understand the logic to a dollar-for-dollar linkage of budget cuts with tax cuts. It sounds like a logical symmetry, but it doesn't make sense to me.

The CHAIRMAN. Well, it's probably not going to go anywhere, because there is opposition from the President and the Speaker on that.

Mr. CANTOR. A COLA on a benefit program, and a cost-of-living on taxes, to me, are entirely different things.

The CHAIRMAN. What about Mr. Keating. In the package we have been looking at—and again, I don't suggest it is going to be the one that is going to pass this committee, if any passes this committee—according to our figures we have about $13 billion in loophole closings, compliance, and eliminating abuses. The Treasury estimates it to be even $18 billion. You don't have any objection to closing tax loopholes, do you?

Mr. KEATING. Well, as we have said in previous testimony to the committee, we would rather see the revenues used from loophole closings to reduce tax rates across the board, so that we not only attack loopholes but make the loopholes less valuable in the future.

The CHAIRMAN. Right.

Well, I don't disagree with base broadening. I think that's what we have in mind, to try to continue to lower the marginal rates. But at the same time, if there are abuses in the code, they ought to be corrected just as we correct abuses, or try to, in Pentagon spending or food stamps or anything else.

Mr. KEATING. Well, I think if Congress acts to reinterpret the law or clarify the law, that's one thing. But I think some deductions, especially those on schedules A, B, and C for individual taxpayers, are quite valuable to them in keeping their tax burden from rising faster than inflation, which it has been doing over the last 15 years.

So I am not supportive in general of closing loopholes as a method of raising revenue.

I would say, though, that if Congress does raise revenue, that is probably the least harmful way to do it.

The CHAIRMAN. Well, in my view it is a positive thing to do. I mean, most working people can't shelter their income; but a lot of people in upper income areas and many big businesses can work it around so that they don't pay any tax at all. And that's not a fair system.

I think everybody ought to be on sort of a level playing field. These are recommendations of the administration, so it is not Congress trying to package up something to frustrate the administration or anyone else.

But some loopholes—it all depends on how you determine them. My loophole might be your tax incentive, or whatever.

I guess the question I would ask is, one would do nothing but spending cuts, and the other one would essentially have a tax package. But you both want to reduce the deficit. We had the Chamber of Commerce yesterday, who has pretty much the same view; or at least the person who was here who said he represented the chamber had pretty much the same view as Mr. Keating: Get spending cuts, but don't do anything on the tax side.

Now, you all know neither side has enough votes to have their way. There are not enough votes here to cut spending and close loopholes to get the deficit down, and there are not enough votes to raise taxes. Now, is it better for organized labor to do nothing than try to work out some compromise? How many people are going to lose their jobs if the economy starts to deteriorate in 1985? Isn't it better to get a little of each? Otherwise, Mondale may have to do it in 1985, if he is your candidate.

Mr. CANTOR. I think you know very well that we have always been willing to compromise.

The CHAIRMAN. Well, you have. I have worked with you on a number of areas.

Mr. CANTOR. But quite frankly, at this juncture, the equity issue is, fundamentally, Mr. Chairman, the 1981 Tax Act. I think most everyone will agree the act, regressed the tax structure, benefit, mostly corporations and the wealthy.

I sincerely believe that our deficit problem now is related to that.

I also feel that the typical worker views this as "well, gee, whatever cuts in benefits that I might be receiving now is really some way to pay for the excesses of 1981." I think now is a difficult time and a wrong time to be asking for that second round of sacrifice. I think there is enough room in the tax structure to cut deficits without harming the economy.

The CHAIRMAN. Well, I would ask the same question of Mr. Keating, because all you want to do is cut spending. Is it better to do nothing than to try to work out a compromise that would have the support of a majority of Democrats and Republicans? I mean, are you so confident in supply-side economics, or whatever they used to call that?

Mr. KEATING. Well, I would say fundamentally what the Congress has to look at is the total amount of Federal spending, not only next year but in future fiscal years.

Federal spending is paid for one way or the other—either we are going to pay for it through taxes or we are going to pay for it through deficits, which will either raise inflation or raise interest rates. We pay for the deficit indirectly. The question is, no one really knows with precision what the effects are on individuals. So we absolutely could not support any compromise that would continue Federal spending growing in future years. That would be completely out of the question.

The CHAIRMAN. That may be true, but there are not enough votes to do what you want to do. Are you going to change the Congress? I mean, I am willing to vote with you if you—how many votes do you have?

Mr. KEATING. Well, that's a good question.

The CHAIRMAN. I have a lot of ideas, but I don't have any votes for them.

Mr. KEATING. Well, I don't think the votes are terribly numerous right now, but I think if there was some way to get the President and Speaker O'Neill to agree that we have to not only have social spending cuts but defense spending cuts—we are not even talking about defense spending cuts, simply a freeze.

The CHAIRMAN. You have included defense spending cuts.

Mr. KEATING. It would do that. Many other organizations—I don't know if the chamber has proposed that.

We must do a lot more to target our benefits, too. Many of the entitlement program benefits are going to people who have a fair amount of money. Medicare is a good example; social security is a good example. We can cut back the growth in those programs without touching the people that really need money to survive.

The CHAIRMAN. I think that's true. I am not sure Mr. Hutton agrees.

Mr. HUTTON. I don't think so, at all.

Mr. KEATING. He may not agree with that, but I think it is an undisputable truth. Millionaires do qualify for medicare benefits and social security benefits, and it is a fact that they don't need them.

The CHAIRMAN. I would just like to ask Mr. Hutton: Let's see. You have what? Four and a half million members?

Mr. HUTTON. Yes.

The CHAIRMAN. And how many children and grandchildren do those 4.5 million members have?

Mr. HUTTON. I wouldn't know, sir. I really wouldn't know.

The CHAIRMAN. I think that's a point we miss when we talk about senior citizens. They all have children and grandchildren.

Mr. HUTTON. They don't all have children.

The CHAIRMAN. Well, not all.

Mr. HUTTON. No, and they don't all have grandchildren, either. They're getting less and less as it goes on.

The CHAIRMAN. Right.

They are all concerned about their children's welfare and their grandchildren's welfare, and I think sometimes we have the feeling that senior citizens aren't willing to contribute anything, so we can't touch medicare and we can't touch social security. If we can't go after some entitlements, even in areas where it doesn't have any impact on the senior citizen—whether it is hospital costs or physicians' fees or cost sharing.

Let's face it, the reason nobody worries about the cost of hospitals or operations is that nobody pays for it. And we have got to be realistic. I don't think most senior citizens are going to say, "Well, I would rather have the interest rates go up and my son lose his job, or not buy the car, but I don't want to give up $2 a month in social security benefits." I think we underestimate them. And some of us are getting close to that group.

Mr. HUTTON. Mr. Chairman, let me just explain one thing. The fact is that for several million, perhaps 4.5 million, older poor people in this country, about all they have got left is their votes, their ability to vote. They have got very little else. And for the past 3 years they have had cutback after cutback after cutback.

The CHAIRMAN. Where?

Mr. HUTTON. Oh, in a number of areas: they have had a cutback in medicare—the first thing that President Reagan did when he came in was cut $25 billion out of Medicare benefits.

The CHAIRMAN. You will have to be a little more precise than that.

Mr. HUTTON. Well, I would love to detail it for you by letter; I don't want to take up too much time this morning.

The CHAIRMAN. We have jurisdiction on that in this committee, and we have made some medicare reductions; but I don't think they impacted on beneficiaries very much.

Mr. HUTTON. Oh, yes. How about the minimum benefit?

The CHAIRMAN. Well, that should have been changed.

Mr. HUTTON. That's another one. It should have been changed, you think?

The CHAIRMAN. Well, we still retained it for those who——

Mr. HUTTON. But the truth is that for the past 3 years they have suffered cutback after cutback, and they have no savings.

Meanwhile, on the other side of the ledger, the corporations and the wealthy people under the 1980——

The CHAIRMAN. Now you are making a campaign speech.

Mr. HUTTON. No, I'm not. I am telling you that you are saying—not you, sir, but——

The CHAIRMAN. You sound like Walter Mondale.

The Hutton. I only wish I could.

The CHAIRMAN. He's doing better.

Mr. HUTTON. He's doing damn well.

The CHAIRMAN. Yes.

Mr. HUTTON. And I tell you that he is going to get a lot of help from poor older people who are really dismayed when they hear people say, "Let's be equitable." And the equity consists of this.

The CHAIRMAN. I hope I'm equitable; I've been trying to defend some of these programs—food stamps and WIC, and others—against unreasonable cuts. I think you would agree.

But on the other hand, I am concerned about what happens to the next generation. And I'm not convinced that senior citizens—obviously those who are low income have to be protected. But we are means-testing social security programs now by taxing benefits. We are recapturing benefits. We are means-testing social security.

Would you object to means-testing medicare?

Mr. HUTTON. Yes, I would.

The CHAIRMAN. Why?

Mr. HUTTON. Because I think it is an unfair proposition to means-test medicare. That's the thing which is an earned right.

The CHAIRMAN. What about social security?

Mr. HUTTON. It is also not means-tested; it's an earned right.

The CHAIRMAN. We are going to start taxing benefits in January.

Mr. HUTTON. Well, that's something else again. I can't stop what you are going to do, Mr. Chairman; what I am trying to say is where it hurts.

Don't get the impression that older people don't look after—where they have children and where they have grandchildren.

I tell you, I came to this country 33 years ago from England, and I've never seen a nation where the older people are more proud to suffer, to fight, to work for their country than they do here in America. And I am proud of what they feel about their children. I think it's great. I think it's wonderful. You should give them a hand.

The CHAIRMAN. Oh, I would give them more than that. But we are looking at medicare. Again, they are not my figures, but we are told by the trustees if we don't do something by the end of 1988 we are going to have to raise payroll taxes 43 percent, which wouldn't please the union members who are working today, or reduce benefits 30 percent. I don't want to do either one, but we have got to look at the way we pay physicians. Physicians have been very good to medicare, but let's face it, medicare has been pretty good to physicians. We have also got to address hospital costs and cost sharing.

Mr. HUTTON. Cost containment is very, very needed. It is overdue. But what administration has moved on it? What administration?

The CHAIRMAN. You are talking about the mandatory cost on hospitals.

Mr. HUTTON. No, I am talking about the excessive 12 to 15 percent inflation in health care costs with a 3.5-percent inflation in everything else.

The CHAIRMAN. Right. Well, it has come down some, but I think we do have prospective payment in place now for hospitals, which is not going to reduce the cost but might at least restrain the cost.

Mr. HUTTON. The answer is not in on that, yet.

The CHAIRMAN. No, it just started in October.

Well, now that we have agreement——

[Laughter]

Mr. KEATING. I would like to say just one other thing, Mr. Chairman. I think we should also look at the State experience as far as looking at votes. Over the past 4 to 5 years, State and local governments have actually slightly reduced their spending as a share of the gross national product. So the votes, and I think the support for restraining government is there. It has already happened at the State and local levels. The question is, why isn't it happening in Congress? And I hope that is something the Congress can address.

The CHAIRMAN. Right.

Well, I don't think we can ever convince people that they should give up something. You can't win that argument. You've got to look at the other side: If we don't do anything, what do they give up? I mean, if inaction costs them more than action, then they had better hope we take action. In my view it has to be bipartisan. It can't be narrow, partisan, campaign—you know, that type of thing. It is going to need Democratic members and Republican members.

I don't think organized labor would oppose the things we are suggesting—the surcharge on upper incomes, a surcharge on corporate income. And we are making it so that corporations who don't pay an effective tax rate still get to pay a little. And then there is a consumption tax in effect, an energy tax, not just on one source but on all sources of energy.

You don't like that one?

Mr. CANTOR. No.

The CHAIRMAN. The other two are OK?

Mr. CANTOR. Well, I think if you would emphasize that. The proposal, as I understand it, is a surtax on corporate economic income; I think it is a wonderful proposal.

The CHAIRMAN. That's right. Yes.

Mr. CANTOR. I think it's great. I have some problems with the energy proposal.

The CHAIRMAN. But the surcharge on individual upper income?

Mr. CANTOR. I haven't seen that proposal in detail, and I don't know what your definition of taxable income is.

The CHAIRMAN. Well, I think it breaks out that these wouldn't even take effect unless you had a taxable income—of $60,000? But it is fairly substantial.

Mr. CANTOR. I am talking about in terms of the base. I am not sure; I will have to look at that.

The CHAIRMAN. Well, we will give that to you.

And then the energy tax. Well, what we have done is to take the President's budget in 1984 on the revenue side and modified some of his proposals. And we are not really touching social security or tax indexing.

Would you object to rounding down the social security COLA?

Mr. HUTTON. Oh, that's another way to steal from the poor. Really, it is.

The CHAIRMAN. Well, I guess that may be; but what I am afraid of is we are going to have grand larceny if we don't do anything, from the poor, and we would rather have a voluntary contribution.

Well, this concludes the first phase of the deficit reduction hearings. As I have indicated, there will be additional hearings.

At 2 this afternoon we will have public hearings on social security coverage for employees of religious organizations. That starts at 2.

We again thank the witnesses and wish you all a Happy New Year.

Mr. CANTOR. Thank you, sir.

Mr. KEATING. Happy New Year, Senator.

[Whereupon, at 11:23 a.m., the hearing was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

TESTIMONY SUBMITTED BY THE HONORABLE JACK KEMP (R-NY)
TO THE SENATE FINANCE COMMITTEE
December 20, 1983

Mr. Chairman:

I appreciate the opportunity to testify to the Senate Finance Committee on the federal deficit.

To the theoretical debate on the effects of Federal deficits, there is little to add. The issues have been widely aired, but the fact that the debate continues shows that no consensus has been reached on the level of theory.

There is near-unanimity, however, on the practical policy question of where deficits come from and how to reduce them. In the short term, the deficits are caused by recession. But viewed in historical perspective, it is clear that the deficits come from spending increases, not tax cuts. And in terms of the the effect on the economy, spending cuts are preferable to tax increases as a method of reducing the deficit.

I think that Murray Weidenbaum's testimony to this committee put the consensus view very well:

> I believe that a general tax increase would be misguided. To state the matter bluntly, deficits are not so undesirable that we should ignore the costs of proposals to reduce them. There are ways of curbing the deficit that would do more economic harm than good, and a general tax increase is a prime example. It would signal to the advocates of more government spending that they now have a clear field. But more basically, it would reverse the beneficial effects of the 1981 tax cuts.

Without the 1981 tax cuts, drastic tax increases would have continued. Thanks to the tax-rate reductions enacted under President Reagan, average tax rates on the U.S. economy have been returned to their historical average of 19%. That is to say, under current law federal taxes will take 19% of national income, and federal revenues will grow at exactly the same rate as the economy. This also means that under current law, federal taxes will take 19% of any <u>increase</u> in our national income.

Obviously, under these circumstances, any increase in the historical size of the deficit could only come from the spending side; as in fact it has. Federal spending has risen from its historical average of just over 19%, to 25% in 1983, and is forecast to remain near or above 24% of GNP indefinitely. The increase in the deficit is caused by increased spending, and nothing else.

Nevertheless, those who favor tax increases instead of spending cuts implicitly claim that such tax increases would not have drastic effects on the economy. An increase from 19% to, say, 20% or 21% of GNP is nothing to get excited about, they say.

The object of my brief testimony, Mr. Chairman, is to show specifically why this is wrong. The critical flaw in this argument is that raising taxes to "only" a 20% or 21% average share of the economy would require taxing economic growth at rates far higher than 20% or 21%.

To highlight this unavoidable problem, Mr. Chairman, I have devised a measure which I call the effective marginal tax rate for the whole economy. This is simply the share taken by Federal taxes of any increase in our national income.

While some kinds of tax increase create greater disincentives than others, the effective marginal tax rate captures the unavoidable problem inherent in any significant tax increase. Raising the average tax burden on the economy requires an even more rapid increase in the federal tax burden on economic growth. But the greater the share of economic growth which is absorbed by Federal taxes, the less likely it is that there will be any economic growth to tax.

There is no way around this problem, though the impact can be spread out by delaying the tax increase. The full increase in the tax on growth must occur regardless of the form of the tax increase. The necessary result is a drop in economic growth, possibly a recession. In fact, both Senator Dole's tax increase proposal and last year's proposed contingency tax would represent far more rapid tax increases than the one under President Carter which precipitated the 1981-82 recession.

Consider the results of these two tax increase plans in terms of the effective marginal tax rate. For purposes of comparison, I assume that each takes effect in FY1986. The comparisons are based on the Congressional Budget Office's latest budget forecast. (The results are shown in Table I.)

Under Senator Dole's "Deficit Reduction Plan" tax increase proposal, instead of 19% the government would take 30% of the year-to-year increase in national income. This represents a 58% increase in effective marginal tax rates from one year to the next.

Under the Administration's contingency tax plan of last year, federal taxes would absorb fully 33% of our economic growth. That represents a 74% increase in effective marginal tax rates on the economy compared with current law.

For purposes of comparison, President Carter's tax increase in FY1981 which led to the 1981-82 recession represented a 28% effective marginal tax rate from one year to the next. Thus both this year's Dole tax increase proposal and last year's Administration contingency tax proposal would represent a more rapid tax increase than in Jimmy Carter's worst year.

Obviously, this could well have the same result as it did when tried by President Carter -- a severe recession. And of course, the recession is the main cause of the current budget deficit. Even if the tax increase did not trigger a recession, it is clear that GNP and predicted tax receipts would be lower than currently forecast.

A review of the data for the past 20 years reveals a clear trend: rises in effective marginal tax rates preceded economic slowdowns and recessions, while declines in effective marginal tax rates preceded stronger growth and recoveries.

This would make sense whether we look at the problem from a demand-side or a supply-side perspective. The demand-sider would say that the effect results from changes in demand, and the supply-sider would say the effect results from changes in incentives. But both theories agree that raising taxes slows down the economy; which requires a re-estimate of budget receipts and outlays; which means a larger baseline budget deficit. (Interestingly, there is no such agreement on the effects of changes in spending.)

In conclusion, Mr. Chairman, while there may be no consensus on the theory of deficits in the abstract, there _is_ a consensus on where they come from and what to do about them:

First, the deficits come from spending increases, not net tax reduction.

Second, by absorbing a large share of the increase in national income, general tax increases would inevitably result in an economic slowdown, worsen the baseline budget outlook, and partly defeat the purpose of reducing the deficit.

Third, the way to reduce the deficit is obviously by restraining spending, not by raising taxes.

I commend you and your committee, Mr. Chairman, for holding these hearings, because you have played a constructive role in eliciting this consensus. Thank you.

THE UNAVOIDABLE PROBLEM WITH A SIGNIFICANT TAX HIKE: A HUGE RISE IN EFFECTIVE MARGINAL TAX RATES

The last time it was tried, the economy plunged into recession.

TAX INCREASE COMPARED WITH CHANGE IN GNP, FY85-86
(current $ billions)

	(A) Change in GNP	(B) Increase in Taxes	(C=B/A) Effective Marginal Tax Rate
CBO baseline under current law	332	63	19%
Dole tax increase plus current law	332	98	30%
Contingency tax plus current law	332	109	33%
Memo:			
Carter tax hike before recession (FY80-81)	298	82	28%

Source: CBO, FY84 Budget, "Dole Deficit Reduction Plan" release

STATEMENT

of the

AMERICAN ASSOCIATION OF RETIRED PERSONS

on

DEFICIT REDUCTION

submitted to the

SENATE COMMITTEE ON FINANCE

December 30, 1983

I. INTRODUCTION

The American Association of Retired Persons (AARP) appreciates this opportunity to present its views on reduction of the federal deficit. The Association continues to advocate responsible efforts to reduce federal budget deficits. In 1982, AARP supported enactment of the Tax Equity and Fiscal Responsibility Act (TEFRA), even though there were provisions--both tax and spending--with which we took exception. Earlier this year we supported Senate Concurrent Resolution 27, the First Budget Resolution for FY 84 and the conference report on the First Budget Resolution, H Con Res 91.

This statement focuses on the need to: (1) reduce the federal deficit; (2) address the key factors responsible for pushing up the forecast deficits; and (3) raise revenue and slow the rate of growth in defense spending. This statement also analyzes some of the spending reduction proposals recently under consideration and suggests alternative revenue-raising options.

America's elderly want to see the deficit reduced and the economy strengthened. This generation of America's elderly knows the meaning of sacrifice having lived through economic depression and World War. However, their ability to assume further financial burdens for the sake of reducing the deficits is extremely limited.

What is the income situation of the elderly? First, there is no question but that the economic status of today's elderly has improved from what it was 10 to 15 years ago. That is a major accomplishment in which the Congress and successive Administrations, both Republican and Democratic, can take pride. The elevated poverty rates among the elderly that prevailed in the early 70's (24.5% in 1970) were reduced to 14% in 1978. since then the rate has fluctuated between 14.1% and 15.7%. It now stands at 14.6%. In fact, as Attachment A shows, most of the reduction in the aged poverty rate occurred prior to the implementation of automatic COLAs. This drop resulted from the large, ad-hoc increases deliberately legislated in the early 1970's to address the extremely adverse poverty situation of older persons at that time.

Secondly, the income situation of the elderly is still far behind that of the non-elderly. As Attachment B shows, median household income of the elderly is only half that of the non-elderly. Since the elderly are concentrated at the lower end of the income spectrum, this makes them more susceptible to even slight reductions in their income, or increases in out-of-pocket costs for health care.

II. EROSION OF THE REVENUE BASE AND GROWING DEFICITS

Despite record cuts in domestic programs, as well as passage of the Tax Equity and Fiscal Responsibility Act (TEFRA), the country faces a record deficit. The FY 84 budget is projected to be $180 to $200 billion in the red. The following table shows the projected current services deficits for each of the next five years expressed in dollar terms and as a percent of GNP.

Fiscal Year	1983 Actual	1984 Est.	CBO Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
Deficit	195	185	192	197	227	249	280
			As a Percent of GNP				
Deficit	6.0	5.2	4.9	4.7	5.0	5.1	5.3

Source: Congressional Budget Office, 12/12/83

While the severity of the recent recession is largely responsible for the FY 83 and FY 84 deficits as well as much of next year's deficit, the deficits in the out-years, 1986 and beyond, are largely due to the basic imbalance between spending and taxing.

When the economy was still in recession and through the early stages of recovery, such deficits did not pose an immediate hazard. However, as the economy continues to pick up momentum, such large deficits run the risk of absorbing too much credit, pushing up interest rates in the competition for available funds, and crowding out private demand for credit needed to facilitate private investment.

Alternatively, uncertainty and apprehension in the financial markets over the prospect of large out-year deficits may contribute to maintenance of high real interest rates sufficient to thwart sound economic growth. A study by CBO indicates that the combinationn of uncertainty about the future course of Federal Reserve policy and the outlook for federal fiscal policy--notably large and increasing deficits--may be contributing to the current high real interest rates and weakness in the economy.

Without a change in fiscal policy, the gap between federal outlays and federal revenues increases in the years ahead. Most of this gap is attributable to rapidly rising defense spending and lower revenue receipts largely due to the excessive tax cuts under ERTA. CBO projects that, even under a standard employment budget, revenues drop from 19.3% of GNP in 1983 to 18.6% by 1989 mainly due to ERTA.

Any responsible effort to reduce the deficit must recognize the effects of Congressional and Administration action over the past few years. As the table below demonstrates, cuts in spending for domestic programs have reduced cumulative deficits from FY 82 through FY 88 by almost $400 billion. Unfortunately, the effect of Congressional action on revenues has increased the deficit (FY 82-88) by $800 billion. In addition, another $285 billion has been added to the deficit through increasing defense spending.

INCREASE IN THE DEFICIT ATTRIBUTABLE TO CONGRESSIONAL POLICY ACTION

(Fiscal years; billions of dollars)

	1982	1983	1984	1985	1986	1987	1988	Total
Tax Reduction	38	68	93	121	154	178	207	+860
Defense spending increases	1	15	27	47	65	65	65	+285
Nondefense spending cuts	-42	-47	-56	-59	-61	-61	-61	-387
Net change in deficit due to policy action	-3	36	64	109	158	182	211	+757

Source: CBO baseline budget projections for fiscal years 1984 to 1988.

On the other hand, entitlements--including Social Security--and domestic discretionary spending, are both projected to decline as a percent of GNP. (Within the entitlement area, Medicare is projected to grow due to still unbridled hospital cost escalation and despite the fact that the elderly are paying more and more for hospitalization.)

As a result of Congressional action over the last few years, the percent of federal outlays for major components of the budget has shifted markedly as shown below:

Components of the Budget	1980	1984
Defense	24%	28%
Non-defense discretionary	24	19
Entitlement/ mandatory spending	43	42
Interest	9	11

(Assumes compliance with First Budget Resolution FY 84.)

Needless to say, the Finance Committee's current stated intent to fashion a deficit reduction package of $1 of spending cuts for $1 of tax increase ignores the huge imbalance in federal fiscal policy that has developed in the last three years. While such a "1 for 1" approach sounds fair, it simply is not. A more reasonable and much more efficient way of reducing the deficit over the long run would be to: (1) apply the same scrutiny to defense spending as has been applied to non-defense spending thereby reducing its rate of growth and (2) restore the revenue base to a fiscally prudent level. Unfortunately, a balanced budget is unattainable in the immediately foreseeable future. However, a steadily declining deficit, rather than a growing one, is achievable and essential if economic recovery is to be sustained.

III. THE NEED TO RESTORE THE TAX BASE

A tax increase must take into account the current economic situation by helping to increase productivity, lessen unemployment and keep inflation down. It should be remembered that inflation did more damage to the elderly's economic situation over the past decade than any other single factor. To be consistent with these economic goals, revenue raising measures should concentrate on eliminating the long-term, structural portion of the deficit, so that federal budget deficits are projected to decline in the out-years.

While the simplest course of action is to levy new taxes or surtaxes, Congress should first exhaust the potential to broaden the tax base.

Increasing Compliance and Reducing Abuse of the Tax Code

One means of raising revenue is to focus on measures aimed at increasing compliance with the tax laws. Substantial revenue (i.e. as much as $100 billion annually) is lost as a result of taxpayers who either fail to file tax returns, under-report income, or overstate deductions. Expanding the Internal Revenue Service's capacity to conduct audits would enable recovery of at least part of this revenue Increasing compliance with the tax laws should be an item of high priority as it represents a means of increasing revenue while not "raising taxes", i.e., without any changes in the substantive provisions of the tax code.

In addition to under-reporting of income and overdeducting, investment in revenue losing tax shelters is draining income from the Treasury. Though tax expenditures are often useful and necessary to create incentives for productive investment, some of the existing tax expenditures have been overused and rightly termed abusive tax shelters.

Despite claims that the 1981 tax cuts would reduce tax shelters, investments for the purpose of sheltering income from taxation have increased in the past two years. Investments in real estate have been created to take advantage of accelerated depreciation. Charitable donations of grossly overvalued property have been used to greatly reduce individuals' taxes. Congress must look toward ways of curtailing schemes which involve transactions with little or no economic justification where the claimed tax benefits are disproportionately large relative to the economic benefit.

In addition to draining revenue and consuming IRS resources, abusive tax shelters foster a cynical attitude toward the tax system on the part of the average taxpayer. In order to function effectively, a voluntary assessment and reporting system requires taxpayer confidence that it is fair and equitable. A perception on the part of taxpayers that the system is designed to encourage and assist the well-to-do to avoid taxes can only lead to a further decrease in voluntary compliance. While greater resources for policing tax fraud and stiffer penalties no doubt will help, there are substantive changes as well which could cut down on abuse. For example, deductions for charitable contributions of appreciated property could be limited to cost unless the property is held for more than five years. This would curtail the incentive to save taxes through donations of overvalued property, but should not prevent property truly acquired for investment or personal use from eventually being donated to museums and other charitable institutions.

Repeal or Modification of Tax Expenditures

A further step toward broadening the tax base would be the curtailment or elimination of tax expenditures which no longer promote economic efficiency or tax equity. Tax expenditures, which are the revenues lost due to exemptions, deductions, and credits, have been increasing at a rate of 14 percent a year since 1975, while direct federal spending has been rising at only 11 percent a year. The Economic Recovery Tax Act [ERTA] added 11 new tax expenditures and expanded 21 already on the books. The Tax Equity and Fiscal Responsibility Act [TEFRA], in turn, reversed some of the revenue loss through tax expenditures due to ERTA. If Congress can control the growth of tax expenditures, it will take a major step toward stabilizing the federal budget. Among the tax expenditures which the Congress should reconsider are the following:

* The 1981 tax act (ERTA) made major changes in corporate tax depreciation rules. Accelerated depreciation for buildings can be taken over a period of 15 years despite the fact that the useful life of the structure is much greater. Increasing the tax-life to 20 years (still a generous write-off period) would raise $19.3 billion over the period 1984-88. The rate of inflation has come down since the advent of these changes; therefore, a lengthening of the tax-life would not seem inappropriate. An increase in the tax-life of real property would also have the affect of reducing the attractiveness of revenue draining real-estate tax shelters.

* Eliminating the percentage depletion allowance which is a write-off of 15% (beginning 1984) of the gross income (up to a limit) from select oil and gas wells would increase federal revenues by about $8.7 billion over the 1984-88 period. The current method often allows a well owner to recover much more than the cost of extraction.

* Repeal of the expensing provision for intangible oil and gas drilling costs would raise about $19.3 billion over the 1984-88 period. Permitting these costs to be expensed rather than capitalized

has the effect of deferring tax payment which is tantamount to the government granting an interest-free loan to the taxpayer. Rather than permitting a deduction for the amount spent on "intangible drilling costs" to be taken in the year the expenditure is made, taxpayers engaged in oil and gas drilling would be required to adopt the general approach of depreciating these costs over a period of years. Given the major restructuring of the corporate income tax that was a part of the Economic Recovery Tax Act of 1981, the decontrol of oil and gas prices and increases in energy prices, this tax break may no longer be necessary.

* Currently, taxpayers are allowed tax credits for certain authorized investments. For property with a five-year tax life (which includes most investments) the credit is 10 percent. Firms may generally depreciate 95 percent of the asset's price (100 percent prior to TEFRA). This permits two overlapping tax benefits for the same investment. A full basis adjustment would restrict depreciation to the firm's net cost of the asset--90% in the case of the regular investment credit--and would raise $12.4 billion from 1984 to 1988.

* The deductibility of consumer interest payments discourages saving and investment and is available only to taxpayers who itemize their deductions. Though promotion of consumption may have been appropriate during the recent recession, a sustained recovery must be fueled by saving and investment. Limiting non-mortgage consumer interest deductions, for example, to $2,000 could raise $9.6 billion over the period 1984-86.

* Under current law, businesses and individuals may deduct from

taxable income the full amount spent on meals and entertainment directly associated with the taxpayer's business. This controversial deduction often results in government subsidy of extravagances that are of questionable necessity to the firm's business. A tax expenditure of this nature is likely to build resentment in the ordinary taxpayer as its benefits run mostly to highly paid executives. Limiting deductions for business meals and entertainment to 50% of the amount spent would raise $5.7 billion over the period 1984 to 1988 and would limit a tax expenditure of dubious value.

Tax Simplification

Current interest in simplification of the tax code may be another avenue to increased revenues. However, while simplification of the tax code is a desirable objective, the elimination of the progressive tax rate structure, which proponents of the flat rate tax espouse, is not. Such a change would violate the longstanding and sound principle that federal income tax liability should be based on "ability-to-pay".

Raising New Taxes

Another method of raising revenue would be to impose new taxes or to increase existing taxes.

* A 10% luxury tax could be imposed on certain expensive consumer purchases. For example, the tax could be imposed on automobiles, boats and yachts in excess of a certain price and on furs and private planes.

* A doubling of the excise tax on liquor, wine and beer would

raise $14.4 billion between 1984-86. Continuing the 16¢ a pack tax on cigarettes after September 30, 1985 will raise about $1.7 billion per year.

One method of raising large amounts of revenue which is under discussion would be the imposition of an across-the-board tax on all forms of energy. Such a tax, however, raises several concerns which must be addressed before the Association could support such a measure. A tax on energy would no doubt be passed on, at least to some extent, to consumers. One effect would be the creation of further incentives to conserve energy which is a laudable goal. However, and particularly in light of the extreme weather conditions the country is experiencing this winter, there is often no choice but to consume considerable amounts of energy. A pass-along of an energy tax would be particularly burdensome to low and moderate income consumers--with the degree of hardship dependent on the part of the country in which the consumer resides. It has been suggested that there may be offsetting adjustments to the zero bracket amount and/or personal exemption deduction to take into account any likely increase in energy prices. While this would be appropriate, it would be of little value to individuals with extremely low incomes who do not pay taxes. Therefore, major increases in the Low Income Home Energy Assistance program would be necessary to insure that such persons do not suffer. Any increased funding of the energy assistance program would be offset many times over by the revenue raised by taxes on energy. Given the experience of the windfall profit tax, any increased funding for energy assistance should be earmarked.

<u>Administration Revenue-Raising Proposals--Contingency Taxes</u>

The Administration, in its FY 84 budget, proposed to increase taxes a total of $83 billion. $61 billion of this amount was in the form of contingent tax increases which *if* triggered would not be effective until FY 86. The Administration would impose:

* a 5% barrel tax on imported and domestic oil; and
* a 5% surcharge on individual and corporate income taxes.

Aside from the merits or demerits of these specific taxes, the overall scheme as proposed would be disruptive to economic recovery. First, neither corporations nor individuals would know for certain until FY 86 whether they would take affect. Secondly, the benefit of such taxes in reducing large out-year deficits would remain uncertain.

The timing of any tax increases should take account of conditions in the economy, the certainty of such increases should not be in doubt. If those taxes are to take effect, they should not be delayed until FY 1986; that would be extemely late in the recovery phase of the present cycle and therefore very risky. The average length of the previous post-World War II recoveries has only been 34 months. The current recovery, which began in late 1982 is already more than a year old.

Delaying or Modifying Indexing

Beginning in 1985, the income tax brackets, the zero bracket amount and the personal exemption are to be indexed to inflation. Indexing is estimated to result in $6 billion in lost revenue in 1985 and over $30 billion in 1988. Moreover, this feature of ERTA was not part of the Administration's original tax proposal. Indexing does, however, provide some protection against inflation particularly for low and moderate income taxpayers--many of whom are elderly.

Should all the above suggested revenue raising measures as well as any others that the Congress might consider be insufficient to reduce adequately the budget deficit, some delay or modification of the indexing due to begin in 1985 would be appropriate.

IV. DISCIPLINING DEFENSE SPENDING

If the Congress reduces spending as part of an overall deficit reduction scheme, then it cannot ignore defense spending. Following the Vietnam war, spending on national defense declined in real terms--as might be expected. This trend was reversed in the late seventies to a 3-4% rate of real growth. Since fiscal year 1982, spending for national defense has accelerated rapidly. Under current policies, national defense spending is projected to continue to grow as a percent of GNP while spending for entitlements--including Social Security--and non-entitlement domestic spending are projected to decline.

Much of the recent debate over defense spending has been in terms of rates of increase. Some call for 10%, others for 7% or 5% or 3% and still others for a freeze. While such shorthand references to rates of increase are probably unavoidable, they are rather arbitrary. What is more important is that the defense budget be subjected to the same scrutiny as domestic programs. Waste in the defense budget does not strengthen national security but erodes public support for it. Even more important is the need for choices to be made which in turn "drive the numbers" rather than the reverse.

AARP urges the Congress to subject the defense budget to the same scrutiny that it has applied to other areas of the budget. While this area is not subject to the review of the Senate Finance Committee, we urge the Committee to use its influence and leverage to assure that any deficit reduction package include a healthy contribution from the defense budget. Such a reduction should come through curtailment in long-term budget authority that would result in significant longer-term outlay savings.

V. DOMESTIC SPENDING REDUCTION PROPOSALS

During the first session of the 98th Congress particularly in its waning days, the Committee on Finance had before it a wide range of proposals to increase costs to Medicare beneficiaries and reduce Social Security beneficiaries' benefits. While AARP does not intend to address each and every such proposal here, several of them deserve comment. The Committee has asked that we not dwell on Social Security and Cost of Living Adjustments (COLA's). However, we would be pleased--and hope that we would be offered the opportunity--to respond to the Committee and/or any of its members on this subject in greater detail should it be considered in the future.

We would like to point out however, there has been significant deficit reduction through changes in Social Security already. Early in 1983, the Congress enacted and the President signed a Social Security solvency package. As a result of these 1983 Amendments, the Social Security Trustees have declared the OASDI Trust Fund to be solvent. Moreover, as part of these Amendments, Social Security beneficiaries are already contributing nearly $70 billion in deficit reduction from the six-month COLA freeze ($40 billion) and from the taxation of benefits ($26.6 billion) provisions. In addition, the Social Security Amendments provide for automatic COLA reductions should adverse economic conditions cause the trust funds' financing to deteriorate. To further reduce future Social Security benefits would not only be a breach of promise but would also be unnecessary since Social Security is operating in the black at the moment and is not adding to the deficit.

Many of the proposals for spending reductions which the Committee has had under discussion would impose new cost-sharing burdens on elderly Medicare beneficiaries. While it is not possible to discuss each and every option under consideration, the following sections review the impact of some of the more important.

Restructure Medicare Part A Cost-Sharing

This proposal would levy new copayments for the second through 60th day of hospitalization, but waive copayments beyond 60 days. This proposal would more than double beneficiary cost sharing for an average hospital stay.

Under current law, beneficiaries pay a first day deductible, which rises automatically each year. <1> Current estimates for the Part A deductible are as follows:

* Beyond 60 days, beneficiaries begin per diem coinsurance of 25% of the first day deductible for the 61st through 90th day. An additional 60 days, the so-called "life time reserve", is also available, at 50% of the first day deductible. The first day deductible is payable each time a beneficiary is hospitalized, unless rehospitalization occurs within a "single spell of illness", i.e. within 60 days of discharge.

1983 (actual)	$304
1984 (actual)	356
1985	404
1986	448
1987	496
1988	540

This proposal would dramatically increase costs for over 99% of beneficiaries hospitalized in a given year. On the other hand, less than one percent of enrollees are in the hospital for 60 days, continuous. Moreover, these increased costs far exceed any amount needed to eliminate cost sharing beyond the 60th day. In order for a beneficiary to gain any benefit from the elimination of coinsurance beyond 60 days they would have to be hospitalized for 77 days. In addition, the proposal does not protect beneficiaries hospitalized for a lengthy stay from physician service costs under Part B or non-Medicare covered costs.

The increased costs to the beneficiary hospitalized for an average stay (11 days) would be as follows:

Current Law 1984	Proposed 1985
	$404. deductible
$356. deductible	+ 323.20 coinsurance
	$727.20

It should also be understood that beneficiaries have little control over the incurring of these costs. Beneficiaries do not admit themselves to hospitals. The decision on whether someone is hospitalized, and for how long, is one made by the physician.

Increase Part B Premium

This proposal, originally made by the Administration in its FY 84 Budget, would nearly triple the Part B Premium by 1989 from $146.00 in 1983 to $408 in 1989. This proposal comes on top of large increases in beneficiary cost sharing under Part B over the past several years:

--An 88% increase in the Part B premium over the past five years;

--Almost a 100% increase in charges to beneficiaries for Part B coinsurance over the past five years;

--A 198% increase in "charge reductions" passed on to beneficiaries for unassigned claims;

Today, beneficiaries pay for over 60% of Part B physician charges under Medicare Part B.

The net effect of this new proposal would be a shrinkage in Social Security checks, particularly if taken in conjunction with a COLA reduction. Over 10 years the increased cost to a single beneficiary would be $1897 and to a couple $3794.

"Participating" Physician Proposal

This proposal extends for an additional year, the freeze on the prevailing charge for physician reimbursement. Earlier this year, as part of its reconciliation savings, the Committee on Finance reported out a provision to freeze the prevailing fee screen under Part B physician reimbursement. In effect, the prevailing fee level would be frozen for a year and a half (on top of the year lag already incorporated in the annual adjustment).

A freeze of this length on the prevailing fee for physician reimbursement will likely have a serious negative effect on physician willingness to accept assignment, resulting in even greater

out-of-pocket costs to the elderly.

Currently, approximately 52 percent of all claims submitted to Medicare are submitted by physicians as "assignment" claims (i.e., the physician is willing to accept Medicare's approved charge as payment in full). In those cases Medicare pays 80% and the beneficiary 20%. (Only 20% of physicians accept assignment in all cases.)

It should be noted that, during the Economic Stabilization Program from August 1971 through April 1974, when prices and wages were controlled, the physician assignment rate, i.e., the percentage of claims submitted by physicians under "assignment" fell more than 11 percent. There is some evidence that an extension of the physician fee screen freeze would produce a drop in the assignment acceptance rate.

In addition to these proposals, the Social Security (Medicare) Advisory Committee has developed several proposals, some of which the Finance Committee is apparently considering, that would impact severely on the elderly. We shall comment here on a few:

* Increase Age of Eligibility

The age of eligibility for Medicare would increase from 65 to 67 beginning in 1985 with full implementation in 1991. After 1991, tne age of eligibility would be periodically adjusted upward to reflect increases in life expectancy. (Estimated savings: $66 billion over the next decade)

AARP strongly opposes this proposal and believes that age 65 should be retained as the age of eligibility for Medicare. Little data exist on how much today's pre-age 65 retirees pay for health insurance; however we could expect health insurance premiums to at least equal $3400/year. This would only cover the premium cost of current Medicare Parts A and B plus increased costs which private insurers associate with marketing, reserve requirements, and protection against adverse selection. Premiums of this magnitude would make health insurance coverage unaffordable for a very substantial number of the elderly.

* Revised Part A Benefits and Increased Part B Premium

The Part A benefit package would be revised to: (1) provide unlimited hospital days in a calendar year; (2) establish a coinsurance for each hospital day equal to 3% of the Part A deductible; (3) establish a coinsurance for the 21st-100th skilled nursing facility (SNF) day equal to 12.5% of the Part A deductible; and (4) limit the Part A deductible to two per year.

The Part B premium would be raised for those who enroll by $98 per year to: (1) eliminate the hospital and SNF coinsurance (premium cost $56 per year); and (2) raise revenues for the HI trust fund (premium cost $42 per year). (The estimated revenue would be $40 billion by 1995.)

To AARP, this proposal represents a significant net increase in already large beneficiary out-of-pocket payments. Unlimited hospital days in a calendar year is an improvement over current Part A benefits. However, beneficiaries will pay an additional $56 per year to eliminate daily hospital and SNF coinsurance with respect to inpatient days which were previously not subject to cost-sharing. Moreover, the $42 per year surcharge to raise revenues for the HI trust fund increases beneficiaries' out-of-pocket payments but does not address the forces driving up Medicare expenditures--uncontrolled escalation in hospital costs and revenue.

* <u>Medicare Assignment</u>

Physicians would decide each year whether or not to accept assignment for all Medicare patients. A directory of physicians who agree to accept assignment in all cases would be published yearly for beneficiaries' use.

As indicated earlier, only 52% of Medicare claims are assigned. AARP believes that this proposal would run a serious risk of decreasing the current assignment acceptance rate, resulting in further increases in beneficiary out-of-pocket payments. A HCFA study based on an econometric analysis of a 1976 survey of physicicans found that the overall assignment rate would fall by 10% if an "always or never" assignment option similar to the Council's were to be put into place.

VI. <u>ALTERNATIVES TO MEDICARE CUTS THAT ADDRESS THE UNDERLYING CAUSES</u>

OF HEALTH CARE COST ESCALATION

AARP believes that changes in the Medicare program should focus on the forces driving up health care costs and not on changes that merely shift cost to beneficiaries and taxpayers. The federal government, as major purchaser of health care services, cannot shrink from its responsibility to abate explosive cost escalation in the health care sector. Since approximately 75 percent of all Medicare expenditures are for hospital costs, the federal government has the market power and the financial interest to abate the excessive rate of hospital cost increases.

Moreover, costs for physician services (Part B of Medicare) are rising faster than Part A costs. Beneficiaries are increasingly hard hit by rising costs for physician services. Currently they bear 60% of the costs for physician services under Part B. From 1980 to 1983, the Part B deductible rose 25%. From 1972 to 1982 coinsurance under Part B rose 345%. From 1977 to 1982 charge reductions on non-assigned claims rose 200%. The elderly are doing more than their fair share already to cover the rising costs of physician services under Part B at a time when the average physician salary net of expenses is over $100,000, according to the American Medical Association. It is time for Congress to look to others than beneficiaries to control rapidly rising Part B costs.

The Association has long urged the Congress to establish across the board (i.e., all payor) limits on increases in hospital costs and revenues. Such an approach would not single out Medicare or Medicaid beneficiaries for special restrictions. Time and again, experience has demonstrated that Medicare-Medicaid specific approaches to hospital cost containment merely lead to cost shifting to private paying patients and their third party payers and thus effect no reduction in the rate of increase in total hospital costs.

If Congress rejects uniform, across-the-board limitations on increasing hospital costs, then alternatively, the Association recommends that Congress actively encourage and/or coerce the states into adopting mandatory hospital rate review programs. Such programs, in the six states that have them, have shown promise in

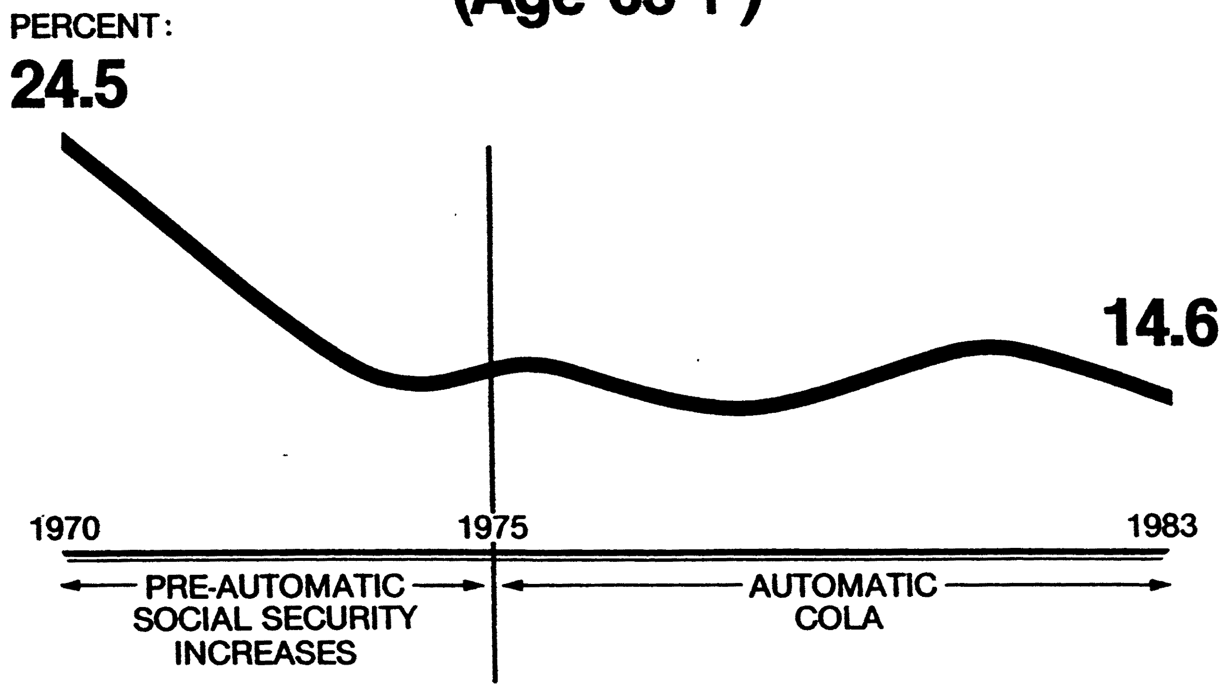
reducing both public and private sector outlays for hospital care. We urge Congress to provide financial incentives for states to initiate effective hospital rate review programs which can produce substantial savings to both government and private purchasers of hospital care services. Had all states held their increases in hospital costs to that experienced by the six states with mandatory rate review, hospital expenditures nationwide would have been $12 billion less in 1981. AARP believes such state hospital rate review programs have demonstrated their ability to reduce health care costs.

VII. CONCLUSION

As in the past, AARP is prepared to work with the Senate Finance Committee to help fashion a constructive and effective deficit reduction package. However, we urge the committee to fashion such a package so that it responds to the forces pushing up the deficit and not merely shift greater burden to those who rely on programs that fall within the jurisdiction of the committee--particularly the elderly.

ATTACHMENT A

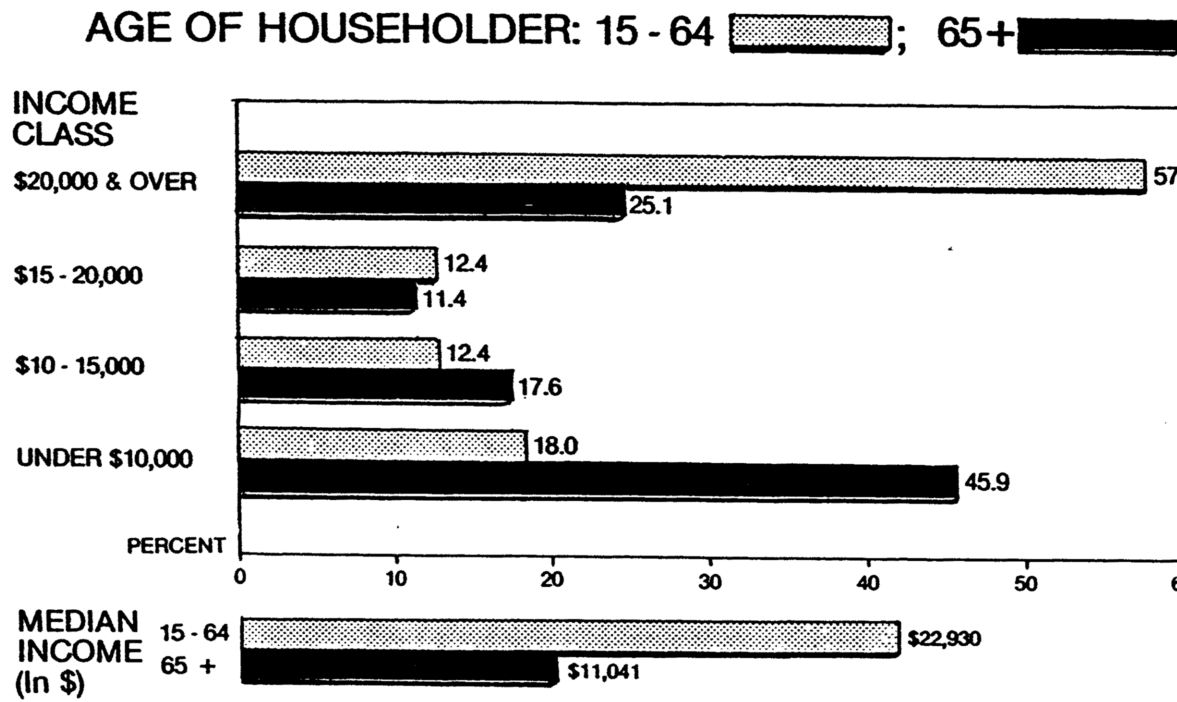
POVERTY RATE
(Age 65 +)



Source: U.S. Bureau of the Census

ATTACHMENT B

1982 HOUSEHOLD INCOME: Elderly versus Non-Elderly



Source: U.S. Bureau of the Census. "Money Income & Poverty Status of Families and Persons in the U.S.: 1982"

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS

Gerald M. Lowrie
202/467-4097

December 16, 1983

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD 219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

The American Bankers Association is submitting these comments on the subject of the need for enactment of a major deficit reduction package and on the specific contents of such a package; the hearings on this subject have been scheduled for December 12 through December 19, 1983.

The hearings address an issue which our Association considers vital to continued economic prosperity of the United States. The Economic Advisory Committee of the American Bankers Association has considered the Federal budget policy and developed a statement presenting its views, a copy of which is attached. Basically, the Committee feels that the deficit will result in real interest rates higher than they would be at lower levels of the deficits and that the deficit should be reduced by significant reductions in the growth of spending.

The hearings are to address three fundamental questions about the massive projected deficits. The first question asks about the economic consequences if the Administration and Congress do not address the deficit problem. If the massive deficit continues, nominal interest rates will be higher than they otherwise would have been and pressures will be put on the Federal Reserve to increase the money supply in an attempt to lower interest rates. But, if the Federal Reserve attempts to do this, expectations of higher inflation will result in even higher interest rates. Thus, the options of the Federal Reserve are limited and in the face of continued high deficits it will be difficult for the Federal Reserve to maintain a monetary policy which will result in continued economic expansion without inflation. Thus, one economic consequence may be a return to the high levels of inflation seen in the 1970s, combined with intermittant periods of slow growth in the economy as seen in the late 1970s and early 1980s because of high interest rates.

Large deficits impede capital formation, and reduce long run productivity and standards of living. These effects depend in part on amount of resources employed in the economy. When there is underemployment in the economy, an increased deficit may have little negative impact on the economy. This was the case in 1980-82.

Currently, the economy is recovering, but there are still unemployed resources such that the deficit is having a small effect on the economy. However, if the large deficits continue into 1985, when the economy's resources are expected to be more fully employed, then the negative effects of high deficits will increase. Because the current projection is that deficits will continue at massive levels through 1985 and beyond, we feel it is important to take immediate steps to reduce them, and decrease their future negative effects on economic growth and productivity.

Any analysis of the economic effects of the deficit must be placed in a global context. The U.S. is financing a large part of its deficit by borrowing from foreign countries, resulting in large inflows of funds. These inflows result in a stronger dollar which makes it more difficult for our exports to compete in the world markets. A large deficit will adversely affect the export industries of the U.S., bringing continuing calls for protectionism and other policies aimed at protecting industries from foreign competition.

The second question asks how soon the problem of the deficit needs to be addressed. We feel that deficit reduction should be accomplished by a decrease in government spending and that this should be implemented as soon as possible. Many of the programs that should be reduced are entitlement programs that continue to grow over time. The longer one waits, the larger the base one is working from and the larger the cuts needed to accomplish the same amount of savings.

Although the deficit is a serious problem, using tax increases to reduce the deficit may create additional problems for the economy and have little effect on reducing the deficit. Tax increases unless structured correctly, produce disincentives to investment and production. They could result in a return to the economic malaise of the late 1970s and early 1980s. The revenues from tax reductions may not be used to decrease the deficit but rather increase expenditures.

The credibility of policymakers is an extremely important aspect of any deficit reduction program. The lack of credibility in economic policymaking was a major cause of economic instability in the late 1970's. Worse than explicit neglect of the deficit problem, would be a program which purports to reduce future deficits through a combination of tax increases which inhibit capital formation and promised future curtailments in spending growth which never materialize. Thus, we believe the most credible deficit reduction program at the current time would be a concentrated head-on attack on spending programs.

The final question asks what specific legislation is needed to reduce the deficits. We are aware that entitlements and defense expenditures constitute a very large portion of the budget. Hence,

AMERICAN
BANKERS
ASSOCIATION

CONTINUING OUR LETTER OF
December 16, 1983

SHEET NO. 3

any credible spending reduction program must attack these two areas.

Bankers fully understand the difficult political problems involved in cutting spending. We do not believe it is our role to specify the way in which specific expenditure reductions are to be achieved. However, we do feel quite strongly about our support of the broad guidelines outlined above. We believe these are reasonable and we will strongly support programs that meets these guidelines.

We appreciate the opportunity to comment on this vitally important issue.

Sincerely,

Gerald Lowrie

Gerald M. Lowrie

STATEMENT OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON THE DEFICIT REDUCTION PACKAGE
DECEMBER 12 - 14, 1983

Introduction

The American Gas Association (A.G.A.) is a national trade association comprised of nearly 300 natural gas distribution and transmission companies serving over 160 million consumers in all 50 states. A.G.A. member companies account for approximately 85% of the annual natural gas utility sales in our nation. Natural gas serves over half of the residential and commercial establishments in the U.S. and more energy users in American industry than any other single fuel.* Further, gas provides a secure source of energy because foreign energy supply developments do not disrupt our nation's access to this clean, efficient fuel.

The A.G.A. recognizes the current difficulties which your Committee, the Congress as a whole, and the Administration face in controlling the federal budget deficit. The regulated gas utility industry is very capital-intensive and thus extremely sensitive to interest rates. We are particularly concerned about the effects of large deficits on the capital markets. For this reason, the gas industry has demonstrated its commitment to deficit reduction on November 29, 1983, when the attendees at the Fifth Annual Gas Industry Bankers Conference adopted a resolution urging the President and the Congress "to address forthrightly, as a

*According to the DOE Monthly Energy Review, industrial consumption of natural gas in 1982 represented 34.4% of the total energy consumed in the United States for purposes other than electric generation.

national priority on a bipartisan basis the most timely and reasonable measures possible to reduce federal budget deficits in a balanced and equitable manner." A copy of this resolution is attached for the record.

Notwithstanding this support and concern for reducing the deficit, A.G.A. does not agree with some of the recommendations set out in the Senate Finance Committee's deficit reduction package. A.G.A. opposes the imposition of an energy tax and a special surtax levied on a new calculation of corporate "economic income". We support the extension of the business enegy tax credits but believe the cogeneration tax credit should be expanded to include gas-fired cogeneration equipment. However, we object to proposed changes in the current rules for utilizing tax credits.

Energy Tax

The A.G.A. adamantly opposes the imposition of a tax on energy.

A broad-based energy tax creates the illusion of being equitable because it is levied on all energy forms. Appearances aside, it is essentially a consumer tax assessed on a basic requirement -- space heating and cooling. Consumers will, in most cases, be unable to offset by conservation the higher cost of energy attributable to the tax. Most low-cost conservation steps have already been taken by consumers, so that additional long-term fuel cost savings will require significant consumer investment. Rather than invest money now and wait for a long-term payback, consumers will probably bear the increased cost of fuel attributable to the tax -- a choice which will eat into their disposable family income.

Moreover, the use of natural gas, as well as electricity, does not generally increase in correlation with higher incomes. Thus, an energy tax would be an extremely regressive one, particularly since low-income individuals spend a much higher percentage of their income on energy than do those with higher incomes. A recent A.G.A. analysis, "Projected National Average Residential Heating Bills" (October 21, 1983), predicted that in 1983, persons with annual incomes below $7,000 can expect to pay 8.7% of their income for gas heating bills, while those in the $29,000 to $35,999 range, for example, will pay only 1.2%. Chairman Dole recently made a statement that the low-income individuals would not be affected because of your Committee's proposal to increase the zero bracket amount. However, this kind of longterm payoff may not help someone who is living from paycheck to paycheck, nor will it aid those who pay no taxes and receive public assistance.

As your Committee is aware, there continues to be a growing number of low-income Americans who are unable to heat their homes adequately or to pay their utility bills each year. This has created a serious -- and growing -- uncollectible accounts problem for regulated energy distribution companies, a problem which, in the final analysis, must have its cost borne by all consumers. Either those customers who can pay must subsidize the non-paying customers, or state and local governments -- with additional help from the Federal Government -- will likely have to increase levels of general assistance to those who cannot meet this increased burden. Raising the cost of energy to consumers will only exacerbate this problem. To partially ameliorate the current problem, the general authorization for the Low-Income Home Energy Assistance Program (LIHEAP) was passed in the Omnibus Budget Reconciliation Act of 1981. Since the authorization expires at the end of FY1984, a full reauthorization of LIHEAP will be required before the start of FY1985 -- approximately the same time that this contingent energy tax is supposed to go into effect.

In recognition of the difficulties some consumers face in paying fuel bills, the A.G.A. supports efforts such as LIHEAP. In fact, 51 of our member companies have established their own fuel assistance programs to help low-income customers -- especially elderly and handicapped persons -- to pay for their basic home heating needs. Also, we supported legislation that allows SSI or AFDC recipients to receive home energy assistance without a reduction in their benefits. However, the aid that these efforts provide would be eroded by raising the cost of energy.

Local authorities also have been active in raising revenue via utility user taxes. These taxes take the form of sales and use taxes, business license fees, and various permit fees -- all of which have a common element: they are included in the utility bill of the consumer. With many local authorities in need of revenue, we believe that such local taxes will increase in the future. To add the across-the-board federal energy tax to these local taxes increases the financial burden of the consumer.

In addition, increased costs of industrial production will ~~also~~ most likely be passed on to purchasers -- regardless of their income. On a national level, this will result in increased prices and decreased purchases, thus slowing our recovery from the current recession. On an international level, the increased prices for American produced goods will have a negative impact on our balance of trade. In addition, an across-the-board energy tax will do nothing to foster the national goal of energy self-sufficiency.

In short, the soundness of this tax is questionable from an economic and energy standpoint. We urge your Committee not to enact this extremely regressive tax. Nevertheless, the A.G.A. realizes that some additional tax revenues combined with spending cuts may be necessary to reduce the current and projected budget deficits. Various A.G.A. committees are currently analyzing other revenue raising measures which will not penalize consumers, unlike a discriminatory energy tax. One of our concerns is that, although additional federal revenues may be necessary, any new tax proposals should be selected from among those having the least adverse impact on our domestic economy. We look forward to working with the members of this committee in the near future to help structure a better means of raising revenue.

Tax On Corporate Economic Income

The A.G.A. questions the wisdom of, and the need for, superimposing an entirely new corporate taxation system on the existing one. In addition, the inability to reduce economic income by loss carryovers would have a particularly negative impact on A.G.A. member companies and on companies in other industries whose income unavoidably fluctuates from one year to the next. Furthermore, the proposal would require that a company calculate depreciation under another method in addition to the different method used to calculate the income tax, to determine earnings and profits, and to prepare financial statements. This would be a substantial and costly burden.

Rather than add a new "layer" to the corporate taxation system, we recommend that your Committee simply consider raising the tax rates for corporations within the existing system. Compliance would be simpler under such a proposal and it would not entail any additional Treasury/IRS regulatory projects. A recurring problem, impediments to business tax planning because of substantive statutory changes, would also be avoided by simply adjusting the tax rates.

Energy Tax Credit Extension

Earlier this year, the A.G.A. supported business energy tax credits and the changes in the affirmative commitment rules in statements presented to the Energy and Agricultural Taxation Subcommittee on S. 1396, the Energy Security Tax Incentives Act of 1983, and on S. 1305, the Renewable Energy Tax Incentive Act of 1983. In these statements, we supported the extension of the business energy tax credit for cogeneration equipment through 1985 and its expansion to cover gas-fired cogeneration equipment. Although we do not have an estimate of the revenue impact, the cost of extending this credit should be outweighed by the benefit to the economy of conserving fuel and helping to drive economic recovery. We strongly urge your Committee to follow the provisions of S. 1305 in this regard. In a related matter discussed in our statements, we supported the extension of the affirmative commitment rule for biomass property. We reaffirm our support for that extension, but do not believe that the limitation contained in S. 1305 -- that only methane-containing gas produced at agricultural facilities -- should be imposed. Major methane recovery projects from landfills can provide significant fuel supplies and should not be excluded from the energy tax credit provisions.

A.G.A. members have a direct and vital interest in the efficient use of natural gas. Cogeneration equipment, through the sequential use of energy to produce both electrical or mechanical energy and useful thermal energy, can quickly save 25-51% of the energy consumed by conventional boilers and other end use equipment.* DOE estimates a potential fuel savings of nearly 2 quads for industrial cogeneration development alone, not accounting for development in the commercial market. A.G.A. thus strongly supports cogeneration as a means of reducing total U.S. energy consumption through the productive use of what would otherwise be wasted energy. (Two-thirds of the energy used to generate electricity conventionally is lost as waste heat.)

Natural gas is the fuel of choice for most cogeneration applications. It is clean, easy to use, and gas-fired

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* "An Energy Conservation and Economic Analysis of Gas-Fired Cogeneration in Commercial and Industrial Applications", Energy Analysis 1981-9 (August 28, 1981; American Gas Association, Arlington, Virginia)

cogeneration equipment is currently available for both commercial and industrial applications. Given the improving gas supply outlook, there is no justification for continuing a tax bias against natural gas-fired cogeneration equipment. Equipment which does not use natural gas (or an oil-derived product) is not generally available for a wide spectrum of applications. In addition, cogeneration equipment using alternative fuels has associated environmental controls and fuel handling costs well beyond the cost of natural gas systems. We urge your Committee to recognize the contribution that gas-fired cogeneration equipment can make towards energy independence by including this equipment in the business energy tax credit scope of eligible expenditures.

The A.G.A. applauds this Committee's proposal to extend the affirmative commitment rules for solar and biomass expenditures and to add an affirmative commitment rule for synthetic fuel production equipment. Such tax benefits are needed by these industries to allow maturation of still-new technologies, thus permitting their development into competitive and complimentary energy industries.

Simplification of Business Tax Credits

The A.G.A. objects to any change in the current rules for utilizing tax credits because such a change will ultimately reduce total capital expenditures. This, in turn, will adversely affect our nation's current economic recovery and jeopardize future economic growth and job development. Because energy and regular investment tax credits would be subject to the same utilization limits under the proposal, investment credits from ordinary business activities will reduce the amount of usable energy credits (and incentives) from alternate energy projects, thereby reducing investment in such energy projects.

Congress made certain tax credits, such as the energy credit, applicable to 100 percent of tax liability to assure that incentives exist for certain costly investments that are of high national priority (including the development of fuel from alternate sources such as coal). As a result, the energy tax credit utilization rules should not be changed, especially since the life of the credit is short. The A.G.A. believes that, at a minimum, projects grandfathered under the existing tax credit extension rules should be grandfathered from any uniform credit ordering as well.

Conclusion

The American Gas Association appreciates this opportunity to present its views to your Committee on these issues of vital importance to our nation and to our member companies. While we recognize that, in a time of burgeoning federal deficits, sacrifices and possible tax increases are necessary, we do not believe that a tax on energy -- imposed on a vital commodity sold by only one industry but used by virtually every entity and individual in this country -- is in the national interest. When the energy tax proposal is considered in conjunction with the corporate economic income proposal, the Senate Finance package appears even more burdensome, since two new taxation proposals will be superimposed on our already over complicated tax structure. We believe that adjusting tax rates within the existing system is a far more logical and efficient approach.

The A.G.A. is prepared to offer any assistance we can to your Committee in its efforts, and urges the adoption of business energy credits for gas-fired cogeneration equipment and of the affirmative commitment rules for alternative energy property as set out in the Committee package.

RESOLUTION OF ATTENDEES AT THE FIFTH ANNUAL GAS INDUSTRY BANKERS CONFERENCE SPONSORED BY AMERICAN GAS ASSOCIATION'S BANKERS ADVISORY COUNCIL

WHEREAS, the Gas Industry Bankers Conference in its fifth annual meeting on November 29, 1983, in Washington, D.C., heard the Honorable Howard Baker, Majority Leader of the U.S.Senate, and the Honorable Robert Dole, Chairman of the Senate Committee on Finance, address the seriousness of the growing national debt and the current and foreseeable federal budget deficits; and

WHEREAS, mounting federal budget deficits by hindering private sector capital formation, pose a threat to continuing economic recovery; and

WHEREAS, a major portion of such federal budget deficits appears to be inherent in the current structure of federal budgeting; and

WHEREAS, there is a clear and serious adverse impact resulting from such federal deficits on the natural gas and banking industries, and on the millions of consumers they serve as well as the U.S. economy and all of its citizens.

THEREFORE, BE IT RESOLVED by the attendees at the A.G.A. Fifth Annual BANKERS CONFERENCE that the President and Congress be encouraged to address forthrightly, as a national priority on a bipartison basis the most timely and reasonable measures possible to reduce federal budget deficits in a balanced and equitable manner.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SENATE FINANCE COMMITTEE
REGARDING DEFICIT REDUCTION

December 28, 1983

The American Farm Bureau Federation represents over three million member families throughout the United States. Farm Bureau members support monetary and fiscal policies that reduce the size of the federal government, encourage private initiative and promote economic growth.

Just as Farm Bureau has a long history of supporting a balanced budget through spending reductions, Congress has an equally long history of unbalancing the budget through spending increases. If the Senate Finance Committee and Congress as a whole are serious about reducing the deficit, we urge another look at the major source of massive budget deficits: the uncontrolled growth of federal entitlement programs. Whether entitlement programs benefit the elderly, veterans, or farmers, the results are the same. Program costs have outstripped taxpayers' ability to pay for them, and neither Congress nor the Administration have been willing to correct the well documented situation of high deficits caused in large part by the growth of the federal entitlement programs.

The Senate Finance Committee's recent hearings on deficit reduction focused on three issues: (1) the economic consequences if no action is taken on the deficits, (2) the timing of deficit reduction, and (3) specific legislation to reduce the deficits. Our response to these points is brief.

First, deficits are a problem because, as a symptom, they indicate a fundamental flaw in our government: the alarming growth rate of federal spending. If such deficit-financed spending continues, the economy will be less productive because of the high level of government intervention in individual spending and saving decisions and general uncertainty in the business community about the Congress' yearly irresponsible tax and spending budget actions.

Second, the time to reduce deficits is now. Political reality assures us, unfortunately, that Congress and the Administration lack the courage to reduce the growth of government programs in election years. But, such action must be taken in 1984. Voters demand responsible budget decisions by the Congress. Members of Congress were elected to make tough decisions. If they continue to postpone these decisions, the situation will only worsen and become more difficult to resolve.

Third, the answer to the government's deficit problem does not rest in the deficit reduction plan being considered by the Senate Finance Committee or in the tax bill reported last session by the

House Ways and Means Committee. Tax increases are not the way to balance the budget. Individual incentives and business initiatives are already stifled by high taxes. Witness the growth of the underground economy of unreported or underreported income as an unfortunate response to the country's progressive tax system.

As Farm Bureau has stated to Congress on many occassions, the budget must be balanced and deficits reduced by spending cuts, not tax increases. We do not support the imposition of an energy tax, corporate and/or individual surtaxes, the delay of scheduled tax cuts including indexing, or any type of contingency tax.

The hearing announcement for the deficit reduction package urged witnesses to refrain from suggesting freezes in Cost-of-Living Adjustments in the Social Security program ostensibly because political reality holds no place for implementation. Farm Bureau suggests to the Committee that this is precisely Congress' problem: its refusal to acknowledge the flaws in entitlement programs. Certainly, it is privately recognized that the Social Security program is still in trouble despite large tax increases in 1983 to bolster the system.

We urge Congress to take these specific actions to address the deficit problem:

(1) Freeze federal spending at the previous fiscal year's total appropriations level with the exception of interest payments on the national debt and an adequate defense.

(2) Enact a three-year freeze or moratorium on COLAs in all federal entitlement programs.

(3) During the COLA moratorium, review all federal entitlement programs to fix the problems that have nearly bankrupted the programs and left genuinely deserving individuals with very little help.

In addition to these steps, we urge Congress to adopt a constitutional amendment to balance the budget and restrict federal spending to a realistic percentage of Gross National Product.

Farm Bureau recognizes that our statement contains points that Congress would prefer to ignore and often has. If it does, however, we can all be assured that the aggregate deficit totals for the next five-year period will exceed the national debt heretofore accumulated since the country's beginning. We urge strong action.

We ask the inclusion of Farm Bureau's statement in the hearing record. Thank you.

American Iron and Steel Institute

1000 16th Street N.W., Washington, D.C. 20036

George T. Esherick
Vice President
Government Relations
(202) 452-7230

December 30, 1983

The Honorable Robert Dole
United States Senate
Chairman, Senate Finance Committee
SD 219 Dirksen Senate Office Building
Washington, DC 20501

Dear Mr. Chairman:

I realize that your hearings held on December 12, 13 and 14 dealt primarily with deficit reduction. We in the steel industry support your efforts to accomplish this with the firm conviction that the initial steps must be through expenditure reductions.

We realize that you will be having hearings on specific tax proposals early in 1984, and would hope that we would have an opportunity to testify at that time.

In view of some of the press accounts earlier this month, we do not want to miss the opportunity to comment at this time on a number of the tax proposals and consequently would like to have the attached statement made a part of the record of your mid-December hearings.

Sincerely,

George T. Esherick

George T. Esherick

GTE/jeg

Attachment

December 12, 1983

Statement for the Record to be Filed
on Behalf of
American Iron and Steel Institute

Senate Finance Committee Hearings
on Deficit Reduction Package

This statement is submitted on behalf of the member companies of the American Iron and Steel Institute (AISI). The AISI is a trade organization representing 58 domestic producers of iron and steel. In the aggregate, these companies employ approximately 300,000 persons at several thousand establishments throughout the United States and generally account for about 86 percent of the total volume of steel produced in this country.

During the formulative stages in the development of the Deficit Reduction Package, the Senate Finance Committee was considering, among other items: (1) a 5% tax on all energy, (2) a 5% tax on book income, i.e. income as reported for financial accounting purposes, and (3) a 15% corporate minimum tax. On November 11, 1983, the Institute became sufficiently concerned about those provisions that we voiced our concern in a letter to all members of the Senate. A copy of that letter is attached.

We would like to express a few thoughts about the general approach to deficit reduction. We believe the principal thrust of deficit reduction must be through spending cuts. The initial concept of TEFRA was to have provided three dollars of spending cuts for every dollar of tax increase. Many of the domestic steel companies were supportive of the whole concept under those circumstances. Given the amount of revenue raised in the first three fiscal years, there should have been nearly $300 billion of spending cuts during the same period. Instead, the Congress finally approved spending cuts of less than $18 billion -- less than 6% of the original amount envisioned. We believe the original level of spending cuts which were contemplated in TEFRA should be implemented.

We do not favor the enactment of any tax increases until substantial expenditure reductions are in place, and then only if these reductions do not result in any meaningful downward movement in interest rates. Therefore, we do not believe that you should be considering tax increases at this time, even if they are made contingent on an equal amount of spending cuts. With regard to various tax proposals which have been proposed, we have the following specific comments.

Minimum Tax

We note with favor that the current Package does not contain a minimum tax provision. This ill-conceived tax attaches selectively to low profit companies, particularly in the mining and metal manufacturing industries. It is nothing more than an attempt to partially deny in the aggregate the benefit of deductions which are individually acceptable. We are pleased that this provision has been withdrawn.

Economic Income Tax

We are relieved that the concept of the economic income base on which the tax is to be applied does not seem to be tied to income as reported for financial accounting purposes. The proposed economic income tax, like the minimum tax, has the unfortunate effect of taking a different income base than taxable income determined in the traditional manner. We cannot understand why it is necessary to inject more complexity into an already overly complex tax structure in order to levy a low rate tax on still another variation of income. It would seem far simpler and more equitable to merely enact a low rate temporary surtax.

In addition, we are particularly disturbed that the separate income tax would not provide for the application of any losses incurred prior to the year of the tax. It is a long-standing principle in the taxation of income to provide for an averaging of income and losses over a reasonable period of time in order to avoid inequitable taxation of cyclical industries which could have alternating periods of economic prosperity and depression. The timing of this particular tax without recognizing prior losses would be especially damaging to steel companies. In the midst of an economic depression in our industry, companies are taking steps to become more profitable in future years, when the tax would be in effect, even though it means increasing losses now. In order to be fair to cyclical industries and to retain the long-established averaging principle, at least those losses sustained in the three years prior to this three year tax should be able to be carried forward.

Energy Tax

The steel industry has been and remains unalterably opposed to any broad based tax on energy consumption whether measured by value or on a BTU basis. It makes no more sense from an economic policy position to single out energy consumed as a source of revenue through taxation than it would to single out all raw materials, all labor, or any other similar major cost of doing business.

Although a compelling case can be made for opposing an energy tax simply because it is questionable tax policy, our real concern is based on pure economic realities. The steel industry is one of the largest single consumers of energy in the country. Even at a low rate, because of the volume, an energy tax would increase the cost of producing domestic steel by several hundred million dollars annually. The steel industry lost $3.2 billion in 1982 and will likely sustain comparable losses again in 1983. The domestic industry is operating in a highly competitive market. Evidence exists that subsidized imports are entering the country in large quantities. Because of these illegal practices, and the continuing economic depression in the industry, many domestic steel companies continue to operate at substantial losses. Any action by the Congress which would unilaterally increase the cost of production under current economic conditions for only domestic companies, some of which are struggling to survive, would further impede our industry's ability to compete with foreign steel manufacturers. We sincerely hope that this onerous and unwarranted cost increase will not be proposed.

Safe Harbor Leasing

The tax changes included in the Tax Equity & Fiscal Responsibility Act (TEFRA) in 1982, including the reduction in basis for one-half of the investment tax credit or reduction in the amount of credit, the cancellation of Accelerated Cost Recovery provisions scheduled to take effect in 1985-86, the new minimum tax preference provisions and the effective termination of safe harbor leasing are devastating to investment planning and substantially reduce the favorable impact on capital investment that was sought by the 1981 changes.

We appreciate the extension to December 31, 1983 the steel industry was granted last year. However, if we are to become thoroughly modern and be able to compete with dumped and subsidized imports, a three to five year extension beyond the scheduled expiration is essential.

American Iron and Steel Institute

1000 16th Street, N.W., Washington, D.C. 20036

Robert B. Peabody
President
(202) 452-7146

November 11, 1983

To: All Members of the United States Stenate

The American Iron and Steel Institute is extremely concerned that the Senate Finance Committee is considering imposing a general 5% tax on all energy as a major revenue raising option. As one of the country's major energy consumers, the industry would be most severely impacted by such a tax. The industry lost $3.2 billion in 1982 and the severe economic conditions of the last few years show no signs of improving appreciably. An additional expense of as much as $300 million due to an energy tax cannot be passed through to steel consumers under current market conditions and must be absorbed. Obviously, an expense of this magnitude could have disastrous consequences and we urge you to reconsider this option.

In addition, we understand that a 5% tax on corporate book income, i.e. income for financial purposes, is being considered. This is a dangerous precedent with far-reaching implications and it should be put aside immediately until the consequences of such an action can be thoroughly examined.

Finally, we note that the 15% corporate minimum tax in some form is once again being considered. We hope that some day this provision, which epitomizes unsound tax and economic policy, will be gone forever. Until that time, please do not make matters any worse by resurrecting the ill-conceived minimum tax advanced by the Administration in early 1982.

If there is to be a tax bill, we would hope you might find creative ways to assist the industry through these extreme economic times rather than burden us with additional costs.

Sincerely,

Robert B. Peabody

Office of Government Relations
Robert G. Weymueller, Director
Fran DuMelle, Associate Director
1101 Vermont Avenue N.W. · Suite 402
Washington, D.C. 20005
(202) 289-5057

AMERICAN LUNG ASSOCIATION
The Christmas Seal People ®

DEFICIT REDUCTION

Statement of

Alfred Munzer, M.D., Chairman
Government Relations Committee

American Lung Association

to the

Finance Committee
United States Senate

December 14, 1983

The projected momentous federal deficits which have every prospect of spiralling out of control would distort every aspect of the U.S. social policy agenda, including health. The American Lung Association, this country's oldest voluntary health association, believes it is essential to keep in mind as our federal leadership considers the range of options for dealing with this overriding public problem that health care, especially for the poor and the elderly, has already been cut inordinately. Entitlement programs such as Medicare and Medicaid have proven handy targets for constant retrenchment, ironically at the very time the eligible populations are on the increase. This nation should keep in mind the rapidly aging population and adopt policies accordingly.

This aging trend is of particular concern to ALA because of its impact on our mission which is the prevention and control of lung diseases. Respiratory diseases constitute a devastating public health problem in the U.S., ranking third among the leading causes of death and sixth among conditions responsible for premature retirement or disability. The Chronic Obstructive Pulmonary Diseases (COPD) are among the most rapidly increasing of the 10 leading causes of death, having a 60% rate of increase between 1969 and 1978.

COPD comprises six unique diagnostic categories with various causes, some unknown. Current available medical therapies do not alter the disease process when initiated after significant impairment has developed. Treatment requirements for the patient with COPD are unavoidably complex and long term and involve many providers. There are many impediments to the health care needs of the COPD patient including availability of resources and financial restrictions. The ALA and its medical section, the American Thoracic Society, will be paying particular attention to ensuring that the newly activated Prospective Payment System does not end up penalizing penalyzing the COPD patient and others with chronic disease.

A major factor in the development of COPD is smoking. The most recent data provided by the Health Care Financing Administration indicates that in the population over 65 years or disabled there were approximately 255,000 hospital discharges recorded for patients with COPD. Reimbursement to medical providers for services to aged and disabled Medicare beneficiaries with COPD for FY 79 totaled $535 million. Of those 255,000 individuals with COPD, an estimated 80% were considered to have a tobacco-related etiology.

At the same time steps are taken to cut down our overall budget drain, we must move to improve and stabilize the financial picture facing Medicare. A variety of proposals to address these funding problems are being readied for submission by the Advisory Council on Social Security. Rather than addressing options which would reduce benefits, the ALA would like to focus at this time on the recommendation calling for an icnrease in the federal excise tax on cigarettes to be earmarked for the Federal Hospital Insurance Trust Fund under the Social Security Act. This step, in our opinion, would be only equitable given the overall drain on Medicare resources caused by smoking-related diseases (cardio-vascular lung cancer, emphysema, etc.) The latest cost estimate is placed at $4 billion annually for Medicare and $13.6 billion in health care cost generally.

As this Committee will remember, the ALA and its partners in the Coalition on Smoking or Health applauded your decision that ultimately resulted in the first increase in the cigarette excise tax in over 30 years. The eight-cent increase was a correct public policy step, even though the level of increase that would have compensated for the cost of living increase since 1951 would have been more than twice that amount.

The ALA supports an increase in the cigarette excist tax based on the concept of a "user" tax. An excise tax on specific products such as cigarettes, since this is not broadly based, will tend to be less regressive and less inflationary than other types of taxes.

The essential first step is to eliminate the "sunset" provision under TEFRA which would return the federal excise tax to a modest eight cents in FY 85. By increasing the amount of the tax at the TEFRA level a further increment of eight cents, experts with whom we consulted advised us that an approximate $4 billion in additional revenue would be generated annually.

In conclusion, a decision to raise the cigarette excise tax also would have important public health implications. Recent studies show that the elasticity of demand for cigarettes is in the range of 0.4. This means a 10% increase in price would decrease consumption by 4%.

Such an increase may not significantly affect the consumption of cigarettes among long-term adult smokers, but will affect teenagers and young adults--those persons not yet addicted to cigarette smoking. Most significantly, it has been shown that a change in price will affect whether one chooses to become a smoker.

Thus, as a first step, we urge you to repeal the sunset clause in TEFRA for the cigarette excise tax. Secondly, we urge careful consideration of the options for further increments in the excise tax on cigarettes.

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STATEMENT OF THE
AMERICAN SOCIETY OF INTERNAL MEDICINE
TO THE SENATE FINANCE COMMITTEE
FOR THE RECORD OF THE DEFICIT REDUCTION HEARINGS
December 12-14, 1983

The American Society of Internal Medicine (ASIM), a professional organization of physicians who are recognized as specialists in internal medicine, is pleased to offer suggestions to the Committee on the important task of reducing this nation's deficit.

The rate of increase in federal health expenditures in programs such as Medicare and Medicaid has contributed to present deficits and threatens to consume an ever increasing share of federal revenues in the future. ASIM has spent considerable time and resources in recent years studying the reasons behind the rapid escalation in health care costs and developing recommendations for making the system more cost effective.

The Society believes that the current incentives inherent in this system must be changed to reward physicians and patients for keeping patients out of the hospital or deciding not to use expensive technology and for more carefully considering the need for medical services. Our specific comments follow:

RECOMMENDATIONS

1. Limit Tax Exemption for Employer Provided Health Insurance and Mandate Appropriate Standard Benefits.

ASIM supports in concept the administration's proposal to limit the tax exemption of employer contributions to employee health insurance plans, but strongly urges that the proposal be modified by Congress to require standard benefits. A tax cap has the potential to encourage consumers to select more cost effective insurance plans, by eliminating the inappropriate and expensive tax subsidy for inflationary "first-dollar" insurance coverage. On the other hand, as opponents of the tax cap have pointed out, a cap by itself could result in the elimination of coverage for services that save money, such as preventive care and early diagnosis and treatment, while more costly hospital and surgical benefits would remain intact.

Therefore, ASIM believes that the administration's proposed tax cap must be combined with appropriate legislation to require employers to offer outpatient, preventive, and catastrophic benefits as a condition of tax deductibility of their contributions to health insurance plans. This would accomplish the administration's goal of encouraging the selection of plans with increased cost sharing, but would eliminate the risk that necessary and cost effective benefits would be dropped. Instead of dropping necessary benefits, employees, employers, and insurers would have an economic incentive to respond to the tax cap by developing health insurance plans with more patient cost sharing, which in turn would encourage patients and physicians to more carefully consider the need for tests and services. Under this alternative proposal, the average level of health insurance protection would actually be improved for those individuals that currently lack adequate benefits. The result would be to move the current system away from first-dollar coverage to the ideal form of insurance protection--one which provides comprehensive benefits, but requires individuals to share in some of the cost of their medical care.

Such a system would also be more fair then the current system. Because self-insured individuals and employees of small firms often receive most of their income in the form of taxable wages, rather than non-taxable health insurance benefits, they indirectly subsidize through higher taxes the more comprehensive group health insurance plans purchased by employees of larger firms. A tax cap coupled with standard benefits would reduce this unfair subsidy.

There is ample precendent in tax law for establishing federal standards as a condition for a special tax treatment. For example, federal law requires pension plans to meet certain congressionally mandated standards, in order for the employers' contribution to be tax deductible. It is equally reasonable for Congress to require certain basic benefits as a condition for special tax treatment of health insurance benefits. Those employers or employees who do not wish to include the standard benefit package would be free to do so, but this choice would no longer be subsidized by the tax system.

A limitation of this tax subsidy would have the important added benefit of producing substantial increased tax revenues, leading to a lower federal deficit. The administration has estimated enactment of the proposal would result in $21.1 billion in increased revenues in FY '84-'87. In addition, the Advisory Council on Social Security has recommended that such a limitation be adopted.

For these reasons, ASIM strongly supports enactment of the proposed tax cap and appropriate standard benefit requirements to encourage individuals to select health insurance plans with adequate benefits and appropriate levels of patient cost sharing.

2. Mandate Improved Medicare and Medicaid Cost Sharing and Expand Protection for Catastrophic Illnesses.

ASIM supports the administration's proposal to provide Medicare catastrophic coverage and to improve Medicare cost sharing. The Society recognizes the savings potential this proposal holds for the Medicare program. The administration has estimated its proposal would save $4.93 billion in FY '84-'87.

Our House of Delegates--which is composed of democratically elected internist leaders from throughout the country--has been on record since 1975 as favoring national health insurance to cover the medical costs of catastrophic illness. The administration's proposal is a significant and welcome step towards this goal.

The Society also strongly supports increased cost sharing for all health insurance plans, including Medicare. Under current law, Medicare beneficiaries and physicians have little or no economic incentive to carefully consider the necessity of each day of hospitalization, once the $350 deductible is satisfied. Our members are aware of many instances where patients could be discharged from the hospital a day earlier, or could be treated in the physician's office or at home rather than in the more expensive hospital setting. However, often these patients remain in the hospital for reasons of convenience--or because it costs the patient more out-of-pocket for the physician to treat him or her on an outpatient basis. Improved Medicare cost sharing in the form of co-insurance for the first sixty days of hospitalization would create a clear incentive for patients and physicians to determine the need for each day of hospitalization solely on the basis of medical factors. ASIM is aware, however, that the widespread availability of supplemental insurance plans that cover Medicare's deductible and co-insurance amounts is counterproductive to the goal of increased cost sharing. Although we have no specific recommendations at this time for addressing this problem, we believe that it requires study by Congress.

ASIM recognizes that considerable concern has been expressed about the burden increased cost sharing will place on beneficiaries. Although we do not necessarily agree that the administration's proposal for most beneficiaries is excessively burdensome, we would urge Congress to consider modifications in the plan to broaden its appeal, rather than rejecting it out of the hand. One option would be to reduce the $350 Part A deductible, but increase the amount of per diem co-insurance required during the first sixty days of hospitalization. This would result in improved Medicare protection for the first day of hospitalization, which is now paid entirely by the beneficiary. Many beneficiaries with short hospital stays could be expected to be better off under this proposal than under current law, despite the increased per diem co-insurance requirements. It would at the same time encourage physicians and patients to consider cost-benefit factors during the very early days of hospitalization.

A second option is to base the amount of increased co-insurance on beneficiaries' income. This would assure that economically disadvantaged individuals are not unduly penalized by co-insurance requirements. The Congressional Budget Office has reported that this option is administratively feasible (Containing Medical Care Costs Through Market Forces, May, 1982).

Some argue that cost sharing and other proposals to influence physician and patient behavior are no longer necessary, since DRGs and prospective pricing will create sufficient incentives for efficiency. ASIM does not agree. Prospective pricing offers direct economic incentives to only one actor in the health care system: the hospital. However, the hospital, by itself, cannot control how many tests a physician orders on how long a patient stays in the hospital--nor should it. The type and frequency of services rendered will continue to be decided primarily by the patient and the physician. Therefore it is essential to create incentives to alter physician and patient behavior--by making patients and physicians more conscious of costs.

In summary, ASIM strongly supports increased cost sharing for Medicare Part A, and urges enactment of the administration proposal with appropriate modifications, if necessary. The Society also supports the administration's plan to mandate modest co-payment by Medicaid beneficiaries. We believe that modest co-payment will lead to greater cost consciousness on the part of Medicaid patients and physicians, without placing an undue economic burden on poorer citizens.

3. Increase Federal Excise Taxes on Alcohol and Tobacco.

In view of the large body of evidence that individuals who abuse alcohol and tobacco generate higher health care costs (thus increasing Medicare expenditures), ASIM believes that it is reasonable to expect these individuals to contribute a relatively larger share of the program's revenue. The Society also believes that this approach is fairer and more equitable than raising payroll taxes across the board, a likely alternative for obtaining increased revenue for the Medicare Trust Fund.

The administration has estimated that increasing the excise taxes on these products by 100% will yield $24.686 billion in increased revenues during FY '84-'87.

4. Enact a Temporary Freeze in the Medicare Economic Index.

In previous testimony and statements, ASIM has called for repeal of the economic index. We continue to believe that the index does not accurately reflect phyicians' actual overhead costs and that repeal is merited.

However, in view of the current economic climate, the need to reduce federal budget expenditures, and the importance of fairly and equitably spreading the burden of budget cuts, ASIM supports a temporary freeze in the economic index for one year or less. The administration estimated such a measure could save $700 million in one year. It is our belief that at a time when all citizens are being asked to sacrifice, physicians must also do their share and voluntarily accept relatively less reimbursement for some services. To assure that the shortfall in reimbursement resulting from the temporary freeze is not inappropriately passed on to beneficiaries, ASIM has urged our members to be sensitive to the economic situation of their patients in responding to the temporary freeze.

It must be recognized that a freeze in the economic index is at best a stop gap measure that does not address the underlying reasons for cost escalation. We strongly urge Congress not to rely on arbitrary caps and ceilings on physician reimbursement in lieu of long term reform. Our recommendations for long term reform in the physician reimbursement system are discussed later in this statement.

While ASIM supports a temporary freeze in the Medicare economic index, the Society strongly opposes any modification of the current individual assignment option. The Society strongly believes that the current option is in the best interest of patients, physicians and the Medicare program. The flexibility inherent in the individual assignment option permits the physician and the patient to decide what billing arrangement best meets the individual patient's needs and desires. Many physicians, for example, routinely accept Medicare assigment for lower income beneficiaries, or for patients that have accrued large medical care bills, but do not accept assignment on services rendered to wealthier beneficiaries or in cases where the out-of-pocket expense to the patient is relatively small. Many internists have reported that by being able to bill wealthier beneficiaries the full fee, they can afford to accept assignment on poorer and sicker beneficiaries.

ASIM opposes mandating assignment, all or nothing assignment as well as "participating physicians" arrangements for Medicare. Under the latter arrangements, a freeze on the amount of reimbursement to patients of physicians not willing to participate by accepting assignment on all claims would apply for a longer period of time than for those physicians willing to participate. Such a system is punitive in its effect on those patients whose personal physicians do not participate. In addition, it should be noted that savings to the Medicare program attributable to the physician charge freeze would be reduced under such a participating physician proposal as compared to an across the board freeze.

ASIM is also opposed to the establishment of a fee schedule for clinical laboratory services. There is no rational basis for establishing such a schedule at 60 percent of the Medicare prevailing rate as has been proposed in the Omnibus Budget Reconciliation Act of 1983 (S. 2062). This proposal to establish fee schedules on a carrier wide basis fails to take into account the different ways that laboratories do business with physicians which naturally result in different costs. For example individual labs differ in the way they process claims and bad debts. In addition there are differences in the quality of laboratory services available. This proposal, by not taking these differences into account, could result in a chilling effect on the ability of physcians to assure quality laboratory service for their Medicare patients.

5. *Enact Legislation Providing for the Development of Legislative Proposals to Reduce the Disparity Between Payment Levels for Physicians' Cognitive and Procedural Services.*

As noted previously, ASIM believes that, in general, the administration's 1983 Health Incentives Reform Program is a step in the right direction towards bringing about positive "incentive based" reform in the health care system. However, the administration's plan fails to address one of the key reasons behind the growing cost of medical care: the current bias in the reimbursement system for high cost technological and surgical procedures. Under the current system, a physician who orders an expensive array of technology intensive diagnostic services will be compensated at a higher level. A physician who conducts a detailed patient interview, and then makes a considered decision to send the patient home or to not utilize certain diagnostic procedures, will be paid far less. A recent study funded by the Health Care Financing Administration (HCFA) shows that on average office visits are undervalued (or surgical procedures overvalued) by four to five-fold under current Medicare allowances. This disparity fuels the demand for high cost procedures, and discourages cost effective personalized and caring services.

ASIM has been working with business, labor, third party payors, and other medical organizations to develop alternative reimbursement systems that would correct this disparity. A number of medical organizations--including the American Academey of Family Physicians, the American Academy of Pediatrics, and the American Psychiatric Association--have expressed agreement with this principle.

The Society commends the Finance Committee for including a provision in the Omnibus Budget Reconciliation Act of 1983 (S. 2062 Section 164) which would direct the Office of Technology Assessment (OTA) to conduct a study examining any imbalance in payments to physicians for cognitive versus technical services. ASIM strongly believes that a new system for determining allowances--one that eliminates the current technology intensive bias--will result in major cost savings, by not penalizing physicians who elect <u>not</u> to perform high cost procedures.

6. Enact Legislation to Develop Mechanisms to Base Allowances for New Procedures on the Resource Costs Required to Perform the Procedure.

As a starting point for developing a "technology neutral" system, ASIM believes that changes should be made in the way that reimbursement allowances are determined for new procedures. New procedures are those technological procedures that are at the point where they have moved beyond the strictly developmental and experimental stages and are beginning to become more widely accepted and utilized by larger numbers of patients and physicians. Under the current reimbursement system, charges for new procedures generally follow the fees set by those physicians who initially pioneer the procedure. Because those physicians have invested considerable time and resources in developing and performing the procedure, their charges appropriately are set at a relatively high level that reflects the extraordinary resource costs and risks required to provide the service. However, as the procedure becomes more widely practiced, the costs and risks of providing the services generally decrease.

Unfortunately, even as the costs decrease, the prevailing charges usually remain at the initially high level established by those physicians who first pioneered the procedure.

The result is that reimbursement allowances remain at artificially inflated levels years after the procedure enters the marketplace.

ASIM again commends the Committee for including in Section 164 of S. 2062, the Omnibus Budget Reconciliation Act of 1983, a directive to OTA to include, in its study findings, recommendations on adjusting Medicare allowances to physicians to reflect decreases over time in costs and risk of new technology and procedures.

Such adjustments can potentially result in considerable federal savings. For the first time, reimbursement allowances will be linked directly to the cost of providing a service. Instead of constant increases in prevailing charges, allowances would gradually decrease. Each time the procedure is performed in subsequent years, Medicare and other third party payors would save money over what would now be paid under the current reimbursement system.

CONCLUSION

The preceding recommendations, if adopted by Congress, would reduce the federal deficit a minimum of $51.416 billion (FY '84-'87), based on projections by the administration and other sources. Substantial additional long-term savings can also be expected to result from the development and implementation of concrete proposals to reduce the disparity in reimbursement between physicians' cognitive and procedural services and to base allowances for new procedures on resource costs.

Effect (in billions) of ASIM's Recommendations
on the
Federal Budget Deficit

Limit Tax Exemption on Employer Contributions	$21.1 (FY '84-'87)
Improve Medicare Cost-Sharing	$ 4.93 (FY '84-'87)
Increase Alcohol and Tobacco Excise Taxes by 100%	$24.686 (FY '84-'87)
Enact One Year Temporary Freeze in Medicare Economic Index	$ .700 (FY '84)*
Reduce Disparity Between Cognitive and Procedural Services	**
Base Allowances for New Procedures on "Resource Costs"	**
TOTAL	$51.416 (FY '84-'87)

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*Based on administration estimate for FY '84. Estimate for 1985 not yet available.

**Savings projections not available at this time.

ASIM looks forward to continuing to work with the Committee in the future as it takes on the important task of reducing federal deficits.

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DEFICIT REDUCTION STATEMENT

by Leon Shull

National Director

Americans for Democratic Action

before United States Senate Committee

on Finance

December 12, 1983

BUDGET PROPOSAL

Americans for Democratic Action appreciate the opportunity to present its views on the federal deficits, and its recommendations for legislative action to sharply reduce them. My name is Leon Shull and I am the National Director of ADA.

We commend the Committee for holding these hearings for we believe those huge, unprecedented deficits pose an ominious threat to the capability of our federal government to meet the legitimate needs of our nation in a broad range of social, welfare and economic domestic, as well as international programs. Bolstering existing measures to keep them current with a growing service demand brought on by high unemployment, expanding population and higher prices will be difficult in the face of record breaking deficits. Clearly, far more difficult will be any effort to initiate long-delayed, and urgently required legislation in health, housing, infrastructure repairs, job creation, international economic assistance and other equally important areas.

Moreover, the present giant budget deficits foster a highly restrictive monetary policy that result in excessive interest rates that seriously harm our economy at home and drastically worsen our trade imbalances leading to severe unemployment in interest-sensitive industries and those engaged in export trade.

The expert witnesses who have already testified before your committee have clearly identified the roots of the federal deficits. Essentially they agree the single dominant cause was the Reagan Administration's 1981 Tax Economic Recovery Act which so drastically and inequitably reduced tax revenues over five years. The enormous loss of some $750 billion was offset, far too little, by the approximate $100 billion levies of the Tax Equity and Fiscal Responsibility Act of 1982.

A second major contributing factor was the deep recession, brought on by misguided supply-side economics and monetary policies.

Third, was the almost doubling of defense outlays from their 1980 level of $136 billion to about $250 in 1984 -- a staggering rise of $114 billion which ADA considers grossly excessive in light of our military power. Indeed the ability of our defense forces to effectively use such huge additional funds is highly questionable. (Proposals by this Administration for future defense spending continue the trend of sharp escalation in military expenditures -- a policy ADA staunchly rejects as unnecessary and even dangerous to U.S. security.)

Fourth, interest on the debt generated by the record deficits adds to that imbalance between outlays and revenues. Net interest in 1980 amounted to \$53 billion. Under the policies of this Administration, deficits will aggregate some \$800 billion for the years 1981 through 1985 -- a total greater than the combined deficits of every president from Washington through Carter. Net interest for FY 1985 -- will be about \$114 billion -- more than \$60 billion, greater than the 1980 figure. With the prospect of a continuation of \$200 billion deficits, net interest payments will continue their sharp upward trend.

In view of this widely-shared analysis of the factors which were responsible for rapid and huge growth in federal deficits, the ADA recommends the following actions:

1. <u>Tax Reform</u>

ADA supports the repeal of the indexing of tax brackets adopted in the 1981 law to become effective in 1985. The budget picture, and the urgency to preserve the government's capacity to meet its needs adequately dictate the repeal.

Secondly ADA supports a major reform of the tax loopholes and special tax preferences which cost the Treasury hundreds of billions each year. Overwhelmingly these tax expenditures benefit wealthy individuals -- those in the top 15 percent of taxpayers and the most powerful, richest corporations. Among the major revisions Congress should adopt are the following:

o Personal Income Tax -- The 1981 tax legislation slashed billions from personal income taxes in a grossly inequitable manner. Fully 35% of the saving went to taxpayers with $50,000 yearly income -- a group comprising only 6% of the total. ADA supports setting a $700 cap on the tax savings any taxpayer gained from the last installment of 10% tax reduction put into effect in July 1983. Such a cap permits the full tax saving to go into effect for about 85% of all taxpayers -- those with income below approximately $45,000 a year, and yields $6-$7 billion per year.

o Oil and Gas -- The oil depletion allowance, the windfall profits tax, and the expensing of intangible drilling costs will cause the Treasury to lose from $18 billion to $24 billion in the 1984-1986 period.

o Foreign Tax Credit -- These dollar-for-dollar tax credits against a multinational company's U.S. income tax liability encourage U.S. business to produce abroad, and sharply reduce taxes paid in this country. The tax credit should be changed to a tax deduction, which could yield some $10 billion in revenues each year.

o Domestic International Sales Corporations (DISC) -- These are special "paper" corporations with no employees or actual operations. The DISC device enables corporations to defer, perhaps indefinitely, taxes on export profits. Ending this foreign tax subsidy would result in an $8-billion saving from 1984 through 1986.

o Investment Tax Credit -- This tax credit for investment in business equipment, combined with depreciation allowances, often results in a zero or negative tax rate on income from new investments. Congress mitigated these projections somewhat in the 1982 TEFRA, but if the credit were cut back from 10 percent to its previous 7 percent, $5.6 billion would be raised in FY 1984, and $20.9 billion in the 1984-1986 period.

o Taxation of Banks -- There is no minimum tax on banks. As a result, the 20 largest commercial banks paid taxes equal to only 2.3 percent of their average income in 1981, according to a study by the Joint Committee on Taxation. This is grossly unfair.

o Capital Gains -- The 1981 law gave further tax breaks to those with gains from sale of stocks, bonds and real estate. Also permitting the avoidance of any tax when such assets are passed on to their heirs violates tax equity. This exclusion should be ended, and a return to the pre 1981 exclusion rate of 50% of other capital gains should be restored. These changes would yield revenues of $8-$10 billion per year.

o Inheritance and Gift Taxes -- The sharp reduction in these taxes in the 1981 law should be repealed. The new provisions virtually wiped out revenues from these sources, with a loss of $3-$5 billion per year.

o Business Entertainment -- The "three-martini lunch" tax break allows businesses and individuals to deduct from taxable income the full amount spent on meals and entertainment. Ending this fringe benefit would bring in $3.1 billion by FY 1986.

This is only a partial listing of the dozens of preferences and tax expenditures which annually cause enormous losses to the Treasury. These windfalls were justified by the Administration as incentives to invest. But as a Newsweek article observed, "Companies appear to be using their increased cash flow (from tax windfalls) for everything but more plants and equipment."

The misguided economic policies that brought on the worst recession since the great depression were accompanied by a highly restrictive monetary policy with excessive interest rates. On the domestic front, the results of exhorbitant interest were devastating to tens of thousands of small businesses, to farmers and to such other interest-sensitive industries of housing and auto. The damage they suffered in so many cases was permanent. High interest rates have also had another depressing impact on the economy. They have been responsible for the huge flows of foreign currencies and the resultant overvalued dollar. So distorted a relationship between the dollar and other countries' currencies, means far higher imports and lower exports as American producers are at a distinct competitive disadvantage. In summation, the trade inbalances in the $60-$80 billion range account for the layoff of hundreds of thousands of American workers.

The intolerably high unemployment levels -- which are expected to persist at 7 1/2-8 percent for another year, exact a heavy toll on the budget. Outlays linked to unemployment must cost the Treasury an additional $7-$8 billion for each 1 percent of unemployment while tax receipts fall by some $22 billion. The net impact of $30 billion added to the deficit provides strong evidence that programs to help create jobs would be of great benefit to the economy, to workers affected, and, the budget.

The first step must be a renewed national commitment to full employment. The Humphrey-Hawkins Full Employment and Balanced Growth Act is still on the statute books. Yet this Administration ignores its responsibility under the Act to develop a program and a timetable for reducing unemployment to 4 percent.

Finally, we are concerned that a series of valuable, essential programs are endangered by the Administration's intention to ask for irresponsible reductions -- in the name of fiscal responsibility.

Budget cuts in the budget set forth and pushed through by this Administration have decimated hundreds of worthwhile domestic programs, eliminated many providing useful services, and reduced benefits in areas serving the nation's neediest such as food stamps, welfare, housing, education, employment and training, women and children's nutrition. We in ADA are deeply disturbed by these harsh, inhumane actions in programs where constituents, because of their disadvantaged circumstances, are unable to lobby effectively to preserve the protections and assistance built up over the years.

We are also deeply disturbed by the growing number of proposals concerning social security, medicare and medicaid programs as potential sources of savings that would help reduce the deficit. We strongly object to this approach and the implications of such proposals.

To begin with the social security fund is now on sound financial footing. Steps to cut benefits-without corresponding cuts in the payroll taxes which finance the current level of benefits is patently unfair. It would, in effect, impose an additional tax on the contributors to the fund - both employers and employees - with the proceeds to be used for reduction of the deficit. We have made our position clear, elsewhere in this statement, that ADA favors increased taxes that are fair, and progressive when the need for higher revenue exists. But we reject the back handed and regressive methods to raise taxes that is represented by changing social security benefit provisions to generate funds for budget reduction.

While medicare, unlike social security, will face a financial problem by the end of the decade, we urge a program of cost containment be instituted. We should not penalize beneficiaries now through either higher premiums, deductibles, or other cost sharing techniques. Cost containment is essential because health care is under the control of providers - doctors and hospitals - not the individual patient. The doctor must admit the patient to the hospital, prescribe the drugs, order the laboratory and other tests, and supplementary medical services.

Any attempt to meet the future financial problems by decreasing benefits or imposing additional financial hurdles on the patient, relieves the pressure for a system of controlling costs aimed at the providers.

As for medicaid, again, cost containment procedures should be instituted. Participants in medicaid are the poorest of the poor and any cuts in their already far from adequate protection would translate into loss of needed medical attention and care or impose new financial burdens on local governments concerned about responsibly looking out for the health of their poor.

From this review, it is abundantly clear, that Congress should act quickly and directly to remove the ominious threat which $200 billion plus deficits pose for the health of the economy and fulfilling government responsibilities. Continuation of deficits of that size spells continued high interest with its disastrous impact on the viability of countless companies and industries, unemployment, trade imbalances, and threaten to undermine important federal programs.

Statement

of

Theodore F. Brophy

Chairman and Chief Executive Officer

GTE Corporation

on behalf of

The Business Roundtable

Submitted to the

Committee on Finance

United States Senate

on

Deficit Reduction Proposals

December 12-14, 1983

Mr. Chairman, distinguished members of the Committee. My name is Theodore F. Brophy. I am Chairman and Chief Executive Officer of GTE Corporation. I serve as Co-Chairman of The Business Roundtable, Chairman of its Taxation Task Force and a member of its Federal Budget Committee. The Roundtable is an organization comprised of approximately two hundred chief executive officers representing corporations that invest billions of dollars of capital and provide millions of jobs in the American economy. I sincerely appreciate the opportunity to present to the Committee The Business Roundtable's views concerning the scope of the deficit problem, the urgent need for action and recommended courses of action for dealing with this difficult and unprecedented situation.

The Roundtable has for some time been deeply concerned about the high level, structural nature and trendline of projected federal budget deficits. Our organization has long been convinced that unless these deficits were placed on a decisive downward slope, they would siphon off large amounts of private capital from the financial markets, cause interest rates to rise and stifle economic recovery.

The inability of Congress and the Administration to successfully complete the budget process in 1983 has exacerbated the severity of the deficit threat and made the need for legislative action more urgent. It is entirely appropriate for this Committee to hold discussions at this time aimed at developing the best strategy for reducing future deficits so that it will be prepared to address the problem in early 1984. We can think of no more worthwhile project.

For a plan to succeed it must be multi-faceted, feasible, credible and supportable on a nonpartisan basis --- a difficult chore under normal circumstances and doubly so in a presidential election year.

While time is of the essence, the challenge is to establish a framework for solving this public finance crisis without sacrificing the important economic and fiscal policy gains of the last few years. Increased growth in capital formation and restoring U.S. competitiveness in world markets are key goals that we cannot lose sight of in our quest to place the federal government's financial books in order. The deficit problem will not be solved overnight, and it is our hope that the business community can be of assistance to Congress and the Administration in developing and implementing a successful, long-range deficit reduction program.

Budget Discipline Needs to Be Continued

The Business Roundtable has supported the Congressional budget process. It has been a positive contribution to budget discipline. We regret that the Congress has adjourned without having complied with the budget process provisions. Nonetheless, we believe that the process should be strengthened rather than weakened. We are transmitting to the Committee staff for your information and consideration a study and set of recommendations on the budget process that was prepared at the request of Chairman Domenici for the Senate Budget Committee.

Structural Deficit Must Be Addressed

The economic recovery that we are experiencing will go a long way toward closing the cyclical portion of the deficit gap. It will expand the tax base and provide additional tax revenues. Our first order of business, therefore, should be to assure that the recovery stays on course -- a far more efficient and effective way to close the deficit gap than tax increases. But continuation of the recovery is by no means guaranteed in today's uncertain economic environment.

Assuming that the recovery does continue for several years, however, we will still be left with a very substantial gap between estimated revenues and expenditures that must be addressed by the Congress -- this is the so-called structural portion of the deficit. The Roundtable believes that the major emphasis for closing this remaining gap must come from reductions in the growth of government spending. Toward this end, we issued a policy statement during the first quarter of 1983 citing five areas where essential savings could be achieved on the expenditure side of the budget, namely:

- Defense,
- Social Security,
- A freeze for twelve months of most non-defense discretionay programs,
- A permanent limit on cost-of-living adjustments for non-means-tested entitlements, and
- Additional long-range savings in medicare.

Unfortunately, only the first two areas noted were addressed to any significant degree during the first session of the 98th Congress. The budget process deliberations themselves made little headway in tightening spending in the other three areas. Renewed efforts must be made in that direction. The Roundtable believes that the major thrust of deficit reduction activity must be directed at the spending side of the budget. If sufficient success is achieved in that area, we would support revenue-raising to reduce the level of deficits more sharply and keep them trending downward on a year-to-year basis. Lower deficits would, of course, provide us with an automatic benefit in the form of lower interest charges in future years. However, until adequate restraint is placed on the spending side, we believe that revenue-raising should not be considered.

Dimensions of the Problem

Near-term, the recovery which began a year ago seems secure. The economy is rising strongly across a broad spectrum of American Industry, and this tide should carry through 1984. Consensus forecasts for 1984 put real GNP growth at about 5.5%. Long-term prospects, however, are not as clear cut. The Roundtable believes that the large federal budget deficits represent a major threat to the long-run health of the economy.

Now that a recovery is well established, the single most important issue facing the economy is the size of the projected budget deficit. Exhibit I shows the trend of federal revenues and expenditures over most of the postwar period as a percentage of GNP. The shaded area in the chart indicates the deficit.

Although there have been cyclical ups and downs in both revenues and expenditures over this period, the chart clearly shows that the trend of expenditures (as a % of GNP) has been upward over most of the postwar period. The long-term trend of tax revenues also appears to tilt slightly upward, and the large tax cuts, enacted in 1981, that have been so widely publicized, have been offset in part by large tax increases, including the one for social security, enacted during the past two years.

In order to take a closer look at these trends during major recovery periods, Exhibit II presents a comparison of three recovery intervals excerpted from Exhibit I. This chart has the advantage of eliminating some of the distortions caused by intervening cycles. It also presents a clearer picture of the underlying trends.

Exhibit II makes several important points:

- o Taxes as a percent of GNP in the present recovery appear to be roughly in line with the two earlier recoveries.
- o Federal spending as a percent of GNP, on the other hand, has ratcheted upward substantially compared to the experience of earlier recoveries.
- o The deficit as a percent of GNP has also become substantially larger over the succeeding decades. Moreover, in the present situation, the deficit is projected to remain unacceptably large even after three years of recovery. This suggests that the structural deficit is expanding rather than contracting.

<u>Large Deficits Distort Economic Horizon</u>

As the recovery progresses, these large structural deficits will distort the economy in two ways: first, they will cause interest rates to rise; and second, they will tend to "crowd out" private capital investment in new plant and equipment.

Large deficits during a recovery will contribute to higher interest rates either because of an increased demand for funds or because of renewed inflationary expectations. High interest rates tend to distort the recovery by depressing capital investment. They also contribute to the high value of the U.S. dollar in foreign exchange markets which tends to depress exports and favors imports.

The charts in Exhibit III illustrate some of these relationships. The first chart shows the magnitude of the deficit. The second compares the trend of interest rates and inflation. Although remarkable progress has been made toward reducing inflation, interest rates have remained relatively high, and, in part, have started moving upward again toward the end of 1983. Obviously, many factors influence the level of interest rates, however, I believe that the large current and projected budget deficits are definitely a significant contributory factor.

Many economists have argued that the large budget deficits are responsible for keeping long-term interest rates two-to-three percentage points higher than they would otherwise be. Or put another way, if Congress and the Administration acted decisively, and with credibility, to lower projected deficits, then long-term interest rates should be expected to fall by two-to-three percentage points, particularly if inflation remains relatively low.

High interest rates, in turn, have contributed to the high value of the U.S. dollar, which is shown in the third chart, by attracting a massive inflow of foreign capital into the U.S. to take advantage of the relatively high yields on dollar investments. The combination of high interest rates and the high value of the U.S. dollar have had a sharply negative effect on the U.S. trade balance. The trade deficit has deteriorated steadily since mid-1980, as shown in the fourth chart, corresponding almost exactly in timing with the rise in the value of the dollar. It has been estimated that at least one million jobs have been lost in the U.S. due to the deterioration in the trade balance. These losses have been particularly acute in the manufacturing sector, in basic industries, such as steel, autos and farm machinery.

In addition to the trade deficit, the high value of the dollar combined with high interest rates represents a growing threat to capital investment in American industry. The construction of new industrial plants in the U.S. is still in a downtrend, a full year after the recession has ended, as shown in the fifth chart.

The large deficits represent a vicious cycle in that the interest payments on the debt have now crossed the $100 billion level, as shown in the sixth chart, and are still rising. The CBO baseline projections show the net interest bill climbing to $178 billion in fiscal year 1989 with the assumption of declining interest rates. If rates remain constant, the net interest cost will be well over $200 billion by the end of the decade. Unless we change the course of forecasted deficits and put it on a downward path, we will be leaving future generations with an enormous debt load to shoulder.

Large Deficits Place Greater Burden on Monetary Policy

Deficits generally tend to crowd out spending for investment more than spending for consumption. The federal government has taken about 60% of all funds raised in the credit markets during fiscal year 1983, up from 33% during fiscal years 1980-1981 and 49% during fiscal year 1982. To place this problem in perspective, a look at the period 1973-1979 reveals that federal participation in the credit markets averaged about 25%.

While it is possible that personal savings could provide adequate funds to satisfy both private and public financing needs, this seems unlikely in view of the enormous size of the projected deficit. Total net savings of the private sector has averaged only about 7% of GNP over the past twenty-five years and is currently running at 6% of GNP. Obviously, with the deficit accounting for about 5% of GNP, most of the available savings will be absorbed by the deficit and there will be very little left for capital formation beyond replacement needs which are satisfied through depreciation.

Large deficits also increase the risk of an early end to the recovery. The deficits make it more difficult for the Federal Reserve to control money supply growth. They also place a greater burden on monetary policy as the only instrument for controlling inflation. A premature or excessive tightening of monetary policy could abort the economic recovery or, alternatively, a failure to tighten adequately could lead to another round of high inflation.

Revenue Increases

The Roundtable has tried to maintain an open mind during the past two years toward the subject of tax increases, provided that such increases were essential to assure a strong, credible, downward trajectory in projected deficits. At the same time we made it clear that we were not advocating tax increases in isolation and did not believe that the revenue side should bear the heaviest part of the burden in the quest to close the deficit gap.

It is imperative that the central focus of deficit reduction be directed toward restraining the growth of government spending, particularly in those areas where expenditures have been on "automatic pilot" with little or no control by the Congress or the Administration. Until spending is properly addressed for fiscal year 1984 and beyond, the Roundtable believes that it is premature to discuss initiatives to increase revenue collection.

Since continuing large deficits may lead to "crowding out", it is important to note that spending reduction is a far more effective and efficient way of alleviating "crowding out" than a tax increase. Furthermore, an <u>income</u> tax increase, as opposed to a <u>consumption</u> tax increase, may be self-defeating in this context because it would tend to reduce savings.

Congress recognized the need in 1981 for a greater emphasis in our tax laws towards capital formation and productivity growth. Unless our nation modernizes its industrial plant and continues to dedicate substantial funds to research activities, our economy will not maintain its competitiveness on a worldwide basis. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), unfortunately, eroded about half of the capital cost recovery incentives enacted in 1981 before they had even had a chance to take effect on the economy. Business received a small share, between 20%-to-25%, of the total benefits enacted in the Economic Recovery Tax Act of 1981 (ERTA), but wound up with a large share, well over 50%, of the total TEFRA tax increase in 1982.

Business will also participate heavily in meeting the increased tax burden generated by the Surface Highway Assistance Act and the Social Security Reform Act. Tax increase legislation has dominated the Congressional agenda for the past two years. It is our firm hope that the capital formation incentives remaining from ERTA will be left in place since we believe they are critical to sustained economy recovery. Capital formation is essential for productivity growth and international competitiveness. Many of our trading partners focus more on consumption-oriented taxes that can be used to improve their balance of payments picture and do not penalize savings and investment activity as severely as direct income taxes. Future deliberations concerning revisions to our tax laws must take into consideration the international trade situation as a key variable.

Assuming that the growth in spending can be sufficiently restrained and the deficit is narrowed through a strong economic recovery, it still appears that new long-term revenue sources will be needed for the fiscal years 1986-1988 time frame if our goal is to eliminate deficit financing and achieve a balanced budget. This Committee will, of course, play a critical role in determining the outcome of the coming debate on the most appropriate long-range national tax policy.

Major structural changes to our tax laws should not be enacted without careful study, public education and Congressional debate. The complexity of the tax system and its bias against savings and investment, as opposed to consumption, dictate thorough review by the Congress before any major revisions are initiated. Our organization would certainly hope that major structural changes to the tax cycle in the future would:

- o Increase the flow of funds for savings and investment.
- o Strengthen U.S. export trade.
- o Provide a less complicated set of tax rules.
- o Plan for a smooth transition from current standards.

The outcome of the debate on long-range tax policy will have a critical impact on he overall future health of the economy. Since the future pattern of jobs, productivity and real incomes are at stake, it is essential that Congress exercise the utmost vision and care in any major restructuring of the tax system.

In Conclusion

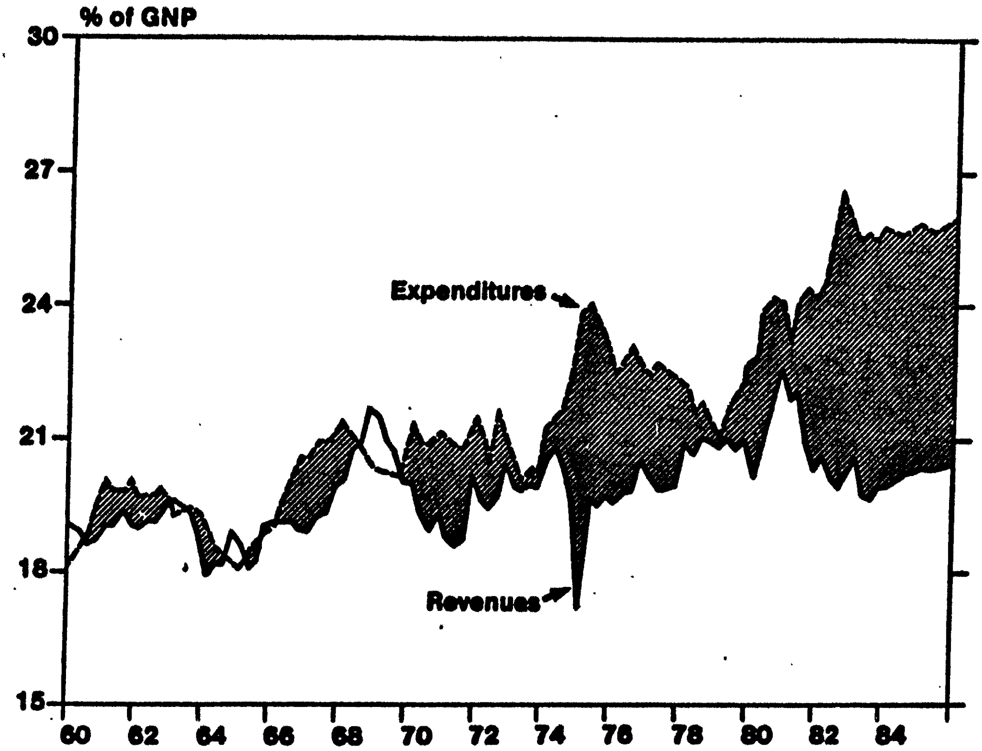
Current forecasts show budget deficits continuing to remain unacceptably high. Even with a vigorous economic recovery, we will still be faced with a large structural deficit. Delaying action to place projected deficits on a downward trend until after the 1984 Presidential election would greatly increase the risk of a premature end to the economic recovery.

Lower projected deficits would enable us to pursue a less stringent monetary policy, allow interest rates and the value of the dollar to come down, encourage capital formation and improve our competitiveness on a worldwide basis. Lower interest rates provide the double benefit of reducing the cost of servicing the national debt, thereby creating additional deficit savings.

The most effectve way to reduce projected deficits and assist economic recovery is to reduce the growth in government spending. While no area of the federal government should be free from scrutiny for savings, the central focus should be directed toward restraining the growth of government spending in those areas where expenditures have been on "automatic pilot" with little or no control by Congress or the Administration. The budget process needs to be strengthened and all resources allocated on a more efficient basis.

EXHIBIT I

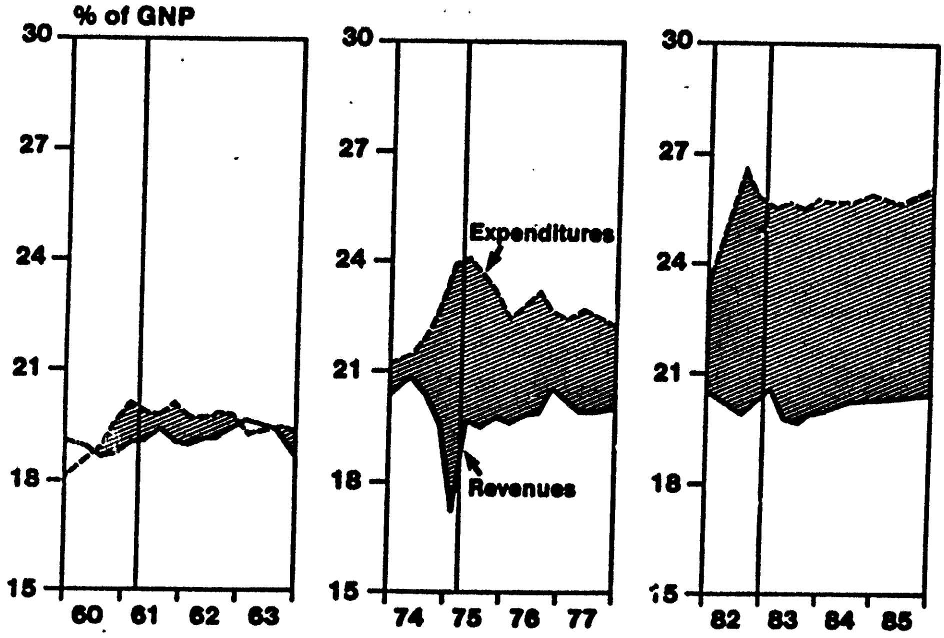
ANALYSIS OF GOVERNMENT SPENDING AND TAX REVENUES AS A PERCENT OF GNP



Source: Data Resources, Inc.

EXHIBIT II

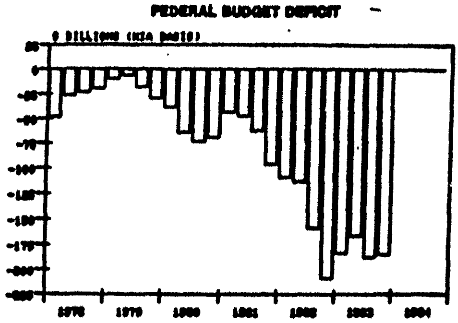
ANALYSIS OF GOVERNMENT SPENDING AND TAX REVENUES AS A PERCENT OF GNP



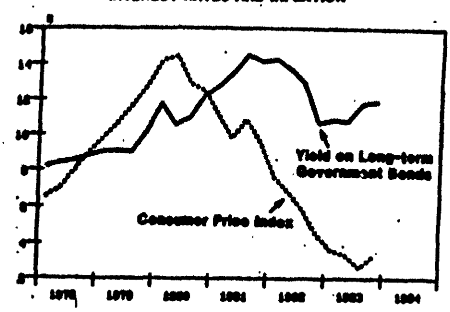
(Vertical Lines Represent Recession Troughs)
Source: Data Resources, Inc.

LARGE DEFICITS AND RELATED AREAS OF CONCERN

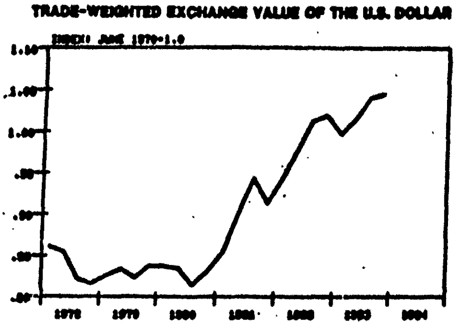
FEDERAL BUDGET DEFICIT



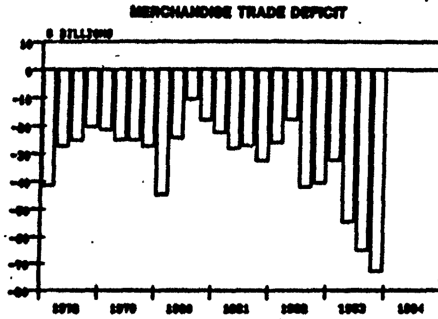
INTEREST RATES AND INFLATION



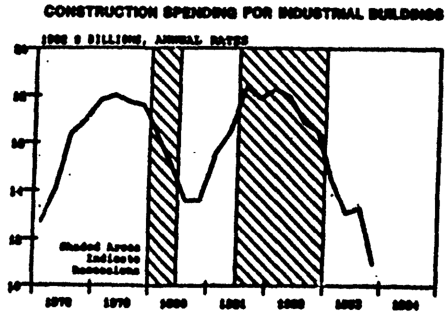
TRADE-WEIGHTED EXCHANGE VALUE OF THE U.S. DOLLAR



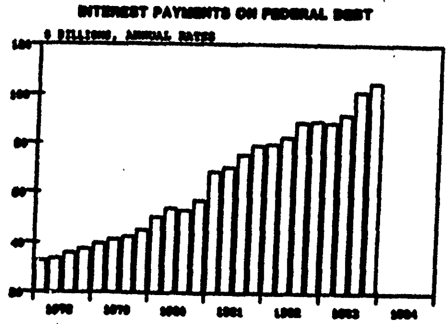
MERCHANDISE TRADE DEFICIT



CONSTRUCTION SPENDING FOR INDUSTRIAL BUILDINGS



INTEREST PAYMENTS ON FEDERAL DEBT



ROUNDTABLE REPORT

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New York, N.Y. 10166
(212) 682-6370

1826 L Street, N.W.
Washington, D.C. 20036
(202) 872-1260

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ROUNDTABLE OPPOSES FASB'S PROPOSED DRASTIC CHANGES IN PENSION ACCOUNTING RULES

A company's earnings, borrowing capacity, cash management and labor relations could be dramatically and adversely affected by proposals of the Financial Accounting Standards Board (FASB) with respect to accounting for pensions and other postemployment benefits. On the basis of that conclusion, reached by its Accounting Principles Task Force, the Roundtable is strongly opposing the proposals and urging its member companies to do the same.

Roger B. Smith, Chief Executive Officer of General Motors and Chairman of the Task Force, expressed the Roundtable arguments against the proposals in a detailed letter to FASB. "In view of the acknowledged complexities and subtleties of the accounting for pensions and other postemployment benefits, we were both surprised and dismayed," he wrote, "to note the revolutionary changes suggested... We see no justification in scrapping this (current) process in favor of a technique that would measure cost as the difference between two ill-defined liabilities...We believe the Board should have approached this from the standpoint of improved disclosure rather than make radical changes in basic financial statements."

Issues involved in the proposals center around the Board's expressed view that pension costs should be attributed to periods during which employee services were rendered and that costs attributed to prior services should be recognized as a liability. The Roundtable's basic conclusion, simply put, is that the cost of a pension plan -- and amendments to it measured by prior service -- should be allocated on a systematic and rational basis to the current and future periods benefitted by the ongoing work force. A pension liability should be recognized on the employer's balance sheet only to the extent that allocated pension costs are not paid or funded.

The Task Force's letter of comment urges that the FASB proceed more cautiously before making any radical changes to employers' accounting for pensions and other postemployment benefits: "The private American pension system has functioned quite well and is very sound. The proposals represent a step backward in the area of fair financial reporting as they would tend to confuse rather than enlighten the reader."

NEW BOOK PROPOSES CHANGES TO IMPROVE RESULTS OF PRESIDENTIAL APPOINTMENT PROCESS

The problems and controversies that have surrounded the recruitment of personnel to serve in Cabinet and sub-Cabinet level jobs in the Federal Government are a familiar part of recent history. Personnel recruiters for President Reagan -- and for some former presidents as well -- have asserted that many of their best prospects were discouraged from accepting government appointments because of the legal hurdles and financial and career sacrifices involved.

In order to address these problems, The Business Roundtable Employee Relations Committee, chaired by Frank P. Doyle, Senior Vice President, General Electric

Company, provided a grant for a study of the Presidential appointments process. The study was conducted by the National Institute of Public Affairs, an affiliate of the National Academy of Public Administration. The Academy is a bipartisan group of public administration experts and former public servants.

Results of the study have now been published in a book entitled America's Unelected Government: Appointing the President's Team. The authors are John W. Macy, Bruce Adams, and J. Jackson Walter, who have had extensive experience in government, the private sector and academia. G. Calvin MacKenzie, who has written widely on the Federal executive branch's personnel problems, was a consultant on the project.

The book is based on the fact that the leadership positions in the Federal Government -- cabinet and sub-cabinet jobs -- are filled by executives, lawyers, professors, and financiers who move between government and the private sector. It concentrates on how they are chosen, recruited, appointed and confirmed. One of the points it makes is that the two-way transition between the public and private sectors should be facilitated.

"There are too many interests, passions and considerations involved in choosing a cabinet for it to be a genteel endeavor," the authors write. "But it is the President's responsibility to appoint men and women whose competence, integrity, creativity and political sensitivity will serve their nation well. When too many appointees fail their Presidents, as they have recently, it becomes necessary to carefully assess and improve the underlying system."

The authors develop an historical perspective on the appointment process, especially during the past 25 years; enumerate some of the factors that deter qualified individuals from Government service; and prescribe a set of recommendations that, while not calling for sweeping reform, would result in what they project as substantial incremental improvement.

The study shows that among the contemporary deterrents to effective and timely functioning of the process are such factors as:

-- Antigovernment campaign rhetoric that discourages qualified candidates from joining "such a discredited organization as the the Federal Government."

-- A circuslike quality in media coverage of post-election appointments that trivializes the important issues that are at stake.

-- Private-sector unwillingness to encourage and facilitate temporary Government services by executives and other employees.

-- Absence of a system to indoctrinate appointees adequately into the complexities of Government operations.

-- A system that seems to require a wasteful and embarassing "re-invention of the wheel" after each election.

Among matters facing appointees are compensation, conflict-of-interest precautions, the transition from private to public service and the shift back to the private sector. The authors conclude that much can be done to improve the appointment process and "ensure a steady flow of talent into the highest levels of Government."

Their recommendations center around five initiatives: 1) broaden the pool of willing, able and competent people; 2) manage the recruiting and appointing process more effectively; 3) clarify the rules, especially those governing conflict of interest and standards of conduct; 4) ease the transition between private and public sector employment by such measures as special capital gains tax treatment for those who must sell investments to avoid conflict of interest, and 5) provide for more flexible compensation treatment for appointees uncoupling the linkage between legislative and executive branch salaries.

NEW PAPER DETAILS BROAD AMERICAN BUSINESS COMMITMENT TO ENVIRONMENTAL PROTECTION

Pointing out that "business has been a prime factor in the substantial progress made over the last 20 years in cleaning up America's air and water and meeting other environmental problems," a new Roundtable paper details the nature of the American business commitment to environmental protection.

Titled Business and the Environment: Challenge and Commitment, the paper offers scores of specific examples or circumstances that illustrate the business community's pro-environmental efforts. The examples fit a number of general categories, including:

-- Coexistence of industrial operations and wildlife.

-- Compatibility of economic growth and environmental protection.

-- Voluntary changes by industry to protect the environment.

-- Continuing research into environmental problems.

-- The search for safe and ecologically sound products.

-- Innovation in disposing of wastes.

-- Transforming pollution problems into business and social benefits.

-- Environmental protection as a day-to-day business goal.

-- Cooperation between public and private sectors to protect the environment.

A sampling of items appearing in the extensive collection:

The petroleum industry has adopted "bottom-loading" of products into trucks and tank cars to reduce the escape of hydrocarbon vapor.

To reduce emissions of various nitrogen oxides from a nitric acid plant a company engineered a patented process that it has successfully licensed to other major producers.

In California a utility company completely rerouted its planned road system to spare a rare plant colony. In Hawaii a company spent $10.2 million to place a water discharge point offshore to avoid thermal stress on a coral reef.

> The amount of glass recycled in the U.S. has doubled in the past three years.
>
> Annual awards are given by the American Paper Institute and the National Forest Products Association to the companies in their industry that have exhibited a "sustained and effective environmental initiative."

The paper is one in a series being issued by the Roundtable's Environment Task Force as part of its Environmental Information Program. The program, which is aimed at developing a more balanced public perception of business efforts to protect the environment, provides materials that can be used to supplement, and reinforce the environmental communications of member companies. James E. Lee, Chief Executive Officer of Gulf Oil, who is Vice Chairman of the Environment Task Force, is in charge of the program.

Another new publication in the program is Environmental Communications Exchange, a periodical that publicizes recent communications on environmental subjects and provides an avenue for coordinating the efforts of member-company environmental and communication specialists. The initial edition cites more than 15 examples of environmentally oriented booklets, films, filmstrip and other communications, summarizing their objectives and contents and providing a point of contact for further information or copies. It also notes articles that have recently appeared in the general and specialized press on environmental subjects.

The papers have been distributed to Roundtable member companies. Additional copies can be obtained by writing Roundtable headquarters.

NORTON COMPANY WINS CORPORATE RESPONSIBILITY ACCOLADE FROM COLUMBIA UNIVERSITY

Columbia University has awarded the 1983 Lawrence A. Wien Prize in Corporate Social Responsibility to Norton Company of Worcester, Mass., a Roundtable member company. University President Michael I. Sovern presented the award to Norton's President and Chief Executive Officer, Donald R. Melville.

Norton was cited for providing "dramatic evidence of the fulfillment of the fundamental belief that business has a responsibility to society as a whole and to the community in which it operates." The citation continued: "Your company has demonstrated an extraordinary sensitivity to the needs of twenty thousand employees and of the communities in which they live throughout the world. You have supported a carefully selected roster of organizations, institutions and programs which significantly contribute to the enhancement of the quality of life in those communities...By making social investments thoughtfully and creatively during a time of extreme economic stringency as well as in prosperous times, you have made an enduring contribution to the lives of everyone touched by your manifold enterprises."

The prize includes fellowships awarded each year in the corporation's name to outstanding students in business and law.

Accepting the award, Mr. Melville said that "we men and women of business should expect ourselves and our companies to be held to the highest conceivable standards. The world demands from us a passionate involvement with the issues of the day, and a commitment to lead our lives and perform our services so that we and our companies are seen clearly to benefit the people and communities with whom we come in contact."

STATEMENT OF

THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

SUBMITTED TO

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

"DEFICIT REDUCTION"

December 12-14, 1983

* * * * * * * * * * *

The Coalition to Reduce High Effective Tax Rates was formed in June 1983 by associations and corporations that share mutual concerns about--

- the long-term effects of high effective business tax rates on economic growth,
- the long-term impact of wide disparities in effective rates on equitable and efficient uses of capital, and
- the near-term possibility that high effective tax rate businesses will be hit by allegedly "equitable" tax increases in the form of a surtax or related other devices that do not fully recognize the tax burdens already borne by such businesses.

The founding members of the Coalition, representing more than 500,000 small businesses and approximately 70 of the FORTUNE 500 industrial corporations, are listed in Appendix A.

The following statement summarizes the Coalition's strong opposition to a surtax (and related proposals) as a component of a deficit reduction package and reviews the documentation that illustrates the high effective tax rates paid by many sectors and companies. An extensive presentation on these matters is attached as Appendix B.

I. Surtax Mechanisms Are Inequitable

The Coalition has not and will not develop a position with respect to either the desirability of, or the means by which to accomplish, tax increases for FY 1985 and beyond.

But the Coalition is very strongly opposed to a surtax-- or to any proposal under any label--that has the effect of raising the effective tax rates of those businesses that already pay high effective tax rates. Contrary to the still-widespread perception that a surtax is fair and equitable, as well as simple to implement, a surtax is an exceedingly inequitable mechanism for raising business taxes.

A. The Basic Surtax

In its most pure and simple format, a surtax applies a percentage rate to the amount of income tax actually payable in one year under the regular computations. The result is an additional amount of tax that is payable for that year. Variations of this simple mechanism would apply the surtax percentage to tax liability computed before tax credits, or to taxable income, or to modified computations of taxable income.

Two companies paying widely divergent effective tax rates--for example 10 percent and 30 percent--would be quite differently impacted by a simple 5 percent surtax. The first company would see its effective rate increase by .5 percentage points (10% rate x 5% surtax) while the second would see a 1.5 percentage point increase (30% rate x 5% surtax).

The result is clear and regretable. The surtax falls most heavily on the company that already pays the highest effective tax rate. The argument that a surtax is fair and equitable apparently ignores this simple fact. A descriptive example is provided on page 10 of Appendix B.

B. Related Mechanisms

Attempts to reduce the harsh effects of the surtax on high effective tax rate companies have resulted in proposals for taxes on modified income bases that allow some recognition of regular tax payments. Given various labels, most of these "hybrids" between a surtax and an enhanced minimum tax retain much of their surtax heritage. (Examples on pages 12 and 13 in Appendix B illustrate this problem.) As such, they are only marginally less objectionable than the simple surtax.

However, the Coalition is concerned that the nomenclature of the proposals will be allowed to mask their true nature. As a result, the Coalition urges the Committee to analyze very carefully all such across-the-board tax increase proposals and to assess their impact on those businesses that already pay high effective tax rates. Proposals that raise taxes on such companies should be discarded.

II. High Effective Rates

The continuing consideration by congressional and Administration policymakers of a surtax and related proposals appears to stem from the still deeply rooted, but erroneous, belief that all businesses pay roughly equivalent and uniformly low rates of tax. Given this view, it is apparent why a surtax is perceived to be equitable; a surtax applied to essentially equal effective rates of tax produces essentially uniform results.

A principal objective of the Coalition is to draw attention to the fact that the underlying belief is wrong. Many businesses pay effective tax rates that are higher--indeed much higher--than is generally believed. In fact, the two annual studies of effective corporate tax rates that are reported by the press and cited members of Congress to document low effective rates also document the widespread nature of much higher effective rates. Unfortunately, the latter results of the very credible work by the staff of the Joint Committee on Taxation and by Tax Analysts of Arlington, Virginia, has been largely ignored.

Summarizing briefly the material in Appendix B, there are a number of industries whose effective rates perennially are in excess of 23 percent (which is one-half of the top 46 percent rate) and are in fact above 30 percent. Among these are beverage companies, food processors, computer and office equipment manufacturers, pharmaceuticals, retailing, and wholesale distribution. These industries and major corporations within them benefit only modestly from the numerous deductions, exemptions and credits that are of considerably more benefit to the profitable companies and industries that pay much lower effective rates as a result. Furthermore, many of these industries and most small businesses are also major payers of employment taxes which increase their overall effective federal tax rates even further.

The effect of these facts is to create a great disparity in effective tax rates to which a surtax would be applied. This disparity also demonstrates the wide range of variations in taxable incomes and available tax credits to which hybrid surtax proposals would be applied.

III. Conclusion

For far too long, the perception that business pays generally low federal tax rates has influenced tax policy debates. That perception is wrong, and that is reason enough to seek to correct it.

But the more immediate and practical reason to address the issue is the continuing legitimacy that it lends to proposals for a surtax on business as an equitable means for raising taxes. If any deficit reduction package is initiated and includes tax increases, this Committee should affirmatively resolve to avoid increasing the already substantial burden borne by high effective rate taxpayers.

APPENDIX A

FOUNDING MEMBERSHIP OF

THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

American Business Conference

Bristol Myers

Dart & Kraft, Inc.

General Mills Inc.

General Foods

Grocery Manufacturers of America

IBM Corporation

National Association of Wholesaler-Distributors

National Federation of Independent Business

National Retail Merchants Association

Pillsbury

Procter & Gamble Manufacturing Company

Small Business United

3M Company

APPENDIX B

I. High Effective Rate Business Taxpayers

An "effective income tax rate" is commonly computed by dividing the amount of taxes paid by the amount of net financial income reported to shareholders. If two companies have net financial incomes of $10 million and $1 million and each pays $350,000 in taxes, their effective tax rates are 3.5 percent and 35 percent respectively. Thus, a company's effective tax rate is determined by the proportion of net income that is paid as income tax, not the absolute dollar amount of taxes paid by each. Therefore, both a very profitable company that operates in a low profit margin industry and a barely profitable company in a distressed industry can have high effective rates while an enormously successful company that realizes generous profit margins can pay a low effective rate due to full utilization of existing tax provisions.

Perennial congressional and press attention is given to effective corporate tax rate studies. Industries and specific companies that pay very low rates in relation to the statutory 46 percent corporate income tax rate are highlighted. Congressional hearings early in 1983 concerning taxation of banks and thrift institutions drew renewed attention to the subject.

Many of the companies and industries that are the subjects of such studies are listed as paying less than one-half of the 46 percent rate, i.e., 23% or lower. A significant number are listed as paying less than one-fourth of the statutory rate, i.e., less than 11.5%. Some are even shown to pay negative tax rates due to tax provisions that produce loss carryforwards for tax purposes while reporting net income to shareholders.

It is certainly correct to observe that many industries and many major corporations make effective use of a series of deductions, exemptions and credits to reduce their effective corporate income tax rates. But it is also correct, although almost always overlooked, that many industries and major corporations pay much higher rates than their more widely publicized counterparts at the lower end of the rate scale. The lack of attention to these taxpayers has allowed an incorrect and troubling public perception to gain credibility, namely that businesses generally and major corporations in particular virtually escape federal taxation.

If a major tax increase bill is initiated in 1984, a number of myths should be exposed and neglected facts must be considered if the Congress and the Administration are to understand existing business tax burdens and how specific tax increase proposals would affect those burdens.

A. Numerous industries and major corporations pay high effective income tax rates.

Although public attention is directed to the low-rate examples, two annual effective corporate tax rate studies also provide extensive information regarding high effective rate industries and corporations. TAX NOTES, which is published weekly by Tax Analysts of Arlington, Virginia, has prepared effective corporate tax rate tables for various industries for several years. In the 1982 TAX NOTES special supplement entitled "Effective Corporate Tax Rates in 1981," Appendix A lists 31 industry groups and their effective rates based on the FORTUNE 500 corporations that were surveyed. Of the 31 groups, there were 14 that had an average 1980-1981 U.S. tax rate on U.S. income that exceeded one-half of the statutory rate (*i.e.*, was greater than 23%). Those industries are the following:

Apparel*

Beverages

Diversified Service Industries

Food Processors

Industrial and Farm Equipment

Instrument Companies

Office Equipment

Pharmaceuticals

Publishing & Printing

Retailers -- food

Retailers -- non-food

Soaps & Cosmetics

Textiles & Vinyl Flooring*

Tobacco

(*The 1981 rate exceeded 23 percent. The industry was not included in the 1980 study.)

The corporate effective rate study for 1982 prepared by the Staff of the Joint Committee on Taxation and by the Government Accounting Office for Representative Pease and Representative Dorgan (formerly for Representative Vanik) listed 30 industry groups using different classifications than those in TAX NOTES. Also using somewhat different computational methodologies, the Pease-Dorgan study lists 10 industries that had an average 1980-1982 U.S. tax rate on U.S. income that exceeded one-half of the statutory rate (i.e., was greater than 23%). Those industries are the following:

x Beverages

x Computers and Office Equipment

x Food Processors

x Instrument Companies

Petroleum

x Pharmaceuticals

x Retailing

x Tobacco

Trucking

Wholesalers (not studied before 1982)

(The "x" indicates groups that are on both the Pease-Dorgan list and the TAX NOTES list above.)

As has been noted by many commentators over a period of years, there are a number of tax accounting judgments used in the two studies on which differing views are held. Furthermore, the use of financial data contained in reports filed with the Securities and Exchange Commission, on which the studies base their computations, may not provide the best means for computing such rates.

While recognizing the problems posed by such matters, the Coalition's review of the studies and their methodologies has resulted in the conclusion that both are sufficiently well prepared to serve important informational functions. The precise effective rate for a company or a industry could vary under different methodologies, but one fundamental fact would not change -- a fact that has been virtually ignored for reasons that are not apparent to us.

> <u>These two annual reports that are perennially cited for their data regarding low effective corporate income tax rates paid by certain large corporations and by whole industries also present extensive statistical information documenting the widespread nature of high effective income tax rates paid by other large corporations and industries</u>.

Therefore, to the extent that the findings of such studies have troubled members of the Committee who are concerned about low effective corporate tax rates, the additional information therein regarding much higher effective rates should be of equal significance. The credibility which has been developed by these studies over a period of years should attract attention to both the low <u>and</u> the high effective tax rate data.

But even this expanded reading of the studies does not completely illustrate the disparities among business tax rates. A number of factors have not been taken into account in the effective tax rate debate. These are discussed in the next sections.

B. Effective tax rate studies have not considered the vast number of mid-size and small businesses.

The TAX NOTES and Pease-Dorgan studies have focused exclusively on major corporations, due to the necessity for using required SEC reports as the sources for the data that are used to make the calculations. In fact, the Pease-Dorgan study of 1982 rates by industry classification considered only 213 of the FORTUNE 500 industrial companies and the FORTUNE 500 service companies. The TAX NOTES study for 1981 surveyed 514 leading U.S. firms from the FORTUNE 500 industrial companies and the FORTUNE 50 non-industrial companies, supplemented by additional companies from the FORTUNE second 500 to replace others that experienced losses and, therefore, were not subject to federal income tax.

The necessity of surveying only the largest corporations quite probably results in some degree of understatement of the overall effective rate for an industry as a whole because the largest companies in an industry are more likely to expend the resources necessary to maximize the benefits of existing tax provisions than are their mid-size competitors. This is particularly likely in the distribution services such as wholesale distribution (which was not studied by either of the two annual reports until 1982) and retailing (where vast numbers of businesses are situated in income levels just below the few very large companies that have been studied).

C. Effective income tax rate studies do not consider the mounting burden of payroll taxes.

The labor-intensity of those industries listed above tends to be higher -- much higher in many cases -- than the sectors benefitting from low effective income tax rates. Therefore, their employment tax burdens, particularly Social Security taxes, have grown dramatically since the early 1970s. Starting at $100 billion in 1967, social insurance taxes (more than 85 percent of which is Social Security tax) are climbing to an estimated $300 billion in 1987. But this very real tax burden is not reflected in the effective income tax rates. For many businesses, particularly smaller companies in service industries, payroll taxes equal or exceed in dollar amounts the federal income taxes paid. Thus, while rarely mentioned, these taxes have become the major tax issue for such businesses.

D. The vast numbers of unincorporated businesses are never discussed.

High marginal tax rates on sole proprietors and partners, ranging up to 50 percent, exceed even the maximum 46 percent corporate rate. Yet these businesses, to whom the employment tax burdens may be even more important, are not taken into consideration when generalizations are made concerning business tax rates.

E. Businesses continue to pay very <u>sizable amounts of federal taxes.</u>

One outgrowth of the attention given to low effective rates appears to be a perception that the corporate income tax has been virtually repealed. Yet the corporate income tax has produced $50 to $70 billion annually from 1976 through 1981 and, after the recessionary trough of 1982 and 1983, is projected by the Congressional Budget Office (CBO) to generate more than $80 billion annually by 1987 and by the Office of Management and Budget (OMB) to produce more than $100 billion by that year. Such amounts certainly are not being generated by a business community that pays overall effective income tax rates of 10 percent, 5 percent, or 0 percent. Instead, they are being paid and will continue to be paid to a significant degree by those industries and companies with much higher effective rates.

Furthermore, more than 50 percent of the mounting social insurance taxes are paid by corporate and non-corporate employers and self-employed individuals, which significantly increases their overall effective federal tax rate.

Thus, even with incomplete information, it is apparent that significant business sectors pay effective <u>income</u> tax rates, not to mention overall tax rates, that are much higher than the minimal percentages paid by industries and companies that are perennially subjected to intensive public scrutiny.

II. The Inequity Of Surtax Mechanisms

Consideration of effective tax rate burdens is much more than an academic inquiry. It is a matter that should have a profound effect on federal tax policy deliberations. The most immediate concern is the potential enactment of a surtax (or a similar mechanism) on businesses.

A. The Basic Surtax

In its most pure and simple format, a surtax applies a percentage rate to the amount of income tax actually payable in one year under the regular computations. The result is an additional amount of tax that is payable for that year. Variations of this simple mechanism would apply the surtax percentage to tax liability computed before tax credits, or to taxable income, or to modified computations of taxable income.

A surtax is often presented as a simple and equitable means for increasing taxes on business because it can apply uniformly to all business taxpayers. This view is probably rooted primarily in the belief that businesses -- or at least major corporations -- _all_ pay low effective rates of tax and therefore would _be_ rather evenly impacted by a surtax.

But a surtax is _not_ uniformly applicable, for the simple reason that all businesses do _not_ pay the same or even similar effective tax rates, as has been outlined above. In fact, a surtax would impose the heaviest burden on those firms that already pay the highest effective tax rates while falling _much_ less heavily -- if at all -- on equally profitable firms that utilize an array of deductions, exemptions and credits to reduce or eliminate taxable income and/or tax liability.

Although oversimplified, the following three example illustrates this point.

VARYING EFFECTS OF A PURE SURTAX

Corporate Tax Computation	Company A	Company B	Company C
Net financial income	$1,000	$1,000	$1,000
Less tax adjustments for			
• ACRS, depletion, loss reserves, etc.	(700)	(100)	(100)
• exempt income	0	(500)	0
Taxable income	300	400	900
Tax at 46% rate	138	184	414
Less investment tax credit (ITC)	(100)	(15)	(15)
Tax paid	38	169	399
Effective tax rate	3.8%	16.9%	39.9%
10% surtax on tax paid	$3.8	$16.9	$39.9%
Total effective rate (regular & surtax)	4.2%	18.6%	43.9%

Although starting with identical financial incomes, the three hypothetical firms are treated much differently for tax purposes. The provisions of the Internal Revenue Code which reduce the taxable incomes and tax liabilities of Company A and Company B have beeh debated and reviewed over the years. Their benefits have been analyzed at length. Some have been expanded, and some have been curtailed. All have been subjected to prolonged scrutiny. Thus, they have generally been judged to be desirable, to varying degrees.

The issue is not whether any specific deduction, exemption or credit -- or any industry-wide grouping of such provisions -- is excessive. The Coalition has no intention of suggesting that any specific tax provision be changed as a means of raising someone else's taxes. Our objective is to reduce the high effective rates that our members pay. Repeal of most of the provisions that benefit low effective rate taxpayers would also increase taxes for our members because virtually all businesses utilize one or more of these provsions to some extent.

Rather, the issue that we raise for consideration is the fact that a surtax intensifies the assymmetries in effective tax rates because it falls heavily on those companies and industries that are able to realize only a modest benefit from all existing tax provisions, such as Company C, while falling very lightly on those who already realize massive tax benefits.

The pure surtax illustrated above is the simplest means by which to illustrate the inequity of the surtax concept. But more complex approaches can retain significant surtax attributes no matter what the label.

For example, a surtax applied to tax liability before tax credits are claimed would "broaden the base" somewhat. In the above example, a 10 percent surtax applied to "Tax at 46% rate" would produce the following results:

	A	B	C
10% surtax on pre-credit tax	$13.80	$18.40	$41.40
Total effective rate (regular & surtax)	5.2%	18.7%	44.0%

In an attempt to "broaden the base" even further, a 10 percent surtax applied to "Taxable income" would produce the following results:

	A	B	C
10% surtax on taxable income	$30.00	$40.00	$90.00
Total effective rate (regular & surtax)	6.8%	20.9%	54.0%

In both situations, the impact of the surtax is to increase substantially the already high effective tax rates of Company C.

B. Related Proposals

Attempts to soften or eliminate this impact may be well intended, but the actual effects of various "hybrids" must be scrutinized very carefully. Their labels are merely that--labels. Their substance is extremely important. Proposals to impose a tax on a broadened base that takes into account regular taxes paid may sound more equitable. But the numbers can illustrate a contrary result.

For example, consider the following illustrations of the three companies under a more complex set of rules for a new tax. The example begins with "Taxable income" (and "Tax paid") as computed in the example on page 10.

New Tax Computation	Company A	Company B	Company C
Taxable income (regular computation)	300	400	900
Tax paid (regular computation)	38	169	399
Add-backs to taxable income for exempt income, ACRS in excess of straight-line/ADR	300	300	50
New base income	600	700	950
Deduction for regular tax paid	(38)	(169)	(399)
New base taxable income	562	531	551
2% of new base taxable income	$ 11.2	$ 10.6	$ 11.0
Total effective rate (regular & new)	4.9%	18.0%	41.0%

The purpose of this approach could be described as a form of minimum tax. The result, nontheless, is to increase C's tax rate by virtually the same amount as for A and B. Variations in numbers, assumptions and add-backs certainly will vary the results, and this example is not intended to represent a wide variety of proposals. It is intended to demonstrate the fact that very extensive analysis of each new proposal is essential.

Conclusion

The Coalition does not have a policy position with respect to enactment of a tax increase bill this year to take effect in FY 1985 and beyond. If the Congress does draft a tax increase bill this year, the Coalition strongly urges that such legislation take into account the facts presented in our statement. High effective tax rates ensure that a surtax would be grossly inequitable and unjustifiably harsh on the companies and industries that already pay such effective rates. The apparent simplicity of a surtax mechanism masks the widely varying effects that it would have on firms with similar income but widely varying tax rates. Therefore, a surtax should not be enacted either for current or contingent revenue raising purposes.

STATEMENT OF

William Lloyd Davis
Executive Administrator
The Council For South Texas Economic Progress
McAllen, Texas

BEFORE THE SENATE COMMITTEE ON FINANCE

HEARING ON REVENUE RAISING ALTERNATIVES

December 15, 1983

My name is William Lloyd Davis. I am Executive Administrator of the Council For South Texas Economic Progress (COSTEP), a non-profit organization concerned with improving economic conditions in the 54 county southernmost region of Texas.

COSTEP's address and telephone number is (512) 682-1201, 520 Pecan, McAllen, Texas 78501.

EDUCATION AND ECONOMIC DEVELOPMENT

COSTEP was formed in the early 1970's for the purpose of bringing respected leaders in the public and private sectors together to develop innovative approaches for alleviating economic conditions which had come to characterize South Texas as one of the nation's regions most severly affected by poverty (36.4% of total population in poverty vs 13.7% nationwide) and low per capita income (50% of the national average). While active in initiating a broad range of job development programs and projects, the founders of COSTEP were equally concerned with the region's need for advancement in education. The issue was stated succinctly in an article appearing in La Luz Magazine titled "South Texas -- a tragic Paradox":

> "The long term economic and social problems that have been barriers to prosperity and development in South Texas arise from several sources. These include ... low levels of educational attainment. In order to permanently improve the quality of life in South Texas, the economy must be diversified and further developed to provide jobs. Since the area's greatest resource is its people, human resource development must occur simultaneously to sustain and maintain any economic growth."

NEED FOR EDUCATIONAL FINANCING

In the course of extensive contacts with leaders in the academic community, the single problem most frequently encountered by COSTEP was the plight of the region's middle income families in financing the cost of education beyond the high school level.

At the high school level, counselors reported that 65% of their graduates planned to continue their education at the post-secondary level but that over 75% would need financial assistance to do so. At the college level, the Financial Aid officers reported steady streams of deserving applicants for whom there was no available source of financial assistance other than the Federal Insured Student Loan Program (available under the Higher Education Act of 1965) and in this regard cited their inability to find willing lenders. Further contacts with bankers in the region confirmed that there were substantial numbers of requests for student loans but that few were granted and then only on a very select and limited basis. This was for several reasons:

(1) the term of student loans is longer than normal for installment loans (ex: four years in school, plus a grace period, plus up to ten years in repayment)

(2) the interest rate charged students was at the time limited to 7% (plus a Special Allowance payment to lenders, which had averaged only 1.70% since its inception in 1969) and
(3) intensive and specialized servicing and collection procedures (beyond those normally associated with bank loans) are required for student loans which are comparatively small balance loans.

Together, these factors caused the return on student loans to be quite unattractive to banks in comparison with other lending alternatives.

Consequently, of 259 commercial banks in the area served by COSTEP, less than 30 had made student loans. Of those making student loans, all had highly restricted and selective lending policies. In fact, the Department of Education Regional Office in Dallas (then U.S. Office of Education) in a letter to COSTEP estimated the unmet demand for student loans in the South Texas area for school year 1974-75 to be the equivalent of 20% of enrolled student population or approximately $16,100,000.

AN APPROACH DEVELOPED

Investigation of alternatives for alleviating the obstacles to commercial lender participation in the FISL Program led to consideration of the creation of a secondary market for FISL Loans. The Student Loan Marketing Association ("Sallie Mae") which had been created several years prior was serving a similar function but, as reported by lenders, only where very large financial institutions and large portfolios of high balance student loans were involved. A need was perceived for a secondary market program tailored to the unique needs of the region's students and its lenders.

At then available rates of return on student loans (7% plus an average of 1.70% Special Allowance = 8.70%), no available source of long term financing for such a secondary market other than the issuance of tax-exempt municipal Bonds was found feasible. Subsequent to passage of the Tax Reform Act of 1976, containing provisions providing for the issuance of Qualified Scholarship Funding Bonds (sections 103 (e) and (c)(5)), the South Texas Higher Education Authority ("STHEA") became operational as a secondary market. In September of 1977 STHEA delivered $20,000,000 in Bonds, estimated to cover loan demand in its service area for the initial two-year period of operations.

OPERATIONS BEGUN

Although STHEA had achieved operational status and had funds available for loan acquisition, the task of developing lender confidence and participation in the new program was still a difficult one as indicated by the initally slow utilization of loan funds from December of 1977 (the Authority's first loan purchase date) through January of 1979:

Period		Amount	Cumulative
December 1977 thru	January, 1978	$ 114,071	114,071
	April, 1978	565,590	679,661
	July, 1978	523,956	1,203,617
	October, 1978	1,833,914	3,037,531
	January, 1979	1,401,838	4,439,369

During this 14 month period, however, the program became highly regarded and during the 18 month from February of 1979 thru August of 1980, STHEA utilized the full remainder of the proceeds of its initial Series A Bond issue, a volume of activity three times that of the earlier period:

April, 1979	$1,999,157	1,999,157
July, 1979	1,221,219	3,220,376
October, 1979	3,527,095	6,747,471
January, 1980	3,584,463	10,331,934
April, 1980	2,512,825	12,844,759
August, 1980	520,134	13,364,893

In March of 1980, surveys were conducted of the 47 lenders then participating in the STHEA program to determine whether or not the program was accomplishing its intended purpose of attracting new lenders into the student loan program and of encouraging existing lenders to more adequately meet the demand for student loans (see Exhibit 1). These surveys revealed that existing lender loan volume had been increased during the first two years of STHEA operation by 286% and that of the 47 lenders, 22 had made their first student loans because of the Authority's program. Many lenders commented that they would not be making student loans were it not for STHEA's secondary market program.

Based upon this assessment of positive results being generated even in the first years of operation, plans were finalized for a second Bond issue.

PROBLEMS DEVELOP

In 1977 when STHEA delivered its first series of Bonds the loan interest rate paid by students at 7% was below the long term Bond interest rate obtainable in the market. By the summer of 1980, at the time STHEA was planning its second Bond issue, long term Bond interest rates were approaching the rate of student loan interest. In order to achieve an affordable Bond interest rate the term of the proposed Bond issue was reduced from 15 years to 10 years. Interest rates continued to rise in the fall of 1980 and in December, STHEA was forced, by market conditions, to withdraw from the market entirely. The market environment was such that the Authority could not obtain an investment grade rating on its Bonds.

Paradoxically, these conditions affected STHEA's outstanding Series of Bonds in a different way. Special Allowance payments (which are tied to T-Bill rates) on acquired loans began to increase significantly in the high interest rate environment; causing the spread between the Bond interest rate and the return on student loans to widen significantly. As a result, the Authority was able to partially offset the need to issue additional Bonds by using unanticipated income to acquire additional loans. From August of 1980 thru April of 1983, $8,258,397 in additional loans were acquired from program revenues; in total the Authority was able to finance $26,062,660 in loans against original Bond proceeds of $17,325,300. This, in an environment where the issuance of new Bonds was not feasible is indicative of the unique nature of student loan Bonds.

Unlike most Revenue based financings where the issuer sets revenues (fees, charges, rates, etc. for the service to be provided) to cover debt service and other costs, the issuer of Student Loan Bonds has no control over the Revenue side of the feasibility equation. Revenue is equal to the base interest rate on student loans (currently 7%, 9% or more recently 8%) plus a variable Special Allowance paid by the government which is designed to provide a total return to the lender equal to the bond equivalent rate on 91-day T-Bills plus 3.5 points. From the rating agency viewpoint, in general, any Bond interest rate sufficiently below the base interest rate on student loans to cover operating costs will receive an investment grade rating. The rating agencies do not however permit the issuer to assume a total return on student loans that is above that guaranteed by law. This is because the rate on 91 day T-Bills is not predictable with any degree of certainty.

In the fall of 1980, alongwith significant other changes in the Higher Education Act, the Special Allowance available to issuers of tax-exempt Student Loan Bonds was reduced to one-half that received by commercial lenders subject to a floor of ½ of 1 percent. According to a report published by the Congressional Budget Office in March 1980, this formula "under most projections of tax-exempt and taxable interest rates" equalizes the net return on student loans between tax-exempt and taxable borrowing rates and offsets "much of the federal revenue loss from the tax-exemption of the Bonds."

Combining money market conditions (in which long term Bond interest rates rose above the base interest return on student loans) with the then new Special Allowance provisions made the issuance of long-term Bonds infeasible; a condition which remains today.

THE CURRENT SITUATION

Following more than two years of dedicated effort, STHEA was able in March 1983 to finance continuation of its student loan program but only through the issuance of short term three year Bonds to be refunded prior to maturity. In order to assure Bondholders that the Authority's obligation will be met, STHEA is annually paying a third party 3/8 of one percent of the amount of loans to be acquired with the proceeds of the Bonds ($487,500 per year) for a future option to sell loans if needed to meet Bond redemption requirements and is obligated to continue to service such loans through full repayment at a low fixed price based on the outstanding loan balance of the portfolio.

Changes in market conditions and the statutory enviroment within which Student Loan Bonds are issued have made it extremely difficult for STHEA and similar Authorities to provide a stable source of student loan financing. Indeed, the issuance of long-term Bonds has not been feasible for over two years and is not currently feasible in todays market. Short term Bonds are feasible only with various forms of credit enhancement.

Compounding these problems, the tax-exempt issuer participating in the student loan program has, over the last several years, been confronted with an environment of constantly changing and increased regulation. Plans of Doing Business are now required to be filed and approved by the Department of Education. Variable loan interest rates and new servicing and collection procedures have required costly changes in Authority operations. Computer software for student loan servicing or to support the administrative operations of Authorities in 1976 would be totally inadequate in 1983. In sum, Authorities have survived but are today highly sensitive to seemingly innocuous proposals for further regulation and control.

Recent proposals, in particular, those pertaining to Student Loan Bonds incorporated in proposed HR 4170 and the agenda item proposed for consideration by Senate Finance (to include the Special Allowance payment in the arbitrage calculations on Student Loan Bonds) would have the effect not of limiting but of terminating the issuance of Qualified Scholarship Funding Bonds.

IMPACT OF PROGRAM TERMINATION

Should termination of the tax-exempt secondary market Student Loan Program became a reality, lenders participating in STHEA's program would immediately begin closing the doors to student borrowers, even though STHEA currently has funds with which to purchase student loans. Why, with the presence of the Washington based Student Loan Marketing Association ("Sallie Mae") and several very large money center Banks active in purchasing loans, would this occur?

Sallie Mae was in operation for about five years before the secondary market tax-exempt organizations came into being but it was only to locally based Authorities in Texas and in other states that a great many commercial lenders responded. Sallie Mae has no commitment to South Texas per se or to any other area of the nation, it has no input from local lenders and in the past has had participation primarily from only the nation's largest of lenders having large portfolios or portfolios of high balance loans to sell. During the period 1981 - 1982 when STHEA had only very limited funds to purchase loans from its participating lenders, only 1 of more than 100 STHEA participating lenders is known to have participated in Sallie Mae's program and that was due to the lender's uncertainty concerning STHEA's future ability to acquire loans that it had already originated in anticipation of acquisition by STHEA. Instead, lenders either ceased making student loans altogether or reverted to severe restrictions on their lending activity.

With regard to the money center Banks dealing nationwide in student loans, what Bank in South Texas, or any other area would want to become dependant on or subject to changes in such institution's purchase policies and lending practices -- would be willing to gear up to provide student loans on a sustained basis knowing that such institution's capital resources and investment interests could be drawn elsewhere overnight. In the recent past there has been some interest on the part of the large money center Banks in purchasing loans outside their normal geographic lending area primarily because of lack of commercial/industrial loan demand. As the economy improves it is doubtful that such interest will continue.

In conclusion, we believe, based upon past history of the program in South Texas, that the reaction of South Texas lenders to termination of the STHEA program would be termination of their own participation in the student loan program. Lenders need stable conditions and more than a purchase-to-purchase commitment to them in order to sustain their participation in meeting the needs of students. Further, because lenders need stable Authority operations, we believe that, were termination of STHEA's statutory Authority to finance be announced, lenders would immediately begin to phase out the making of loans, even though the Authority currently has funds available for loan purchase.

The federal alternative to the secondary market approach, if deserving and qualified students are to receive financial assistance, is either increased grants or an expansion of direct government loans; which would require increased appropriations (taxes) or increased borrowing (debt) to finance the principal amount of aid to be provided, administrative costs and long term loan servicing.

The alternative, if existing financing is not replaced, is that a great number of deserving and qualified borrowers, particularly students of middle income families, will not be able to finance the cost of an education at the post-secondary level.

In South Texas, the record of increased loan origination by commercial lenders is indicative of the value of the program in more adequately assuring qualified students the opportunity to obtain an education. In total the STHEA program in South Texas has generated the particiaption of 102 commercial lenders in providing $62,331,100 in financing for 14,835 students (average of $4202 per borrower) for attendance at 737 institutions of higher education. For comparative purposes, while the volume of loans has been increased significantly on a percentage basis, the 14,835 students financed since inception of the STHEA program in South Texas represent the equivalent of less than 10% of the region's 133,798 estimated 1982 post secondary enrollments. Approximately 40% of students financed are of Mexican-American descent, the vast majority of which are from families that have been able to move into middle income status from more humble beginnings. These are families that characteristically have more family members to feed, clothe and educate than the national average (3.12 persons per family vs 2.75 nationally). In 1980, less than 25% of the South Texas region's families earned more than $35,000, an amount roughly comparable to the $30,000 adjusted income rule applicable to the student loan program.

From 1970 to 1980 the number of households in the region grew at a rate of 45.5% compared with the national average of 26.7%. These are families that are earning families but not earning enough to afford today's cost of education without the assistance provided by the student loan program.

The tax-exempt secondary market approach to improving access to higher education is a concept that has proven its ability to do more than just more adequately meet the demand for student loans. It has served as a vehicle for involving lenders in state and local financial circles in the public concern about education. STHEA is governed by a board of eleven members, the majority of which are chief executive officers of financial institutions. These individuals accepted a commitment to higher education upon formation of STHEA -- A commitment of voluntary service that had not existed previously. To lose Higher Education Authorities in Texas and in other states and local areas is to lose the participation of what is now a substantial number of concerned citizens in what has become an effective voluntary partnership between government and the private sector, harnessed to the public purpose of assisting each individual achieve his or her maximum productive potential through education. Maintaining the viability of the Authority secondary market program is one of the best assurances that government doesn't perform a service which the private sector can and is willing to provide.

In addition to bringing the talents and resources of individuals in the financial community to bear upon educational needs, the tax-exempt Higher Education Authority approach has also served to cause the investment of a greater portion of the nation's capital resources in education. In the absence of Qualified Scholarship Funding Bonds, such capital will naturally continue to seek tax-favored investment; however, will the product of remaining tax-sheltered investment alternatives better serve the "public" interest than does the current investment in education?

ALTERNATIVE APPROACHES NEEDED

The formal education of an individual is not something that is easily interrupted through no fault of the student and then begun again at some later time. There is a current generation of students to be served whose time will pass if the opportunity is not available today. Additionally, at any given point in time there are students that have begun their education with the help of student loans that, if the program is terminated, would not be able to complete what has been started.

If it is the desire of the Congress to abruptly terminate a program that has contributed effectively to providing access to higher education, regardless of the consequences, in the interest of short term fiscal expediency, then such position should be stated forthrightly so that those who mistakenly continue to struggle to support the government's efforts in this area may clearly know the congressional intent.

If on the other hand, the desire of Congress is to effect changes in the tax-exempt Higher Education Authority approach to educational financing, changes that preserve its educational benefits while yet responding to urgent federal fiscal needs, then available alternatives for accomplishing both should be considered and the issuer's of Qualified Scholarship Funding Bonds can and would be a most willing ally.

The cost of the student loan program and tax-exempt issuers participation in it can be reduced. The volume of tax-exempt financing for such purpose can also be reduced. If it is the desire of Congress, of the Senate Finance Committee, to preserve worthwhile and necessary public benefits while yet responding to the need for efficiency and economy in government, then we would urge that the issue of tax-exempt student Loan Bond financing be resolved through careful consideration of the alternatives for accomplishing both. The surgeon's scalpel is needed -- not the butcher's axe.

In closing, we appreciate the opportunity to present to the committee some our views concerning Qualified Scholarship Funding Bonds, our desire to see the benefits of the program continued in our area and our willingness, together with that of others, to support the efforts of Congress in seeking ways to cope with pressing fiscal concerns while yet maintaining a vitally needed service to those in need of educational financing. We would appreciate the opportunity to supplement this testimony with additional data prior to the end of January and information which we hope will be useful to the committee in its deliberations on this subject.

STHEA STUDENT LOAN PROGRAM EVALUATION

INTRODUCTION

STHEA delivered its first series of bonds in September, 1977 and its first acquisition of loans from banks was in December, 1977. Since we have now been in operation for 2½ years and since a second series of bonds is planned in the near future, we believe it to be an appropriate time to evaluate our performance as a service to banks and students and to request any suggestions that your bank might have concerning ways to improve the program.

PART ONE

Has the STHEA secondary market program assisted your bank in increasing the availability of loans to students?

1. Comments: ______________________________

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2. Please indicate the amount of FISL loans originated by your bank (from line 2, column B, of the annual "call report", OE Form 1166-2, submitted to the Office of Education) for the years indicated.

	FISL LOANS ORIGINATED
year ended September 30, 1977	$__________
year ended September 30, 1978	$__________
year ended September 30, 1979	$__________

PART TWO

1. Please indicate any problems that your bank has encountered in originating and conveying student loans to STHEA: __________

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2. Please indicate any suggestion(s) that you have whereby the Authority's service to your bank would be improved: __________

____

____

____

____

BY: Name: ______________

Title: ______________

Bank: ______________

City: ______________

Please return to:

William L. Davis, Secretary
STHEA
520 Pecan
McAllen, Texas 78501

(8-22-80)

STHEA STUDENT LOAN PROGRAM EVALUATION

1. Has the STHEA secondary market program assisted your bank in increasing the availability of loans to students?

"Yes, without the availability of STHEA purchasing our loans, we would have stopped making them."

Roy Reichenback, Vice President
Nolte National Bank, Seguin, TX

"Yes. We are making loans to students who we normally would not have made without your loan purchase program because of the time and paperwork involved in servicing the loans. We have in the past been more selective because of this reason."

John A. Calkins, President
Raymondville State Bank, Raymondville, TX

"Yes, without the secondary program we would probably not have made as many loans."

Billy McDaniel, Vice President
First National Bank of Flour Bluff
Corpus Christi, Texas

"Yes, otherwise it (student loans) might be limited to a certain dollar volume each year and student loan policy limited to applicants meeting specific qualifications."

Lucia Galvan, Asst. Cashier
First State Bank of San Diego, Tex.

"Yes. The Authority's service to our bank has been excellent. We need the authority to continue to keep us updated on changes."

H. H. Laechelin, Executive Vice President
First National Bank of Beeville, Texas

"Without the STHEA secondary market program, we would probably not be making student loans."

C. E. Langston, Jr., Vice President
First National Bank of Mission, Texas

"I can truthfully say that without the STHEA secondary market program my bank would not be making FISL's. With this program, I can continue to offer student loans. Keep up the good work!"

William F. Ermel, Assistant Vice President
Seguin State Bank & Trust Co., Seguin, TX

"Yes, prior to STHEA we didn't make any loans to students. At first we made loans to only those students referred to us by the local junior college. Since then we have met with local high school officials and students and informed them of the availability of these loans. As a result our volume of student loans has rapidly increased. STHEA personnel are willing to answer questions and our problems are solved before they occur. They also are very good about keeping us informed of new procedures when changes do occur."

Marilyn Powers, Assistant Vice President
Union State Bank, East Bernard, Texas

"The secondary market has made it very much easier for us to service the student in not only getting his loans approved faster, but also letting us serve him more efficiently.

Evaristo Leal, Assistant Cashier
The Citizens State Bank, Donna, Texas

"We only serve our customers. We are very satisfied with the program."

Rick Edwards, Vice President
Gulfway National Bank, Corpus Christi

"STHEA has proved to be an asset in processing student loans."

Beverly Cowan, Administrative Officer
Harlingen State Bank, Harlingen, Texas

"Yes, we would not be offering student loans if it was not for the STHEA secondary market."

Orlando S. Leal, Assistant Vice President
Guaranty National Bank, Corpus Christi

"Yes, our bank had not participated in any student loan program until STHEA."

Charlotte Bogue, Installment Loan Officer
Corpus Christi Bank & Trust

"Yes, tremendous help to the students."

Ben R. Ingle, Assistant Cashier
Metropolitan National Bank, McAllen, TX

"We do not have the staff to service all of the student loans we make for our customers. Without this program we would be making very few student loans."

Rey Paez, Assistant Vice President
First National Bank of Seguin, Texas

"Our demand for student loans has increased tremendously and this secondary market program will assist our bank in meeting this demand. The Authority's service to our bank has been excellent."

Lupita Galvan, Assistant Cashier
First National Bank of McAllen, Texas

"Yes. We were not making any student loans until STHEA came into being, because of the problems we were having with these loans. More than likely, we still would not be issuing loans if this program had not been originated."

Joyce Stewart, Assistant Cashier
First National Bank in George West, Texas

"If it was not for the Student Secondary Market, we would not participate in the Student Loan Program at all."

Robert C. Rankin, Vice President
Elsa State Bank & Trust Co., Elsa Texas

"Yes, prior to getting involved with the STHEA program, we had curtailed our student loans considerably. Without this particular program, we feel that we would limit or possibly stop our student loans. We feel that the service and cooperation from those involved at STHEA is excellent."

Henry Gomez, Vice President
Del Rio Bank and Trust Company

"Yes. NBC was not making student loans prior to the start of the Secondary Market Program.

Arturo R. Vega, Assistant Vice President
National Bank of Commerce, San Antonio

"Most definitely, yes. Without the STHEA secondary market program it would be most difficult to justify 7% student loans."

Juan Rosenbaum, Vice President
Plaza Bank, San Antonio, Texas

"STHEA has increased our loan portfolio tremendously, we now are able to disburse a total amount of $250,000 a quarter to students in the undergraduate and graduate program"

Rudy Cisneros, Jr., Loan Officer
McAllen State Bank, McAllen, Texas

"Yes. With STHEA purchasing the student loans quarterly, this eliminates considerable work for the Bank, . . . We are now able to accomodate more students.

Eloisa Likens, Loan Officer
First National Bank at Brownsville, TX

"Yes. We know we have an outlet for these loans."

Mike Macher, Vice President
The First State Bank, Louise, Texas

"Very definitely. Being a smaller town, in an area where no other banks make Student Loans available, this gives us the chance to handle as many students as apply."

Deani Klein, Secretary of Installment Loans
First National Bank, Kerrville, TX

"Yes, our Federally Insured Student Loans would be minimal without STHEA."

Dennis Burleson, Sr. Vice President
First-State Bank & Trust Co., Mission, TX

"Definitely. Prior to our participation with STHEA, this bank had not participated in the Federal Insured Student Loan Program."

Gordon Jenkins, Ass't Vice President
Security State Bank, Pharr, Texas

"Without this program, we would not be making student loans, primarily because we do not have the staff to service the loans."

Bob Bales, Ass't Vice President
Broadway National Bank, San Antonio, TX

(8-22-80)

2. Please indicate the amount of FISL loans originated by your bank (from line 2, column B, of the annual "call report", OE Form 1166-2, submitted to the Office of Education) for the years indicated.

BANK	YEAR ENDED SEPT 30, 1977 $	YEAR ENDED SEPT 30, 1979 $	PERCENT CHANGE %
Alamo Bank of Texas - Alamo	-0-	90,000	*
Broadway National Bank - San Antonio	388,813	581,623	+ 49.6
Citizen's State Bank - Donna	-0-	50,718.28	*
Corpus Christi Bank & Trust	-0-	21,795	*
Del Rio Bank & Trust	250,851	329,671	+ 31.4
Elsa State Bank & Trust Co.	-0-	500	*
First National Bank of Beeville	-0-	11,250	*
First National Bank at Brownsville	196,647	297,566.03	+ 51.3
First National Bank of Eagle Lake	16,650	34,416	+106.7
First National Bank of Edinburg			
First National Bank of Flour Bluff -CC	45,418	81,338	+ 79.1
First National Bank of George West	-0-	33,290	*
First National Bank of Kerrville	100,242	122,782.23	+ 22.4
First National Bank of McAllen	11,026	542,091	+ 48.2
First National Bank of Mission	-0-	150,132	*
First National Bank of Seguin	66,495	172,963	+160.1
First National Bank of Weslaco	-0-	177,055	*
First National Bank - Yorktown	20,284	52,900	+160.8
First National Bank of Zapata	21,400	42,250	+ 97.4
First State Bank & Trust - Edinburg	-0-	509,581	*
First State Bank - Louise	-0-	4,200	*
First State Bank & Trust - Mission	7,500	135,500	+1706.7
First State Bank of San Diego	70,125	215,230	+206.9
First Victoria National	248,857	298,923	+ 20.1
Frost National Bank - San Antonio	371,422	1,087,272	+192.7
Guaranty National Bank & Trust - CC	-0-	5,000	*
Gulfway National Bank of Corpus Ch	-0-	86,700	*
Harlingen National Bank	3,000	81,108	+2603.6
Harlingen State Bank	-0-	76,521	*
Hidalgo County Bank & Trust	-0-	36,745	*
International Bank of Commerce - Laredo	-0-	140,191	*
The Laredo National Bank	73,923	415,201	+461.7

BANK	YEAR ENDED SEPT 30, 1977 $	YEAR ENDED SEPT 30, 1979 $	PERCENT CHANGE %
McAllen State Bank			
Metropolitan National Bank - McAllen	42,809	100,172	+134.0
Mid Valley State Bank - Weslaco	-0-	33,850	*
National Bank of Commerce - San Antonio	-0-	1,250,534	*
National Bank of Ft. Sam Houston	425,093	1,324,101	+211.5
The Nolte National Bank of Seguin	59,247	221,356	+273.6
Pan American Bank - Brownsville	34,800	308,355	+786.1
Plaza National Bank - San Antonio	-0-	154,035	*
Raymondville Bank of Texas	-0-	49,500	*
Raymondville State Bank	19,500	101,727	+421.7
The San Benito Bank & Trust	-0-	95,488	*
Security State Bank - Pharr	-0-	25,350	*
Seguin State Bank & Trust Co.	90,485	236,405	+161.3
Union National Bank of Laredo	11,050	54,282	+391.2
Union State Bank - East Bernard	-0-	110,468	*
TOTAL	$2,575,637	$9,950,135.54	+286%

* Denotes lenders that were making no student loans prior to the advent of the STHEA secondary market program.

STATEMENT

of the

EMPIRE STATE PETROLEUM ASSOCIATION
INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION
NEW ENGLAND FUEL INSTITUTE
PENNSYLVANIA PETROLEUM ASSOCIATION
and
NORTHEAST COALITION FOR ENERGY EQUITY

on the

"DEFICIT REDUCTION PACKAGE"

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

Washington, D.C.

December 30, 1983

The Empire State Petroleum Association ("ESPA"),*/ the Independent Fuel Terminal Operators Association ("IFTOA"),**/ the New England Fuel Institute ("NEFI"),***/ the Pennsylvania Petroleum Association ("PPA"),****/ and the Northeast Coalition for Energy Equity*****/ hereby

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*/ ESPA represents over 500 independent retail home heating oil marketers and approximately 400 independent gasoline jobbers who serve every part of New York State. New York has a greater number of oil-heated homes and consumes more home heating oil than any other state.

**/ IFTOA is an association composed of 16 companies which operate deepwater oil terminals along the East Coast from Maine to Florida. None is affiliated with a major oil company. Members are primarily marketers of residual fuel oils (Nos. 4, 5 and 6 fuels) and home heating oil (No. 2 fuel); several companies also market significant volumes of gasoline at wholesale and retail levels. Members handle nearly 50% of the non-utility residual fuel oil shipped to the East Coast, nearly 60% of the non-utility residual fuel oil shipped to New England, 25% of the No. 2 heating oil shipped to the East Coast, and more than 50% of the No. 2 heating oil shipped to New England.

***/ NEFI is an association of 1,132 independent retail and wholesale home heating oil distributors throughout the six New England states. The independent marketers serve 2.12 million retail home heating oil consumers and distribute 86% of the approximately 2.9 billion gallons of home heating oil sold in the New England area at the retail level and 47% of the gallonage sold at wholesale. Oil is used to heat 69% of all buildings in New England, both commercial and residential.

****/ PPA is the associaton of independent fuel oil and gasoline marketers in Pennsylvania. It represents over 500 petroleum marketers. Pennsylvania is the second largest home heating oil consuming state in the country.

*****/ The Northeast Coalition is an ad hoc group representing fuel oil marketers throughout the Northeast. It seeks parity in prices for oil and gas in residential markets.

submit comments on the "Deficit Reduction Package" currently under consideration by this Committee. Our trade associations represent marketers of refined petroleum products on the East Coast. Specifically, we wish to comment on the Committee's proposal to impose a 2.5 percent tax on energy sources for three years beginning in 1985.

I. Import Fee

As the Committee knows, last January the President proposed a standby tax plan which would have imposed a $5 per barrel excise tax on domestic and imported oil under certain future conditions. In addition to this "contingency tax," certain Members of Congress proposed a $5-$10 per barrel import fee on crude oil and refined petroleum products as a means of reducing the federal budget deficit. In late October, this Committee itself reviewed a proposal for a $3 per barrel fee on imported oil and a $1 per barrel tax on domestic oil. We further understand that on December 13 Secretary of The Treasury Donald Regan announced that the President will include a contingency tax in the 1985 Budget. While no specific tax was mentioned, it is possible that the $5 per barrel fee on oil will be considered.

Our associations strongly oppose any import fees because such fees would be inflationary, would limit the economic recovery and would be an inequitable and inefficient method of raising federal revenue. Accordingly, we urge this Committee, for the reasons set forth below, to reject such proposals.

A. Economic Impact

A fee applied to imported crude oil and products would raise the price of every barrel of oil consumed in the United States because the market price of domestically-produced crude oil and domestically-refined products would rise with the price of imports. Each dollar of a fee would raise annual consumer petroleum costs by about $5.5 billion per year.*/ Moreover, a $5 per barrel fee would increase the inflation rate by nearly one percentage point and reduce the GNP by $25-$30 billion.**/ (A $10 per barrel fee would, of course, have a proportionately greater impact).

As this Committee is well aware, OPEC has already been forced to reduce the price of its marker crude oil by $5 per barrel, and since the price reduction in March, 1983, crude oil producers have experienced weakness in the demand for their output. Moreover, there is some chance that the price may fall still further in 1984.

During the past year, consumers have benefited from the increased purchasing power which has resulted from the low prices. Thus, if Congress were to enact an oil import fee, it would deprive the American consumer of these benefits and could hinder the economic recovery generated by price reductions.

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*/ This cost estimate is based on the Department of Energy's ("DOE") report that demand in 1982 was approximately 15.2 million barrels per day. U.S. Department of Energy, "Monthly Energy Review," DOE/EIA/0035 (83/02) (February 1983).

**/ Petroleum Industry Research Foundation, Inc., "The Oil Import Fee Issue" (April 19, 1982) at 6.

B. Inequitable Impact

1. On Regions.

An oil import fee would affect several regions of the country and certain consumers more adversely than others. First, a fee would be felt more directly by the Northeast and portions of the Southeast because these regions rely more heavily on oil for heating, commercial, industrial and agricultural processing, power generation and transportation.

Second, a fee would discriminate against the nation's 14 million home heating oil consumers. Despite the past several years' increase in natural gas prices, the differences between residential heating oil and natural gas prices remain significant.*/ Natural gas prices have stabilized at a level about 20 percent below average home heating oil prices. Accordingly, there is no energy or economic policy justification for discriminating against heating oil consumers. An import fee would only exacerbate an already difficult situation.

2. On Trading Partners

Since 1977 the United States has steadily reduced its dependence on imported oil, and thus its vulnerability to supply disruptions. For the first time since 1973, OPEC

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*/ The Bureau of Labor Statistics price comparisons for the lower 48 states reflect natural gas prices ranging from \$4.98/MMBTU to \$8.01/MMBTU, which is 63 to 99 percent of the home heating oil price. See U.S. Department of Labor, Bureau of Labor Statistics, "Consumer Prices; Energy and Food," November 1983.

members are not the principal suppliers of oil to the United States.

Accordingly, an oil import fee would have only a minor impact on the OPEC nations, but a severe effect on such non-OPEC nations as Canada, Mexico and the United Kingdom, from which the United States receives nearly half of its oil imports. These countries are among our nation's strongest trading partners.

C. Inefficient Method of Raising Revenues

An oil import fee is a very inefficient method of raising revenues to reduce the budget deficit. Each dollar of fee would result in a net increase in Treasury revenues of only about 38 cents.*/ Sixty-two cents would be lost through (1) decreases in collection of other taxes resulting from higher petroleum prices and their effect on the economy, and (2) increased federal outlays for petroleum and social programs.

D. Market Intervention

An import fee would constitute a major intervention by the government into the market. Historically such intervention results in distortions and inefficiencies. In light of this problem, coupled with the inequities and inefficiencies discussed, Congress should not impose an oil import fee.

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*/ Petroleum Industry Research Foundation, Inc., "The Oil Import Fee Issue" (April 19, 1982) at 7.

II. Energy Tax

While the Committee's proposal to impose a 2.5 percent tax on all sources of energy would also interfere with the market, it would not exacerbate, to the same degree, the inequities among fuels and among regions of the country. However, an across-the-board tax would still create significant problems. As a result, our associations also oppose this form of tax as a means of reducing the federal budget deficit.

A. Economic Impact

An energy tax, much like an import fee, will be inflationary and will create distortions in the economy. Consumers will certainly pay more for the energy they use directly. Moreover, because all goods and services have an energy component, consumers will pay more as manufacturers, farmers and other suppliers pass through their own energy tax payments. In addition, as consumer purchasing power is reduced, there will be a corresponding reduction in real GNP and employment.

B. Inequitable Impact

1. Energy-Intensive Industries

While the Committee's proposal states that some type of exemption, credit or refund will be available to "energy exports," it is not clear that the Committee has or will consider the effect of such a tax on energy-intensive industries, regardless of whether they export their products.

The steel, petrochemical, plastic, automobile, and airline industries all would be adversely affected. Those goods and services would become less competitive in the world market. More importantly, they would be less able to compete with imports in the domestic market. If those industries are placed at such a disadvantage, they will cut back production, American jobs will be lost, and the economic recovery will falter.

2. Trade Deficits

In addition, because all industries rely to some degree on energy, the competitiveness of all U.S. products would be affected. Thus, any possible balance of payment benefits due to reduced petroleum imports would be offset by reductions in exported products.

In late November the Department of Commerce announced that the trade deficit reached a record high level in October.

> The trade deficit jumped to a monthly record in October, following a temporary improvement in September. Imports increased sharply while exports slipped. The $9.0-billion October deficit far exceeded the $6.4 billion average monthly shortfall in the third quarter. Large deficits will continue in 1984.*/

An energy tax would only heighten this problem.

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*/ "Statement of Secretary of Commerce Malcolm Baldridge on Merchandise Trade for October," United States Department of Commerce News, Washington, D.C., November 29, 1983.

C. <u>Inefficient Revenue-Raising Method</u>

As this Committee is well aware, the primary reason for imposing an energy tax would be to raise revenue and reduce the federal budget deficit. However, such a tax is a very inefficient method of accomplishing this objective. Revenues collected would be offset directly by federal outlays for energy and for entitlements programs, many of which are adjusted automatically to reflect inflation, and indirectly by reduced GNP and greater unemployment. Thus, while a 2.5 percent tax could collect about $17 billion over three years, the net revenues raised would be substantially below that figure.

III. <u>Tax on All Energy Sources</u>

If Congress decides to adopt such an across-the-board tax despite all of the distortions which it will create, it must ensure that such a tax is equally imposed on <u>all sources of energy</u>. We are concerned that tax rates based on "the national average price of each taxable energy source" may still result in inequities because such computations ignore differences in transportation and regional fuel dependency.

In addition, an across-the-board energy tax must avoid creating regional distortions. The tax must not place the East Coast at an economic disadvantage or favor consumers of natural gas and other energy sources over consumers of oil. Moreover, to the degree an across-the-board energy tax relies upon a percentage computation and does not impose a uniform cents-per-barrel equivalent tax on all energy sources, certain petroleum products, particularly residual fuel oil and home heating oil, will be competitively disadvantaged. To avoid this result, the tax should be established at an equivalent cents per barrel rate.

IV. Conclusion

In sum, the Empire State Petroleum Association, the Independent Fuel Terminal Operators Association, the New England Fuel Institute, the Pennsylvania Petroleum Association, and the Northeast Coalition for Energy Equity strongly oppose an oil import fee or energy tax because both are inflationary, inequitable and inefficient as a means of reducing the deficit.

Thank you very much.

Commentary on Deficit Reduction Proposals

Submitted to

The United States Senate

Committee on Finance

December 1983

Submitted by

Edison Electric Institute
1111 19th Street, N.W.
Washington, D.C. 20036

COMMENTARY FOR THE SENATE FINANCE COMMITTEE HEARINGS ON THE DEFICIT

The Edison Electric Institute is the national association of investor-owned electric utility companies. Its members provide over 77 percent of the country's electricity, and serve over three-quarters of the U.S. population. We are pleased to offer our view of the deficit problem and to relate the probable effects of both the deficit and the reduction proposals.

The prospect of sustained, large deficits projected well into the future is a compelling vision. Federal spending overruns in the area of $200 billion are forecast by most observers to occur under otherwise healthy economic conditions. The future revenue shortfalls cannot be attributed to an ailing economy, but instead signal a perpetual imbalance of revenues and expenditures as they are presently formed. This structural deficit has given occasion for economists of diverse perspectives to form a general concensus of opinion that the long-term consequences of such consistently large deficits are potentially severe, and that the situation must be remedied. Included in this group are some economists who ordinarily question commonly held views of the dangers of the deficit. The near unity of opinion stems from the fact that the relentless inequality of spending and income, which now appears to be embedded in the economy, is not ordinary.

In fact, there is not an historical base for analysis which matches the outlook for the future. Never before have we faced peacetime deficits of such persistence and magnitude in proportion to total GNP. Since 1950 the deficit/GNP ratio has reached three percent during only three years. Now we confront a deficit/GNP ratio in excess of four percent for the next five to six years at a minimum. Moreover, the proportion of the excess spending to total output is not the only problem. In addition this implies an increasing burden on balancing the budget as total cumulative debt plus interest escalates by its own momentum. The deficit incurred in each successive year would have to decrease, through spending reductions or tax increases, by the amount of interest on outstanding debt for all previous years just to maintain a stable annual addition to total debt. In the words of Herbert Stein, who testified before the Committee on the subject, "the whole process feeds on itself." 1/ The quantum leap from deficits of $13 billion in 1967 and $46 billion in 1977 to $183 billion in 1983 assures that the interest payable will be a sizeable sum.

The main concern with deficits, of course, is that they have to be financed. The likely consequences differ according to who "buys" the debt. If the deficit is financed by Federal Reserve acquisition of securities, the result can be an increase in the general price level. The alternative method, bond sales to the public, can raise the real interest rate and depress private investment as the government competes with the private sector for funds. Government demands for money are said to crowd out savings available for private investment when they absorb larger proportions of total savings. It is the crowding-out effect that is of most concern today. We already are experiencing high real interest rates and only 4.4 percent of the 1982 deficit was acquired by the Federal Reserve. The balance was financed by the public.

High real interest rates associated with large deficits also injure the economy by contributing to the overvaluation of the dollar in foreign exchange markets. While the high interest return on investment has attracted capital inflows from abroad, thus mitigating the crowding out of domestic funds available, the increased demand for the dollar has put upward pressure on its cost in international exchange. The result is a financial disadvantage for U.S. exporters and for domestic firms that compete with imports.

The electric utility industry has a real stake in the level of interest rates because it is highly capital intensive. In fact, except for government, utilities are the dominant participants in capital markets. Utilities account for one-fifth of all new industrial construction, undertake one-quarter of all corporate financing, and issue one-half of all new common stock for nonfinancial companies. During the 1983-1987 period, electric utilities expect to spend $160 billion on construction of new plant and equipment. Of the $126 billion total cash construction expenditures required for the previous five-year period, $86 billion, or 68 percent of the total, was externally generated and therefore subject to the prevailing interest rates. 2/

The Congressional Research Service investigated the effects of higher interest rates that could result from deficit financing. The study does not take a position on the likelihood of deficits remaining at high levels or whether or not crowding out will take place, but merely simulates the impacts a one-half percent and one percent interest rate increase would have on various industries if these increases should occur. Of all the industries examined, electric, gas, and sanitary public utilities suffer the largest reduction in output due to higher costs incurred from interest rate increases. The combination of the Tax Equity and Fiscal Responsibility Act (TEFRA) and a counteracting one-half percent rise in interest rates increases the cost of capital, which in turn raises the price of electricity. The demand for electricity consequently drops by 1.7 percent. TEFRA plus price increases caused by a one percent interest rate hike reduces demand by 5.29 percent. 3/ Clearly, to the extent that the real interest rate rises due to large deficit financing, electric utilities are affected considerably.

Crowding out can affect not only the affordability of funds for investment, but also their availability to private enterprise. As large government borrowing encroaches on available savings, that remaining for capital formation by the private sector is necessarily reduced. In 1983 the federal government could absorb 43 percent of total available credit market funds. 4/ The depletion of funds for investment in new capital stock, upon which future productivity will be based, is a primary concern raised by the deficit outlook.

In addition to the financial market constraints on capital formation that can be imposed by a sustained level of excessive government spending, fiscal policy embodied in tax legislation can deter investment as well. Both the incentives carried in tax policy and the stability of that policy are important to investment.

This is especially true for electric utilities. Investment in utility plant and equipment has an exceptionally long lead time from the decision to invest to commercial operation. Nuclear plants, which are relatively capital intensive, require approximately twelve years to build, and coal plants, relatively fuel intensive, require about seven years. Secondly, once a plant is in place it will remain in place a long time. The median service life for plants that have been retired is 40 to 50 years with nearly ten percent of retired plants exceeding 55 years of service life. 5/

Capital formation and productivity remain problems for both corporate planners and government policymakers. The linkages between the two are difficult to conceptualize and have proven even more difficult to quantify. Nevertheless, it is likely that insufficient productive investment, including lack of R&D expenditures and diversion of investment to nonproductive efforts, has been a major factor contributing to the slowdown in productivity growth since 1965.

Although electric utilities are more capital intensive than most industries, adequate and appropriate capital equipment is central to the productivity performance of the economy as a whole. Four-fifths of U.S. industries have experienced lower productivity growth since 1973 than they had from 1948 to that year. The average annual rate of change declined from 3.0 percent to 0.8 percent. Consequently, capital is needed in the private sector to restore productivity and to sustain economic growth.

When unanticipated government decisions change the parameters of the investment decision, capital in place can be made economically obsolete and less productive. That is, capital in place, although prudently chosen in the past, becomes inappropriate under the new conditions imposed by policy changes. Investment in addition to what would otherwise be normal is required to replace the prematurely obsolete capital. Government policy in general, and deficit reduction measures in particular, should strive for stability and increased availability of capital to the private sector in order to encourage capital formation and to improve productivity.

Recent tax changes show especially well how much the tax aspects of an investment decision can change in a short time. In 1981 the Economic Recovery Tax Act (ERTA) made major changes in the direction of encouraging capital formation and saving. Because of evidence of low productivity and insufficient capital formation, Congress decided that a tax stimulus for investment and economic recovery was needed. The creation of an accelerated cost recovery system, changes in the availability of investment tax credits, and other provisions of ERTA provided benefits for investment purposes to electric utilities. Yet, in the following year, 1982, TEFRA cut these expected benefits in half.

This is just a single example of how important it is to maintain stability and harmony among national objectives. Instability can nullify otherwise optimal decisions of the past.

New policies are now under consideration. Energy taxes are again being viewed as one mechanism to raise revenue in order to reduce the deficit. The questions raised by this proposal are highly complex and intertwined with broad tax policy, energy policy, economic policy, and the consequences of the deficit itself. When reviewing the policy choices we must be very clear about the objectives we want to achieve, the benefits and costs we should balance, and the trade-offs we must necessarily make.

Generally, any tax can have one of two purposes: (1) to raise revenue or (2) to correct a defect in the price system,. The primary purpose of the current proposal is for additional revenue to reduce the deficit.

However, bringing down the deficit is actually only an intermediate goal. What is really of interest is the health of the economy. Therefore, it must be emphasized that energy taxes are an inappropriate vehicle for this aim because they adversely affect the economy.

We know immediately that energy taxes would be inflationary as measured by the various price indices. Energy prices would be higher.

We also know that billions of dollars would be collected from consumers ($16.7 billion from 1985-1987 under the current proposal). The role of energy producers as tax collectors will expand. An opinion survey taken this year indicates the public opposes energy taxes. This opposition crosses the bounds of geographical regions, political parties, and family income. 6/

There are additional but less direct consequences of which we can be quite certain. (1) The impact of energy taxes would vary by region. States with high per capita energy consumption, whether for climatalogical, geographic, or economic reasons, would pay higher per capita taxes. Thus, energy taxes in effect would constitute regional economic policy. (2) Energy taxes are also well known to be regressive by imposing a disproportionate burden on lower income households. (3) Another consequence would be the competitive impacts, both domestic and international, on industries with varying uses and sources of energy. Manufacturers that employ an energy-intensive means of production, for example, steel and aluminum companies, would be penalized. Many of those who would suffer the most are already struggling to compete in world markets. All three of the above points illustrate that even with a seemingly uniform energy tax, such as the ad valorem tax proposed, the effects are not evenly distributed among taxpayers.

Another disparity we urge the Committee to consider is that utilities are both consumers and producers of energy. If utilities are taxed on the primary energy used for electricity generation and also are required to levy a tax on their electrical output, the price effects of the tax borne by electricity would be substantially greater because, compared to other energy forms, electricity would be taxed twice.

In addition to specific adverse impacts seen on the micro-economic level, energy taxes may well be counterproductive in the broader scheme of the economy. Recent econometric studies have shown that the fall in the rate of economic growth in the 1970s was due to a dramatic decline in productivity. The energy price increases of that decade contributed to the drop in productivity growth. [7/] Given the body of analysis available to us today, we must consider higher energy prices induced by energy taxes to be a threat to productivity and economic growth.

A recent study by Data Resources, Inc., found a broad-based energy tax to have surprising results: not only is it inefficient dollar for dollar in reducing the deficit, but it actually undermines one of the ultimate goals of deficit reduction by suppressing business investment - hence, capital formation - below the level which would be undertaken without the energy tax.

In the Data Resources simulation the energy tax generated the following course of events: an immediate rise in inflation confronts a steadfast Federal Reserve hold on money supply, resulting in a general suppression of the economy. Consequently, federal revenues decrease and spending for transfer payments increases. After the second-round effects filter through state and local governments, the federal deficit is reduced by only 38 cents for each dollar of the energy tax. Secondly, saving is decreased due to lesser income and business investment is actually less than it would be under the same scenario without the energy tax. [8/]

In short, energy taxes are burdensome and fraught with unintended consequences. The deficit should be dealt with through policies that work directly on the problem, and not through the costly and ineffective means of energy taxes.

As the Finance Committee is all too aware, there are no simple cures for the deficit problem. We commend the Committee on the resolve with which it is undertaking a technically difficult and politically unsavory task.

It appears that revenues and expenditures are so out of kilter that corrective measures will be required on both sides. On the revenue side, the structural nature of the federal deficit implies the need for structural tax reform.

Tax systems typically are evaluated by the criteria of fairness, economic efficiency, and practicality for implementation. 9/ The present tax system was considered deficient in all three categories, particularly economic efficiency, by the participants in the White House conference on capital formation. 10/

Consequently, as the Congress seeks ways to reduce the deficit, we strongly recommend that additional tax distortions for revenue raising purposes not be added to an already jerry-built system.

Now is the time to consider fundamental tax reform. For example, the tax system could be simpler and more efficient. Implementing a modest level of tax reform directed at reducing the deficit could be timely.

Alternative tax systems that, if properly structured, may fit the standards of fairness, efficiency, and practicality are consumption, value-added, and flat-rate taxes. While there are advantages and disadvantages to each, variations of these reform measures merit consideration. By shifting incentives from consumption to saving, retaining incentives for capital formation, and by broadening the tax base, they offer at least the potential of stimulating the economy and mitigating the deficit problem. Also, unlike energy taxes, they need not be imposed on specific or essential commodities. Adoption of this kind of tax system by other nations proves that implementation can be feasible.

Tax policies should assist in determining our economic future rather than adapting to it in piecemeal fashion. Investment incentives or disincentives carried by tax policy today will define, in part, the capital stock of the future. If tax policy can be formed carefully and deliberately so as to endure, at least fundamentally, the passage of time, that in itself will provide some stimulus for investment. To the extent that we can reduce the instability of policies affecting the investment decision and provide for adequate capital availability to pursue public and private investment decisions, productivity and overall economic performance will be enhanced.

FOOTNOTES

1. Stein, Herbert, "Controlling the Budget Deficit: If Not Now, When? If Not Us, Who?," The Economist, December 1983, p.7.

2. EEI Construction Expenditures Survey.

3. Gravelle, Jane G., Congressional Research Service, Effects of Tax Depreciation Changes and Federal Deficits on the Allocation of Capital and Output, July 1983, p. 25.

4. Gough, Robert A., "Will Big Deficits Spoil the Recovery?, The Data Resources Review of the U.S. Economy, June 1983, pp. 1.23 and 1.24.

5. Inventory of Retired U.S. Steam Electric Power Plant, Utility Data Institute, July 1982.

6. Opinion Research Corporation, ORC Public Opinion Index Report to Management, September 1983, p. 10.

7. Jorgenson, Dale W., The Role of Energy in Productivity Growth, May 1983, p. 46.

8. Brinner, Roger and Caton, Christopher, "Energy Tax: An Inferior Cure for the Federal Deficit", The Data Resources Review of the U.S. Economy, September 1983, p. 1.17.

9. Bradford, David F., "The Choice Between Income and Consumption Taxes," Tax Notes, August 23, 1982.

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The Economist

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BUSINESS BRIEF

America cannot afford its cost of capital

American businessmen have long complained that raising money is too expensive. Their arguments usually allude to real rates of interest which—taking triple A corporate bond yields minus the rate of inflation—are about 7%. In fact the real cost of capital is much higher. This week, Mr George Hatsopoulos, chairman of a Massachusetts high-tech company and a director of the Federal Reserve Bank of Boston, told the joint economic committee of congress that the real annual cost is close on 20% and has been at this level since 1974.

Backed by detailed research* from a team of businessmen, engineers and economists (including some from the Massachusetts Institute of Technology) Mr Hatsopoulos argued that this high real cost of capital (three times the level in Japan) is American industry's biggest handicap. It is smothering economic growth and innovation, and lies behind growing import penetration (especially from Japan).

Estimating the cost of capital is more complex than the stripping of inflation from bond yields. Capital costs depend both on where the capital comes from (debt or equity) and where it is going to (fixed assets, inventories or receivables). These different uses of capital have different tax allowances, depreciation rates, etc, which affect the overall cost. Chart 1 shows where non-farm, non-financial American companies have raised money since 1960, and what they have done with it.

The overall real cost of business investment has two ingredients:

- The basic cost of raising money—a weighted average of the cost of debt and the cost of equity. For the marginal cost of investment (the cost of one extra unit) the appropriate weighting is a company's target debt-equity ratio. This, says Mr Hatsopoulos, for the average American company, is 1:3.
- The costs and benefits arising from the different ways the money is used: depreciation, tax rates, investment allowances, inflation rates, and inventory obsolescence.

The overall cost of capital is a weighted average of the costs of money invested in buildings, land, inventories and net receivables (ie, unpaid bills). The weights come from the data in chart 1.

Getting it

The cost of fixed-interest debt is easy to measure: it is the triple A corporate bond yield. Working out the cost of equity is a little harder. Companies often use the reciprocal of the price-earnings (p/e) ratio as a surrogate. However, equity costs depend on many other factors, the most important being projected dividend growth. They can be high even when p/e ratios are high.

A better estimate of the cost of equity is the rate at which expected future dividends (as perceived by the company's management) must be discounted to arrive at the company's present stockmarket valuation. This way of working out equity costs is analogous to the way the cost or yield of a bond is worked out—namely, the rate at which its coupon stream must be discounted to arrive at the bond's current market value.

Equity costs fall when the market value of a firm's shares rise, because the rate at which the (unchanged) dividend stream has to be discounted falls. Companies often assume that financing investment through retained earnings is cheaper than through rights issues. But both sorts of equity cost the same in America where companies can repurchase their shares at market value.

The cost of equity (so defined) boils down to the sum of today's dividend yield and the projected dividend growth rate. The first is known; the second is the devil to forecast. Dividend growth for companies as a whole will depend on a host of factors: expected inflation; the projected real return on capital; and forecast tax, depreciation and investment allowance schedules.

The overall cost of capital depends on the relative use of debt and equity. Since 1961, the Hatsopoulos study finds that the ratio of debt to total capital rose from about 20% to a peak of 27% in 1972 before falling back to about 22% for the two years 1980-81.

This finding—that balance-sheet gearing is quite modest and is lower today than in 1972—is reassuring. But it contrasts with the diagnosis of other economists and brokers (such as Salomon Brothers) who have gnashed their teeth over a secular decline in equity ratios since the 1950s, and a current debt-equity ratio of almost one. How come?

Some of the difference arises because the Hatsopoulos group looks at companies' net debt (total debt minus liquid assets). The alarmists look at gross debt. The difference is material: in 1981 liquid assets were 20% of total debt. In addition, Mr Hatsopoulos eschews book valuation of debt. He revalues debt by multiplying book values by the ratio of the market value to the book value of bonds quoted on the New York Stock Exchange.

Equity costs are a much more important component of the total cost of money than bond yields. In 1981, the nominal pre-tax cost of equity was well above 30%; triple A bond rates were about 12% (see chart 2).

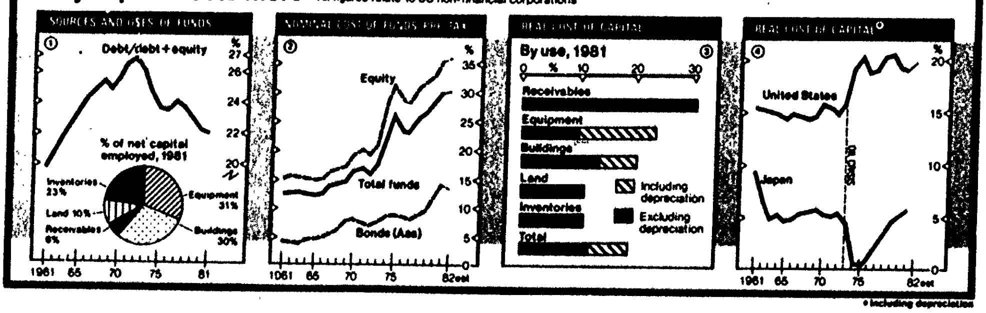
Since the level of the stockmarket is the key to the cost of equity, it is also a main determinant of the cost of capital. Wall Street's recent boom has done much more to reduce funding costs than the earlier fall in interest rates. The very sharp rise in the cost of money in 1974 was primarily a reflection of the stockmarket's plunge.

Equity is more expensive than debt for two reasons: risk and tax. Investors demand a higher return from equities because bondholders get an earlier crack at the assets of bankrupt companies. The premium on this risk is the gap between bond yields and after-tax equity costs.

Also, under the American (and most other) tax regimes, dividends are paid out of after-tax corporate income while interest is paid out of before-tax income. For equity and debt to command roughly comparable risk-adjusted yields in investors' portfolios, the pre-tax cost of equity has to stand at more than

* High cost of capital: Handicap of American industry. By George Hatsopoulos, Thermo Electron Corporation, 101 First Avenue, Waltham, Massachusetts. Figures in our article are drawn from the study, which was sponsored by the American Business Conference.

Why capital costs more All figures relate to US non-financial corporations



* Including depreciation

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twice the pre-tax cost of debt.

Why then do American companies rely so heavily on equity? Mainly, of course, because, come hard times, dividends can be pared and—in extremis—even passed. Bond interest and principal repayments must be met on the nail. But American corporate treasurers also rely on equity out of habit, ignorant of the fact that in 1981, when bond yields hit the roof (namely 14%), equity was even more expensive.

Using it

The cost of raising money is only one element in the overall cost of capital. Each way of using the money incurs a different net cost because of different adjustments for inflation, taxation, depreciation and investment allowances. For example, the cost of fixed assets (equipment and buildings) is the cost of capital plus the cost of depreciation less the benefit from tax credits and investment allowances and less the benefit from inflation.

Depreciation is the dominant factor. In 1981, for example, the real cost of equipment, excluding depreciation, was 9.4%—very close to the real cost of funds of 8.9% (the nominal cost less the expected inflation rate). But, with depreciation included, the real cost of equipment shot up to 23.3% (see chart 3).

Land is straightforward. It does not depreciate—anyway, the taxman does not recognise the possibility. So the real cost of land is the same as the real cost of capital. Effectively, so is the real cost of holding inventories. But the real cost of holding net receivables (unpaid bills) is the full nominal cost of money. Unpaid bills gain nothing from rising prices or tax breaks.

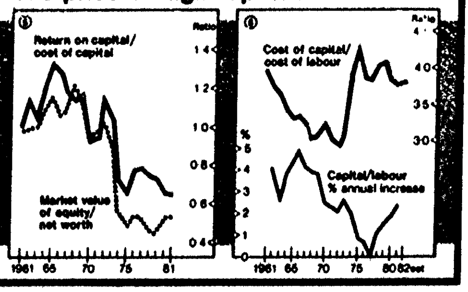
The overall real cost of capital is significantly higher than the real cost of raising money for two main reasons:

- Depreciation raised the cost of equipment and buildings by about 14 and six percentage points respectively in 1981.
- The cost of receivables is very high (about 30% in 1981) because there is no offset for inflation or tax.

Since 1960, about 60% of all capital raised has been channelled into equipment and buildings, in roughly equal proportions. The fraction spent on land has fallen sharply—from 17% to 10%. The slack has been taken up by inventories (up from 21% to 23%) and net receivables (up from 1% to 5%).

Relative costs have also changed. In 1961, the cost of financing equipment, buildings, land and inventories (net of depreciation) was similar. Since then, tax changes have been biased towards equipment. By 1981, the cost of financing buildings, inventories and receivables had risen by about 40%, 25% and 140%. The cost of buying equipment, by contrast, stayed put. This has favoured basic industries such as steel (which carry large fixed assets) at the expense of high-tech industries (which do not).

In the two decades to 1981, real capital costs rose from 15% to almost 20%. The big jump came in 1974. Of the 3.35 percentage points jump in that year, only 0.35 of a point was due to higher inflation. Three points reflected a steeper real cost of funds—mostly due to the stock-market's fall pushing up real equity costs.



The price of high capital costs

Over the whole 20-year period, a higher real cost of funds and higher inflation (which pushed up the overall real cost of capital by four points and nearly two points respectively) were mitigated by an increasingly liberal tax regime (which knocked 3.2 points off capital costs).

However, President Reagan's 1981 Economic Recovery Tax Act (which was heralded as a breakthrough) did not help much. A one-point rise in the after-tax cost of capital would be enough to wipe out its effects. Some of the act's benefits will anyway have been eroded by the belt-tightening 1982 Tax Equity and Fiscal Responsibility Act.

Regretting it

There have been at least four important consequences of the high real cost of raising money in America.

- The cost of capital has risen much more sharply than the cost of labour (see chart 6). The result is, although companies are still year-on-year employing more capital for each hour of labour, the capital-to-labour ratio is growing at only 1% a year compared with an average 3.3% a year before 1974.

Mr Hatsopoulos does not accept the argument that the substitution of labour for capital should be encouraged (eg, by abolishing investment incentives). He holds that the route to higher employment is through faster growth, which requires higher capital-labour ratios and which, in turn, waits on a lower real cost of capital.

- Corporate profitability has not increased to compensate for the rising cost of capital. The ratio of the return on capital to its cost has been falling since the mid-1960s (see chart 5). In every single one of the past eight years, the ratio has been less than 80%. Corporate America has not even been covering its costs. At the same time, the ratio of the market value of companies' equity to their net worth has plunged by 50%.

The collapse in equity values during the 1970s has led to the surge of acquisitions and takeovers. When the return on capital is less than its cost, new investment makes little sense. But the same investment, undertaken by snapping up an existing business, can be profitable if assets are acquired at well below replacement cost.

- American companies' high real cost of capital hurts their international competitiveness. Higher productivity in Japan, the Hatsopoulos report suggests, is at least in part due to higher capital investment (twice America's as a percentage of gdp) boosted by extraordinarily low real capital costs.

Until the oil crisis of 1973, the real cost of capital in Japan was about half what it was in America (see chart 4). Since then, the gap has widened. In 1981, the inflation-adjusted cost of capital in Japan was a mere 5½% against 19% in the United States. When depreciation costs are stripped out, the real cost of capital in Japan is consistently negative. This compares with a real rate in the United States of about 13%.

Two reasons for Japan's advantage: (i) Balance-sheet gearing is much higher (on average net debt is probably about 75% of capital employed). But in times of growth, Japanese companies' debt-to-capital ratios can rise well above 75%. Debt of 5-10 times equity is not unusual. (ii) The nominal cost of debt is very low, frequently below expected inflation.

Japan's capital-cost advantage is almost as significant as its better-documented wage-cost advantage. In 1981, says Mr Hatsopoulos, a typical product costing $10,000 to manufacture in America would cost only $4,900 in Japan. The lower marginal cost of capital accounts for 45% of the total cost saving of $5,100.

- American innovation is being squashed by high real capital costs. The economic value of new ideas is very sensitive to the cost of capital. That means that new technologies may be developed profitably in Japan yet remain uneconomic in America. The Hatsopoulos paper calculates that, in order to offset the benefits of lower Japanese capital costs, American venture capital companies need an (unthinkable) subsidy of $6 for every $1 that they raise.

How can America's high cost of capital be reduced? Mr Hatsopoulos is more concerned to identify the problem than solve it. But he does make two suggestions:

(a) Restore the benign macro-economic conditions of the 1960s—4% inflation, low real interest rates and low equity risk premiums. That would reduce the real cost of capital to about 13½% (a little below the 15% cost of the 1960s owing to more generous capital allowances).

(b) Revamp the tax code. If dividends on cumulative preferred stock had, like interest payments, been tax-deductible the cost of capital to profitable firms would have fallen from 18.8% to 9.8% in 1981. That would have reduced Japan's capital-cost advantage on a product costing $10,000 from $2,300 to just $700.

Statement on Prospects for the Economy
Economic Advisory Committee
November, 1983

I. PROSPECTS FOR THE ECONOMY

Real economic activity peaked in July of 1981 and hit bottom in November of 1982. Since November, 1982, the recovery in most respects has proceeded in an average fashion. However, there are some areas of concern that are worth watching.

The first year of the recovery was lead by consumer spending, particularly housing and autos. Accompanying the recovery have been two distinct periods of monetary policy. From November 1982 to July 1983 the money supply grew at an annual rate of 13.4 percent. This aggregate has been growing at an annual rate of 2.1 percent over the last 3 months. Throughout the recovery fiscal policy has continued to be expansionary. The budget deficit for the fiscal year ended September 1983 was $195.4 billion. Official projections have it staying at approximately this level in the next fiscal year.

The current recovery is a unique period of adjustment to what has been a fundamental break with the 1970's. The world economy is flat with slight prospects for strong recovery in the OECD countries for this year or next year. In addition, the international debt situation and the high value of the dollar have resulted in declines in U.S. exports to some countries.

Fiscal and Monetary Policies

Fiscal and monetary policies of the recent past and in the near future will be important determinants of the course of economic activity this year and in 1984. Fiscal policy has been on an expansionary path and will remain so for at least the next couple of years. Monetary policy became stimulative in the middle of last year but monetary authorities have recently adopted a more moderate stance. With a stronger economy now, the Federal Reserve will be more conscious of the need to control inflation. It will attempt to follow policies accommodative enough to maintain the recovery but restrictive enough to prevent it from getting out of hand.

Financing the projected large levels of government spending growth is a problem today and will continue to be a problem. If Congress and the Administration fail to reduce the projected growth of government spending and the associated outyear deficits, the combination of massive Treasury borrowing requirements and potentially strong private demands for credit spell serious trouble for the economy. This trouble would occur because of the dilemma in which the Federal Reserve would be placed. The large deficits will result in high nominal interest rates, no matter how they are financed. With stable money growth, the increased borrowing due to the deficit will result in high nominal interest rates and cause a slowdown in the economy. If the Federal Reserve attempts to lower interest rates through an easier monetary policy, such a policy will immediately engender expectations of higher inflation which will build higher inflation premiums into interest rates and frustrate attemps to lower them by direct central bank action. The slowdown would occur anyway. If the deficits are closed through tax increases rather than spending reductions, impediments to private sector growth and job creation will be significantly increased.

Economic and Financial Prospects Through 1984

Given current policies and the state of the economy, the recovery should continue through 1984. However, higher real interest rates could weaken the recovery due to their effects on interest sensitive industries, housing, and the debt repayment capacities of less developed countries.

In the second year of the recovery, economic growth will be more moderate, but sustainable — around 4 1/2 percent. The trend toward more moderate economic growth will be facilitated by the current slowdown in money growth. The world economy will be weak, and the dollar will be relatively high, leading to weak demand for exports. Consumer spending including durables and housing will moderate in 1984 relative to its strong growth in 1983. This is the normal pattern in the second year of a recovery and it will be accentuated by the slowdown in money growth and social security tax increases.

The growth in business fixed investment spending has lagged the growth in consumer spending but the lag has not been greater than is normal for this stage of the economic recovery. We expect this type of spending to pick up in the second stage of the recovery. Cost cutting efforts by corporations, moderate wage demands, and the net effects on business taxation of the Economic Recovery Tax Act of 1981, and the Tax Equity and Fiscal Responsibility Act of 1982 have produced significant increases in internal corporate cash flows. High levels of real interest rates, and uncertainty about the continuation of economic expansion beyond 1984 may have somewhat of a dampening effect on this type of spending. On balance, we expect business fixed investment to have a positive influence on sustained economic growth in 1984. Inventory accumulation will slow down in 1984 as inventories reach the more normal levels associated with the second year of an economic recovery.

Given the economic growth, there should be a strong rise in employment and a decline in the rate of unemployment. The behavior of unemployment will depend upon growth of the labor force and the return of discouraged workers into the labor force. The best news on inflation is now behind us, but we still expect the CPI to average less than 4 percent in 1983 and somewhat higher in 1984. The behavior of inflation after that will depend upon monetary and fiscal policy. We have already noted that, without substantial budgetary changes, fiscal policy will be on an expansionary path for some time to come.

Although the growth of the money supply has slowed in recent months, 1984 is an election year and we may see political pressures to expand it at a higher rate. Corporate profits are likely to remain strong, particularly in relation to the dismal performance of corporate earnings in recent years. Interest rates in 1984 will be about the same as in 1983, although there is a good prospect for a decline in the levels of the rates in early 1984 and a rise in the second half of 1984.

Long Term Economic and Financial Prospects

Over the long term our most important economic policy need is control of government spending. Recent legislation has resulted in tax increases but no significant reductions in the prospective rate of growth of spending. Most of the easy reductions in prospective spending growth rates have already been made. Fiscal policies will continue to restrain economic growth for many years unless additional difficult cuts are made.

The committee expects a moderate rate of inflation over the balance of the decade. This should have a moderating effect on nominal interest rates. The secular real growth of GNP is likely to be around 3 to 3-1/2 percent over this period. The forecast assumes implementation of sound budget policies as described in section II of this statement and monetary policy consistent with the eventual achievement of price stability. This growth rate does not mean that all industries will share equally in this growth or that all firms within an industry will share equally in this growth. Calls for protectionism will be a negative factor in the long run, particularly if we see a continuation of slow growth in the economies of the rest of the world and a strong dollar.

Conclusion

The outlook for the economy is encouraging, especially in relation to the performance of recent years. Of course, many unpredictable events can sidetrack any forecast. The greatest threats to the longevity of this recovery are that Congress and the Administration will be unable to get a grip on the spending problems that loom so large on the horizon or that the Federal Reserve will follow monetary policy that leads to a reignition of inflation.

II. FEDERAL BUDGET POLICY

The Administration has based its economic program on four main elements: reductions in the rate of growth of government spending and taxes, monetary policy designed to reduce inflation and a program to reduce the regulatory burden on businesses and individuals. The first two elements directly influence the budget. Reductions in taxes were carried out through the Economic Recovery Tax Act in 1981. However, some of the reductions were eliminated in 1982 by the Tax Equity and Fiscal Responsibility Act (TEFRA). Expenditure reductions were accomplished in the 1983 budget. However the deficits, including off budget items, are estimated to be approximately $200 billion in FY 1984 and FY 1985 and over $150 billion in FY 1986 and FY 1987.

Our Committee feels that the prospective deficits will result in real interest rates higher than they would have been at lower levels of deficits. These high deficits and increased rates will have adverse effects on the economy which are meaningful and worthy of attention.

The Committee believes significant reductions in the growth of spending should be an urgent government priority. All sectors of expenditures should be candidates for reduction. Since defense and direct benefit payments for individuals make up 71% of government expenditures in 1984 according to the recommended budget, these areas must be examined closely.

The Committee is skeptical of the benefits of advocating tax increases. Tax increases may have negative impacts on the long run health of the economy and seem to do little to decrease deficits. In particular, our fear is that tax increases, ostensibly to reduce deficits, may shift the political focus away from the need to reduce spending and, in the end, not achieve any real reduction in the deficit. TEFRA was enacted to decrease budget deficits.

After its enactment the estimated budget deficits for the next two years are still about $200 billion. Its actual effect on the deficit is small and it has had a negative impact on the prospects for long term growth of the economy by decreasing the incentive to invest.

A most important need for both businesses and individuals is to have consistent tax policies over time so as to facilitate rational financial planning and reduced deficits. The tax system should be structured so as to maximize the amount of funds going to productive investment in the private sector. A healthy, growing private sector of the economy can best be facilitated by significant reductions in government spending so as to free up real resources for private investment.

UNITED STATES SENATE

COMMITTEE ON FINANCE

Hearings on Deficit Reduction Package, December 12, 13, and 14, 1983

STATEMENT BY E. RAY CANTERBERY, PROFESSOR OF ECONOMICS, FLORIDA STATE UNIVERSITY, ON DEFICIT PROBLEM AND TAX REFORM

1. The Deficit Problem

The size of projected and prolonged budget deficits are well-known. Most economists and elected officials are also aware of most of the consequences. Presently U.S. real interest rates are about 100 percent greater than their historical averages. Business expansion nonetheless has proceeded at a reasonable pace during the past year because retained earnings have been growing rapidly. This fortuitous growth in corporate liquidity cannot be sustained throughout 1984 and the competition between the federal government and businesses will place considerable upward pressure on interest rates sometime during the year. The economic stagnation that characterized 1979-1982 could return.

Even if we are very lucky and the economic slowdown does not begin until 1985, it would be a mistake to wait any longer to address the deficit problem. Interest payments on debt, 11 percent of the federal budget in fiscal 1983, already is greater than spending on social support programs. However, at currently projected deficits interest payments will rise to 29 percent of the budget by the year 2000. Private debt also has been growing rapidly, even at historically high interest rates. Together, at the 1970s growth rates for national income and net interest income, the entire U.S. national income would equal net interest income sometime in 1996! We would be a nation whose sole source of national product would the printing of debt claims.

Despite the magnitude of the problem, the proposals have been piecemeal. "Bipartisanship" seems to demand only the appearance of addressing the difficulties--a few billion cut here and there, a few billion extra revenue from cumbersome sur-taxes here and there. The sur-taxes, in particular, are counterproductive because if they are to be fair, they must be imposed on Higher-income households. However, since these households are able to reduce their income tax bases, the extra tax revenue cannot be expected to be high. There are those in the Congress and the White House who apparently believe that American citizens would prefer another recession in 1985 to tax reform beginning in 1984. Since professors must believe in learning curves, we hope that these are not the same officials who believed that citizens preferred the 1981-1982 depression to unaltered tax rates.

2. Tax Reform I: Income Taxation and Entitlements

Quite simply, we need a new tax base. The income tax code has been amended to the point that it no longer resembles remotely a fair and viable system. The first step in reform is to simplify the income tax system even while increasing its fairness to assure compliance. First, all tax preferences would be eliminated so that all income (including unearned income) is taxed alike. Of course, this cannot be done in one giant step, but we could begin--in 1984. The most flagrant preferences (such as unequal taxation of capital gains) would go first. Eventually, as the overall shape of tax reform became visible, the politically sensitive preferences such as (first) home interest deductions could be eliminated.

The second step makes the elements of the first palatable. Every family, rich or poor, buys necessities. Exemptions for dependents under the income tax code were originally meant to cover the above contingency, namely, to provide a tax credit equal to the amount spent simply to maintain life. Rather than increasing this exemption as the cost of necessities has gone up, the Congress has added special exemptions on the basis of the power of special interests. Small groups have enjoyed great gains at the expense of the general public. I recommend that there ultimately be only <u>one</u> exemption, the only exemption that is truly neutral. The household income tax exemption for dependents would be raised to a value equal to the cost of a marketbasket of necessities. The value of this sole exemption would vary only with the demographics of the household. For example, the BLS "lower" consumption budget or a share of it, say 80 percent, could be used as the measure of the necessities basket for the urban household of four.

The third step would introduce a new tax rate schedule. A flat tax rate would apply to <u>all</u> income (once all preferences are eliminated) in excess of the minimal consumption budget (gross discretionary income) in <u>each</u> income interval, a rate progressively higher at higher discretionary income intervals. Suppose, for example, that the necessities basket for an urban family of four were priced at $10,000 for 1984. Then, such a family with a gross income of $30,000 would pay income taxes only on $20,000 or only on its gross discretionary income. In turn, the tax rate on $20,000 discretionary income might be 15 percent and that on $100,000 out of $110,000 gross income, 30 percent. The maximum marginal tax rate would be exceedingly attractive to all but the most greedy. Since any positive rate of inflation would increase the size of the consumption budget each year, "bracket creep" for all taxpayers, rich and poor alike, would be avoided. Ideological neutrality is sustained because the expenditure patterns of rich nad poor alike show that both place highest value on essentials.

We would still have a problem (as we do today) with the unemployed and present unemployables who have incomes below the minimal consumption budget. Conservatives bemoan the "disincentives" of the hodgepodge of welfare services: liberals complain about the infringements upon freedom and dignity from the various "needs tests". The negative income tax, endorsed by liberal Nobelist James Tobin and conservative Nobelist Milton Friedman, is an ingenious system for transferring income to the poor whereby a minimum income would be guaranteed providing income supplements. The supplement should be sufficient to maintain the social minimum for necessities and would be reduced by some fraction (less than 1) as the household earned additional income. Since an increase in earnings would always add to disposable income available to the household, the supplement would not be a disincentive to seeking employment. Moreover, the negative income tax would eliminate the need to bring new workers into the social security system and ultimately the payroll tax connected with such future benefits.

Our society is committed to the provision of absolute necessities for every person in need. However, the welfare programs are comprised of a strange assortment of "incomes in kind". The government can best reduce its direct bureaucratic involvement in such programs by moving toward a cash payment system as quickly as possible. Even before the full implementation of a negative income tax, administered solely by the Internal Revenue Service, the government could convert the food stamp program into a cash program. Then, the household would have the freedom to allocate such resources to best meet its immediate needs. A negative income tax would enable the government to get out of the public housing business, medicare and most entitlement programs.

3. Tax Reform II: A Value-Added Tax Base

Still, the income tax is not the ideal form of taxation. An effectively progressive income tax (essential for equity) cannot be neutral in its impact on the allocation of resources. A flat but progressive tax on discretionary income, in the absence of other revenue sources, would tax personal saving at a high marginal rate. However, a part of this impact is mitigated by other sources of investment funds. Total federal taxes paid by corporations has steadily declined from 23 percent of total federal tax collections in 1958 to 9 percent in 1983. A great share of gross business investment is financed from retained corporate earnings. These earnings come from consumer expenditures that would be bolstered by spending from tax-exempt income and the negative income tax. However, in the interest of neutrality and the avoidance of double taxation of corporate profits, we need to make the final step and reduce corporate profits taxes to zero. At the worst, this final action would make the world quieter. The giant corporation would have to forgo its annual compliant that it is being "taxed to death".

The death of corporate income taxation and the residual problems with even a reforned personal income tax system brings us to a needed and desirable alternative tax base. For a quarter-century public interest in a value-added tax has waxed and waned in the United States but never quite disappeared. During 1979 and 1980 Senator Russell Long and Representative Al Ullman, chairmen of the two main congressional tax-writing committees, courageously supported such a tax. We cannot avoid speculating how much different economic history might have been if Ullman's H. R. 5665, the Tax Restructuring Act of 1979, had been considered and passed. In my judgment VAT failed to gain widespread support because it was not considered within the context of a larger debate on tax structure and equity. The above changes in the structure of income and corporate taxation eliminates the main objections to a value-added tax.

Administrative efficiency demands that all consumption should be taxed at a single, flat rate. In the interests of equity, this means that VAT should <u>not</u> be implemented without a reduction in the income taxes paid on the personal income allocated to necessiti s. Rather than a cumbersome problem-plagued system in which a different VAT rate applies to different goods and services, the value of the VAT paid in the price of neccesities would simply increase the value of the income tax credit for necessities. As with inflation, any increase in VAT would raise the value of the exemption by about the same amount. In this way VAT would be both administratively efficient and equitable. Otherwise, a VAT on neccessities such as food and medicine would be regressive with respect to money income.

A value-added tax would raise the price level by at least the percentage of the tax and thus must be implemented in stages. These increases could be coordinated with the proposed changes in the income tax structure. For example, careful study might conclude that a 2 percent VAT would be appropriate in the first year of the new tax. In theory, the tax base for VAT is the value added to the product at each level of production. In practice, the tax base is measured by the increase in sales price at each stage of production. Each stage in the chain collects the VAT on its sales, takes a credit for VAT paid on purchases to other firms, and remits the net amount to the IRS. At the end of the chain, the consumer pays the full amount of the tax in the sales price of the good or service and with no other reform measure would bear the full burden.

The value-added tax can take at least three forms--gross-product, income-type, or consumption type. The consumption-type VAT is recommended because it is neutral with regard to prices of consumption goods as long as the base is comprehensive and the rate is single. The consumption variant also provides the most neutral treatment of capital assets and is the easiest in this regard to administer, in part because arbitrary depreciation allowances need not be calibrated. The consumption-type VAT is equivalent to instantaneous depreciation of new physical capital.

Since value added is the value that a business firm adds in the course of its operations to the goods and services it purchases from other firms, such value is added by handling or processing these purchases with the firm's labor force, machinery, buildings and capital goods. In the consumption variant of VAT the initial acquisition of capital goods is treated the same way as the purchase of supplies. Under this tax base, the firm may deduct, in the year of the purchase, the full value of the capital good. The value-added by the capital equipment is not subject to taxation until later years, as the equipment is consumed in the process of production. Thus, taxation on the "value" of capital happens only once.

Let us consider the following example for the tax base under the consumption variant of VAT. The firm's gross receipts are $125,000 during the taxable year. During the accounting period the firm purchases $25,000 of materials and supplies from other firms and $10,000 of machines (capital goods). The tax base would be $90,000: the purchases on both current account ($25,000 for materials and supplies) and capital account ($10,000 for the machines) are subtracted from the gross receipts from final sales.

The exemptions from the VAT base must be rare. However, most experts would agree to the following exemptions. Exports would be exempt in order to avoid taxing our foreign neighbors (whose own VAT is refunded on our purchases). Also exempt would be the rental value of owner-occupied homes because of the administrative nightmare of calculating imputed (unobserved) values. Federal government purchases would be excluded because the government would pay the tax (as a part of prices) and derive no net revenue from it.

Under these provisions the VAT tax base would equal approximately 60 percent of Gross National Product. If 1983 GNP turns out to be $3500 billion, the tax base would be about $2100 billion, and one percentage point of VAT would yield an additional tax revenue of $21 billion. The recommended first-stage tax of 2 percent would yield about $42 billion. Again, I emphasize that the consumption-type VAT is efficient and equitable only if accompanied by a necessities income tax credit for all households.

We need comprehensive tax reform. A piecemeal approach is destined to fail. Because of the magnitude of the new revenue required to end the deficit problem, the required tax change will have tremendous changes in allocations of resources and degree of equity among households. Those changes are unacceptable. Every part of the elephant must be examined; otherwise, many persons and businesses will be crushed by its mis-step.

STATEMENT OF WILLIAM A. MAAS

EXECUTIVE VICE PRESIDENT

FLORISTS' TRANSWORLD DELIVERY ASSOCIATION

SOUTHFIELD, MICHIGAN

ON THE

REDUCTION OF THE FEDERAL DEFICIT

Submitted for the Record of Hearings

Committee on Finance

U.S. Senate

Washington, D.C.

December 30, 1983

Mr. Chairman and Members of the Committee:

This testimony is presented on behalf of Florists' Transworld Delivery Association, a member-owned cooperative of independent small businessmen. FTD is the oldest and largest of the florist intercity delivery services -- wire services, as they are sometimes called. Its 20,000 members do business in virtually every city and town in the U.S. Founded in 1910, FTD provides marketing, research, educational, and other services to its members, while serving as a clearinghouse for member transactions.

There is no question that the U.S. economy has recovered to a substantial degree from the 1981-82 recession. While it is worth noting that this recession was hard on small businesses such as ours in terms of bankruptcies, we feel that attention should now be concentrated on the "up side"; that is, continuation and expansion of the period of relative prosperity in which we now find ourselves.

We still feel that for businesses marketing highly perishable products which are dependent upon discretionary purchasing by the consumer, the current recovery still leaves us at risk. We would agree with a recent statement by House Small Business Chairman Parren J. Mitchell that we have a "mixed economic outlook for small businesses. Small business depends to a great extent on short-term bank loans. Interest rates on those loans averaged three to four percentage points above the rate of inflation between 1952 and 1980. Current rates on short-term small business loans are seven to ten percentage points above inflation, which is expected to be about 4.5 percent this year. The high short-term rates will slow the recovery, thus harming small business."

This situation is but one of several that leads us to agree with the proposition that the $1.4 trillion public debt is the biggest obstacle to a sustained economic recovery.

Members of this committee have forthrightly sought to grapple with this problem through a balanced approach to reducing entitlement kinds of spending and proposing necessary tax increases. It was regrettable that action could not be taken in 1983 to bring spending into line with Senate and House Budget Committee targets, thereby bringing about a substantial reduction in the federal deficit over the next three years.

We are encouraged by the fact that Legislative and Executive Branch leaders now seem more ready to deal with this problem in the second session of Congress - even though it is an election year.

Failure to achieve results in this area, even if on a limited basis at first, can only result in bigger federal government borrowing in the capital markets, which will dry up funds available for business to invest and in other ways expand our economy on a sound basis. Such a negative situation would also mean continued high interest rates and, most likely, reduced ability to control inflation.

We understand that the staffs of this committee and the Joint Committee on Taxation, together with the Treasury Department, are drafting legislation to implement a federal budget deficit reduction, and that the plan will be considered by this committee in February, 1984. With the fiscal 1984 budget deficit now pegged at about $185 billion; it behooves all of us -- as Senators Dole and Danforth have stated -- to take effective action to turn back the trend toward ever expanding deficits.

We believe that businesses, large and small, must get behind a solid and well developed program of deficit reduction in their own long range self interest, which we think coincides with the national interest.

Thank you for this opportunity to present our views.

123083

STATEMENT
OF THE
GREATER HOUSTON HOSPITAL COUNCIL

SENATE FINANCE COMMITTEE HEARINGS
ON
DEFICIT REDUCTION PACKAGE

DECEMBER 12, 13, and 14, 1983

The Greater Houston Hospital Council, founded in 1970, is a metropolitan association of over 80 hospitals within a geographic region of 15 counties in the Texas Gulf Coast area. We represent approximately 27% of the hospital beds in Texas and 2% in the nation and are comprised of a broad cross section of not-for-profit, investor-owned, county, district, state and federal hospitals. However, the primary mission of the Greater Houston Hospital Council is a singular one: to promote the common interests of our members so that their service to the community will be of greatest value to its citizens.

Members of GHHC provide the best quality health care at reasonable costs. In a survey recently conducted by the Equitable Life Assurance Society of the United States, the daily service charges of Houston area hospitals for a semi-private room were 25% below the national average. Our members are committed to cost containment and reduction where possible.

The Greater Houston Hospital Council understands the dangers posed to the nation by current federal deficit levels. We believe that every segment of society should make sacrifices to assure the stability of our economy and we commend Chairman Dole and the members of the Senate Finance Committee for addressing this problem. However, we believe that the hospital industry has made unprecedented sacrifices and undergone sweeping changes already this year to control federal expenditures. Never before has any industry experienced such revolutionary changes in its financial system as those presented by the conversion to a prospective pricing system under Medicare. We strongly urge the Congress not to make additional changes in the prospective pricing system before we can adjust to the new system. As you know, the Social Security Amendments of 1983 (P.L. 98-21) were signed into law beginning on October 1, 1983. However, a majority of hospitals whose cost reporting year begins in January or later, have not yet intitiated prospective pricing. To change what has hardly begun is not fair to thousands of hospital administrators working hard to implement the new system. Changes in the federal blend timing, a DRG rate freeze, or the elimination of the annual 1% increase for increased technology will reduce the economic rewards of cost-effective behavior and jeopardize a system that has not yet been tried.

The GHHC is anxious to cooperate in the solutions to health care financing problems. We hope the Congress will recognize the enormous challenge being confronted by the hospital industry and will, as we have, commit itself to the success of the prospective pricing system.

THE INSTITUTE FOR THE STUDY AND ENCOURAGEMENT OF COMMON SENSE ECONOMICS

The Need for Prompt Enactment of a Major Deficit Reduction Package

Statement of Grant R. Sykes before the Committee on Finance, United States Senate December 12-14, 1983

Summary of Remarks

Before one can know what to do about controlling the Federal deficit it is first necessary to recognize what does and what does not cause the deficit. The deficit is not caused by taxes being too low. It is not caused by the needs of national defense, It is caused by misplaced public sentiment and by the corruption of the political role of the Federal Government. Most Americans are already over-taxed and over-borrowed. Because American business operates in a high tax economy, it is difficult for it to compete internationally without reliance upon overt and covert export subsidies.

The Solution to the deficit problem calls for the implementation of revolutionary ideas that will convert a high tax economy to a high investment economy. This will be possible only by greatly diminishing the role of the Federal Government in all areas of American life. Some ways in which this may be done are offered in this paper.

Statement of Grant R. Sykes

Gentlemen, I am pleased to present this paper on behalf of The Institute for the Study and Encouragement of Common Sense Economics. The Institute consists of myself and others alarmed by the steady drift of the American Economy toward the abyss of financial disaster. We are unincorporated.

I. First, what are the Economic Consequences if the Administration and Congress do nothing to address the deficit problem?

It should be obvious that inescapable disaster will follow if nothing is done, or if the wrong things are done.

II. Second, do we need to act in Early 1984 or can we afford to wait to address the deficits?

Whether we can afford to wait or not depends on how lucky we are. It is an imponderable as to when the public will awake and see that the Emperor has no clothes. It may be tomorrow. It may be next year or the year after. But, awake it must because the Emperor's closet is bare, and the public can no longer be given gifts of something with nothing.

III. What specific legislation is recommended to reduce the deficit?

The major item in the deficit wracked federal budget, and the one which is most unnecessary, is interest on the national debt. This item is not only enormous, it is unpredictable. The rate of interest is now beyond the power of the authorities to manipulate except in the very near term and with unpredictable results. To eliminate interest it is necessary to eliminate the national debt. This can be done by (1) inflation - a kind of underhanded default, (2) by heavy taxation - a sacrifice of public welfare to assure salvation of the international financial establishment, or (3) by the exercise of genius and imagination.

We will probably be forced to dissolve the system of fractional reserve banking. Every time the Government spends borrowed money it creats a potential credit of 5 to 10 times as much in the banking system whether or not there is any increase in the production of goods and services. This fuels potential run-a-way prices. Even when the Government borrows from a saver it multiplies the credit supply. This is because a new credit instrument supports extra credit for the lender, even as the cash lent to and spent by the Government returns to the banking system.

A system for converting the present national debt into "productive" bank credit has been suggested as a means for wiping out the interest cost of the national debt. This can be done by the use of bank medallions, specifically, gold medallions. This system would provide fractional gold reserves without providing open ended credit expansion beyond the actual needs of a productive and healthy economy. I prepared a paper discussing how such a conversion of public debt to bank credit would work. It is available to those truly interested in resolving the problem of the high cost of the national debt. [1]

1 See Sykes, Grant, letter to Secretary Regan with attached paper "How to Implement a Gold Standard as an Effective Investment of Fiscal Policy", January 18, 1982. Included with the appendix to the Report to Congress of the Gold Commission.

Another order of business whould be the enactment of a flat rate tax to replace both payroll taxes and the income tax. With such a tax all individuals not engaged in business would escape harrassment by the Internal Revenue Service since all income taxes would be collected from businesses paying wages, interest, or dividends - all at a flat rate. There would be no deductions for interest, charity and whatever. Therefore there would be no need for federal interference in church affairs either. More important, everyone, not just wage earners, would pay income taxes. After all, the Social Security Tax is a flat tax already, and it falls on gross wages. A flat rate tax of 20% would cover all transfer payments including Veterans benefits and the payroll of the Government, both civilian and military. Under the proposed flat rate tax the first $2,000 of tax revenue collected would go to a taxpayer's IRA. Joint taxpayers would be able to put $4,000 into IRAs. This would provide IRA retirement benefits for housewives with no income of their own. Since IRA funds, unlike Social Security receipts, would be invested in stocks, bonds and mortgages, (income producing rather than tax consuming investments) they would provide high investment rates for the U.S. economy.

Because all sums raised by the flat rate tax in excess of $2,000 per taxpayer would not go into IRAs, they would be available for Government payrolls and for welfare schemes. By the way, Food Stamps should be paid only to institutions housing and feeding welfare clients and not directly to the clients. This would eliminate waste and cheating in these idleness provoking programs.

The Federal Judiciary could easily be dismantled. It is not necessary to have both federal and state courts. We do not have both federal and state bars and lawyers. Why do we need Federal Judges? This Congress could strive to adopt legislation that would operate within the states as Uniform state laws do now. All laws should be administered by state authorities. There is hardly a federal function, including the Post Office, the Federal Reserve, CAA, FCC, FTC, ICC etc., that couldn't be more effectively and efficiently handled on a decentralized basis. Sure, there would be some differences in administrative interpretation, but then we've always had a law with majority and minority rules and it has worked beautifully because it met local needs and mores. What we have now is more akin to a bureaucratic dictatorship than a popular republic.

As to contractural procurement needs of the Government, these should not be financed out of income taxes but by excises and tariffs. If the Government needs to make 10% of the toll telephone calls it can tax toll calls 10%. If it needs 20% of the steel production it just takes 20& of all steel produced or imported into the country. If Armed Forces mess halls take 4% of the canned peas produced, slap a 4% excise on canned peas and allow the manufacturer to pay the tax in kind if he chooses. With excises and tariffs fixed to meet actual planned requirements, there is absolutely no reason to have unbalanced budgets.

Finally, tariffs must be raised. Competive free trade is fine but the American economy is a high tax economy. Goods entering this country from low tax economies must be subjected to tariffs to enable domestic manufacturers to compete without being placed at an unfair disadvantage.

I will be happy to enlarge upon these remarks at any time. I may be reached at the address below.

Thank you very much.

Grant R. Sykes
5001 Seminary Road, #910
Alexandria, Va. 22311
Telephone number - 931-1921

Statement
by
Norman B. Ture, Chairman of the Board,
Institute for Research on the Economics of Taxation
to
Committee on Finance, U.S. Senate
on
A Deficit Reduction Package

I applaud the Committee's holding hearings on whether or not a major deficit reduction package is needed in 1984. As the recovery continues at a healthy pace, it is important that we not impede it with tax increases aimed at counteracting the allegedly adverse effects of the projected budget deficits. No tax raising action is either needed or desirable in 1984. The Congress and the Administration should focus attention, instead, on a basic overhaul of the Federal tax structure as the long-run goal of tax policy. Priority should be given to replacing the existing jumble of taxes with a flat rate, uniform and broad-based consumption tax.

The U.S. Congress has made it through one more year without raising the fiscal foot and shooting same. If they are to have continuing success, I believe, policy makers should be guided more by facts and less by a conventional (but mistaken) wisdom. If they were, they would observe that the recovery is proceeding very well without the burden of new, additional taxes. Certainly no tax increases should be enacted before the recovery is substantially achieved and the economy is on a sturdy, sustained growth path.

IRET has sought repeatedly in 1983 to demonstrate that budget deficits are not the fiscal villian. We have insisted that deficits do not generate inflation, they do not raise interest rates, they do not crowd out private capital formation. The facts about the economy's performance in 1983 certainly affirm those contentions, not the contrary assertions of the conventional wisdom.

Because the facts don't support the assertion that budget deficits produce these adverse economic consequences, those who insist on this notion maintain that these dreadful effects are yet to come. They have, in fact, been insisting on this since early 1981. Bear in mind that today is the very future to which the dire forecasts of early 1981 referred. But even as the deficits soared since that time, interest rates plunged, the inflation rate moderated to rates reminiscent of the 1960s, and private capital outlays have been the fastest growing element in the economic surge over the past year.

This certainly is not to suggest that Federal budget deficits themselves generated the recovery, the slowdown in inflation, or the drop in interest rates. Rather it is to urge a rejection of the simplistic budgetary arithmetic which, in the face of stubbornly contradicting facts, is used to urge the Congress to commit an act of fiscal insanity by raising taxes.

The appropriate focus, I believe, should be on what the government spends money on, why it does so, how it does so, and the real costs of its doing so, on the one hand, and on what kinds of taxes the government imposes, on the other.

Federal outlays, not budget deficits, preempt the economy's production capabilities and subsidize a vast array of business and household activities, hence distort business and household decision-making. Federal taxes, not budget deficits, impact like excises on the costs of and rewards for the myriad types of business and household activities, masking the signals of the market place about the most efficient use of our production capabilities.

Surely the Congress, along with the vast majority of the Americans it represents, does not believe that all Federal spending programs would satisfy the appropriate budget criteria. Surely the Congress cannot believe that we have a tax system which least impedes efficient use of our production capability and the activities upon which economic progress depends. Doing something on both of these scores should be the primary concerns of Congressional budget policy, not manipulating budgetary aggregates in the pursuit of some presumably optimal budget deficit.

If the Congress is serious about putting the Federal Government's fiscal house in order, its first and most urgent efforts should be directed toward getting control, at long last, of Federal spending. What is required are not outlay ceilings in budget resolutions but, rather, the closest, most exacting scrutiny of the content of spending programs. No program should be exempted from this rigorous examination. Labeling a spending program an "entitlement," hence immune to the most drastic budgetary surgery, is simply to cop out. Many of the entitlement programs are vestiges of earlier and different times and circumstances; it strains credulity that these programs should not have been materially altered by now, if not entirely phased out. It is difficult to understand why the Congress does not recognize that the frequent crises in one or another part of the social security system are signals of the basic defects of the system and why it has not yet resolved to "privatize" the provisions for retirement income. If the Congress refuses to tackle such spending issues, difficult though they may be, it should not be surprised to learn it does not enjoy the public's confidence in claims about the need for tax increases.

I certainly don't mean this last comment as an endorsement of the truly weird fiscal prescription which calls for matching spending cuts and tax increases. This approach to deficit reduction has no basis in economic theory --- Keynesian, supply side, monetarist, or any other. It is justified instead primarily on the basis of a grossly distorted notion of fairness: if some people are to be injured by efforts to bring order out of fiscal chaos, others must be hurt as least as much. This "I'll hurt me if you'll hurt you" notion of fairness obscures the issue to which this approach ostensibly is addressed, i.e., that the budget deficits presumably will hurt the economy, hence what is called for are fiscal actions which will avert that hurt. Whether "fair" or not, tax increases will raise business costs by increasing the costs of labor, capital, and most likely, energy supplies, and will, therefore, impair the recovery and undermine the economy's growth. This kind of fairness, in short, is completely at odds with the very goal ostensibly sought by deficit reduction. This isn't fairness; it's fiscal inanity.

Common sense, one would think, argues that if there is any reason to raise taxes, it's to pay for increased spending. For the same reason, the more government spending can be cut, the less is the need to raise taxes. If fiscal-budgetary policy insists on pairing tax increases with spending cuts, wouldn't it be just as sensible to insist on cutting taxes when spending is expected to increase or to go up faster than before?

You may recall that matching spending cuts with tax reductions was precisely what President Reagan called for early in 1981. As it turned out, the Congress and the Administration delivered on only half of the fiscal package --- the tax reductions. But the Economic Recovery Tax Act of 1981 certainly should not be blamed for the ballooning of the Federal budget deficits. These are largely the result of the 1979-82 recession and the failure to slow adequately the growth in Federal Government spending. Congress' own official forecasters, the Congressional Budget Office, stated in a February 1983 Report to the Senate and House Committees on the Budget, "Over the entire 5-year period [FY 82-86], 60 percent of the change in outlook from surpluses to budget deficits can be attributed to the failure of the economy to perform as projected 2 years ago." 1/

In July of 1981, the Congressional Budget Office estimated that if the first Budget Resolution for 1982 became law, by as early a date as FY 1984 the government would be showing a surplus in the budget. This estimate wasn't the "rosy scenerio" of the Administration, but the prediction of Congress' own bipartisan budget office.

In 1981, the Congressional Budget Office projected that real GNP growth for calendar years 1982-86 would average a modest 4.4 percent. Federal outlays in FY '84 were then

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1/ Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1984 - 1988: A Report to the Senate and House Committees on the Budget, Part II" February, 1983 (p. 18) estimated to be $774 billion. But by February of 1983 outlays for FY '84 were estimated to be $850 billion, $76 billion more. 2/ Had there been no decrease at all in revenues, the increase in Federal outlays would account for much of our current deficit.

Behind this raise-taxes-to-cut-spending tactic there appears to be the perception of a "them and us" body politic. Some of us, in this view, are the beneficiaries of government spending while others of us are supposed to pay for the government's outlays. This "two America" view completely misfocuses fiscal policy, casting it as an adversary proceeding between haves and havenots. In fact, with few exceptions we are all at both the paying and receiving ends of the government's fiscal activity. All of us will be hurt by tax increases which must make productive, market-oriented economic activity more costly. And all of us will benefit from those reductions in government spending which free up production resources for more productive uses in the private sector, make it less costly

2/ Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1984 - 1988: A Report to the Senate and House Committees on the Budget, Part II" February, 1983 (Table 5, p. 16).

to use our time and talents in such pursuits, and reduce dependency on government supports. The American people have been clamoring for years for a slowdown in the growth of Federal Government spending; not to reduce budget deficits and certainly not to hurt themselves but, on the contrary, to provide us all with the benefits afforded by a more efficient economy, less distorted by government intervention. The fairness issue is even more mistaken than the "deficits-crowd-out" argument.

Raising Taxes Doesn't Cut Spending

Whether or not the American public buys the fairness argument, it's hard to believe they would be persuaded this time around that raising taxes actually puts a hold on government spending. It was, after all, little more than a year ago that the Congress and the Administration were telling us that TEFRA --- the largest tax increase in our history --- was necessary in order to cut spending, that for every dollar of tax increase there would be a $3 cut in outlays. The fiscal 1983 budget results are in and they show what everyone should have known all along: raising taxes facilitates spending increases, not spending reductions. The payoff for the largest tax increase in our history was to be a promised $280 billion in spending cuts. Much of these were not real (e.g., interest outlays would be reduced because interest rates would be lower because the government would borrow less; of course, the government borrowed more and this additional borrowing increased interest disbursements even though interest rates fell along with the record increase --- $235 billion --- in the public debt), but after adjusting for these cosmetic savings, the spending cuts actually agreed to in the first concurrent budget resolution totaled only $146 billion. Of that amount, however, only $53 billion were reflected in actual appropriations. By the time the last scene was played out, $74 billion in additional outlays had been agreed to. Federal spending had been increased by $21 billion above the levels in the current services estimates prevailing before the concurrent resolution. The promised spending cuts for which a huge tax increase price is to be paid turned out to be spending increases. 3/

This wasn't the first time the raise taxes-cut spending ploy had been tried. The Revenue and Expenditure Control Act of 1968 imposed a 10 percent income tax surcharge on

3/ The Economic and Budget Outlook: An Update. Congressional Budget Office, August, 1983. (See p. 101). "Cuts" based upon Office of Management and Budget estimates of baseline outlays as of September 1983.

individual and corporate taxpayers as the price to be paid for a tight clamp on Federal spending; a freeze was imposed on outlays other than social security benefits, defense, and interest. While Federal spending was soon allowed to increase, the "temporary" tax was in effect for 2-1/2 years.

Consumption-Based Flat-Rate Taxes: The Best Choice

Although I do not believe that a tax increase is necessary or desirable at this time, there is work that the Congressional tax-writing committees should get under way in 1984: a basic overhaul of the tax system. The present system is too complex; even worse, it strongly penalizes saving and all productivity-advancing activity. It is best described as a hodge-podge of selective excises; as such, it distorts market signals about relative prices and costs and induces misallocation of our production inputs. Tax policy should aim at junking the present tax system, replacing it with a uniformly and broadly applicable flat-rate, consumption-based tax. This clearly, is not a chore that can be completed overnight. It is a long-range project, the aim of which is to provide a tax climate far more conducive than the present one to a progressive, efficient, free-market economy. The effort to achieve that kind of tax climate should be careful and deliberate, not impelled to unwarranted haste by a mistaken urgency about deficits.

The revenue target for this restructured Federal tax system should be determined when it is clear that economic recovery is well in hand along with prospects for sustained economic growth. The basic decisions to be made in those circumstances pertain to the fundamental concerns of Federal spending policy suggested above: what kinds of things should the Federal Government do, how can it most efficiently do those things, and, consequently, how much are the appropriate outlays for each spending program. The trend path of Federal spending determined on this basis should be matched by the trend path of Federal revenues, derived principally from a broad consumption-based, flat-rate tax. To be sure, this budget strategy might call for an initial increase in revenues above the levels expected with the present tax structure. But one would hope that, in a prosperous and growing economy, the trend rate of growth of Federal spending, guided by the appropriate decision-making criteria, would be less than the trend rate of growth in the economy's total output and income. On that assumption, reductions in the consumption-based flat tax rate should occur frequently and regularly.

The Congress and the Administration will need to refocus their fiscal-budgetary attention and energies to achieve a rational budget policy. The second session of the 98th Congress affords the opportunity to initiate a period of fiscal reconstruction. One must hope that opportunity will not be lost in a futile chase after deficit reduction.

Written Statement

of

Kelly, Appleman, Hart & Hallman

Fort Worth, Texas

Senate Finance Committee

Hearings on Deficit Reduction Package

Held

December 12, 13 and 14, 1983

Submitted
December 29, 1983

The hearings focus on the problems to our economy resulting from a higher federal deficit. We strongly believe this emphasis is appropriate, necessary, and timely.

The series of questions in the Press Release focuses the issues correctly. We believe the deficits need to be addressed immediately in order that any economic recovery not be disrupted. Therefore, action in 1984 is necessary and the country can ill afford to wait until after 1985. As for specific Legislation to reduce the federal deficit, we strongly urge the committee to pass legislation that would increase economic activity and thereby increase revenue flow to the Treasury and reduce the federal deficit.

Specifically, we refer to legislation to clarify the current application of §355 to a family owned corporation primarily involved in the oil and gas business. Legislation resolving ambiguities in the application of current law would vastly increase the business activity of the corporations involved and generate substantial tax revenues to the Government.

The following is a brief summary of the factual situation and the equitable legislative solution.

<u>Current Factual Situation</u> - Four brothers own a substantial corporation primarily involved in the oil and gas business. The business formation is as indicated in Chart A. For sound business reasons, generally to ease decision making and let each individual brother proceed independently of the

others, a corporate division is necessary. After the division each brother would have an independent corporation. The business formation after a division would be as indicated in Chart B. A possibility of a ruling from the IRS was considered but is not feasible for a number of reasons. Primarily, there is doubt under current law whether oil and gas properties can be divided under §355 on an "undivided interest in the whole" basis. Because oil and gas properties are difficult to value a division on a property by property basis would be inequitable. Additionally, current law is unclear in situations where the separate corporations will utilize technical expertise of the distributing corporation in oil field services and exploration rather than undertaking these services themselves. In short, there are unresolved issues concerning the trade or business and business purpose requirements of current law that need statutory clarification.

Proposed Legislative Solution - The statute would be clarified to insure that the trade or business requirement and business purpose requirement would be met in this intra-family division of a corporation.

There are a number of reasons why this clarification is sound policy:

- o Assets subject to depletion are very difficult to value. Consequently, the only fair and equitable division would be on an "undivided interest in the whole" and not on a property by property basis. This unique aspect of oil and gas properties needs to be recognized in the §355 area.
- o The separate corporations should be able to utilize technical expertise in oil field services and exploration rather than undertaking these services themselves. This allows

maximum utilization of resources, is cost effective, and provides needed business flexibility.

- o Business activity and capital formation would be increased by a division. Intra-family disputes would be eliminated and each family member could pursue their entrepreneurial, capital formation opportunities apart from unnecessary familial restraints.

- o Each individual corporation would exercise completely independent investment decision making based on each corporation's independent advisors and investment strategy.

- o There is no possibility of a "bail out" of corporate earnings and profits in the division under this legislation.

- o Additional oil and gas exploration would be at the separate corporation level and not at the individual person level; therefore, tax reduction opportunities are reduced.

- o Each corporation after the division would pay corporate income taxes and shareholders would pay ordinary income tax on the dividends received.

- o Each corporation would individually assess risks of loss from investment decisions and not be imperiled by imprudent investments by other family members.

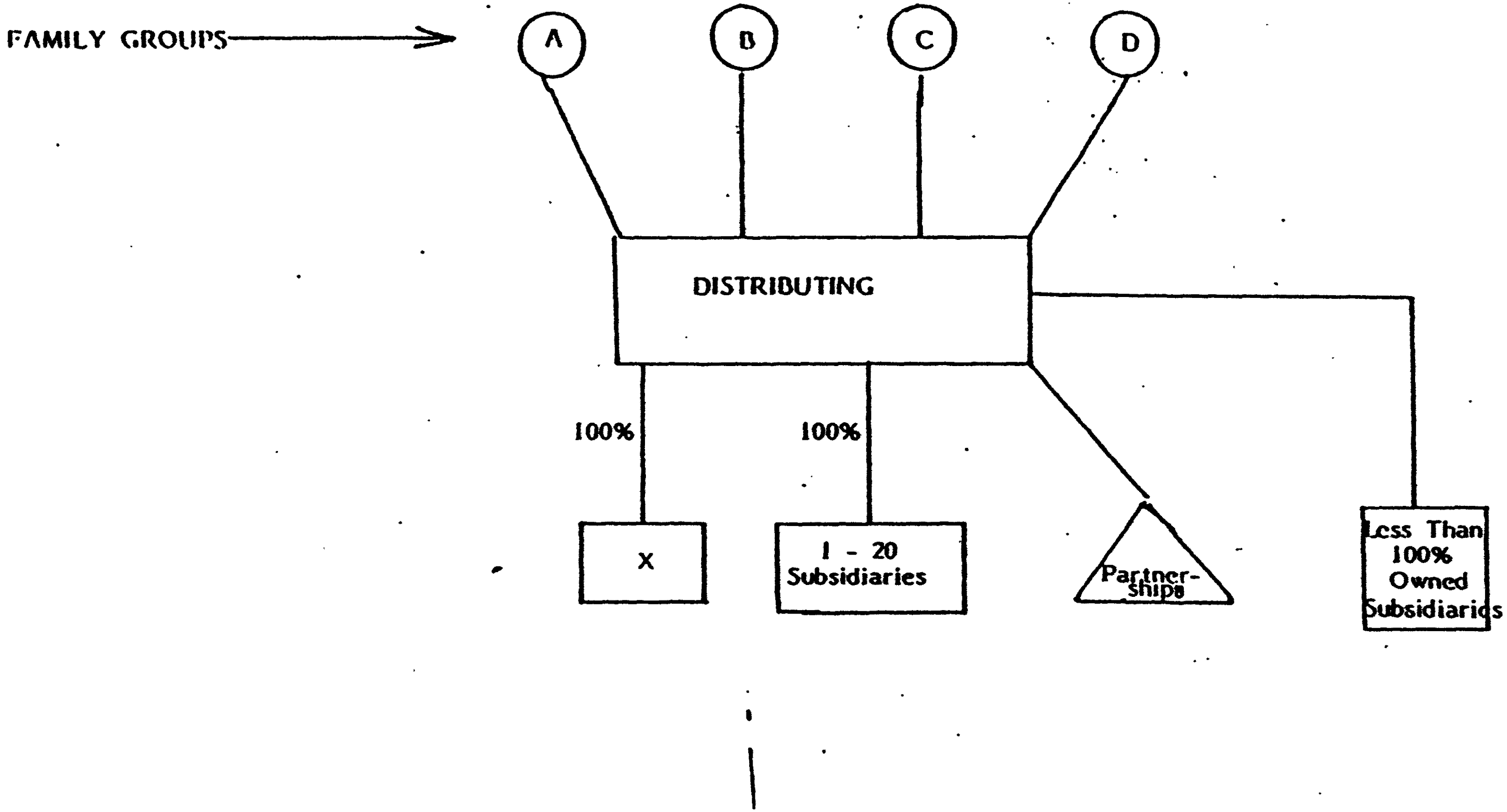
- o Allowing a tax-free division would give each separate corporation and shareholders greater access to capital markets for business expansion.

- o The legislation contains several requirements to prevent abuse or unintended applications.

- o There is no revenue loss from the legislation. In fact, tax revenues should increase pursuant to a division.

This transaction is in no way intended to be a device for the distribution of earnings and profits or any "bail out" of earnings and profits. The legislation does not change and is not intended to change current law requirements under the device test or provisions of $302 to prevent "bail outs."

As such, the affected parties and their counsel will continue to work with the Treasury, Joint Committee, Finance Committee, and Ways & Means Committee to develop a legislative clarification. The brothers affected merely desire to be able to pursue business opportunities independent of the current group arrangement.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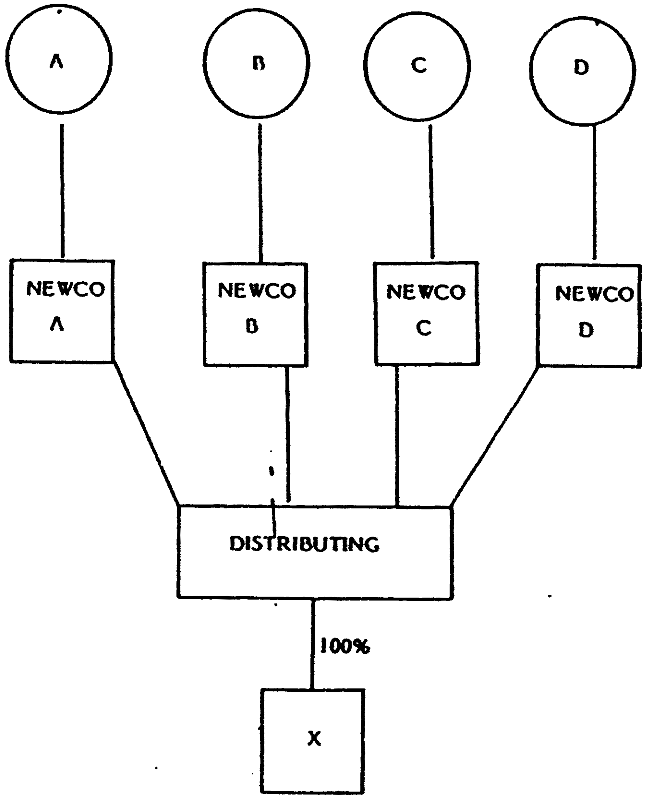

Assets of the Newco's consist of oil and gas, farming, real estate, securities, stock-in less than wholly owned subsidiaries, and partnership interests.

WRITTEN TESTIMONY
OF
MESA PETROLEUM CO.
AS REPRESENTATIVE OF
THE GULF INVESTORS GROUP

HEARINGS ON DEFICIT REDUCTION PACKAGE
SENATE FINANCE COMMITTEE
UNITED STATES SENATE
DECEMBER 12, 13 and 14, 1983

I. SUMMARY

BENEFITS OF ROYALTY TRUSTS TO SHAREHOLDERS:

-- A distribution of oil and gas royalties to a royalty trust can be very beneficial to shareholders. Royalty trusts have a strong record of enhancing shareholder value over both the long and short term. A royalty trust provides shareholders, in addition to their shares of common stock, with a direct interest in the net profits from a portion of oil and gas properties. Although individual and other shareholders may have to pay taxes upon receiving the distribution of the trust interests, the creation of a royalty trust will enhance the value of a shareholder's investment by an amount which will substantially exceed the related tax liability.

BENEFITS OF ROYALTY TRUSTS TO THE ECONOMY AND CAPITAL MARKETS:

-- The creation of royalty trusts provides a more efficient business structure for many energy commpanies which is clearly beneficial to our economy as a whole and our capital markets. A major goal of U.S. economic policy is to promote the most efficient use of capital. If business operations can be structured in the most efficient manner, a corporation will maximize the value of its stock, and be able to raise capital at attractive rates. This will increase both profits and employment. Greater efficiency and cost effectiveness in the energy industry is also desirable to help achieve U.S. energy objectives.

PIECEMEAL CORPORATE INCOME TAX CHANGES
SHOULD BE AVOIDED BY CONGRESS:

-- Congress is currently considering several tax changes which would discourage needed equity investment and reduce stock market liquidity to the detriment of all investors. Piecemeal changes in fundamental corporate income tax concepts can result in many inconsistencies and distortions and should be avoided.

PROPOSED TAX ON APPRECIATION SHOULD BE REJECTED:

-- Congress should reject the proposal to tax distributing corporations on ordinary distributions of appreciated property to shareholders. Since a distributing corporation realizes no gain on the transfer of appreciated property, no tax should be imposed on the distributing corporation. In many instances, the distribution will be taxed at the individual shareholder level on the receipt of these distributions. The imposition of this new appreciation tax would simply result in additional "multiple" taxation which has an adverse impact on capital formation. In particular, the proposal results in the imposition of an excessive capital gains tax burden in many instances.

PROPOSED BASIS REDUCTION SHOULD BE REJECTED:

-- Congress should reject the proposal to reduce, by the amount of certain extraordinary dividends, the basis of certain stock held by corporate shareholders. Enactment of this proposal will result in unnecessary multiple taxation, reduce stock market liquidity and aggravate the existing bias in the tax law in favor of debt as compared to equity financing. The arbitrary one year holding period in this proposal would add yet more complexity to the Internal Revenue Code. In terms of the realities of today's capital markets, a one year holding period clearly cannot be considered a short period of time since the performance of portfolio investments is often measured on a monthly or quarterly basis. Corporate investors provide an important source of liquidity to our capital markets which provides discipline and ensures greater efficiency in pricing. Disincentives to corporate equity investment such as this proposal will discourage such investment and reduce liquidity. The tax code, in many instances, encourages the use of debt and this proposal would further encourage highly leveraged capital structures which impair the ability of corporations to withstand adverse economic developments.

PROPOSED RESTRICTIONS ON THE INTEREST PAID DEDUCTION AND DIVIDENDS RECEIVED DEDUCTION SHOULD BE REJECTED:

These proposals relating to corporate indebtedness to purchase stock would also reduce market liquidity, discourage equity investment and raise the cost of capital for many companies. The proposals are inconsistent with recent action by Congress to encourage investors to take the types of risk needed to develop new products and processes in order to promote economic growth and to boost productivity.

II. ADVANTAGES OF A ROYALTY TRUST TO SHAREHOLDERS AND TO THE ECONOMY

Description of an Oil and Gas Net Profits Interest

An oil and gas "net profits interest" is an interest in oil and gas production which entitles the holder to be paid a specified percentage or fraction of the value of oil and gas produced from the property or properties subject to the royalty. The interest can be a percentage or fraction of the gross value or a percentage or fraction of the net profits. As an example, assume a 10 percent royalty on properties which produce oil and gas valued at \$1,000 with production costs equalling \$200. The royalty payable based upon gross value would be:

10 percent x \$1,000 = \$100

while the royalty payable based upon net profits would be:

10 percent x (\$1,000 - \$200) = \$80

Royalty Trusts

A royalty trust is created when a net profits interest in identifiable oil and gas properties is conveyed (typically by an oil and gas company) to a trustee. The trustee holds the interest on behalf of numerous individuals and entities who are the beneficial owners of the royalty (typically in proportion to their share of ownership in the company). The trustee delivers to the beneficial owners "units of beneficial interest" which evidence each owner's proportionate interest and disburses the proceeds to such beneficial owners. The trust has no employees and is not engaged in a trade or business other than receiving and distributing income.

Why are Royalty Trusts Created?

Most royalty trusts are created in order to increase shareholder value. The shareholders are the real owners of the company and a royalty trust distribution operates to give the actual owners of the company a direct interest in oil and gas properties held by the company.

Why Place the Royalties in a Trust?

Generally, royalty trusts have numerous properties and thousands of beneficiaries. That is, numerous oil and gas producing properties are burdened with a royalty that is owned by a great many more people than is typical. It is not practical to enter into the real property conveyances for each owner as is usually the case in the conveyance of a royalty. Therefore, the conveyance is made to a trustee who maintains internal records relating to the undivided ownership of the beneficiaries and the proper distribution of the royalty income.

Units of Beneficial Interest in a Large Royalty Trust are Generally Traded on a Stock Exchange

The units are listed and traded simply to provide liquidity to the numerous royalty owners. Usually, oil and gas interests are bought and sold in private transactions. Because a royalty trust involves so many individuals who own a portion of the same property interest covering the same properties, many sales and exchanges take place. Listing on the exchange provides the owners with public information concerning the properties, including reserve data that meets SEC requirements. The trustee engages outside auditors to audit the royalty revenue and disbursements and related financial information. Typically, professional Wall Street financial analysts publish their opinions as to the value of the royalties.

The Specific Benefits to Shareholders of a Royalty Trust

A distribution of oil and gas royalties into a royalty trust is extremely beneficial to shareholders. Royalty trusts have a strong record of enhancing shareholder value over both the short and long term. A royalty trust provides shareholders, in addition to their common shares, with a direct interest in the net profits from a portion of the oil and gas properties. Although, as previously noted, shareholders often have to pay taxes on the receipt of the distribution of the trust interests, enhancement in value of the shareholder's investment, as well as the increase in income from the investment, which can be achieved by a trust substantially exceeds this related tax liability.

The Benefit of Royalty Trusts to the Economy and Capital Markets

In many instances the creation of royalty trusts provides a more efficient business structure which is clearly beneficial to our economy as a whole and our capital markets. A major goal of U.S. economic policy is to promote the most efficient use of capital. Formation of the most efficient structure for a business to operate will maximize the value of the corporations's stock, enable the company to raise capital at the most attractive rates and maximize both profits and employment. A more efficient energy industry will enable the U.S. to achieve its national energy objectives in the best manner.

Some Income Tax Aspects of Royalty Trusts

The initial distribution to a royalty trust is treated as an in-kind dividend and is generally taxed in the same manner as any other dividend. An investment in a royalty trust subsequent to the distribution involves exactly the same investment and tax characteristics as buying a royalty in a private oil and gas transaction, buying a building or buying a piece of land. The holder of an interest in the royalty trust must look solely to oil and gas production to recover his investment. As oil and gas is produced and his investment is depleted, the investor recovers a portion of his investment as cost depletion. That is, over time, the portion of his oil and gas proceeds that represent a return of his initial investment are not taxed. This is similar to depreciation of a building or the subtraction of the original cost of land from the selling price to determine taxable gain. The cash received merely has an income component and a return of capital component exactly like a host of other normal business transactions.

III. PIECEMEAL MODIFICATIONS TO MAJOR CORPORATE INCOME TAX CONCEPTS LEAD TO MANY UNDESIRABLE CONSEQUENCES

Piecemeal changes to major corporate income tax concepts can lead to arbitrary investment distortions, new complexity and business uncertainty. These types of changes should only be adopted as part of a major restructuring of the whole corporate income tax system to ensure that all of the provisions are consistent with one another and achieve the objectives stated by Congress. This obviously requires extensive public hearings and very detailed analysis of the probable impact of any changes on all sectors of the economy.

Issues involving the tax treatment of changes in business structure -- whether liquidations, partial liquidations, reorganizations, distributions to royalty trusts, transfers to publicly traded limited partnerships or otherwise -- are extremely complicated as documented in "The Reform and Simplification of the Income Taxation of Corporations," A Preliminary Report Prepared By the Staff, Committee on Finance, United States Senate, S. Prt. 98-95, September 22, 1983.

IV. CONGRESS MUST REJECT THE PROPOSED TAX ON THE DISTRIBUTING CORPORATION ON ORDINARY DISTRIBUTIONS OF APPRECIATED PROPERTY TO SHAREHOLDERS

As part of his November 16, 1983 deficit reduction package,[1] Senator Robert Dole (R.-Kansas), Chairman of the Senate

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1/ "Summary of Proposed Deficit Reduction Package," November 16, 1983, Senator Robert Dole, page 4; "Description of Proposed Deficit Reduction Package," November 16, 1983, Senator Robert Dole, page 18.

Finance Committee, proposed that "any ordinary, non-liquidating distribution of appreciated property would be taxable to the distributing corporation for distributions after the date of Committee action pursuant to plans adopted after that date. Certain exceptions of present law (relating to, among other things, partial liquidations, carryover basis situations, and distributions of qualifying stock) would remain."

This proposal would have an adverse impact on the economy and should be rejected. A corporation realizes no gain on a transfer of this nature. Furthermore, in many instances the distribution will be taxed at the individual shareholder level at tax rates of up to 50 percent. An additional layer of tax will unnecessarily impede the free flow of capital in the economy and result in many inefficiencies. Since this type of change raises many fundamental corporate tax policy issues, Congress should defer action on the proposal until it has an opportunity to thoroughly analyze the entire corporate income tax structure.

First, the fundamental rationale for the Supreme Court's decision in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) was that the distributing corporation "derived no taxable gain from the distribution" of the appreciated property. The Court said "this was no sale; assets were not used to discharge indebtedness."[2] Where no taxable gain is realized, there

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2/ 296 U.S. 200, at page 206.

is simply no justification for the imposition of a tax. This fundamental and long standing principle in our tax law must not be reversed.

Second, this proposal is particularly troublesome in light of the fact that in many instances individual shareholders will be fully taxed on the receipt of such appreciated property at ordinary income tax rates of as high as 50 percent. Thus, a heavy tax burden will often be imposed even in the absence of new legislation.3/

3/ With respect to distributions in kind to noncorporate distributees, if the value of the distributed property is fully covered by the corporation's current or post-1913 earnings and profits, the distribution is a taxable "dividend" to the extent of its fair market value, under sections 301(b)(1)(A), 301(c), and 316. However, if the value of the distributed property exceeds the corporation's current and post-1913 earnings and profits, the regulations state that the distribution is a "dividend" only to the extent of the earnings and profits. (Regs. § 1.316-1(a)(2)). The balance would reduce the basis of the distributee's stock under section 301(c)(2), with any excess over basis being subject to section 301(c)(3) and taxed as a capital gain.

With respect to distributions in kind to corporate distributees, section 301(b)(1)(B) provides that the "amount" of a distribution to such a distributee is the property's fair market value (determined as of the time of the distribution) or its adjusted basis in the hands of the distributing corporation, whichever is the lesser. The corporate distributee's basis for the distributed property similarly is the lower of the property's value or its adjusted basis (increased by the distributing corporation's recognized gain) in the hands of the distributing corporation (section 301(d)(2)). Having determined the "amount" of the distribution under section 301(b), the distributee corporation must report the part that is covered by earnings and profits as a dividend, and the balance, if any, as a capital distribution subject to the rules of sections 301(c)(2) and 301(c)(3).

Earnings and profits are not exclusively defined in the tax code. Section 312 of the tax code does provide, however, certain

FOOTNOTE CONTINUED

Third, this proposal would remove certain important symmetry in the tax code. Generally, the transfer by an individual proprietor of his business assets to a newly formed corporation in exchange for all of its stock is not a taxable event. Under section 351(a) of the tax code, no gain or loss is recognized if "property" is transferred to a corporation "solely in exchange for stock or securities in such corporation," and if the transferor or transferors are "in control" of the corporation "immediately after the exchange."4/ In Portland Oil Co. v. CIR, the court said that the purpose of section 351 is to save the taxpayer

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3/ FOOTNOTE CONTINUED

special rules for the computation of earnings and profits. In general, earnings and profits can be computed by making certain adjustments to taxable income. Added to taxable income are items like interest on State and municipal obligations and certain other amounts exempt from tax. Also added to earnings and profits are life insurance proceeds and compensation for injuries or sickness received with respect to employees or others. Certain deductions allowed in computing taxable income are not allowed in computing earnings and profits. For example, the tax code expressly limits accelerated depreciation deductions in computing earnings and profits (section 312(K)). Other deductions limited or denied in computing earnings and profits are the dividends received deduction and the net operating loss and capital loss carryover deductions. Finally, certain deductions not permitted in computuing taxable income are allowed in computing earnings and profits. Dividend distributions, Federal income taxes paid, interest deductions disallowed under section 265, excess charitable contributions, excess capital losses and payments disallowed under section 267 are allowed as deductions in computing earnings and profits.

4/ Under sections 351(a) and 368(c), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

from an immediate recognition of gain in instances "where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain."5/ Likewise, under current law, the distribution of appreciated property by a corporation to its shareholders does not result in a tax on the distributing corporation. These provisions permit the free transfer of capital and provide symmetry between certain transfers into a corporation by shareholders and certain transfers out of a corporation to shareholders. The proposal to tax the corporation on certain distributions of appreciated property to shareholders would unnecessarily remove this symmetry. When assets are transferred into a corporation, the shareholders expect the corporation to create wealth and generate value. The retained earnings of the corporation are not taxed to the shareholders. When assets are taken out of the corporation, these assets will no longer provide growth and will no longer increase the value of the corporation. Consequently, there is no justification to tax a corporate entity on its shrinkage in size in these types of transactions.

Fourth, the imposition of "multiple" layers of tax discourages investment and impedes the most efficient allocation of capital in our economy. Business entities need the flexibility to restructure operations to reduce production costs and to

5/ Portland Oil Co. v. CIR, 109 F.2d 479, 488 (1st Cir.)

contribute to overall productivity improvement. The proposed tax on appreciation is completely inconsistent with the investment incentives enacted by Congress in 1981 as part of the Economic Recovery Tax Act (ERTA).6/ The Report of the Senate Finance Committee accompanying ERTA stated that high tax rates "are an important cause of the economic distortion and inefficiency currently induced by the individual income tax" and also stated that reductions in tax rates are "intended to eliminate a substantial disincentive to investment."7/

Fifth, the issues concerning the taxation of a corporation on the distribution of appreciated property are similar to the issues concerning the taxation of corporate acquisitions and corporate liquidations. The recent report of the staff of the Senate Finance Committee entitled "The Reform and Simplification of the Income Taxation of Corporations"8/ includes major proposals with respect to corporate acquisitions, liquidations and distributions. In fact, the Staff Report points out the desirability of consistency and simplicity with respect to the tax treatment of acquisitions, liquidations and distributions.

6/ P.L. 97-34

7/ Report of the Committee on Finance, United States Senate, Economic Recovery Tax Act of 1981, Senate Report 97-144, page 25.

8/ "The Reform and Simplification of the Income Taxation of Corporations," A Preliminary Report Prepared by the Staff, Committee on Finance, United States Senate, S. Prt. 98-95, September 22, 1983.

To ensure such consistency, Congressional action on the tax treatment of distributions should be deferred until the many complex, broader policy issues can be addressed.

At the October 24, 1983 Senate Finance Committee hearings on this Staff Report, Deputy Assistant Secretary of the Treasury Ronald Pearlman emphasized the complexity of these kinds of changes. He stated:

> "We wish to emphasize that the scope of these proposals is enormous. They would make fundamental changes to the rules that govern the most basic, as well as the most intricate, corporate transactions, some of which have been in the law since 1918. The proposals would affect, to some degree, every corporation and every shareholder. Accordingly, we strongly believe that adoption of these proposals should come only after they have been translated into specific statutory provisions and subjected to deliberate and detailed technical and policy analyses by all interested parties."

Furthermore, the Senate Finance Committee staff, itself, recognized that imposing a tax on appreciation of property in these types of situations is a drastic step. Accordingly, the staff suggested a 12 year phase-in of this new tax with respect to "historic assets."

Sixth, there are a wide variety of reasons for the disposition of appreciated assets by a corporation. As examples, a corporation may be forced to dispose of business assets under pressure from regulatory authorities or lenders or a corporation may be forced to dispose of assets by virtue of high property taxes. If shareholders of a corporation can put these unwanted assets to productive use, present law provides for only a shareholder level tax upon the distribution of capital assets. Thus, imposition of a double tax interferes with good business practices.

V. CONGRESS MUST REJECT THE PROPOSAL TO REDUCE BY THE AMOUNT OF CERTAIN EXTRAORDINARY DIVIDENDS THE BASIS OF CERTAIN STOCK HELD BY CORPORATE SHAREHOLDERS

As part of his November 16, 1983 deficit reduction package, Senator Robert Dole proposed that the "fair market value of extraordinary dividends (to the extent not subject to tax) would reduce the basis in stock held one year or less by a corporation. The shareholder corporation's holding period for dividends of property could not exceed its holding period for its stock in the distributing corporation."

Senator Robert Dole further elaborated that "extraordinary dividends would include dividends received within any 90-day period with a fair market value equal to or greater than 10 percent (five percent in the case of preferred stock) of the value of the stock. Extraordinary dividends would also include dividends received within any one-year period with a fair market value equal to or greater than 20 percent of the value of the stock (common or preferred)."

Enactment of this proposal will result in unnecessary multiple taxation, reduce stock market liquidity and aggravate the existing bias in the tax law in favor of debt and against equity financing.

The proposed basis reduction has the effect of arbitrarily adding another layer of income taxation to certain corporate transactions in which one corporation (the investing corporation) invests in the shares of stock of another corporation which happens to make certain distributions to shareholders (the distributing corporation). First, the earnings of the distributing corporation are subject to the regular corporate income tax at rates which go as high as 46 percent under section 11(b) of the tax code. Second, in some instances, depending upon the characteristics of the distributing corporation, that distributing corporation will also be subject to the 15 percent "add-on" minimum tax under section 56 of the tax code.9/ Third, in many

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9/ Under present law, corporations must pay a minimum tax on certain preferences. This tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preference items included in the base of the minimum tax for corporations are: (1) accelerated depreciation on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years); (2) amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable); (3) in the case of certain financial institutions, the excess of the bad debt deductions over the amount of the deduction computed on the basis of actual experience; (4) percentage depletion in excess of the adjusted basis of the property; and (5) 18/46 of the corporation's net capital gain.

In addition, the Tax Equity and Fiscal Responsibility Act of 1982 scaled back the following corporate tax preferences by 15 percent: percentage depletion for coal and iron ore; excess bad debt reserves of financial institutions; interest incurred by financial institutions to carry tax-exempt obligations acquired after 1982; DISC; section 1250 recapture on real estate; rapid amortization of pollution control facilities; intangible drilling

FOOTNOTE CONTINUED

instances, dividends paid by the investing corporation to its own individual shareholders will be taxed to those individuals at rates as high as 50 percent pursuant to sections 61(a)(7) and 316 of the tax code. Fourth, Senator Dole's proposed basis reduction, in some instances, could add a substantial capital gains tax upon the disposition of the relevant stock by the investing corporation.

Multiple layers of tax are a clear impediment to capital formation. These tax burdens impede the free flow of capital and distort the pricing of capital assets. Accordingly, Congress should not adopt this corporate basis reduction proposal.

It is essential to point out that corporate investment in the stock market provides an important source of liquidity to ensure that our capital markets perform as efficiently as possible in allocating investment in our economy. Such investment provides important market discipline to avoid economic distortions. Thus, the basis reduction proposal could reduce stock market liquidity.

Our tax law already has a distinct bias in favor of debt financing as compared to equity financing. To the extent that the proposal reduces equity investment, the proposal increases this bias. Under current tax law, the most important example of

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9/ FOOTNOTE CONTINUED

costs of integrated oil companies (which are to be amortized over 36 months) and mining exploration and development costs (sec. 291).

this bias is the fact that a corporation will obtain a deduction under section 163(a) of the tax code for interest paid on indebtedness whereas dividends paid on stock are not deductible.10/ Boris I. Bittker and James S. Eustice, two of the leading corporate income tax scholars, have stated that this bias in the tax code "may stimulate the excessive use of debt instead of equity investment in the corporate capital structure, thereby increasing fixed annual charges and helping to bring on insolvency, with consequent economic dislocation and losses both to the enterprise and the national economy."11/

Thus, the proposed amendment to the tax code would tend to further encourage a highly leveraged capital structure which impairs the ability of corporations to withstand adverse economic developments.

10/ Payment of debt at maturity may constitute a "reasonable business need" under section 533(a) of the tax code which will justify an accumulation of earnings and profits and thus help to avoid the accumulated earnings penalty tax imposed by section 531 of the code; the redemption of stock, however, is less likely to qualify as a "reasonable need of the business." Payment of principal on debt will ordinarily be a tax-free recovery of basis to the creditor (or will produce capital gain under section 1232 if the collections exceed the adjusted basis of the debt); whereas the redemption of stock is often taxed as a dividend to the redeemed shareholders.

11/ Federal Income Taxation of Corporations and Shareholders, Boris I. Bittker and James S. Eustice, 1979, page 4-3.

VI. CONGRESS MUST REJECT THE PROPOSED RESTRICTIONS ON THE INTEREST PAID DEDUCTION AND DIVIDENDS RECEIVED DEDUCTION WITH RESPECT TO CERTAIN CORPORATE INDEBTEDNESS

As part of his November 16, 1983 deficit reduction package, Senator Robert Dole proposed that "the deduction for dividends received and for interest paid or incurred would be appropriately limited where the corporate indebtedness is allocable to the purchase or ownership of the dividend paying stock. The provision is effective for indebtedness incurred after the date of Committee action."12/

Under section 243 of the tax code, a corporate shareholder may generally deduct 85 percent of the dividends it receives. In addition, under section 163 of the tax code, interest paid or accrued on money borrowed by a corporation is generally fully deductible.

This proposal would reduce stock market liquidity and discourage equity financing. The proposal would make certain stock less attractive to corporate investors and thus increase financing costs for many corporations. The proposal is inconsistent with the action taken by Congress in recent years to encourage risk taking and increase equity investment by such measures as the reductions in the capital gains tax. The 1978 Revenue Act

12/ "Summary of Proposed Deficit Reduction Package," November 16, 1983, Senator Robert Dole, page 4; "Description of Proposed Deficit Reduction Package," November 16, 1983, Senator Robert Dole, page 16.

increased the capital gains exclusion for individuals from 50 to 60 percent. The 1978 Revenue Act also reduced the corporate alternative tax rate on capital gains from 30 to 28 percent.13/ With respect to these changes, the Report of the Senate Finance Committee for the 1978 Revenue Act stated that "the improved mobility of capital and the increased after-tax profitability of potential investments will lead to a substantial increase in investment activity."14/ In 1981, Congress took further steps which would help promote equity investment by reducing the maximum income tax rate on individuals from 70 to 50 percent.

13/ Under section 1201 of the tax code, a corporation cannot take advantage of the special 60 percent capital gains exclusion. Instead a corporation computes its tax in the following manner: The excess of net long-term capital gain over net short-term capital loss is included in income and a tax at the regular corporate tax rates is computed. Then an alternative tax is determined by: (1) Computing a tax at the regular tax rates on the corporation's taxable income minus the excess of net long-term capital gain over net short-term capital loss, and (2) adding to this the alternative capital gain tax computed by multiplying the excess net long-term capital gain by 28 percent. The method producing the lower result is used.

A corporation, like an individual, offsets its capital losses against its capital gains. But if it has an over-all capital loss, the corporation, unlike an individual, may not offset it against ordinary income to any extent. Instead, the corporation's excess capital loss is subject to the carryover and carryback provisions.

14/ "Revenue Act of 1978," Report of the Committee on Finance, United States Senate, S. Rpt. 95-1263, page 15.

VII. CONCLUSION

In summary, tax proposals that impede the creation of oil and gas royalty trusts will reduce market efficiency. There is simply no justification in terms of U.S. economic or energy policy for the adoption of such restrictions. Oil and gas royalty trusts can improve business productivity and provide for the most efficient allocation of capital in our economy. This will also help maximize the efficiency of the U.S. energy industry.

STATEMENT OF THE UNIVERSITY OF MICHIGAN
Ann Arbor, Michigan

Hearings on Deficit Reduction Package

Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Background

The Senate Finance Committee has considered the problem of abusive tax shelters during the first term of the 98th Congress. Among the tax shelters considered abusive, as outlined by Administration officials and various Finance Committee personnel, are certain gifts of appreciated property to charitable non-profit institutions.

The University of Michigan relies heavily on private charitable contributions, including gifts of appreciated property, to fund many of its programs. Accordingly, the University of Michigan would welcome the adoption of enhanced incentives for charitable giving. However, if such inducements are tied to a lengthening of the holding period for gifts of appreciated property, as has been proposed, marketable securities traded on an established exchange should be exempted from the extended holding period. Such readily marketable securities have not been targeted as an area of abuse because the fair market value can be easily and accurately determined. Gifts of marketable securities to all charities would likely vanish if they were subjected to a five year holding period.

Present Law

Under present law, an individual who makes a gift of property that has appreciated since the date it was acquired is generally entitled to a tax deduction for the fair market value of the property. If the donor sold the appreciated property and then donated the proceeds, he would be taxed on the value received in excess of his adjusted basis in the property. The donor would be entitled to a deduction only for the proceeds actually given to charity. The charity would get a concurrent benefit of only the amount of the proceeds from the sale that are actually donated. The tax law offers an incentive to make gifts of appreciated property because the donor does not have to pay the tax on the increase in value which exceeds the basis of the property and the donee gets the full value of the property because it is not reduced by any tax paid on the increase in value.

The Over-valuation Problem

The Treasury Department contends that over-valuation of contributed non-cash property is prevalent and that donors of appreciated property get unjustified deductions when the property is over-valued. Treasury has recommended more stringent restrictions on the deduction such as the extended holding period for gifts of appreciated property. Similarly, the Democratic Study Group has suggested that the "over-valuation" problem could be substantially eliminated by providing that appreciated property must be treated as ordinary income property unless the taxpayer has held the property for at least five years. The charitable deduction would therefore be limited to a donor's basis in the property if it is contributed to a charitable organization and has been held for less than five years.

The concerns of the Treasury Department and the Democratic Study Group appear to be well-documented. The Joint Committee on Taxation's pamphlet on Tax Shelters (JCS 29-83), which was prepared for the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, outlines schemes where donors purchase property, hold it for one year, and then donate the property to a charity while taking a deduction for a value of two to three times its original cost. Treasury and the DSG believe that a five-year holding period would discourage such abuse by postponing for a substantial period of time the realization of the tax benefit from the contribution of appreciated property. While the extended holding period may well alleviate the identified abuses, the University of Michigan is concerned that if the holding period governs all types of gifts, the ability of non-profit organizations to raise funds to support their charitable purposes will be severely compromised. This is especially true if the five-year holding period were to cover gifts of marketable securities. The University of Michigan, for this reason, embraces the recommendation of the Treasury Department and the President's Committee on the Arts and the Humanities that the five-year holding period should not apply to property which is readily tradeable on an established market. This approach should be adopted by the Finance Committee if it adopts a five-year holding period rule.

Such an exclusion makes eminent sense because marketable securities are subject to precise valuation based on actual sales and exchanges of similar securities. The determination of the fair market value of the property can be done as accurately one year after the purchase as it can be done five years after the purchase.

For these reasons, The University of Michigan respectfully submits this testimony in support of enhanced incentives for charitable contributions. If the incentives are tied to an increase in the holding period for capital gain property, an exclusion for marketable securities traded on an established market should be adopted.

STATEMENT

of

CARL E. BAGGE

PRESIDENT

of the

NATIONAL COAL ASSOCIATION

on the

PROPOSED DEFICIT REDUCTION PACKAGE

to the

SENATE COMMITTEE ON FINANCE

December 23, 1983

Washington, D.C.

STATEMENT OF CARL E. BAGGE

PRESIDENT, NATIONAL COAL ASSOCIATION

I am addressing these remarks to the proposed Deficit Reduction Package on which hearings were held on December 12-14. My comments as set forth herein reflect the views of the National Coal Association and I respectfully request they be included in the printed record. Our organization represents producers of well over half the commercial coal production in the United States. We also number in our membership support industries such as equipment suppliers, transporters, selling companies, and consultants.

I will speak primarily of two of the proposed items in the package; the Energy Tax, and Time Value of Money -- Premature Accrual.

Energy Tax

It will come as no surprise to you, Mr. Chairman, that the National Coal Association is unalterably opposed to any form of tax on either energy production or consumption. We believe, as do others, that the correct course of action is for Congress and the Administration to face up squarely to its responsibility of reducing Federal expenditures to bring them roughly in line with projected revenues.

The energy tax proposed in the Deficit Reduction Package, while still objectionable, is none-the-less more reasonable than a tax on the Btu content of fuels. Presumably either would be broad-based, applying to all forms of energy sources. Such a tax would have far-reaching adverse effects on the nation's economy.

First, it would be inflationary since ultimately the tax would be passed on to the consuming public. Further, while raising revenues it could contribute to the deficit, since increased prices created by inflation would boost the cost of entitlement programs.

Second, it would inhibit whatever hope exists for the economic recovery of our industry in the near future.- I am sure you have some awareness of how this recession has affected the coal industry in terms of mine closings, indefinite layoffs, lost wages, postponement of productivity-improving investments, and lost profits necessary to sustain a viable source of energy supply over the long run. The coal industry was one of the last of the major industries to be hit by the recession. We are only now beginning to emerge from it.

Finally, an energy tax would further reduce the competitiveness of energy intensive U.S. industries in the struggle for international markets.

Presumably, with respect to fossil fuels, a Btu tax would be assessed at the mine-mouth or well-head. Assume for example a Btu tax of $2.00 per barrel with respect to oil. Since a ton of coal equates to about four barrels of oil, the tax on a ton of coal would be $8.00. How would that impact on the coal industry?

First, consider our <u>Export Market</u>:

> Presumably, some type of exemption or credit would be provided for exports. This is critical, and let me explain why. An $8.00 increase in the price of a ton of coal would literally kill the struggling coal export market. This would occur at a time when the market is very soft and when we are competing with countries such as Poland, which are dumping coal on the market at a loss, and other countries whose coal industry is government subsidized. A substantial tax increase coupled with our ever increasing mine-to-port transportation costs due to rail rate increases could reduce exports by half and result in about a three billion dollar reduction on the plus side of our balance of payments. Apart from losing the existing U.S. coal export market, national security impacts would result by preventing U.S. coal from substituting for mid-

east oil world-wide to some extent, Russian gas in Europe and oil in the Pacific Rim countries.

Second, the <u>Differential Price Impacts</u> on coal are severe. A uniform Btu tax raises the price of coal more than oil or natural gas. For instance, a $2.00 tax on a $30.00 barrel of oil is a 6 percent increase. An $8.00 tax on a ton of $30.00 coal is a 27 percent increase. Although the absolute price differential is roughly maintained, the relative attractiveness of coal conversion and early retirement of oil and gas fired units would be greatly diminished. From an energy policy perspective, the Btu tax discourages consumption of domestic coal as opposed to imported oil. This is clearly not in the national interest and is directly counter to legislation dating back to 1974 to encourage coal consumption.

Third, <u>End-Use Impacts</u> of a Btu tax on coal are disproportinate. Electric utilities account for over 80 percent of domestic coal consumption. Therefore, it is electricity and not coal that competes directly with oil and gas in the non-utility markets. Coal utilities plants have on the average 34 percent conversion efficiency, whereas oil and gas have over 60 percent efficiency. Consequently, this efficiency differential at end-use could impose a much larger tax on coal than on oil and gas.

The broad-based energy tax currently discussed is an ad valorem tax on various fuels, presumably on equal percentage tax, collected by the producer. Although this tax could avoid some of the more extreme impacts of a Btu tax, it too discourages consumption of domestic coal making it less competitive with other fuels. Ad valorem taxes tend to be permanent taxes, automatically raising with the rate of inflation and real cost of delivering coal.

Since export coal would be exempted, one of the more onerous possible aspects would be precluded.

While structured in the form of an ad valorem tax, the proposed energy tax would not be administered as such. Rather, the tax would be converted to dollars or cents per commodity unit. The tax rates would be based on the national average price for each taxable energy source during the previous 12-month period. This may work well for other energy sources which have relatively narrow price deviations. For instance, a barrel of oil is generally priced at X dollars, and that price holds throughout the petroleum industry. All producers would be equally impacted.

This is not the case with respect to coal. Coal per ton varies in price from perhaps eight dollars a ton to over $50 a ton, and in some instances the price might go higher. The result of a fixed cents per ton tax would be most inequitable to the lower priced producer. Assume an average price of $35.00 per ton nationwide. At two percent this would equal 70 cents tax, or a tax of 8.75 percent on eight dollar coal. On $50.00 coal, the tax would be only 1.4 percent. In the highly competitive coal industry where contracts are negotiated in fractions of a cent per ton, the result of the proposed tax could create measurable inequities.

In closing, let me reiterate that the National Coal Association is unalterably opposed to any form of energy tax.

<u>Accrual of Reclamation Reserves</u>

Under the proposal there is discussion on the subject of the Time Value of Money-Premature Accrual, wherein it is stated that, "A special rule would be provided for certain coal mine reclamation expenses". The subject of accrual of reclamation reserves was treated in depth at hearings held before Senator Wallop's Subcommittee on Energy and Agricultural Taxation on May 23, of this year. Therefore, I will not burden the record with a lengthy discussion of the subject. Rather, I refer you to the testimony of Joseph E. Nicholls, Jr., at that hearing. NCA strongly supports legislation introduced by Senator Wallop (S.237) and a similar, but not identical bill, introduced by Senator Specter (S.1307).

Thank you for affording us the opportunity to present our views on these two subjects so important to the coal industry.

NATIONAL TAX EQUALITY ASSOCIATION

1000 CONNECTICUT AVENUE BUILDING, WASHINGTON, D.C. 20036, TELEPHONE (202) 296-5424

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STATEMENT OF

NATIONAL TAX EQUALITY ASSOCIATION

SUBMITTED TO

SENATE FINANCE COMMITTEE

FOR

DEFICIT REDUCTION HEARINGS

DECEMBER 12, 1983

The National Tax Equality Association, composed of business and community bank members concerned about federal tax policy, appreciates this opportunity to present our view on budget deficit reduction proposals to the Senate Finance Committee.

For a number of years, our committee has been concerned that continuing large budget deficits will impede future economic growth and productivity. In 1982 this association put forth a special effort to convince Congress that legislation was needed to reduce the budget deficit. At that time, we outlined specific budget cuts and revenue increases that would have reduced deficits by $90 billion in FY 1983, $145 billion in FY 1984, and an additional $200 billion in 1985.

Some of the proposals were enacted by the Congress through lower defense appropriations, social security reforms, and through tax legislation including the Tax Equity and Fiscal Responsibility Act. Unfortunately, not enough deficit reductions were accomplished.

The first Concurrent Budget Resolution passed by the Congress to set targets for FY 1984 included a declining trend in deficits reaching $145 billion in 1986. These figures are dependent upon various policy assumptions including acceptance by the Administration and the Congress of specific spending and taxation levels. Enactment of measures necessary to reach these levels looks doubtful, and the result will be $200 billion deficit projections for the next three years. An August 1983 economic outlook review compiled by the Congressional Budget Office for House and Senate committees outlines budget deficits for 1984 through 1986 in the following table:

TABLE I. IMPACT ON 1984 BUDGET RESOLUTION DEFICIT TARGETS FOR 1984-1986 OF NO ACTION ON RECONCILIATION INSTRUCTIONS AND RESERVE FUND AUTHORIZATIONS (By fiscal year, in billions of dollars)

	1984	1985	1986	Cumulative 3-Year Total
Budget Resolution Targets a/	179	161	131	471
CBO reestimates	12	19	16	47
No Action on Reconciliation Instructions	15	19	52	85
No Action on Reserve Fund Authorizations	-9	-3	-2	-14
Net Interest Cost Impact of No Action	*	2	5	7
Resulting Deficits	198	198	102	597

* Less than $500 million.

a/ Including the reserve fund for new initiatives in domestic programs.
Source: Congressional Budget Office

Recently the Congressional Budget Office estimated that the deficit could reach $250 billion by 1988, if interest rates remain about what they are today.

If these levels of deficit projections are fairly accurate, the corresponding percentage of budget deficit as a component of Gross National Product will equal between 5.4% and 5.6% for 1983 through 1986, based on recent economic forecasts. If unemployment in 1986 were approximately 7.6% to 7.8 %, with continued growth of 5% GNP, the deficit would have to be reduced by more than two-thirds to arrive at a deficit percentage of GNP comparable to 1981 of 2%. 1/

1/ Congressional Budget Office, The Economic and Budget Outlook: An Update, August 1983

ECONOMIC EFFECTS OF HUGE BUDGET DEFICITS

We believe, as we have maintained over the years, that such high deficits and high deficit percentages of gross national product will contribute to financial instability, lower productivity, and a reduced standard of living for all Americans.

While there are a number of probable economic scenarios due to high deficits, outlined by policymakers and economists, we must determine if any of the scenarios is likely to occur, or perhaps is already underway, and what damage to the economy that scenario may cause.

First, we must examine current economic conditions which will reveal any trends important to our analysis of deficit impact on the economy. For 1983, economic forecasts on the strength of the recovery were understated. The Reagan Administration's original estimate of 1.4% real economic growth vastly underestimated what will be an annual rate of GNP growth exceeding 6%. Growth will remain strong for the next year. Employment is climbing at a surprising rate, industrial production is increasing at a 9.5% annual rate, retail sales moved at an annual rate of 7% in October. 2/ All of these growth factors will result in strong economy with high demand for investment capital.

One factor that constitutes a threat to recovery is the possibility of an excessively restrictive monetary policy by the Federal Reserve. Recently, Nobel laureate economist Dr. Milton Friedman predicted the return of recession in 1984 due to such a restrictive policy. Indeed, two indicators demonstrate that the Federal Reserve has been and will continue tight money until GNP growth corresponds with a level deemed necessary to prevent inflation. Some analysts speculate that the goal of Federal Reserve Chairman Paul Volcker is to limit growth to just under 4% annual rate of GNP. M1, money supply narrowly defined, dipped below the Fed's target range in November and early December, and has been running at the low end

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2/ Council of Economic Advisors, Economic Indicators, November 1983 of the 5% to 9% range for months. Treasury Secretary Regan recently warned the Fed about such a low rate of M1 growth. The other indicator revealing restrictive policy is the increase in bank borrowings for mandated reserves from the Fed. Actual borrowings have averaged $935 million over the past four weeks compared to $600 million in October, demonstrating greater restraint on the money supply. 3/

These two economic conditions, strong growth and tight monetary policy, provide a formula for upward pressure on interest rates. Combined with huge budget deficits financed to a great extent by Treasury borrowing, the groundwork is established for an economic scenario often discussed: high interest rates and federal borrowing to finance deficits "crowd out" private investment, halting recovery and perhaps pushing the economy back to recession.

We believe this scenario is a fairly accurate account of what is underway in the economy today, and there is further evidence that the "crowding out" problem will significantly worsen. Consumer demand for borrowing has increased and continues to increase, raising competition for capital from the national savings pool. Also, it appears that business borrowing needs will increase. Capital spending for plant and equipment rose to an annual growth rate of 16% in the third quarter and is expected to reach 24% in the fourth quarter. 4/

While excessive real interest cost may not have deterred business investment early in the recovery, business will become more sensitive as profits drop, due to a more stable rate of growth, and loan demand increases. An additional factor aggravating the "crowding out" dilemma is the continued reduction in the national savings rates. Despite high interest payments on savings due to market rates and deregulation, despite tax deferred IRAs and other tax incentives to spur savings, the rate has fallen from 6% in 1982 to 4.7% in the third quarter of this year.

3/ Federal Reserve Bank of St. Louis, U.S. Financial Data, Nov. 18, 1983, Dec. 2 & 9, 1983

4/ U.S. Dept. of Commerce, Bureau of Economic Analysis, Plant and Equipment Expenditures Reports, December, 1983

This reduces available capital to finance the federal budget deficit and business investment.

While monetary policy is an important factor contributing to economic damage in the "crowding out" scenario, the impact of the budget deficit is clear. As stated earlier, we believe that such impact harms the economy, and especially long term economic growth and productivity.

Incidentally, we agree with economists who assert that as much as the deficit contributes to high interest rates, it also exacerbates balance of trade problems, and raises deficit financing interest expenses, which exact their own toll on economic productivity. Recently, Congressional Budget Office Director Rudolph Penner explained that the cost of financing the deficit alone exceeds any revenue increase proposals currently under consideration. Penner stated that "The mathematics are in place for an explosion, and we cannot remain on this path forever." 5/

Much of the current debate surrounding the deficit question centers on whether deficit reductions should be enacted immediately, and whether those reductions should involve expenditure cuts or revenue increases. Because of the negative economic consequences of high deficits outlined above, the National Tax Equality Association supports a program composed of some combination of tax increases and budget cuts to be enacted in 1984, as early in the year as possible. A downward trend in deficits should be established with the objective of $100 billion deficits by 1986. This will substantially reduce the probability of "crowding out" and provide enough time for policy to impact upon the economy. Action is needed in 1984 to demonstrate to the financial markets and the American people that Congress is serious about dealing with the deficit problem.

5/ Rudolph Penner, Director CBO, statement before the American Enterprise Institute, December 5, 1983

REDUCING THE BUDGET DEFICITS WITH TAX INCREASES

Various deficit reduction proposals have been proposed and considered by policymakers and the appropriate Congressional committees. Most of the plans rely heavily on tax increases, based on the premise that tax increases are less damaging to the economy than financing deficits through borrowing. 6/

The National Tax Equality Association opposes these proposals for a number of tax policy and economic reasons. Essentially, it is questionable whether budget deficit reductions through tax increases produce favorable results for the economy. 7/ The imperative considerations include the amount of budget cuts that will accompany the tax hikes, and the incidence of the taxation. Will the tax increases fall on savings capital, reducing the national savings pool and negating the intention of the policy? Will the tax increases fall on investment capital reducing productive investment and GNP growth, and increasing loan demand? Are the tax increases raising marginal tax rates and/or are they inequitable, thereby promulgating tax avoidance? Unfortunately, many of the proposals currently discussed including individual and corporate surtaxes, tax rate indexation minus 2½ or 3 percentage points, and minimum corporate taxes fall heavily on savings and investment capital, increase marginal tax rates reducing work incentive, and are quite regressive. While these proposals are intended to diffuse political opposition to a deficit reduction package they fail in this objective due to the extreme economic impact.

6/ Various Congressional proposals call for large tax increases including a plan offered by Senator Domenici and Senator Chiles with tax increases of $57.3 billion; almost double the plan's spending reductions of $30.3 billion. Also, Senator Bob Dole's latest proposal calls for $75 billion in tax increases.

7/ For further analysis of the economic impact of deficit reduction through tax increases, see Institute for Research on the Economics of Taxation Economic Report Number 19, "Dealing with the Deficit: Are Tax Increases the Answer?" Dr. Norman Ture.

The National Tax Equality Association recommends a departure from current suggested tax policies in order to improve prospects for success, and moreover, because a lack of tax revenues is not the primary cause for deficits, unrestrained spending is. According to figures distributed by the Council of Economic Advisors, total budget outlays and receipts for 1970 were 20.2% and 19.9% of GNP respectively. This policy produced a deficit equal to .3% of GNP. In 1983, receipts totaled 18.6 of GNP and outlays surged to 24.6% of GNP, producing a deficit of 6% of GNP. Americans have contributed their fair share of taxes through recent tax increases prescribed by the Social Security Reform package and the Tax Equity and Fiscal Responsibility Act. While further tax increases may be necessary to achieve adequate budget cuts, emphasis should be placed on reduced spending.

Mr. Chairman, to comply with your request that testimony presents specific suggestions to reduce the deficit, we have developed a package of tax reform revenue raisers and also suggested areas to examine for budget cuts. In keeping with our tax policy considerations outlined previously, our revenue measures are for the most part reform initiatives designed to promote fairness and to limit impact on savings and work incentive. In fact, the measures favor savings relative to consumption. The suggested tax measures have been subject to discussions and examination by both the Senate Finance Committee and the House Ways and Means Committee. Considering out effort to promote tax fairness, probably additional revisions could be developed upon close examination of the tax code. We have chosen measures from various reform or revenue raising lists recently circulated. The tax package raises approximately $50 billion over three years. The following is an outline of the revenue provisions.

TABLE II. DEFICIT REDUCTION REVENUE ITEMS	FY '84	FY '85	FY '86	Total by Item
Real Property Depreciation Reform	.1	.5	1.1	1.7
Reconciliation Bill minus postponement of interest exclusion	1.7	4.6	7.1	13.4-3.9 = 9.5
Cap charitable deduction for non-itemizers at 25% of first $100 of contributions	*	.3	1.6	1.9
$3 bbl oil import fee and $1 bbl tax on domestic oil	--	6.6	8.9	15.5
Limit dividend deductions for Sec. 521 & Subchapter T corporations	.9	1.0	1.1	3.0
Repeal Credit Union exemption	.2	.2	.2	.6
Limit non-business, non-investment interest deductions to $10,000	.6	1.8	2.0	4.4
Revised real estate recapture	.1	.3	.5	.9
Eliminate Capital Gains for non-productive Assets; disallow treatment for gold, coins, art, etc.	1.9	2.0	2.1	6.0
Require 10% Withholding on Independent Contractors	.6	.9	1.2	2.7
Extend Cigarette Tax	--	--	1.7	1.7
Totals by Year	6.1	18.20	27.50	50.10

BUDGET EXPENDITURE REDUCTIONS ESSENTIAL

Many in the Congress lay blame for the budget deficits on 1981 tax cuts passed as part of the Program for Economic Recovery, but those tax cuts merely served to prevent rapid escalation in the marginal tax rates for most Americans. The 1982 Tax Equity and Fiscal Responsibility tax bill was supposed to be a vehicle for delivery of $3 of budget cuts for every $1 dollar in tax hikes, but only one-third of the budget cuts will be realized. It is time for the Congress to ante-up the budget cuts due the American people. It is a debt that can be paid if Congressional leadership will act.

The National Tax Equality Association proposes that the Congress immediately begin examination of the budget-cutting agenda outlined by the President's Private Sector Survey on Cost Control. We commend Senator William Armstrong's effort to pass a resolution whereby Congressional committees will schedule hearings to consider the various measures included in the "Grace Commission" report. About $180 billion in expenditure cuts and savings over three years requiring legislation are detailed. If the Congress would work to pass even half of that figure, combined with administrative savings outlined by the report, and our tax proposal, the budget deficit would be reduced to tolerable levels.

The report was compiled at the expense of the private sector to identify opportunities to reduce government costs through increased efficiency, enhanced accountability and control, management improvements, and specific recommendations of expenditure reductions where programs may be inefficient or outdated. Thirty-six "task forces" studied and submitted detailed outlines for savings. The Congress simply has to pick and choose. We suggest your special attention to savings under Congressional authority classified as "Fully Substantiated." This would produce about $120 billion in deficit cuts that are well documented and also are politically palatable.

Another area of concern regarding spending is the defense budget. The Administration will include a request for FY '85 defense budget authority of about $305 billion, a 16% increase over 1984 budget of $262.4. The Office of Management and Budget prefers a figure in the area of $290 billion which would correspond with the Congressional Budget Resolution passed earlier this year. We urge the Administration to adopt the $290 billion level achieving a 11% increase in budget authority over 1984 and demonstrating willingness to tackle the deficit problem with utmost fairness and equity in application of necessary sacrifice.

A third area involving huge government expenditures and subject to extensive study recommending comprehensive Congressional action is the budget for federal pension programs. 8/ The current retirement programs for federal workers create enormous financial burdens for taxpayers and the burdens will only grow unless major changes are adopted. Substantial savings would be realized with minor adjustments in the cost of living adjustment formula, such as a ceiling on COLA increases corresponding with minimum Social Security benefits for retirees whose annual aggregate benefits exceed benefits paid to new retirees. Another adjustment would limit future COLAs by computing benefit increases with a national wage index or the consumer price index, depending on which is less expensive. 9/

Mr. Chairman, our last suggestion for budget savings is our endorsement of "line-item veto authority" for the President to allow some control over domestic spending that otherwise cannot be addressed due to political pressures.

We visualize some combination of the above spending reduction proposals to total approximately $50 billion in FY 1985 and $60 billion in FY 1986. We commend your attention to this problem and hope the Congress will act expeditiously. Our Association will continue its efforts to involve our members in the process, and we offer our assistance to the Senate Finance Committee in any manner necessary.

8/ Government Accounting Office, Federal Employee Demographics and Integration of State Retirement Plans with Social Security, GAO-FPCD-83-38

9/ These proposals have been introduced in the 98th Congress by Rep. J. Erlenborn who is member of the Government Operations Committee.

STATEMENT OF THE

OIL INVESTMENT INSTITUTE

TO THE

SENATE COMMITTEE ON FINANCE

The Oil Investment Institute ("OII") is a national organization of independent oil and natural gas operators who sponsor Federally registered oil and gas programs which allow investors to participate directly in the petroleum industry as limited partners. During the five year period 1977-81, these public and private partnerships accounted for approximately 20 percent of all domestic onshore petroleum exploration and development expenditures, thus providing an important source of capital for the oil and natural gas industry, and providing millions of barrels of reserves to help secure the future energy needs of America. We are grateful for the opportunity to present our views on certain proposals related to abusive tax shelters in connection with the hearings on deficit reduction held by this Committee on December 12-14, 1983. We respectfully request that this statement be made a part of the permanent record of those hearings.

The OII supports the general efforts of the Finance Committee and the Treasury to stop abusive tax shelters. However, we are opposed to the proposal now before the Committee to prohibit the recognition for Federal income tax purposes of special item allocations by partnerships.

SUMMARY

Partnerships currently make special item allocations for legitimate business purposes, Item allocations are recognized for Federal income tax purposes under present law only if the allocation has "substantial economic effect."

We oppose the proposal for the following reasons:

Distortion. Failure to recognize item allocations for Federal income tax purposes will result in distortion of the taxable income of the partners as compared to their economic income.

New Tax Avoidance. Failure to recognize item allocations may open a new tax avoidance technique whereby taxation of economic income to some partners may be deferred in contradiction of the present "substantial economic effect" safeguard, and possibly converted to long term capital gain.

Reversal of Improvements in Partnership Taxation. The proposed change would reverse important improvements in taxation of partners made by the 1954 Code, the 1976 amendments and currently proposed regulations which strictly interpret the "substantial economic effect rule".

Return to Uncertainty. Adoption of the proposal would apparently return the law to the uncertainty which existed prior to 1954 under which some item allocations and similar arrangements were apparently recognized through various fictional concepts while others were not, a situation which would encourage partners to take opposing positions leaving the Internal Revenue Service in the middle.

Specific Exceptions Not Sufficient. No list of specific exceptions to non-recognition of item allocations can ever cover all situations where item allocations should be recognized. The exceptions proposed for oil and gas partnerships do not include expenses of operating oil and gas wells or interest, the special allocation of which is just as normal and legitimate as intangible drilling costs, depreciation and depletion.

Not A Cure. The proposal is not an effective cure for any real present abuse of the income tax laws. The "creation" of net income to one partner and a net loss to another partner is no different from the effect of many ordinary non-partnership transactions. In fact, the present income tax effect of most partnership item allocations would be unchanged if the same economic transaction occurred outside of the partnership context.

A Better Solution. If allocation of partnership income in consideration for what would otherwise be a capitalized cost to the partnerhsip is the abuse sought to be cured, it must be recognized that such effect is not unique item allocations, but may also occur from allocations of net income. A carefully drawn version of another proposal before the Committee is the appropriate response to this situation.

We do not oppose two other related proposals before the Committee:

Capital Expenditures. We do not oppose the proposal to require capitalization of distributions to a partner which represent capital expenditures, but only if the effect of capitalization is no harsher than if an immediate payment had been made equal to the future distributions.

Contributed Property. We do not oppose the proposal to require special allocation of gain, loss, depreciation and depletion with respect to contributed property, but only if limited to the difference between the adjusted tax basis and the fair market value for which the contributor is given credit under the partnership aggreement.

DISCUSSION

The Proposal

The Senate Finance Committee has under consideration, according to a Committee document released on November 17, 1983, a proposal to prohibit recognition for Federal income tax purposes of special allocations of individual items of income or deduction by a partnership. Only the bottom line net income or net loss would be allocated for income tax purposes. Exceptions are proposed for intangible drilling costs and depletion for oil and gas, and depreciation for real estate.

Two other related changes are also being considered. One would be to require all gain or loss from contributed property to be allocated to the contributing party and depreciation and depletion to be allocated in the ratio of contributions to adjusted basis. Perhaps, although not clear, the allocation of gain or loss to the contributing partner would be limited to the appreciation or depreciation reflected in the credit to the contributor at the time of contribution. The other change would require distributions to a partner for services to be capitalized if a similar payment to one not a partner would be required to be capitalized.

These changes were first proposed by Treasury at a subcommittee hearing on June 24, 1983. Treasury asserted that the recognition of item allocations could be used to (1) create income and loss for partners where the partnership has no net taxable income or loss, and (2) transform what would otherwise be a capital expenditure into the equivalent of a deductible expense.

What abuse?

The first statement is technically not correct in stating that such allocations "create income and loss." Section 704(b) permits the separate allocation of "income, gain, loss, deduction or credit." It does not permit the "creation" of such items. An item of income is not the same as "net income" nor is an item of loss the same as a "net loss." Such allocations may, however, result in some partners having net taxable income (allocated losses and deductions in excess of allocated income and gains) while others have a net taxable loss (allocated losses and deductions in excess of allocated income and gains). The present rules accomplish the desirable effect of currently taxing each partner on the economic income effectively allocated to or received by him. However, the same effect can be achieved outside of the partnership rules in most cases where item allocations are used, as in the example below.

The second point made by Treasury was that item allocations may transform a capital expenditure into a deductible expense, citing syndication costs as an example. It must first be recognized that this effect is not unique to item allocations, it may also result from "bottom line" allocations of net income which would be unaffected by the proposed item allocation rule. If this is the concern, the separate proposal to require capitalization of any such distributions should be sufficient and would not have the drastic effect of total nonrecognition of item allocations. However, this concept could introduce its own distortions unless carefully drafted to exclude distributions which continue for at least the recovery period for the capitalized cost.

Outside of the capital expenditure illustration which can be easily cured, no example of abusive use of item allocations has been given. The Internal Revenue Service has been consistently successful in its challenges of partnership allocations even without the benefit of the new proposed regulations which are highly restrictive.

Uses of Item Allocations

Item allocations may be used by partnerships for many reasons. They are utilized by many industries and by partnerships of all sizes because they reflect economic reality.

One use is to compensate a partner for his services, A real estate partnership may allocate a percentage of gross rents (often 5%) to the managing partner for his services in managing the property. While this is similar to a salary, it would not necessarily fall under the "guaranteed payment" salary rules of Section 707(c) because it is based on income and Section 707(c) covers only payments not contingent on income.

Another use is to compensate a partner for use of capital. An allocation of a percentage of gross income might be provided to a partner who has contributed more than a prorata share of capital. While this would be similar to "interest" covered by Section 707(c), it would not necessarily be subject to Section 707(c) since it is contingent on income. Alternatively, interest expense might be specially allocated to a partner who has not contributed his prorata share of capital.

Item allocations may be used to reflect a special sharing of risk which a partner is to bear in return for his agreed upon share of income. This often involves special allocations of depreciation, research and experimental costs or intangible drilling costs.

Oil and gas partnerships often allow each partner an election to participate in the drilling of an additional well on existing properties by contribution of his share of development and equipment costs. One who elects not to participate may receive a reduced share of income from the new well free of costs or a back in interest after those who participate have received 300% or more of their costs.

Example of Resulting Distortion

Assume that Partnership ABC proposes to drill an additional well in which C elects not to participate. As a result of this "non-consent" election, C will receive, under the partnership agreement, only 6% of the revenues from the new well and all other income and deductions of the new well will be allocated to A and B. The income for the year under the agreement might be as follows:

	A	B	C	Total
Present Law:				
New well:				
Revenues	47	47	6	100
IDC and depreciation	(200)	(200)		(400)
Net taxable	(153)	(153)	6	(300)
Old wells:				
Net taxable income	60	60	60	180
Net Taxable Income*(Loss)	(93)	(93)	66	(120)
Proposed Change:				
Alternative 1	(40)	(40)	(40)	(120)
Alternative 2	(60)	(60)	--	(120)

Under existing Section 704(b), provided the allocations have the required "substantial economic effect", partner C would be required to report his $66 of taxable income and A and B would claim a net deductionof $93 each.

If item allocations are not recognized and the fictions developed under pre-1954 law, discussed below, are not to be followed, two possibilities appear. One (Alternative 1) would be to allocate the $120 of net loss $40 to each partner in accordance with the general sharing ratio. Another (Alternative 2) would be to allocate the $120 of net loss $60 each to A and B and none to C, In either event C's equity in the partnership would be increased by $66, but the tax on such income would be deferred so long as he did not withdraw cash in excess of the adjusted basis of his interest. When cash withdrawals do exceed basis, some or all of the gain may be long term capital gain. A and B, who bore the economic risk that the new well might be dry, do not receive a current deduction for the decrease in their equity accounts. On termination and dispostion of the properties they will have a deduction for their remaining basis, but it may be only a capital loss.

If an exception is included to allow intangible drilling costs and depreciation of oil and gas partnerships to continue to be allocated on an item basis, the particular problem in this example might be avoided, but not necessarily. If the operation in which C did not participate was a "workover" or a "redrilling" rather than drilling of a new well, the deductions may be characterized for income tax purposes as "operating expenses" rather than as intangible drilling costs. See Burke and Bowhay, Income Taxation of Natural Resources (1983) Section 14.15. Also, B and C could experience a net loss from operating costs on the new well in a later year in which the other wells may realize net income.

In any event repeal of item allocations would be ineffective because this partnership could avoid the distortions and uncertainties of a prohibition on item allocation by distributing to C a 6% royalty interest in the new well and forming a separate partnership between A and B for this property. The royalty payments would be taxed separately to C and excluded from the income of the new AB partnership.

This illustrates that in this example, and probably most others, the existing effect of item allocations can be retained if the partners are willing to bear the administrative cost and burden of restructuring their arrangement as multiple partnerships or to be outside the partnership.

Return to Uncertainty and A New Loophole

The 1954 Code was the first to expressly sanction the allocation of individual items of income or deduction. It was also the first to allow deductions for salary payments to partners, a situation closely related to item allocations in that salary payments may result in net income to the recipient while other partners have a net loss. In these respects, the 1954 Code, in effect, codified the modifications to pre-1954 law which have been found necessary by the Bureau and the courts.

In 1919 the Bureau of Internal Revenue had ruled that a prorata sharing of each partnership item was required. OD 140, 1 CB 174. Early court decisions also held that no deduction was permitted to the partnership itself for salaries to partners, but that salaries were merely to be considered in the allocaiton of the net income. Estate of S. U.Tilton, 8 BTA 914 (1927).

The actual allocation of partnership income and expense was not and cannot be limited by permitted methods of allocation for Federal income tax purposes and partners do agree to item allocations and to salary withdrawals which may produce an economic profit to one partner and a loss to another.

The restraints of a single bottom line net income or loss allocation proved unsatisfactory and the Bureau then developed and applied concepts which, at least in many cases, produced essentially the same results as required by the 1954 Code.

Where a partnership agreement provided for different sharing of income or losses from a particular activity, the Bureau applied a "separate partnership" concept and construed each business or venture as a separate partnership in order to permit the allocation of taxable income or loss to coincide with each partner's share of economic income. Joseph P. Driscoll, "Major Points of Impact of the New Partnership Regulations", University of Southern California, 1956 Tax Institute, 195, 200.

One specific situation involved the question of the source of a payment to a foreign partner by a partnership conducting business in the U.S. and in a foreign country. The partnership agreement provided the payment was to be charged to profits of the foreign operation and the IRS concluded the income to the recipient of the payment should be treated as foreign source income to the extent of the foreign profit, not as a prorata share of the total partnership income. GCM 17255, XV-2CB 243 (1936).

This GCM was later reconciled under the 1939 Code with the prorata requirement of OD 140 in Revenue Ruling 56-134, 1956-1 CB 649. It explained the holding of the GCM as being based on the fiction that there were actually two partnerships, one conducting the U.S. operations and another conducting the foreign operations. No standards were ever published, however, as to when the separate partnership fiction should be applied.

Where salary payments exceeded the net income of the partnership, the Internal Revenue Service adopted, in GCM 6582, VIII-2 CB 200 (1929), a position to recognize shifts in capital accounts which produces essentially the same result as salary deductions under the 1954 Code. This was based on Augustine M. Lloyd, 15 BTA 82 (1929).

Under this theory, where salaries exceeded net income of the partnership the excess was then considered a withdrawal of capital. To the extent the excess was a withdrawal from the capital of other partners, the salary was taxable to the recipient and deductible to the other partners. This is exactly the result under the "guaranteed payment" rules of the 1954 Code.

The economic result of salary payments in excess of net income before deduction of the salary is exactly the same as a special allocation of gross income in excess of the net income. The result under the 1954 Code is the same, the recipient of the special allocation of gross income is required to report such amount currently.

No reported authority had been found as to the treatment prior to the 1954 Code of item allocations which economically produced net income to one partner and a net loss to another where the allocation could not be characterized as salary or as a separate partnership. It would be reasonable to expect that such allocations may have been treated by some partners , and possibly by the Bureau, the same as excess salary payments. That treatment would have been the logical result as the item allocations would have produced the same "shift" in partnership capital accounts as salary in excess of net income. If this theory was applied, however, it remains uncertain whether the resulting income and deductions were recognized in the year of the item allocation or only in the year distributions were actually made to the partner receiving the positive "shift".

Example of Pre-1954 Law

If we may return to the example outlined above of the ABC oil and gas partnership, we might speculate on the tax treatment of the partners if the adoption of the proposal results in a return to pre-1954 law.

The new well might be treated as a separate partnership. A and B would each then have only a $150 deduction not their actual $153 loss on the new well under the agreement. C would not be required to report the $6 of income credited to him from the new well. Could C's interest in the new well be regarded as a separate partnership? This would seem to be an overextension of the separate partnership approach. Could C's $6 credit be regarded as a salary payment? It would be logical that it should be treated the same as a salary payment with the result under pre-1954 law that each partner's taxable income would be the same as under the 1954 Code, at least if the $6 were distributed in the same year. However, since there is no published authority under pre-1954 law on this point, the result must be regarded as uncertain.

A partnership arrangement such as the one outlined above might be intentionally arranged so as to defer income to C. A and B may be in a non-taxable situation or they may claim deductions for the same amount as under present law under the separate partnership or shift in capital theories while C may report no income, or even claim a share of the same loss claimed by A and B.

Reversal of 1954 Code Improvements

In the development of the 1954 Code, Congress expressly recognized the many difficulties and uncertainties in the area of partnership taxation and sought to present a detailed structure to provide certainty. The House Ways and Means Committee made this statement (H. Rept. 1337, 83rd Cong., 2nd Sess., [1954],p. 65):

> The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences.
>
> This confusion is particularly unfortunate in view of the great number of business enterprises and ventures carried on in partnership form. It should also be noted that the partnership form of organization is much more commonly employed by small business and in farming operations than the corporate form.
>
> Because of the vital need for clarification, your

> committee has undertaken the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws. In establishing a broad pattern applicable to partnerships generally, the principal objectives have been simplicity, flexibility, and equity as between the partners.

While there was not significant discussion of the recognition of item allocations, the similar problem of partners' salaries was discussed:

> Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive share of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary. The existing approach has been to treat the fixed salary in such years as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. Such treatment is unrealistic and unnecessarily complicated. The bill provides that payment of a fixed or guaranteed amount for services shall be treated as salary income to the recipient and allowed as a business deduction to the partnership.

The 1954 Code as adopted expressly recognized item allocations by requiring that a partner report his distributive share of each item of income or deduction as determined under the agreement unless the principal purpose was avoidance or evasion, interpretated by the regulations and the courts to mean "substantial economic effect." Section 704.

Some noted, however, that the substantial economic effect rule literally applied only to item allocations, not to "bottom line" allocations of net income and net loss, and attempted to use this to defer taxation of economic income. In 1976, the avoidance or evasion rule was restated as "substantial economic effect" and expressly extended to bottom line allocations as well as item allocations.

A further important improvement is the very detailed and restrictive regulations currently proposed under Section 704(b) to clearly define the "substantial economic effect" rule and require that the income or loss reported by each partner accurately reflect his economic income or loss.

The proposal to eliminate Section 704(b) also eliminates the parameters of proper use of item allocations developed over many years. Creative minds would be free from the restrictions of the present "substantial economic effect" rule and the door would be open to creative partnership structures where certain partners would be in receipt of economic income, but the tax on such income could be deferred, perhaps indefinitely, or converted into long term capital gain upon distribution.

Areas of Real Abuse

Areas of tax shelter abuse in which the Internal Revenue Service has recently been active do not involve abusive partnership item allocations, but transactions completely outside the partnership context:

Loans disguised as purchase of assets.
Inflated purchase price of motion pictures, real estate, equipment of livestock.
Inflated drilling prices.
Liabilities without risk or without economic substance.
Accelerated interest deductions (rule of 78's).
Commodity, futures and securities transactions.
Minimum annual royalties without economic substance.
Failure to recognize gain on disposition of property subject to debt.

The Oil Investment Institute will work with Treasury and the Finance Committee to develop and support proposals which can effectively halt abusive tax shelters.

Summary

In summary, the adoption of the proposal would not stop any identified abuse of the tax laws, would be a backwards step in the law of partnership taxation, and would create uncertainty.

An adoption of non-recognition of item allocations could, as illustrated above, also have the effect of opening a new avenue for tax avoidance. Creative structuring with item allocations could then perhaps result in an almost indefinite deferral of economic income to high bracket partners and eventual conversion into long term capital gain at only the cost of deduction deferrals to other low bracket partners, free of any restrictions from the "substantial economic effect" test.

If the rules are left uncertain, the partners may well take differing positions, leaving the Internal Revenue Service in the middle.

SUPPLEMENT - OTHER PROPOSALS

Capitalization of Compensation Distributions

One proposal being considered would require distributions to a partner for services to be capitalized if payments to one not a partner for the same services would be chargeable to capital.

While such a proposal appears on the surface to be a desirable one to prevent the use of item allocations to achieve a deduction of capital expenditures, it will need to be carefully drawn to avoid introducing distortions and uncertainties.

Such allocations do not necessarily result in a distortion favoring the taxpayers. Consider a real estate partnership in which one partner is allocated a percentage of gross income for the 20 year term of the partnership in return for architechtural services for improvements to partnership real estate. If the amount to be paid were reduced to an amount certain, the partnership would have annual deductions of 1/15th of the principal amount. As an allocation of gross income the effect may be only a 1/20th deduction each year.

If the proposal required that only the distributions made each year could be added to the depreciable basis and only 1/15th of the amounts actually paid could be deducted, the effect is much reduced deduction in the first year and a bunching of deductions in later years. This would be a deferral of deductions from what should be the case and what would be the case if the obligation to the architect were stated as a specified amount to be paid to one not a partner.

A similar situation results under present law from acquisition of a patent in return for royalty payments. While each payment is theoretically an expenditure to be capitalized subject to depreciation, the distortion problem has been avoided by allowing a current year depreciation deduction for an amount equal to the payments made in the current year. Allied Tube and Conduit Corporation, TC Memo 1975-281.

Another example would be an oil and gas partnership which provides for a share of gross income (or, perhaps, gross income less recurring operating expenses) to a partner in return for services in evaluating and acquiring oil and gas properties. If each distribution, to the extent attributable for services on properties acquired, were capitalized and added to depletable basis only when paid, the depletion deductions would be distorted. Under existing law, if a similar royalty or net profits interest were held outside the partnership, the payments made to the holder of that interest would be deductible or excludible from partnership gross income prior to computation of depletion. Section 613; Kirby Petroleum Company v. Commissioner, 326 U.S. 599 (1945), 46-1 U.S.T.C. 9149. If the treatment were different in a partnership it would only encourage the partners to restructure their relationship.

Therefore, if this proposal is to be adopted, it should be made clear that it has no application where the distributions are to continue over at least a substantial portion of the life or the recovery period of the asset against which the payment would be capitalized.

Another problem will be the difficulty of determining what proportion of distributions to a partner are to be capitalized where the payment may relate to a variety of contributions, cash or property contributed to the partnership, services for which a deduction would be proper as well as services of a capital nature.

Contributed Property

Another provision being considered would make mandatory a rule apparently similar to present Section 704(c) which allows an optional special allocation of depreciation, depletion, gain and loss on contributed property to take into account the appreciation or depreciation in value of the property at the time of contribution.

If the mandatory application of this rule is limited to the difference between the adjusted basis of the property and the value for which the partner is given credit in the partnership capital accounts pursuant to the partnership agreement (assuming unrelated parties), the result should not be unfair.

Property contributed to a partnership is often property which is difficult to value precisely. Therefore, in order to avoid haggling over the exact present value of the property, the parties may use the contributing partner's cost basis for purposes of partnership accounting and take the potential appreciation into account in detemining the ratio for sharing of income and loss.

If the mandatory rule is to be applied to the actual fair market value of such property as it may later be determined by the Internal Revenue Service or the courts, the proposal may produce the same problems and uncertainties as the nonrecognition of item allocations.

Consider partnership AB where A contributes undeveloped land and B contributes capital for improvements. Assume that A is given credit for his adjusted tax basis of \$100, the sharing of income, gain and loss is equal and the property, after improvement, is sold for a gain of \$100 of which \$50 is allocable to land. The partnership accounts would allocate the gain as follows:

	A	B	Total
Gain on Sale	50	50	100

However, if it is later determined that the value of the land was actually \$150 when contributed and the proposal is applied to the actual value upon contribution, the gain would appear to be allocable as follows:

	A	B	Total
Gain on land up to $50	50		50
Balance of gain	25	25	50
Total Gain	75	25	100

B would be taxed on only $25 of gain even though his equity in the partnership has increased by $50. A would be taxed on $75 even though his equity is increased by only $50. If the partnership were immediately terminated, A would actually receive only his original $100 credit plus the $50 share of gain under the partnership agreement, not the $75 which would be included in his taxable income. This will again raise the question of whether the fictions of the pre-1954 law will then be applied to increase B's taxable income and allow a deduction to A. If so, the change will only produce confusion. If not, it will open a new avenue for structuring of tax deferral techniques.

In summary, this proposal should be limited to the difference between the adjusted tax basis of property contributed and the value for which credit is given in the partnership accounts.

STATEMENT OF THE

OIL INVESTMENT INSTITUTE

TO THE

SENATE COMMITTEE ON FINANCE

December 22, 1983

The Oil Investment Institute ("OII") is a national organization of independent oil and natural gas operators who sponsor Federally registered oil and gas programs which allow investors to participate directly in the petroleum industry as limited partners. During the five year period 1977-81, these public and private partnerships accounted for approximately 20 percent of all domestic onshore petroleum exploration and development expenditures, thus providing an important source of capital for the oil and natural gas industry, and providing millions of barrels of reserves to help secure the future energy needs of America. We are grateful for the opportunity to present our views on certain proposals related to abusive tax shelters in connection with the hearings on deficit reduction held by this Committee on December 12-14, 1983. We respectfully request that this statement be made a part of the permanent record of those hearings.

The OII supports the general efforts of the Finance Committee and the Treasury to stop abusive tax shelters. However, we are opposed to the proposal now before the Committee to prohibit the recognition for Federal income tax purposes of special item allocations by partnerships.

SUMMARY

Partnerships currently make special item allocations for legitimate business purposes, Item allocations are recognized for Federal income tax purposes under present law only if the allocation has "substantial economic effect."

We oppose the proposal for the following reasons:

Distortion. Failure to recognize item allocations for Federal income tax purposes will result in distortion of the taxable income of the partners as compared to their economic income.

New Tax Avoidance. Failure to recognize item allocations may open a new tax avoidance technique whereby taxation of economic income to some partners may be deferred in contradiction of the present "substantial economic effect" safeguard, and possibly converted to long term capital gain.

Reversal of Improvements in Partnership Taxation. The proposed change would reverse important improvements in taxation of partners made by the 1954 Code, the 1976 amendments and currently proposed regulations which strictly interpret the "substantial economic effect rule".

Return to Uncertainty. Adoption of the proposal would apparently return the law to the uncertainty which existed prior to 1954 under which some item allocations and similar arrangements were apparently recognized through various fictional concepts while others were not, a situation which would encourage partners to take opposing positions leaving the Internal Revenue Service in the middle.

Specific Exceptions Not Sufficient. No list of specific exceptions to non-recognition of item allocations can ever cover all situations where item allocations should be recognized. The exceptions proposed for oil and gas partnerships do not include expenses of operating oil and gas wells or interest, the special allocation of which is just as normal and legitimate as intangible drilling costs, depreciation and depletion.

Not A Cure. The proposal is not an effective cure for any real present abuse of the income tax laws. The "creation" of net income to one partner and a net loss to another partner is no different from the effect of many ordinary non-partnership transactions. In fact, the present income tax effect of most partnership item allocations would be unchanged if the same economic transaction occurred outside of the partnership context.

A Better Solution. If allocation of partnership income in consideration for what would otherwise be a capitalized cost to the partnerhsip is the abuse sought to be cured, it must be recognized that such effect is not unique item allocations, but may also occur from allocations of net income. A carefully drawn version of another proposal before the Committee is the appropriate response to this situation.

We do not oppose two other related proposals before the Committee:

Capital Expenditures. We do not oppose the proposal to require capitalization of distributions to a partner which represent capital expenditures, but only if the effect of capitalization is no harsher than if an immediate payment had been made equal to the future distributions.

Contributed Property. We do not oppose the proposal to require special allocation of gain, loss, depreciation and depletion with respect to contributed property, but only if limited to the difference between the adjusted tax basis and the fair market value for which the contributor is given credit under the partnership aggreement.

DISCUSSION

The Proposal

The Senate Finance Committee has under consideration, according to a Committee document released on November 17, 1983, a proposal to prohibit recognition for Federal income tax purposes of special allocations of individual items of income or deduction by a partnership. Only the bottom line net income or net loss would be allocated for income tax purposes. Exceptions are proposed for intangible drilling costs and depletion for oil and gas, and depreciation for real estate.

Two other related changes are also being considered. One would be to require all gain or loss from contributed property to be allocated to the contributing party and depreciation and depletion to be allocated in the ratio of contributions to adjusted basis. Perhaps, although not clear, the allocation of gain or loss to the contributing partner would be limited to the appreciation or depreciation reflected in the credit to the contributor at the time of contribution. The other change would require distributions to a partner for services to be capitalized if a similar payment to one not a partner would be required to be capitalized.

These changes were first proposed by Treasury at a subcommittee hearing on June 24, 1983. Treasury asserted that the recognition of item allocations could be used to (1) create income and loss for partners where the partnership has no net taxable income or loss, and (2) transform what would otherwise be a capital expenditure into the equivalent of a deductible expense.

What abuse?

The first statement is technically not correct in stating that such allocations "create income and loss." Section 704(b) permits the separate allocation of "income, gain, loss, deduction or credit." It does not permit the "creation" of such items. An item of income is not the same as "net income" nor is an item of loss the same as a "net loss." Such allocations may, however, result in some partners having net taxable income (allocated losses and deductions in excess of allocated income and gains) while others have a net taxable loss (allocated losses and deductions in excess of allocated income and gains). The present rules accomplish the desirable effect of currently taxing each partner on the economic income effectively allocated to or received by him. However, the same effect can be achieved outside of the partnership rules in most cases where item allocations are used, as in the example below.

The second point made by Treasury was that item allocations may transform a capital expenditure into a deductible expense, citing syndication costs as an example. It must first be recognized that this effect is not unique to item allocations, it may also result from "bottom line" allocations of net income which would be unaffected by the proposed item allocation rule. If this is the concern, the separate proposal to require capitalization of any such distributions should be sufficient and would not have the drastic effect of total nonrecognition of item allocations. However, this concept could introduce its own distortions unless carefully drafted to exclude distributions which continue for at least the recovery period for the capitalized cost.

Outside of the capital expenditure illustration which can be easily cured, no example of abusive use of item allocations has been given. The Internal Revenue Service has been consistently successful in its challenges of partnership allocations even without the benefit of the new proposed regulations which are highly restrictive.

Uses of Item Allocations

Item allocations may be used by partnerships for many reasons. They are utilized by many industries and by partnerships of all sizes because they reflect economic reality.

One use is to compensate a partner for his services, A real estate partnership may allocate a percentage of gross rents (often 5%) to the managing partner for his services in managing the property. While this is similar to a salary, it would not necessarily fall under the "guaranteed payment" salary rules of Section 707(c) because it is based on income and Section 707(c) covers only payments not contingent on income.

Another use is to compensate a partner for use of capital. An allocation of a percentage of gross income might be provided to a partner who has contributed more than a prorata share of capital. While this would be similar to "interest" covered by Section 707(c), it would not necessarily be subject to Section 707(c) since it is contingent on income. Alternatively, interest expense might be specially allocated to a partner who has not contributed his prorata share of capital.

Item allocations may be used to reflect a special sharing of risk which a partner is to bear in return for his agreed upon share of income. This often involves special allocations of depreciation, research and experimental costs or intangible drilling costs.

Oil and gas partnerships often allow each partner an election to participate in the drilling of an additional well on existing properties by contribution of his share of development and equipment costs. One who elects not to participate may receive a reduced share of income from the new well free of costs or a back in interest after those who participate have received 300% or more of their costs.

Example of Resulting Distortion

Assume that Partnership ABC proposes to drill an additional well in which C elects not to participate. As a result of this "non-consent" election, C will receive, under the partnership agreement, only 6% of the revenues from the new well and all other income and deductions of the new well will be allocated to A and B. The income for the year under the agreement might be as follows:

	A	B	C	Total
Present Law:				
New well:				
Revenues	47	47	6	100
IDC and depreciation	(200)	(200)		(400)
Net taxable	(153)	(153)	6	(300)
Old wells:				
Net taxable income	60	60	60	180
Net Taxable Income (Loss)	(93)	(93)	66	(120)
Proposed Change:				
Alternative 1	(40)	(40)	(40)	(120)
Alternative 2	(60)	(60)	--	(120)

Under existing Section 704(b), provided the allocations have the required "substantial economic effect", partner C would be required to report his $66 of taxable income and A and B would claim a net deductionof $93 each.

If item allocations are not recognized and the fictions developed under pre-1954 law, discussed below, are not to be followed, two possibilities appear. One (Alternative 1) would be to allocate the $120 of net loss $40 to each partner in accordance with the general sharing ratio. Another (Alternative 2) would be to allocate the $120 of net loss $60 each to A and B and none to C, In either event C's equity in the partnership would be increased by $66, but the tax on such income would be deferred so long as he did not withdraw cash in excess of the adjusted basis of his interest. When cash withdrawals do exceed basis, some or all of the gain may be long term capital gain. A and B, who bore the economic risk that the new well might be dry, do not receive a current deduction for the decrease in their equity accounts. On termination and dispostion of the properties they will have a deduction for their remaining basis, but it may be only a capital loss.

If an exception is included to allow intangible drilling costs and depreciation of oil and gas partnerships to continue to be allocated on an item basis, the particular problem in this example might be avoided, but not necessarily. If the operation in which C did not participate was a "workover" or a "redrilling" rather than drilling of a new well, the deductions may be characterized for income tax purposes as "operating expenses" rather than as intangible drilling costs. See Burke and Bowhay, Income Taxation of Natural Resources (1983) Section 14.15. Also, B and C could experience a net loss from operating costs on the new well in a later year in which the other wells may realize net income.

In any event repeal of item allocations would be ineffective because this partnership could avoid the distortions and uncertainties of a prohibition on item allocation by distributing to C a 6% royalty interest in the new well and forming a separate partnership between A and B for this property. The royalty payments would be taxed separately to C and excluded from the income of the new AB partnership.

This illustrates that in this example, and probably most others, the existing effect of item allocations can be retained if the partners are willing to bear the administrative cost and burden of restructuring their arrangement as multiple partnerships or to be outside the partnership.

Return to Uncertainty and A New Loophole

The 1954 Code was the first to expressly sanction the allocation of individual items of income or deduction. It was also the first to allow deductions for salary payments to partners, a situation closely related to item allocations in that salary payments may result in net income to the recipient while other partners have a net loss. In these respects, the 1954 Code, in effect, codified the modifications to pre-1954 law which have been found necessary by the Bureau and the courts.

In 1919 the Bureau of Internal Revenue had ruled that a prorata sharing of each partnership item was required. OD 140, 1 CB 174. Early court decisions also held that no deduction was permitted to the partnership itself for salaries to partners, but that salaries were merely to be considered in the allocaiton of the net income. Estate of S. U.Tilton, 8 BTA 914 (1927).

The actual allocation of partnership income and expense was not and cannot be limited by permitted methods of allocation for Federal income tax purposes and partners do agree to item allocations and to salary withdrawals which may produce an economic profit to one partner and a loss to another.

The restraints of a single bottom line net income or loss allocation proved unsatisfactory and the Bureau then developed and applied concepts which, at least in many cases, produced essentially the same results as required by the 1954 Code.

Where a partnership agreement provided for different sharing of income or losses from a particular activity, the Bureau applied a "separate partnership" concept and construed each business or venture as a separate partnership in order to permit the allocation of taxable income or loss to coincide with each partner's share of economic income. Joseph P. Driscoll, "Major Points of Impact of the New Partnership Regulations", University of Southern California, 1956 Tax Institute, 195, 200.

One specific situation involved the question of the source of a payment to a foreign partner by a partnership conducting business in the U.S. and in a foreign country. The partnership agreement provided the payment was to be charged to profits of the foreign operation and the IRS concluded the income to the recipient of the payment should be treated as foreign source income to the extent of the foreign profit, not as a prorata share of the total partnership income. GCM 17255, XV-2CB 243 (1936).

This GCM was later reconciled under the 1939 Code with the prorata requirement of OD 140 in Revenue Ruling 56-134, 1956-1 CB 649. It explained the holding of the GCM as being based on the fiction that there were actually two partnerships, one conducting the U.S. operations and another conducting the foreign operations. No standards were ever published, however, as to when the separate partnership fiction should be applied.

Where salary payments exceeded the net income of the partnership, the Internal Revenue Service adopted, in GCM 6582, VIII-2 CB 200 (1929), a position to recognize shifts in capital accounts which produces essentially the same result as salary deductions under the 1954 Code. This was based on Augustine M. Lloyd, 15 BTA 82 (1929).

Under this theory, where salaries exceeded net income of the partnership the excess was then considered a withdrawal of capital. To the extent the excess was a withdrawal from the capital of other partners, the salary was taxable to the recipient and deductible to the other partners. This is exactly the result under the "guaranteed payment" rules of the 1954 Code.

The economic result of salary payments in excess of net income before deduction of the salary is exactly the same as a special allocation of gross income in excess of the net income. The result under the 1954 Code is the same, the recipient of the special allocation of gross income is required to report such amount currently.

No reported authority had been found as to the treatment prior to the 1954 Code of item allocations which economically produced net income to one partner and a net loss to another where the allocation could not be characterized as salary or as a separate partnership. It would be reasonable to expect that such allocations may have been treated by some partners , and possibly by the Bureau, the same as excess salary payments. That treatment would have been the logical result as the item allocations would have produced the same "shift" in partnership capital accounts as salary in excess of net income. If this theory was applied, however, it remains uncertain whether the resulting income and deductions were recognized in the year of the item allocation or only in the year distributions were actually made to the partner receiving the positive "shift".

Example of Pre-1954 Law

If we may return to the example outlined above of the ABC oil and gas partnership, we might speculate on the tax treatment of the partners' if the adoption of the proposal results in a return to pre-1954 law.

The new well might be treated as a separate partnership. A and B would each then have only a $150 deduction not their actual $153 loss on the new well under the agreement. C would not be required to report the $6 of income credited to him from the new well. Could C's interest in the new well be regarded as a separate partnership? This would seem to be an overextension of the separate partnership approach. Could C's $6 credit be regarded as a salary payment? It would be logical that it should be treated the same as a salary payment with the result under pre-1954 law that each partner's taxable income would be the same as under the 1954 Code, at least if the $6 were distributed in the same year. However, since there is no published authority under pre-1954 law on this point, the result must be regarded as uncertain.

A partnership arrangement such as the one outlined above might be intentionally arranged so as to defer income to C. A and B may be in a non-taxable situation or they may claim deductions for the same amount as under present law under the separate partnership or shift in capital theories while C may report no income, or even claim a share of the same loss claimed by A and B.

Reversal of 1954 Code Improvements

In the development of the 1954 Code, Congress expressly recognized the many difficulties and uncertainties in the area of partnership taxation and sought to present a detailed structure to provide certainty. The House Ways and Means Committee made this statement (H. Rept. 1337, 83rd Cong., 2nd Sess., [1954],p. 65):

> The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences.
>
> This confusion is particularly unfortunate in view of the great number of business enterprises and ventures carried on in partnership form. It should also be noted that the partnership form of organization is much more commonly employed by small business and in farming operations than the corporate form.
>
> Because of the vital need for clarification, your

> committee has undertaken the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws. In establishing a broad pattern applicable to partnerships generally, the principal objectives have been simplicity, flexibility, and equity as between the partners.

While there was not significant discussion of the recognition of item allocations, the similar problem of partners' salaries was discussed:

> Under present law, fixed payments to a partner are not recognized as a salary but considered as a distributive share of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary. The existing approach has been to treat the fixed salary in such years as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. Such treatment is unrealistic and unnecessarily complicated. The bill provides that payment of a fixed or guaranteed amount for services shall be treated as salary income to the recipient and allowed as a business deduction to the partnership.

The 1954 Code as adopted expressly recognized item allocations by requiring that a partner report his distributive share of each item of income or deduction as determined under the agreement unless the principal purpose was avoidance or evasion, interpretated by the regulations and the courts to mean "substantial economic effect." Section 704.

Some noted, however, that the substantial economic effect rule literally applied only to item allocations, not to "bottom line" allocations of net income and net loss, and attempted to use this to defer taxation of economic income. In 1976, the avoidance or evasion rule was restated as "substantial economic effect" and expressly extended to bottom line allocations as well as item allocations.

A further important improvement is the very detailed and restrictive regulations currently proposed under Section 704(b) to clearly define the "substantial economic effect" rule and require that the income or loss reported by each partner accurately reflect his economic income or loss.

The proposal to eliminate Section 704(b) also eliminates the parameters of proper use of item allocations developed over many years. Creative minds would be free from the restrictions of the present "substantial economic effect" rule and the door would be open to creative partnership structures where certain partners would be in receipt of economic income, but the tax on such income could be deferred, perhaps indefinitely, or converted into long term capital gain upon distribution.

Areas of Real Abuse

Areas of tax shelter abuse in which the Internal Revenue Service has recently been active do not involve abusive partnership item allocations, but transactions completely outside the partnership context:

Loans disguised as purchase of assets.
Inflated purchase price of motion pictures, real estate, equipment of livestock.
Inflated drilling prices.
Liabilities without risk or without economic substance.
Accelerated interest deductions (rule of 78's).
Commodity, futures and securities transactions.
Minimum annual royalties without economic substance.
Failure to recognize gain on disposition of property subject to debt.

The Oil Investment Institute will work with Treasury and the Finance Committee to develop and support proposals which can effectively halt abusive tax shelters.

Summary

In summary, the adoption of the proposal would not stop any identified abuse of the tax laws, would be a backwards step in the law of partnership taxation, and would create uncertainty.

An adoption of non-recognition of item allocations could, as illustrated above, also have the effect of opening a new avenue for tax avoidance. Creative structuring with item allocations could then perhaps result in an almost indefinite deferral of economic income to high bracket partners and eventual conversion into long term capital gain at only the cost of deduction deferrals to other low bracket partners, free of any restrictions from the "substantial economic effect" test.

If the rules are left uncertain, the partners may well take differing positions, leaving the Internal Revenue Service in the middle.

SUPPLEMENT - OTHER PROPOSALS

Capitalization of Compensation Distributions

One proposal being considered would require distributions ~~to~~ a partner for services to be capitalized if payments to one not a partner for the same services would be chargeable to capital.

While such a proposal appears on the surface to be a desirable one to prevent the use of item allocations to achieve a deduction of capital expenditures, it will need to be carefully drawn to avoid introducing distortions and uncertainties.

Such allocations do not necessarily result in a distortion favoring the taxpayers. Consider a real estate partnership in which one partner is allocated a percentage of gross income for the 20 year term of the partnership in return for architechtural services for improvements to partnership real estate. If the amount to be paid were reduced to an amount certain, the partnership would have annual deductions of 1/15th of the principal amount. As an allocation of gross income the effect may be only a 1/20th deduction each year.

If the proposal required that only the distributions made each year could be added to the depreciable basis and only 1/15th of the amounts actually paid could be deducted, the effect is much reduced deduction in the first year and a bunching of deductions in later years. This would be a deferral of deductions from what should be the case and what would be the case if the obligation to the architect were stated as a specified amount to be paid to one not a partner.

A similar situation results under present law from acquisition of a patent in return for royalty payments. While each payment is theoretically an expenditure to be capitalized subject to depreciation, the distortion problem has been avoided by allowing a current year depreciation deduction for an amount equal to the payments made in the current year. Allied Tube and Conduit Corporation, TC Memo 1975-281.

Another example would be an oil and gas partnership which provides for a share of gross income (or, perhaps, gross income less recurring operating expenses) to a partner in return for services in evaluating and acquiring oil and gas properties. If each distribution, to the extent attributable for services on properties acquired, were capitalized and added to depletable basis only when paid, the depletion deductions would be distorted. Under existing law, if a similar royalty or net profits interest were held outside the partnership, the payments made to the holder of that interest would be deductible or excludible from partnership gross income prior to computation of depletion. Section 613; Kirby Petroleum Company v. Commissioner, 326 U.S. 599 (1945), 46-1 U.S.T.C. 9149. If the treatment were different in a partnership it would only encourage the partners to restructure their relationship.

Therefore, if this proposal is to be adopted, it should be made clear that it has no application where the distributions are to continue over at least a substantial portion of the life or the recovery period of the asset against which the payment would be capitalized.

Another problem will be the difficulty of determining what proportion of distributions to a partner are to be capitalized where the payment may relate to a variety of contributions, cash or property contributed to the partnership, services for which a deduction would be proper as well as services of a capital nature.

Contributed Property

Another provision being considered would make mandatory a rule apparently similar to present Section 704(c) which allows an optional special allocation of depreciation, depletion, gain and loss on contributed property to take into account the appreciation or depreciation in value of the property at the time of contribution.

If the mandatory application of this rule is limited to the difference between the adjusted basis of the property and the value for which the partner is given credit in the partnership capital accounts pursuant to the partnership agreement (assuming unrelated parties), the result should not be unfair.

Property contributed to a partnership is often property which is difficult to value precisely. Therefore, in order to avoid haggling over the exact present value of the property, the parties may use the contributing partner's cost basis for purposes of partnership accounting and take the potential appreciation into account in detemining the ratio for sharing of income and loss.

If the mandatory rule is to be applied to the actual fair market value of such property as it may later be determined by the Internal Revenue Service or the courts, the proposal may produce the same problems and uncertainties as the nonrecognition of item allocations.

Consider partnership AB where A contributes undeveloped land and B contributes capital for improvements. Assume that A is given credit for his adjusted tax basis of $100, the sharing of income, gain and loss is equal and the property, after improvement, is sold for a gain of $100 of which $50 is allocable to land. The partnership accounts would allocate the gain as follows:

	A	B	Total
Gain on Sale	50	50	100

However, if it is later determined that the value of the land was actually $150 when contributed and the proposal is applied to the actual value upon contribution, the gain would appear to be allocable as follows:

30-228 O—84——50

	A	B	Total
Gain on land up to $50	50		50
Balance of gain	25	25	50
Total Gain	75	25	100

B would be taxed on only $25 of gain even though his equity in the partnership has increased by $50. A would be taxed on $75 even though his equity is increased by only $50. If the partnership were immediately terminated, A would actually receive only his original $100 credit plus the $50 share of gain under the partnership agreement, not the $75 which would be included in his taxable income. This will again raise the question of whether the fictions of the pre-1954 law will then be applied to increase B's taxable income and allow a deduction to A. If so, the change will only produce confusion. If not, it will open a new avenue for structuring of tax deferral techniques.

In summary, this proposal should be limited to the difference between the adjusted tax basis of property contributed and the value for which credit is given in the partnership accounts.

Pfizer

PFIZER INC., 235 EAST 42nd STREET, NEW YORK, N. Y. 10017

EDMUND T. PRATT, JR.
Chairman of the Board

December 8, 1983

The Honorable Robert Dole
Chairman
Finance Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I would appreciate your including this letter as part of the hearing record of the Senate Finance Committee hearings scheduled for December 12, 13, and 14, 1983, on the possible contents of a deficit reduction package.

On behalf of the 63 members of the Emergency Committee for American Trade, I urge that any consideration given to the concept of a corporate franchise tax on economic income not compromise the foreign tax credit by subjecting foreign income subject to the foreign tax credit to an additional franchise tax. This would clearly undermine the foreign tax credit's purpose of avoiding double taxation.

Unlike a variety of domestic tax credits or other tax provisions whose purposes are to provide incentives to the undertaking of desired and beneficial economic activities in the United States, the foreign tax credit is designed to avoid double taxation of income earned abroad while assuring that the higher of either the foreign or the United States tax rate is paid on such foreign source income. The foreign tax credit is neither a tax "preference" nor a tax incentive device.

As specific proposals are developed and subsequently considered by the Finance Committee, I would appreciate the opportunity of more fully expressing the views of ECAT on proposals concerning the taxation of foreign source income.

Thank you for your consideration.

Sincerely,

Edmund T. Pratt, Jr.

Edmund T. Pratt, Jr.

STATE OF SOUTH CAROLINA

OFFICE OF STATE TREASURER

GRADY L. PATTERSON, JR.
TREASURER

P. O. DRAWER 11778

COLUMBIA
29211

December 15, 1983

Honorable Robert Dole
United States Senator
Chairman, Committee on Finance
2213 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Dole:

Reference is made to the hearings you are now conducting on the astronomical federal budget deficits, and I respectfully request that this letter be considered and made a ~~part of the record of~~ t~~hese hearing~~s.

These huge federal deficits are the single most compelling domestic problem facing this nation in my judgement.

The Congress must come to grips with this budget disarray in order for our great experiment in democracy to survive.

There is a way to deal with these astronomical deficits but the concept will not be easy, it will not be painless, and it cannot be done in a year or two.

The only practical, equitable and politically feasible way of reducing these great deficits is to level off federal expenditures to a level of the preceding year's expenditures. In short, give all agencies, in general terms, what they got the preceding year. No one would get less than the year before thus no budget would be cut. There simply would be no increases.

This method would be fair and equitable and all segments of society would participate equally in the leveling off of expenditures. This would allow revenues to catch up with the expenditure level over a period of several years without tax increases. It would be a measured plan spread over several years and would not be a shock to the budget process.

Such a plan would require strong bipartisan support and complete commitment from the President and the Congress.

I believe the American people would accept such a plan if they knew that all segments of society and all areas of government would share equally in reducing and eventually eliminating these large federal deficits. A long-term bipartisan commitment to such a plan from Congress would lower inflationary expectations, lower interest rates, and improve economic activity.

The argument that these federal deficits cannot be reduced and eliminated and the federal budget balanced is a myth. The Congress can and must muster the will to act.

As an example of what can be done the State of South Carolina has just come through three very tough and stressful economic years. During the last two years the State took the necessary action to keep its budget balanced by reducing expenditures during each budget year and drawing on a constitutionally mandated rainy day reserve fund. The State made prompt, tough, and fair decisions and reduced expenditures proportionately resulting in a balanced budget. In the process no agency got less than it did the preceding year.

Through it all we maintained our AAA credit rating and kept our financial house in order. Budget pressures have now eased because of these actions and the improved economy.

Additionally, we should pass a constitutional amendment limiting federal expenditures to a percentage of the Gross National Product. Such a fiscal discipline would limit the expense of governing ourselves and would tie the cost of government, in some measure, to our ability to pay.

In conclusion, there is a compelling, burning desire among the citizens of this great country to eliminate these huge federal deficits. People are tired of excuses as to why this country cannot balance its budget. All citizens suffer as a result of these deficits because their dollars continue to buy fewer and fewer goods and services.

I believe it is critical that we raise the level of awareness among the citizens as to the severity of this problem.

With kindest regards, I am

Very truly yours,

Grady L. Patterson

Grady L. Patterson, Jr.
State Treasurer

GLPJr:pd

SUBMISSION FOR THE RECORD

By

Robert M. Rutledge III

Executive Director

Texas A&M University Development Foundation

TO THE

DEFICIT REDUCTION HEARINGS

Senate Committee on Finance

December 21, 1983

My name is Robert M. Rutledge III. I am the Executive Director of the Texas A&M University Development Foundation, a non-profit corporation formed for the purpose of soliciting and managing funds for the benefit of Texas A&M University. I am an attorney, a member of the State Bar of Texas and in addition to my nine years in capital fund solicitation, I have three and a half years experience in the private practice of law in Houston, Texas.

It is my pleasure to submit for the record before this committee my thoughts upon proposed legislation that would require certain capital gain property to be held for more than five years prior to the donor having the ability to claim more than the adjusted basis of the property as a charitable deduction.

The charitable deduction was incorporated into the Income Tax Act of 1913 by the War Revenue Act of 1917 as a stimulus to encourage the giving of wealth for public purposes. Although the charitable deduction today enjoys widespread public support, attempts to lessen its effectiveness through prohibiting the full fair market deductibility of appreciated property will, in my opinion, reduce substantially charitable giving to institutions of higher education. This would occur at a time when proposed reductions in government spending is expected to increase the demand for gifts from the private sector by institutions of higher education.

The proposed legislation requiring that certain property be held for this period of time, does not directly or indirectly address the perceived problem;

that problem being verification of fair market value of certain capital gain assets. Thus, we are faced with proposed legislation that does not correct the perceived evil, but in fact, would seem to substantially harm future gifts to institutions of higher education.

I would request that there not be imposed the five year holding period on certain capital gain property but if after thoughtful consideration other, more direct means be found to correct the problem of valuation abuse.

Hearing on Deficit Reduction Package – December 12, 1983

Testimony of Transco Energy Company

Introduction

This testimony is given on behalf of Transco Energy Company ("Transco"). Transco, with assets well in excess of $3 billion, is engaged through various subsidiaries in the operation of a major interstate gas pipeline, domestic oil and gas exploration and production and other energy related activities. Shares of Transco's common stock are traded on the New York Stock Exchange.

Transco is a general partner of Transco Exploration Partners, Ltd. ("TXP"), a Texas limited partnership, formed to succeed to the oil and gas exploration production business conducted by Transco Exploration Company ("TXC"), a wholly-owned subsidiary of Transco, primarily offshore Louisiana and Texas in the Gulf of Mexico. Transco and TXC together own approximately 90% of TXP. Units (limited partner interests) of TXP are also traded on the New York Stock Exchange.

Transco wishes to testify in opposition to two items listed in the Summary of Proposed Deficit Reduction Package issued by Senator Dole on November 16, 1983. The items to which Transco objects are listed as Ordinary Distributions of Appreciated Property (item C(2)) (the "Distribution Rule") and Transfers of Partnership Interests by Corporations (item C(3)) (the "Partnership Interests Rule"). Both such items have the effect of taxing to a distributing corporation a distribution in kind as if the property distributed had been sold by the corporation and the proceeds were distributed. There are five principal reasons why Transco is opposed to such items.

Broadening of Corporate Tax

Both the Distribution Rule and the Partnership Interests Rule will have the effect of causing a corporation to realize and recognize as taxable income, as of the date of distribution, any difference between the Federal income tax basis and the fair market value of property distributed. Under present law, gain recognized on such distributions is limited to certain recapture items by virtue of Sections 751, 1245, 1250 and 1254 of the Internal Revenue Code of 1954, as amended (the "Code"), as well as the recapture of investment tax credits under Section 47 of the Code, among others. It follows that adoption of these two proposals will increase the corporate level tax.

The proposals are inconsistent with statements made by President Reagan with respect to the taxation of corporations in general. The thrust of such comments was at the very least that corporate level taxes should not be expanded. Consequently, the Treasury has testified as to its opposition to broadening the corporate tax system. In the statement of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy) before the Committee on Finance, United States Senate in hearings with respect to the Report on Reform of Corporate Taxation, October 24, 1983, he stated: "[W]e are not prepared at this time to support proposals which significantly broaden the two-tier tax system of taxing corporate profits." To tax unrealized appreciation on distributions of appreciated property or partnership interests is to do precisely that.

Discourages Capital Formation

The Distribution Rule and the Partnership Interest Rule will also serve to discourage capital formation in corporate form, the traditional form of conducting large, industrial activities (such as ownership and operation of major interstate gas pipelines). Because the two proposals will have the effect of taxing at the corporate level appreciation which is not now taxed, adoption of such proposals will increase the cost of providing shareholders an after-tax yield. Accordingly, shareholders who might otherwise be induced to invest in corporations may be discouraged from doing so. At a time when capital formation is to be encouraged in order to spur the economy to recovery, it seems anomalous to adopt proposals which can only have the opposite effect.

Discriminatory Rules

The Distribution Rule and the Partnership Interests Rule are also discriminatory in application. The rules would allow a distribution in corporate form, provided the other applicable rules set forth in the Code are met, while a distribution of assets not in corporate form will attract an additional tax. Business, in order to avoid the corporate level tax, will find itself trying to meet the complicated rules of corporate dispositions - - with the resultant loss of executive time and efficiency. Thus, one often stated objective of tax reform — simplicity - - is not achieved or aided by the proposals since, depending upon the form of transaction, different tax results will occur. Indeed, an ever greater premium will be placed on the form that a transaction takes. Also, because the rules distinguish between ordinary and liquidating distributions, not only will the interest of simplicity not be served, the rules may serve to motivate liquidations or partial liquidations. Accordingly, the discriminatory element of the rules may have a further negative effect on capital formation by encouraging liquidations. Furthermore, consideration of the rules may encourage premature distributions which will also serve to reduce the corporate tax base and impair capital formation.

Detrimental Reliance

Corporate business has, for some years, structured its activities in the belief that distributions of appreciated property or distributions of partnership interests would not be treated as a sale of such assets by a corporation. While exceptions to this general rule exist, a number of businesses have been operated with a potential distribution in mind. For example, while a distribution of its interest in TXP may never be effected by Transco or TXC because of the recapture potential discussed above, the distribution of interests in TXP was one among many alternatives considered but dismissed at the time that TXP was formed. Adoption of the proposals would eliminate any new consideration of that alternative or, to be more precise, make utilization of such alternative so costly as to make further consideration impractical. It would appear inequitable to reach such a result.

No Realization

It should not be overlooked, of course, that a distribution by a corporate taxpayer of appreciated property does not cause a realization of the value of such property, a well established and recognized principle of tax theory, the very essence of the holding of General Utilities. While it is recognized that Congress may move to overturn this established tax theory, as enunciated in the General Utilities, such action should not be taken lightly in view of the considerations mentioned above.

Summary

In summary, Transco is opposed to the adoption of the rules to tax distributions of appreciated property and partnership interests as was proposed by Senator Dole on November 16, 1983. Such opposition is founded upon the fact that adoption of such proposals would (1) broaden the corporate tax base at a time when both the Reagan Administration and many tax theorists are questioning the two-tier tax system, (2) discourage capital formation at a time when encouraging capital formation would seem to be in the National interest, (3) not only create more traps for the unwary (because of the complexity of the rules) but also may encourage liquidations, and (4) be inequitable to business that has structured its activities in reliance upon the belief that distributions of appreciated property or partnership interests will not be treated as sales. Also, adoption would overturn a well established principle of tax theory. For these reasons, Transco respectfully requests that these two items not be included in the Proposed Deficit Reduction Package.

NORM ZADEH, PH.D.

PROPOSAL FOR REDUCING THE DEFICIT

1. Finance a larger portion of the deficit using non-interest bearing Fed credit instead of interest-bearing bonds.

2. Raise banking reserve requirements so that the additional Fed credit can not be used to create a surge of new loans which would lead to more inflation.

Advantages

1. This proposal can be implemented by the Fed and the Treasury and does not involve endless debate over budget cuts.

Please include this proposal in the report to be issued by Mr. Dole.

Best wishes,

N

Norm Zadeh, Ph.D.

former professor, Stanford University

P.O. BOX 11707, MARINA DEL REY, CALIFORNIA 90295 • (213) 827-2503